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Financial Globalization and Monetary Policy

This Economic Letter *is adapted from a speech by Mark Spiegel, Vice President and Director of the Center for Pacific Basin Studies, delivered at the Bank of Korea's 15th annual Central Banking Seminar, "Increasing Capital Flows among Countries and Monetary Policy," in Seoul, Republic of Korea, September 18-21, 2007.*

My remarks concern monetary policymakers' opportunities and challenges in the face of the growing volume of international capital movements. The topic is currently of particular interest for two reasons: First, this year marks the tenth anniversary of the devastating Asian financial crisis, in which issues associated with disruptive capital flows were paramount. Second, world financial markets are currently experiencing substantial turbulence; although it is due primarily to the "subprime" mortgage crisis taking place in the United States, international financial linkages have also played a prominent propagating role.

Scope of financial globalization

"Financial openness"—the sum of the stocks of external assets and liabilities of foreign direct investment (FDI) and portfolio investment as a percent of GDP—took off in both industrial and emerging market economies in the latter half of the 1990s (Lane and Milesi-Feretti 2003). Several reasons underlie these increases in capital movements, including financial innovations, which have reduced the cost of holding foreign assets and thereby increased investors' demand for internationally diversified portfolios, as well as the proliferation of sophisticated vehicles for hedging foreign risk exposure that has allowed investors to reduce the riskiness of a given level of foreign exposure.

These flows have coincided with a large buildup of net surplus positions by emerging market economies, and, in particular, by emerging Asian nations, whose current account surpluses are now at levels comparable to those that followed the Asian financial crisis. As of the current year, Asian holdings of foreign exchange reserves excluding gold reached close to $3 trillion.

These increased capital flows have had a number of important impacts on the international economy. In particular, emerging market economies have become net creditors, which has allowed some developed economies, notably the United States, to finance large current account imbalances at relatively favorable rates.

This pattern of capital flows, with developed economies being net borrowers from emerging economies, is generally considered to be non-standard for a couple of reasons. First, standard theory suggests that capital scarcity in developing countries leaves their marginal products of capital higher than the developed countries as a group. Second, at least for the rapidly growing developing countries, higher expected future incomes provide an incentive to run current account deficits now to smooth consumption. Instead, paradoxically, the largest net surpluses we observe in the data come from some of the most rapidly growing countries, such as China.

Much work has gone into explaining this paradoxical investment pattern. One theory focuses on differences in the quality of financial intermediation between developed and emerging market economies, where portfolio capital moves from south to north, to return as FDI (e.g., Mendoza et al., 2007). Alternatively, the so-called Bretton Woods II school argues that net outflows from China serve as collateral against future opportunistic behavior. A third approach (articulated in Bernanke 2005), argues that poor investment opportunities in Asia have resulted in a global "savings glut" that has freed up capital for lending to developed economies.

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Financial globalization and optimal monetary policy

The increased volume of trade in financial assets has had a significant impact on international borrowing terms, as spreads on emerging market bonds have decreased markedly over time; for example, the Emerging Markets Bond Index yield has fallen from over 16% in 1998 to just over 6% in 2006. While this decline reflects a benign decrease in the cost of borrowing by emerging market economies, it also reflects the fact that debt obligations across countries are now being treated as more substitutable than they once were.

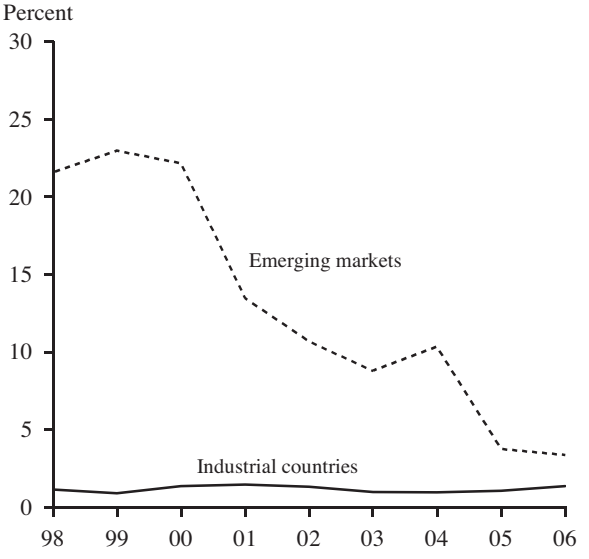
As financial markets thus become more integrated, the sensitivity of domestic and foreign investors to interest rate differentials increases. Over the last few years, yield curves across nations with comparable default-risk characteristics have converged. In this environment, longer-term real interest rates are likely to be less sensitive to transitory movements in the Fed's policy rate, the federal funds rate, suggesting that financial globalization has left interest rates less sensitive to monetary policy than in the past. In addition, this increased sensitivity reduces the effectiveness of the inflation tax, which implies that governments should rely less on this revenue-raising instrument, all else equal.

Of course, there are some caveats to this contention. Central banks acting in concert, as when several recently moved to inject liquidity into the financial system, can still have a substantial impact on financial markets. Moreover, as Rogoff (2006) noted, to the extent that central banks in Asian countries as well as in the oil-exporting countries target the dollar in their monetary policies, the impact of Fed policy actions will be amplified.

Monetary policy responses to financial globalization

The additional discipline placed on monetary authorities from enhanced financial integration has led more countries to pay increasing attention to targeting the inflation rate, formally or informally, as their policy goal. For example, nearly half the OECD countries now formally target inflation, as do ten emerging market economies, and the European Monetary Union (EMU) enunciates an inflation target, while the U.S. cites "price stability" as one of its two monetary policy goals. Inflation-targeting regimes have proved to be durable. So far, such regimes, which have existed for over 16 years, have been abandoned only by Finland and Spain, which did so in order to join the EMU, which itself has an inflation target (Rose 2007).

Figure 1
Inflation variability, 1998-2006



Source: *International Financial Statistics*, IMF. Measurement is in percent, measured as standard deviation.

The increased focus on price stability has not been limited to formal inflation-targeting regimes. In 1998 average inflation rates for a representative group of emerging market economies stood at 16% higher than those prevailing in industrial countries. By 2006, that gap had been reduced to 6%, or just 4% above average levels in industrial countries.

The variability of inflation has also declined markedly in emerging market economies. Standard economic theory suggests that the variability of inflation, rather than its level, is key to determining output volatility. In practice, high inflation tends to coincide with variable inflation, which is why keeping the rate of inflation under control is usually sufficient to control its variability as well. Over the preceding ten years, as average inflation rates fell in emerging market economies, the variability of inflation in those countries has fallen as well (see Figure 1).

The renewed focus on controlling inflation and inflation expectations has led to improved conditions in capital markets. Emerging market economies have moved from bank borrowing in external so-called "hard" currencies towards external borrowing in bonds denominated in their domestic currencies with relatively long maturities and fixed interest rates. Korea and Thailand introduced 10-year domestic-currency bonds in the 1990s, while, by the year 2000, Brazil, Chile, Colombia, Indonesia, Mexico, and Russia had also issued domestic

currency bonds (Kroszner 2007). As these instruments have become more standard, their yields have decreased, allowing these countries to borrow at favorable terms.

This shift has achieved several desirable effects. First, currency risk has been shifted from borrower to lender. Second, the fixed interest rates have shifted interest rate risk to creditors as well. Third, the longer maturities reduce the risk of disruptive "sudden stops" in credit that have resulted in costly failures in the past. Fourth, government issues in local currency have helped encourage the development of local bond markets by providing "benchmark" yield curves for pricing private debt. Finally, when defaults do take place in bond markets, contagion is limited by the wide dispersion of creditors.

Financial globalization and emerging market economies

While financial globalization raises opportunities for acquiring capital at more favorable interest rates, it also brings new challenges for emerging market economies. In particular, globalization raises the possibility of exacerbated exchange rate volatility, which can be a source of output variability; that is, emerging economies may suffer terms of trade shocks from real exchange rate changes when nominal exchange rate movements are not passed through to changes in domestic prices. Exchange rate depreciations can also lead to inflationary pressure through increased import prices. Finally, as many emerging market economies continue to have liabilities denominated in dollars, exchange rate depreciations can lead to "currency mismatch" issues, as exchange rate movements raise the relative value of liabilities and damage the nation's balance sheet as a whole.

These issues are often raised in discussions of the impact of financial globalization because some believe that emerging market central banks that pursue price stability, or even formal inflation targets, leave themselves open to exchange rate volatility. The intuition behind this concern is the so-called "impossible trinity," which notes that a country cannot simultaneously pursue price and exchange rate targets while maintaining open capital accounts. However, recent studies, such as Rose (2007) have found that countries that target inflation experience no more exchange rate volatility on average than do countries that do not target inflation.

Conclusion

Financial globalization has provided an additional source of market discipline and, as Mishkin (2000) has pointed out, encouraged central banks to concentrate on stabilizing prices and not on stabilizing output. In practice, this change in policy has resulted in the benign results of decreased output volatility, lower inflation rates, and reduced borrowing costs worldwide.

Mark M. Spiegel
Vice President

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