

Financial Globalisation

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Jarle Berge Colloquium: Monetary Policy and Globalisation

Norges Bank

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Introduction

— Spectacular increase in cross-border financial positions since mid-1990s

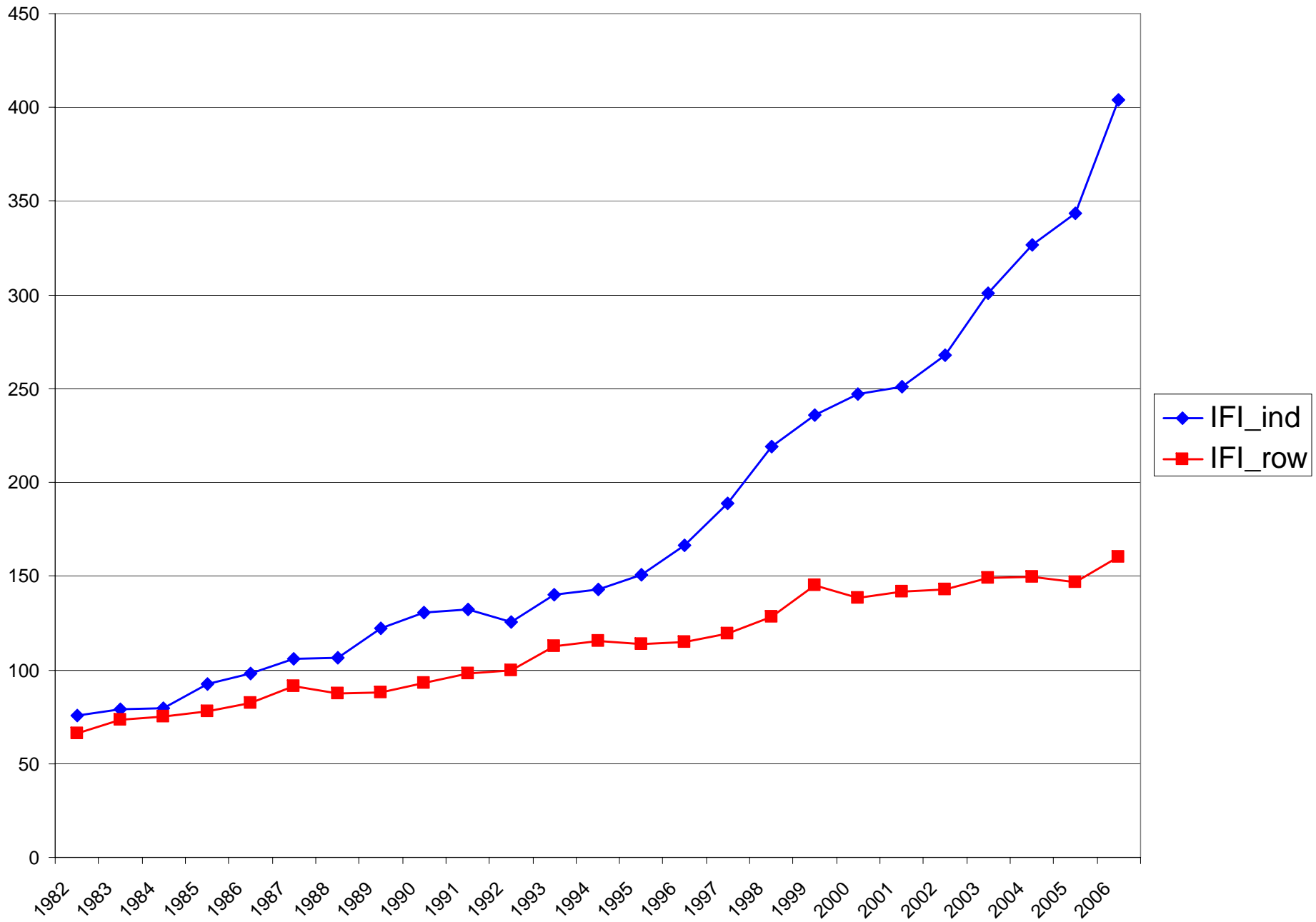
Implications

- In principle, increase in international risk sharing, improving macroeconomic stability
- Long-term: impact on economic structures, productivity growth
- *Decline in home bias: increased elasticity of capital flows and potential for larger and more persistent current account imbalances*
- *Transmission of monetary policy affected by increased importance of global factors in asset pricing*
- *Regulatory challenge: cross-border dimensions to financial stability*
- *Role of valuation channel in external adjustment*

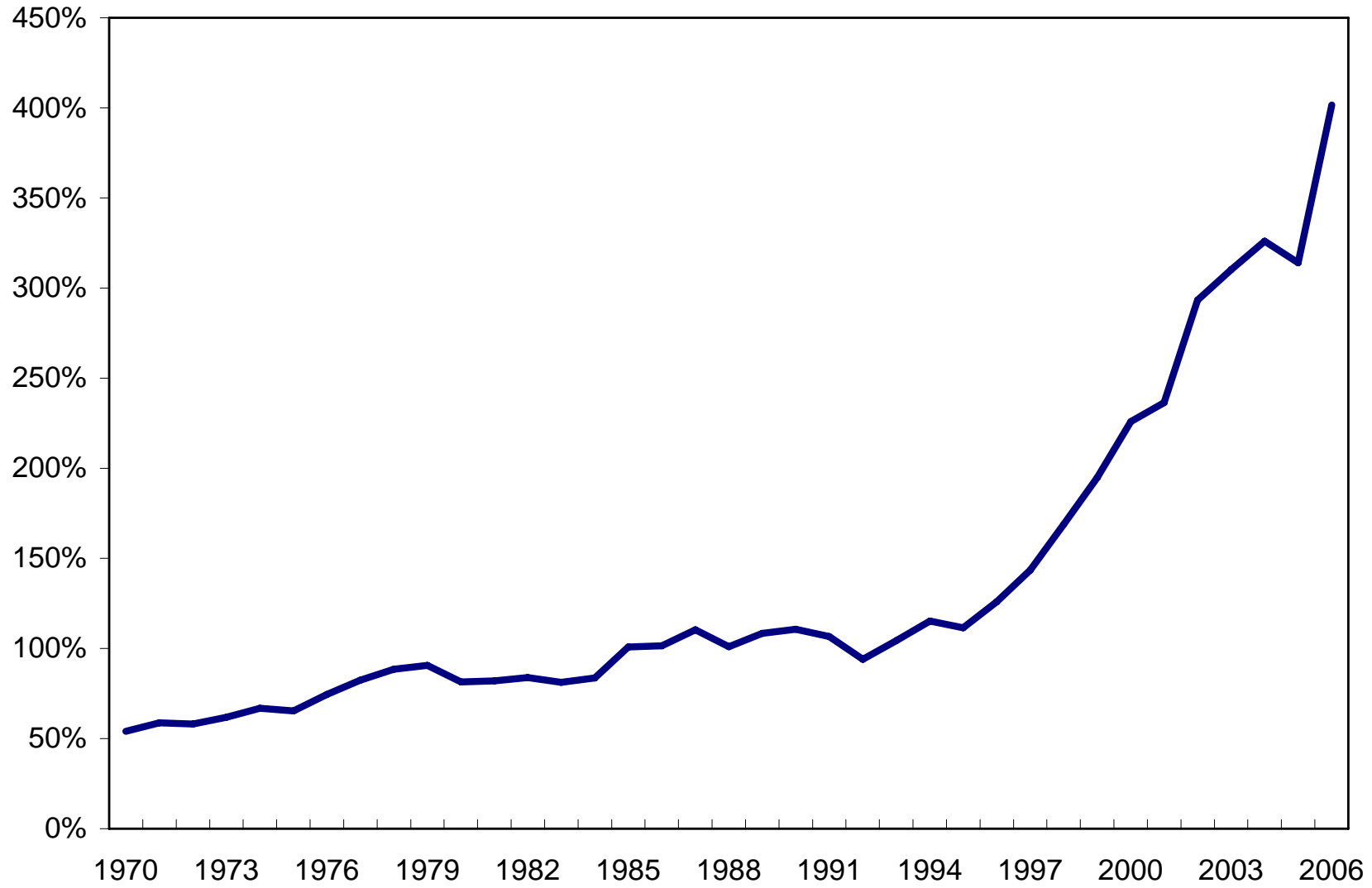
Outline

- Financial Globalisation: Stylised Facts
- Global Imbalances
- Valuation Channel of Adjustment
- The Dynamics of Financial Globalisation

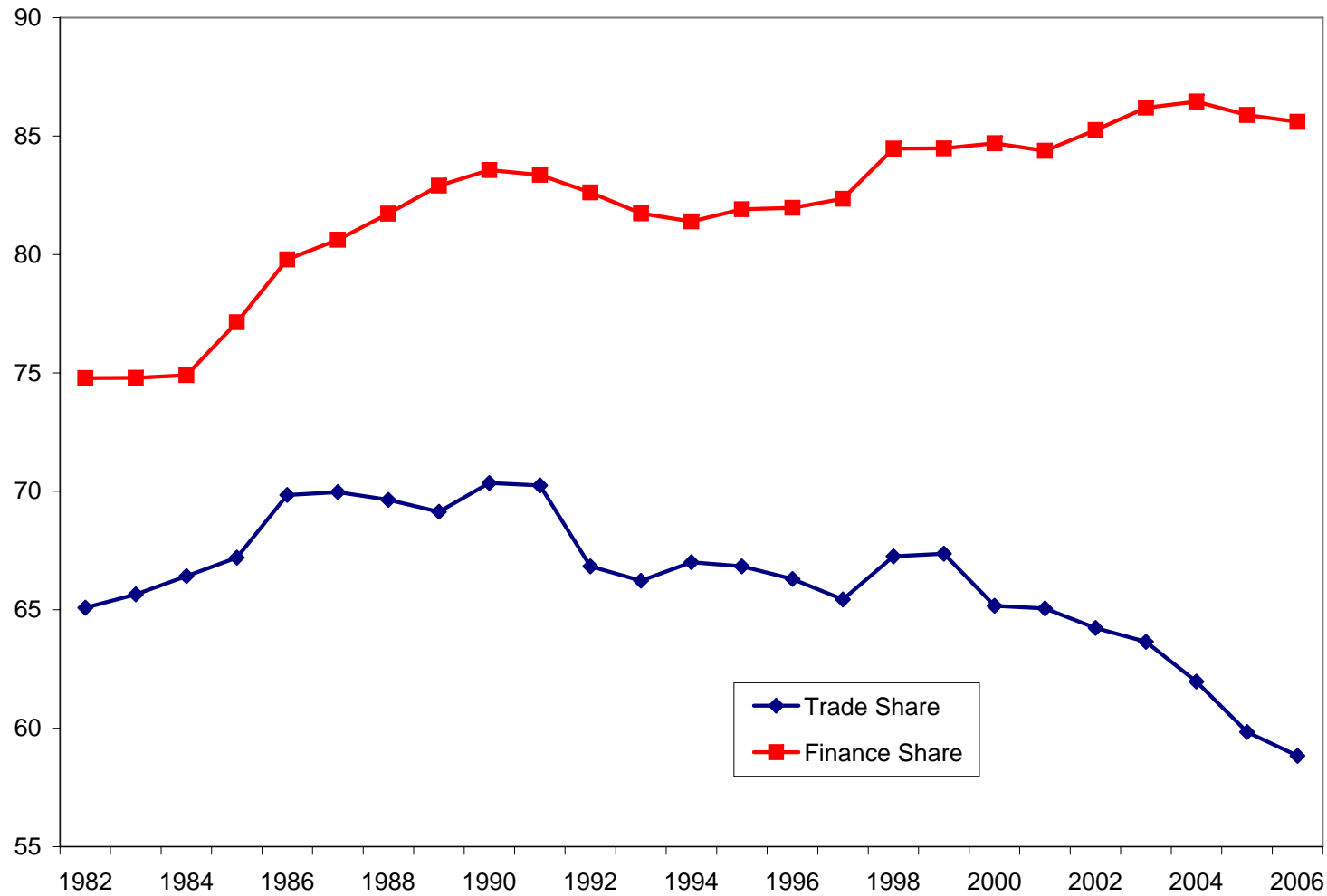
International Financial Integration, 1982-2006



International Financial Integration: Norway, 1970-2006
(sum of foreign assets and liabilities as a ratio to GDP)



Advanced Countries: Global Finance Share versus Global Trade Share



The Differential Nature of Financial Globalisation

- Tremendous Heterogeneity in international financial linkages
- Extensive cross-border asset trade among advanced economies
- Financial Innovation (Securitization, Hedge Funds, SPVs, ...): (a) often targeted at cross-border arbitrage; (b) innovation in country A creates demand from investors in country B
- The Euro (Intra-EMU asset trade but also extra-EMU asset trade)

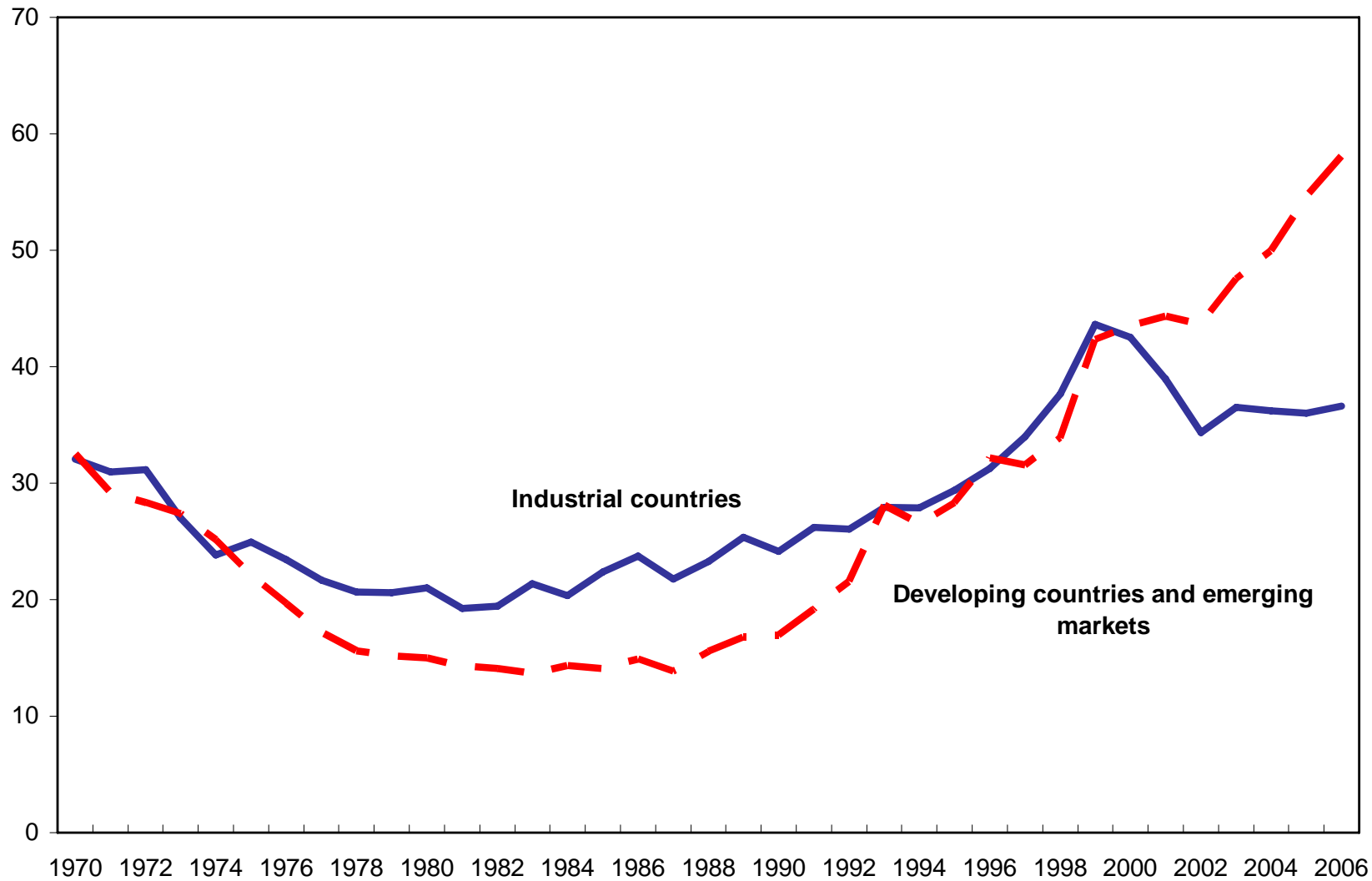
Financial Globalisation and Developing Countries

- Lower degree of participation in wave of financial innovation
- Currency risk still a limiting factor
- Improvement in net external position
- Shift towards equity financing of liabilities (FDI, portfolio equity)
- Growth in gross foreign assets (but reserves largest component)

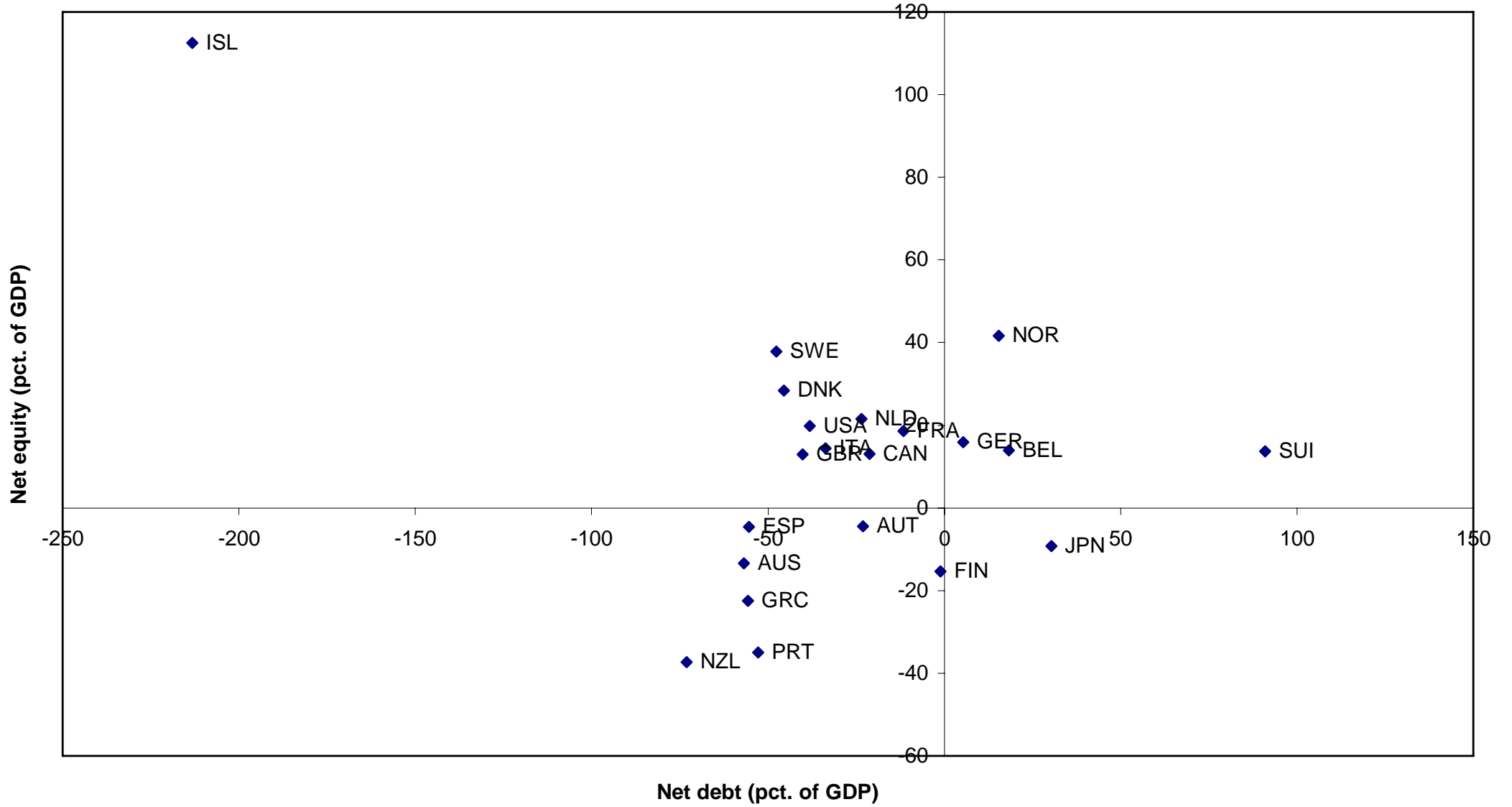
Features of the Global Distribution

- Advanced economies net borrower from developing countries
- Advanced economies 'long equity, short debt'; opposite pattern holds for many developing countries
- Trade and financial integration at different stages
- Implications for international transmission of shocks

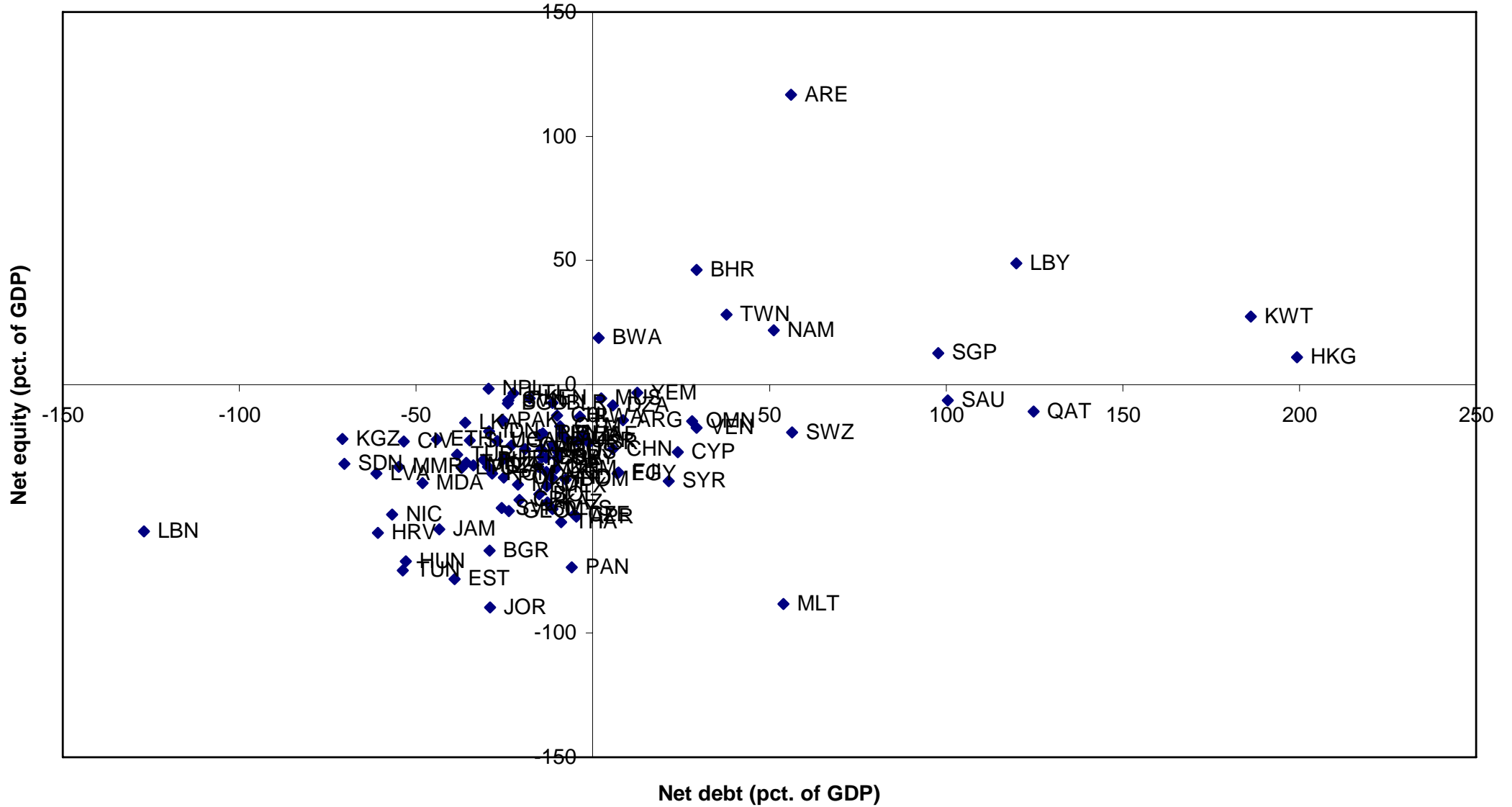
Equity Share in External Liabilities: Industrial Country Group and Emerging Markets and Developing Country Group, 1970-2006



Net Equity Position vs. Net Debt Position: Industrial Group, 2006



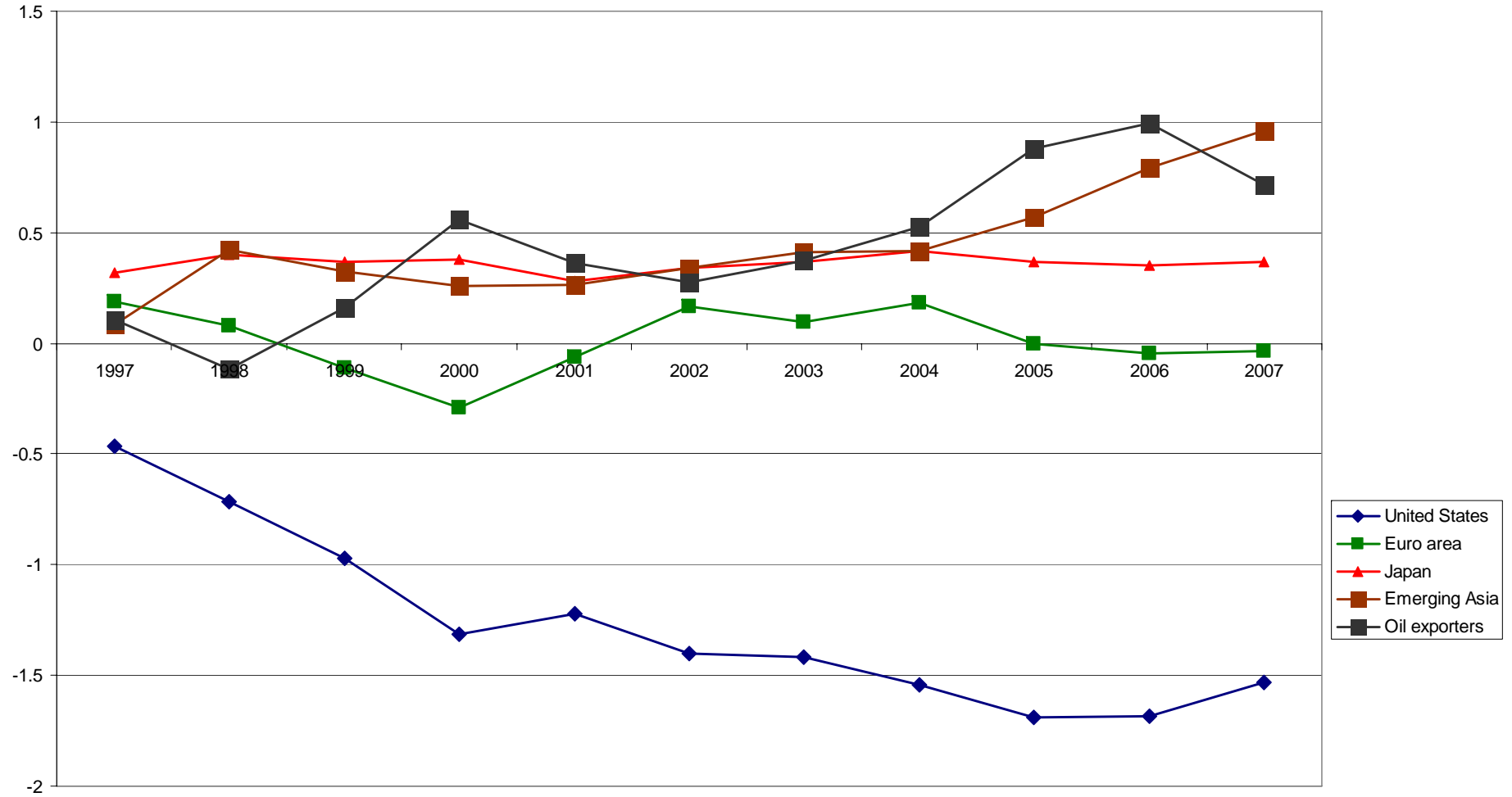
Net Equity Position versus Net Debt Position: Emerging Markets and Developing Countries



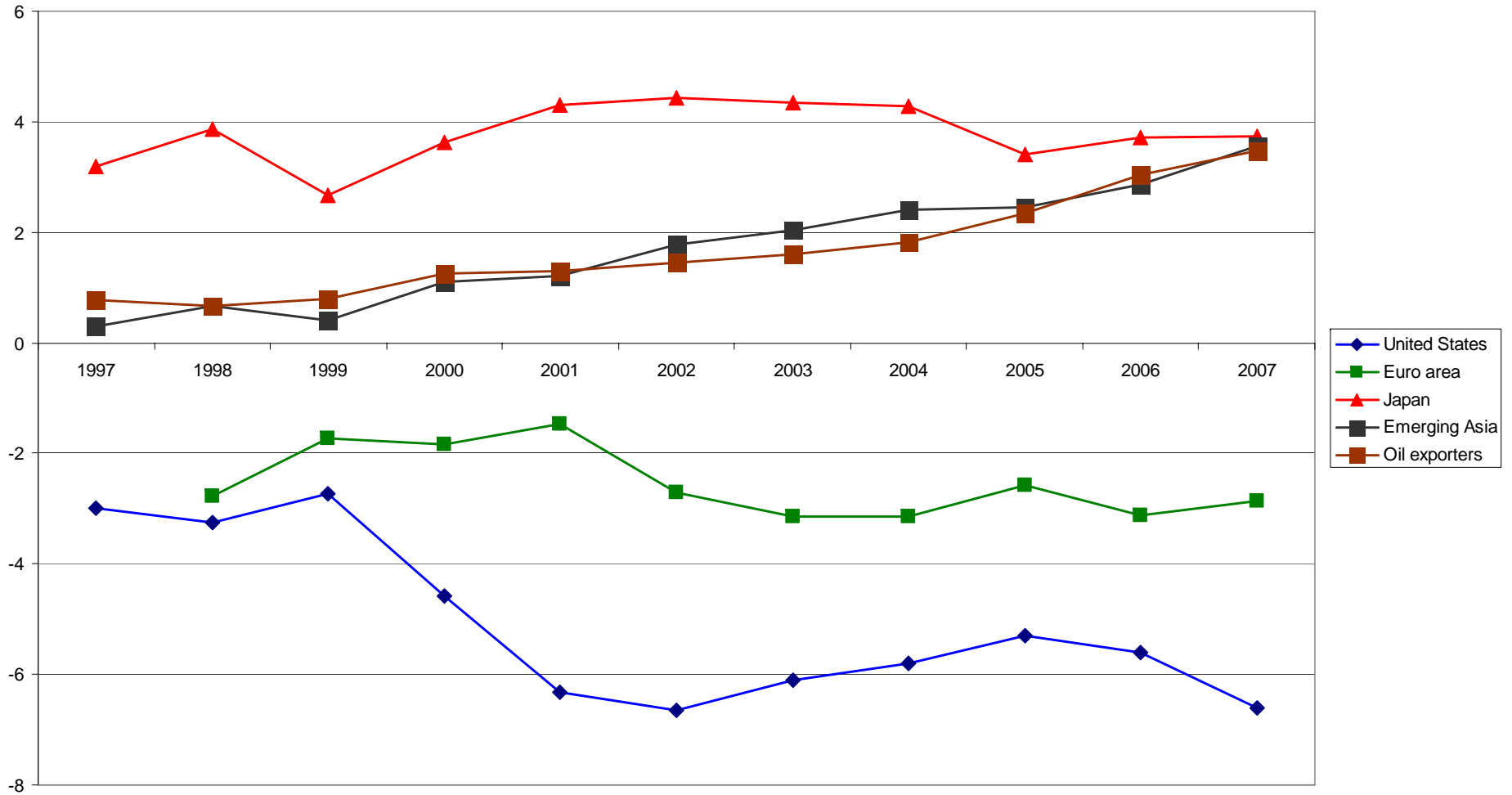
Global Imbalances

- Increased dispersion in current account positions
- Current account imbalances highly persistent
- Little evidence that debtor countries pay higher risk premia
- Policy concern: Sharp current account reversals can be disruptive for output, exchange rates and asset prices
- Exchange rate adjustment: trade balance channel; valuation channel

Global Imbalances: Current Account

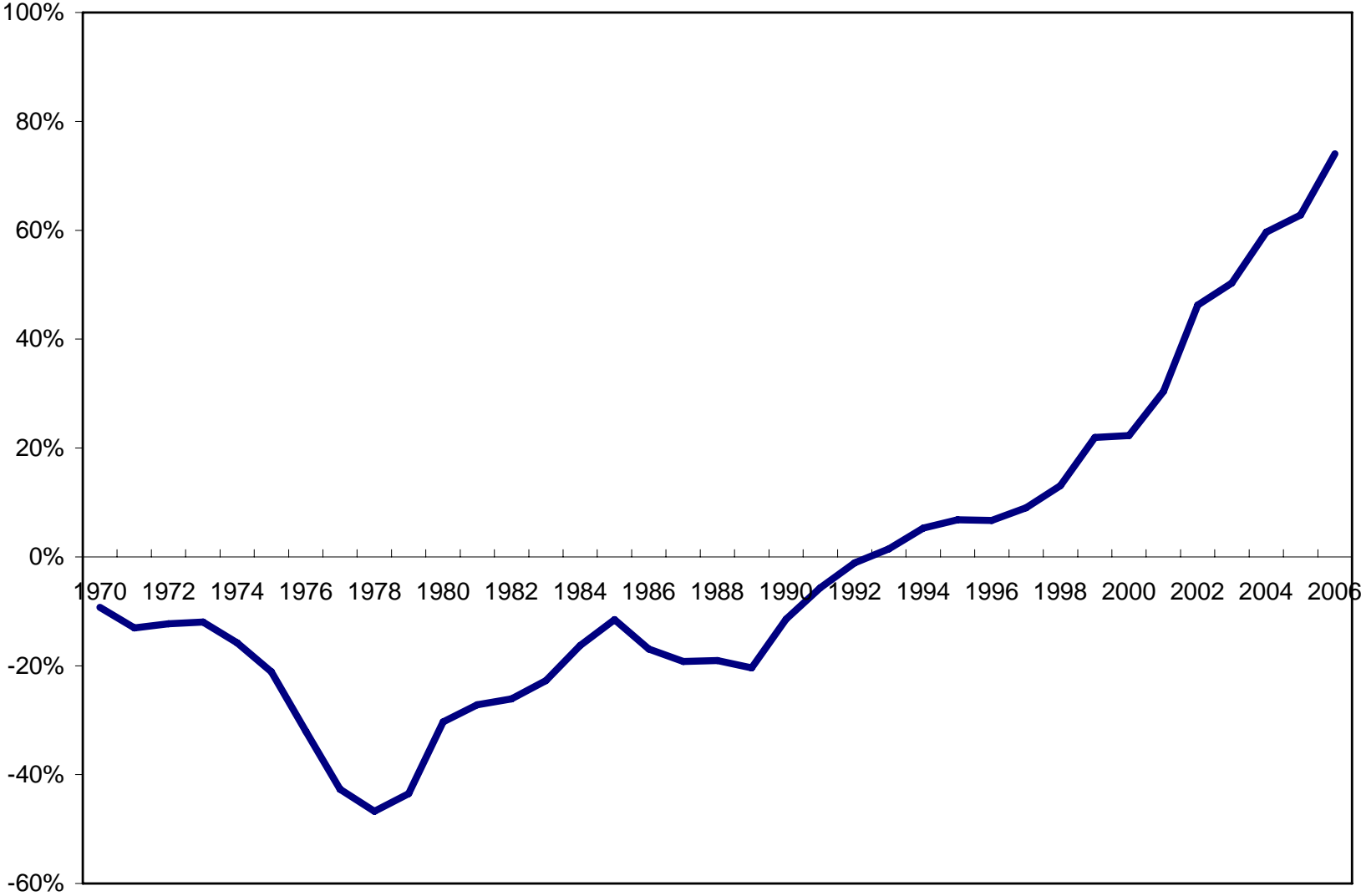


Global Imbalances: NFA positions



Net Foreign Asset Position: Norway, 1970-2006

(as a ratio to GDP)



Dynamics of External Positions

- In addition to role of capital flows, increasing importance of valuation effects (capital gains and losses on external assets and liabilities)
- Valuation channel an important transmission mechanism for exchange rate movements
- Advanced countries versus emerging market economies

Decomposition of NFA Dynamics, 2001-2006

	Initial NFA	D(NFA)	CUM. CA	BGST	INV INC	KA, EO	Growth Adj.	Val. Gains
Japan	33.1	8.0	17.3	7.1	10.2	-2.6	-2.0	-4.7
Euro Area	-7.3	-7.0	1.5	2.9	-1.4	-2.8	2.9	-8.7
Canada	-8.5	3.1	7.1	14.0	-6.9	1.5	3.7	-9.2
Switzerland	119.9	-5.2	61.1	13.9	47.2	6.5	-40.3	-32.6
United States	-23.8	6.4	-24.1	-25.9	1.8	-0.2	5.6	25.0

NFA Dynamics: Norway

	Initial NFA	D(NFA)	CUM. CA	BGST	INV INC	KA, EO	Growth Adj.	Val. Gains
Norway	30.4	43.6	56.6	54.1	2.0	-10.8	-14.9	13.3

Sources of Net Valuation Gains

- Composition effect (long equity, short debt; maturity structure)
- Return differentials within categories
- Portfolio returns
- FDI returns
- Differentials and currency movements

The Valuation Channel and the Exchange Rate

- Liabilities mostly in domestic currency; assets have high FC component
- Depreciation generates net capital gain
- Timing: US dollar depreciates when US net external liabilities cyclically large
- Lucas critique: non-exploitable policy
- Interest rate parity kicks in if depreciation expected
- Monetary policy driven by domestic concerns

Table 4. Currency composition of net external position, 2005 (percent of GDP)

	Net external position	Net domestic currency position	Net U.S. dollar position	Net other currencies position
China	12.5	-28.3	29.2	11.6
Euro Area	-15.0	-65.5	16.8	34.5
Japan	35.9	-26.9	38.5	21.9
United States	-21.5	(-74.8)	-74.8	53.4

Lane and Milesi-Ferretti, "Europe and Global Imbalances", *Economic Policy*, July 2007

Valuation Losses: IMF Global Economic Model, Disruptive Scenario

	China	Euro Area	Japan	United States
Valuation Losses	-16.0	-4.1	-17.2	6.9

Lane and Milesi-Ferretti “Europe and Global Imbalances”,
Economic Policy, July 2007

Valuation Impact of a Dollar Crash

Table 11: Effects of a 20 percent Depreciation of the US Dollar

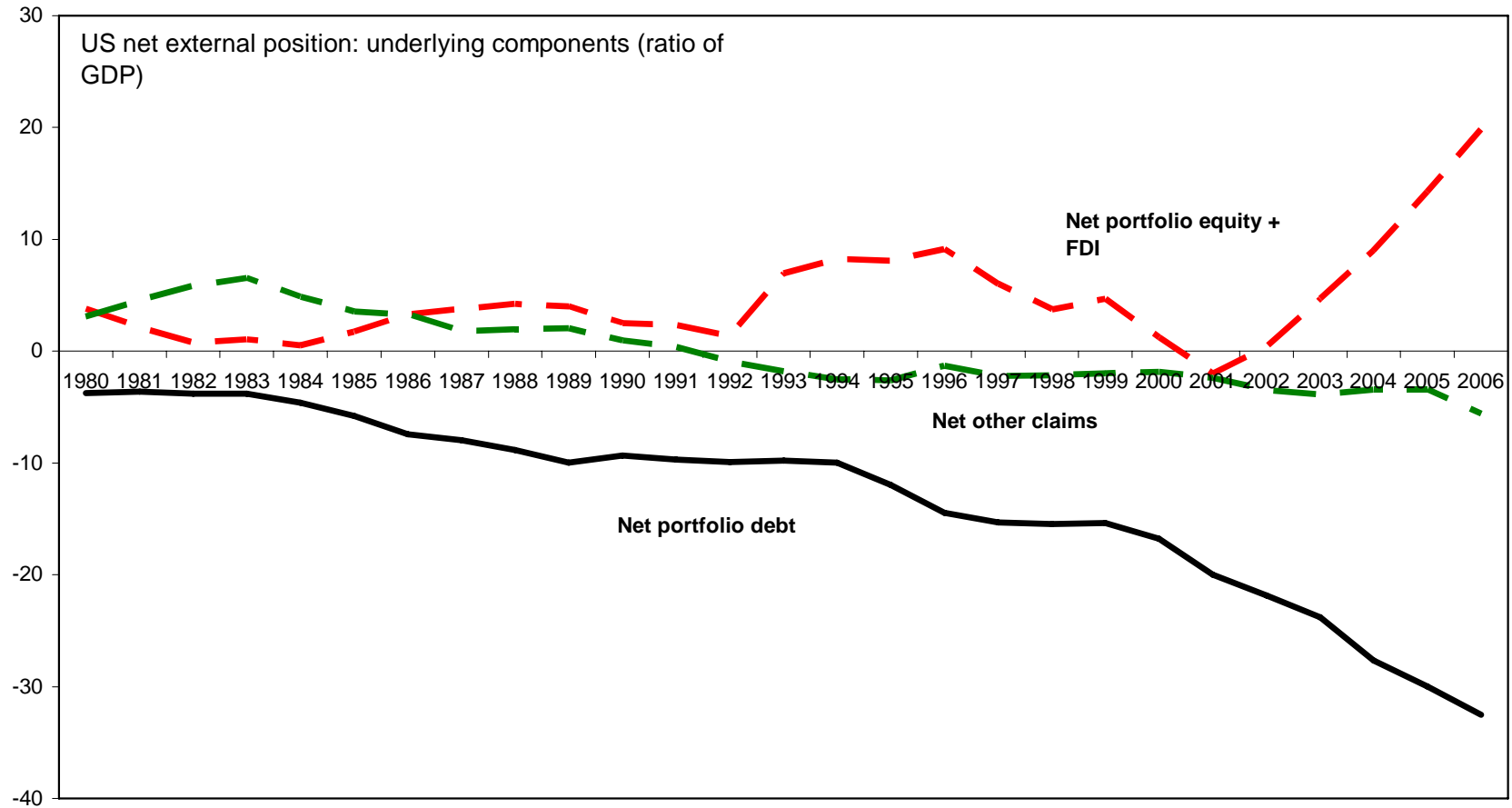
Group	Trade		Net Financial		VAL^{sr}	
	mean	median	mean	median	mean	median
All	-2.6	-1.5	1.2	0.2	0.5	0.5
Advanced	-1.3	-1.3	-0.7	-0.7	-3.3	-1.7
EMU	-1.3	-1.2	-0.3	-0.2	-1.9	-0.5
Non-EMU	-1.2	-2.0	-1.1	-1.6	-4.8	-5.1
Developing	-2.8	-1.2	2.7	3.0	3.5	3.1
Emerging	-3.2	-2.5	-0.5	-0.7	-2.9	-0.8

Percentage change in Trade and Net Financial indices in the case of a 20 percent across the board depreciation of the US dollar, plus the implied valuation changes.

- Lane and Shambaugh (2007), “Financial Exchange Rates and International Currency Exposures”

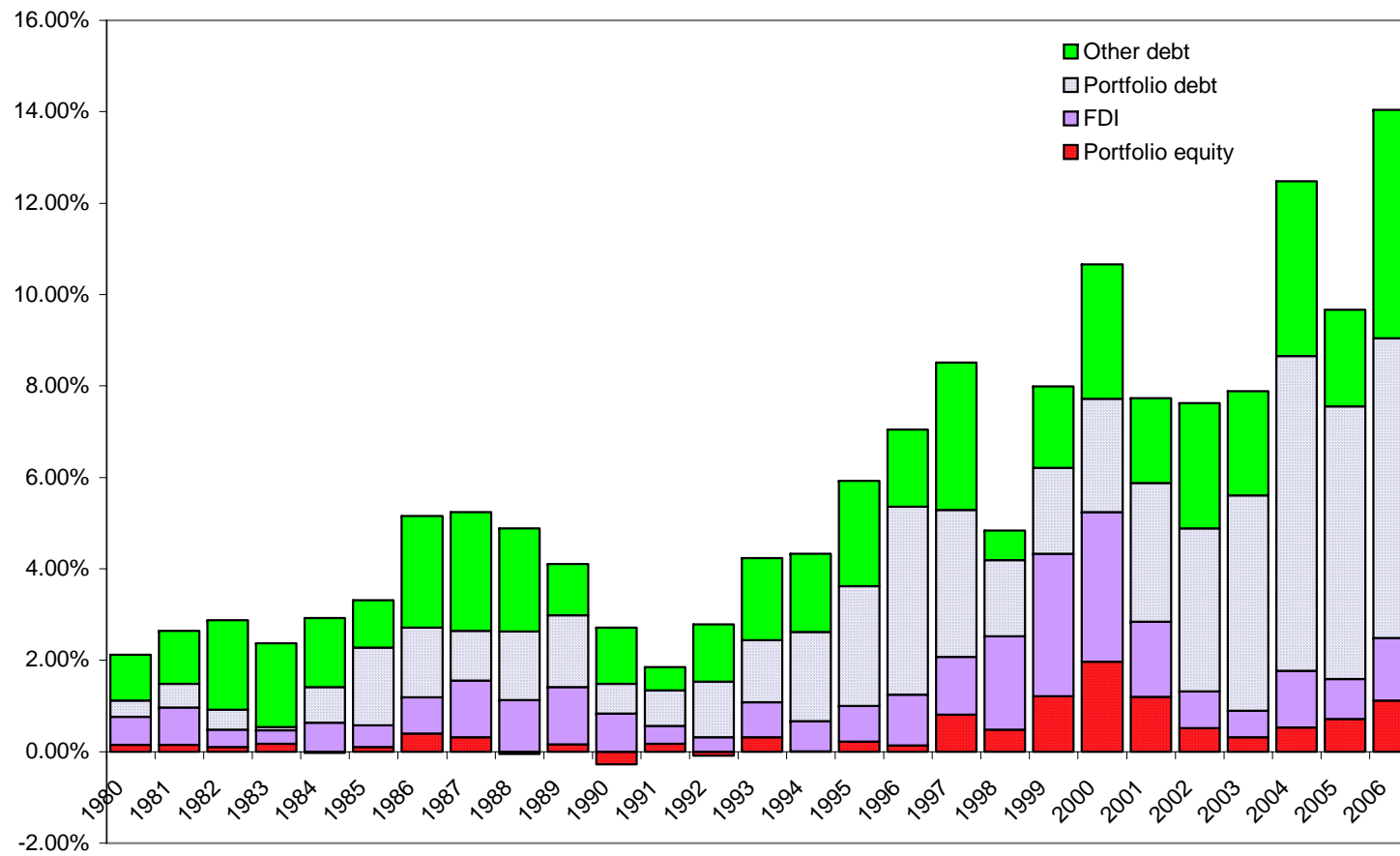
The US external portfolio (net)

The US external portfolio (net)



Composition of US K-inflows

Composition of US K-inflows



Shifts in the US International Balance Sheet

1. Decline of equity inflows
2. Within debt, increased reliance on official flows
3. Limits to official flows
4. Limits to valuation channel as an adjustment mechanism

Adjustment already in train:

- Dollar weakness boosting US exports
- Slowdown in US: decline in import growth

Monetary policy issue:

- Relative price movements versus persistent inflation.
- ‘Sophisticated’ inflation targeting

Future Trends in Financial Globalisation

- Depends on pace of trade integration
- Deepening of domestic financial systems
- Convergence in scale and characteristics of international financial integration between advanced and developing economies
- Decline in relative importance of reserves (and SWFs)
- Reversal of capital flows: China as world's largest debtor economy?

Risk Factors

- Regulatory Failures
- Convergence process could be interrupted by crises, especially in developing countries
- Self-fulfilling pessimism
- Small, less liquid financial systems and shifts in global portfolios (e.g. current surge in capital flows to developing countries)
- One response: financial repression and financial insularity
- Trade-off between stability and long-term growth?

Conclusions

- Variable geometry of trade integration and financial integration
- For advanced economies, financial innovation and monetary integration key drivers of growth in cross-border holdings
- Asymmetries between advanced and developing groups
- Convergence conditional on domestic financial development in the latter group