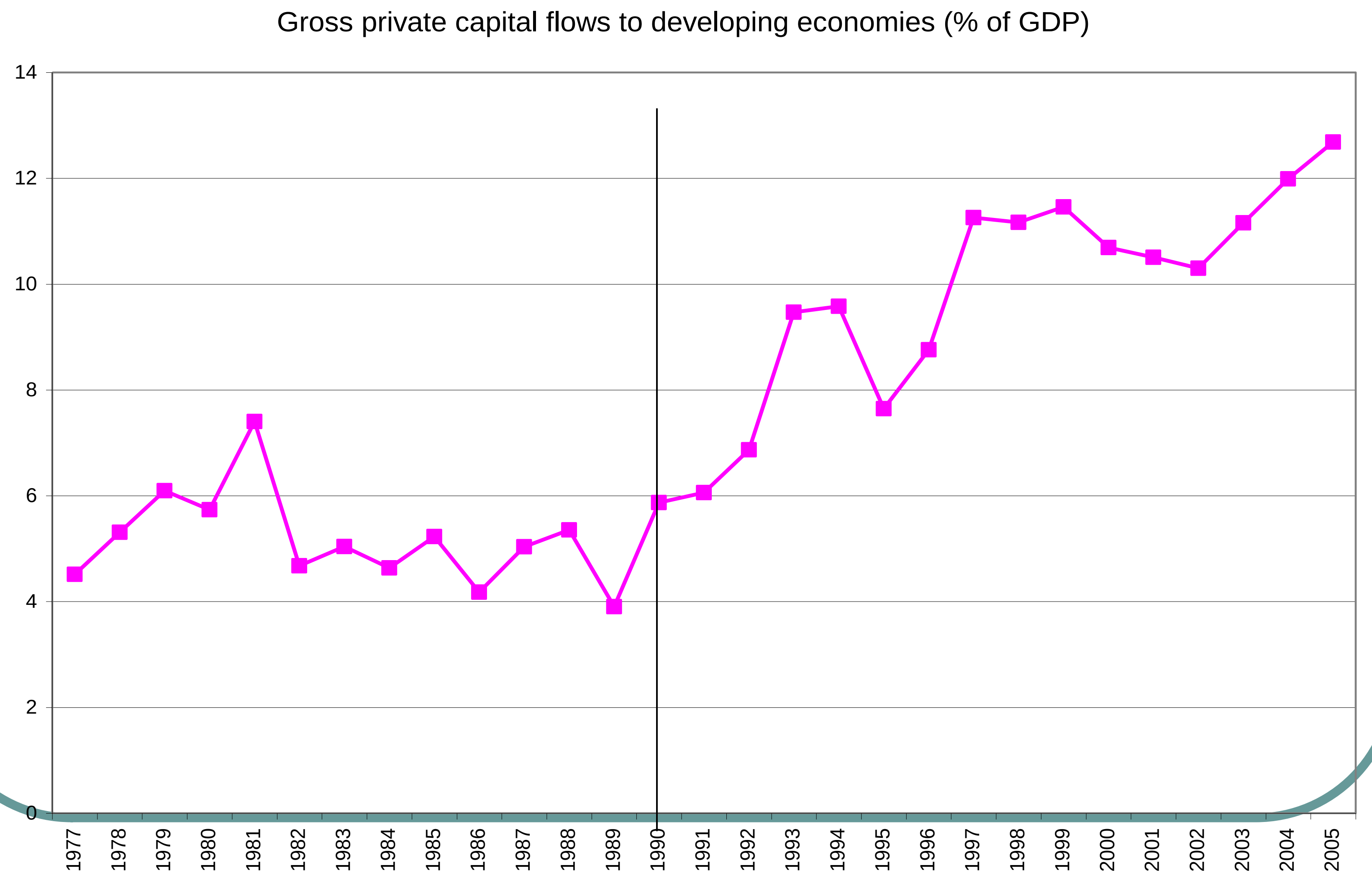
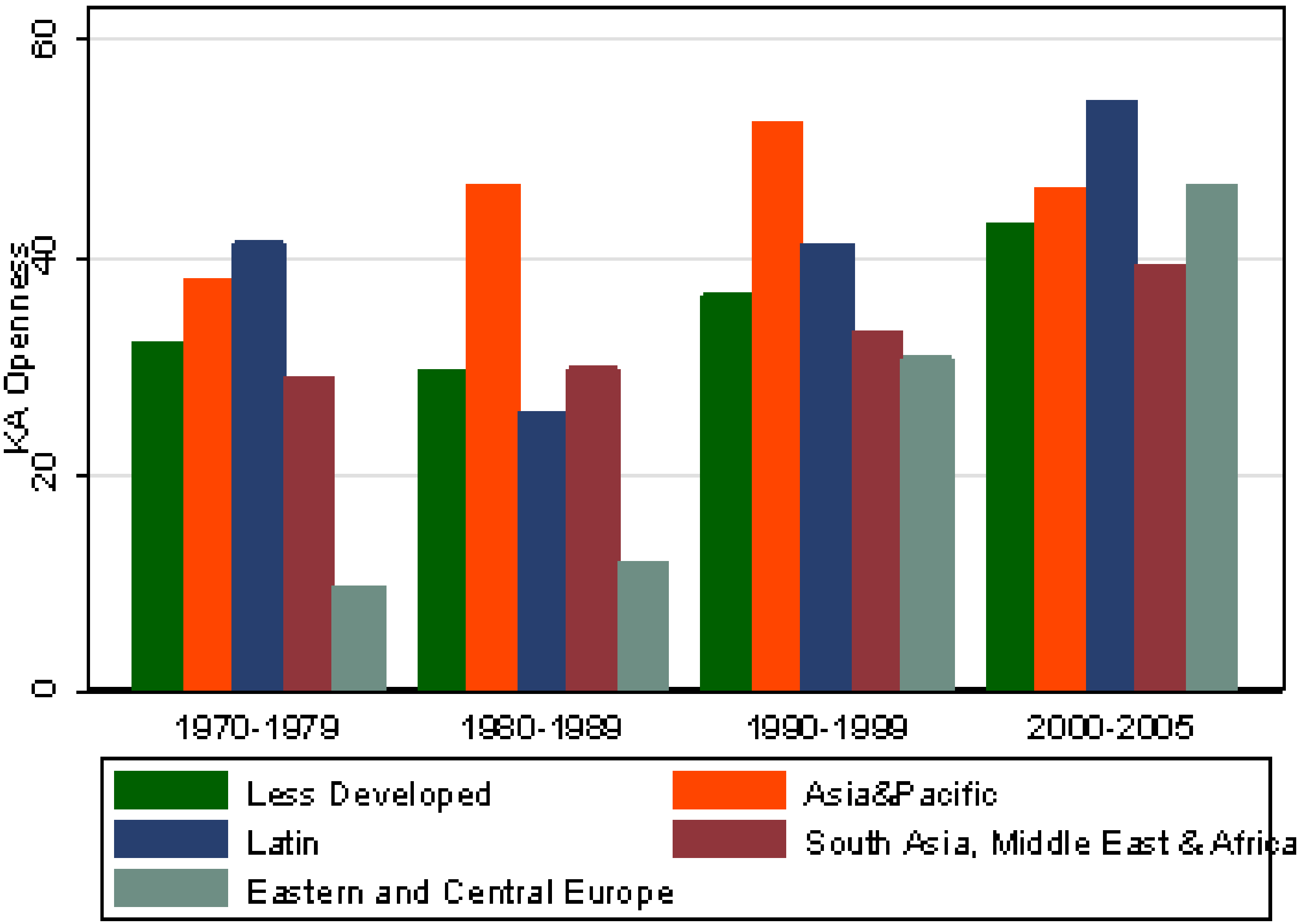
The Disappointment of Financial Globalization

(Based on a keynote lecture given by Professor Dani Rodrik at the Bank of Thailand's International Symposium 2008)

Financial globalization: flows



Financial globalization: policies



Source: Chinn and Ito (2007)

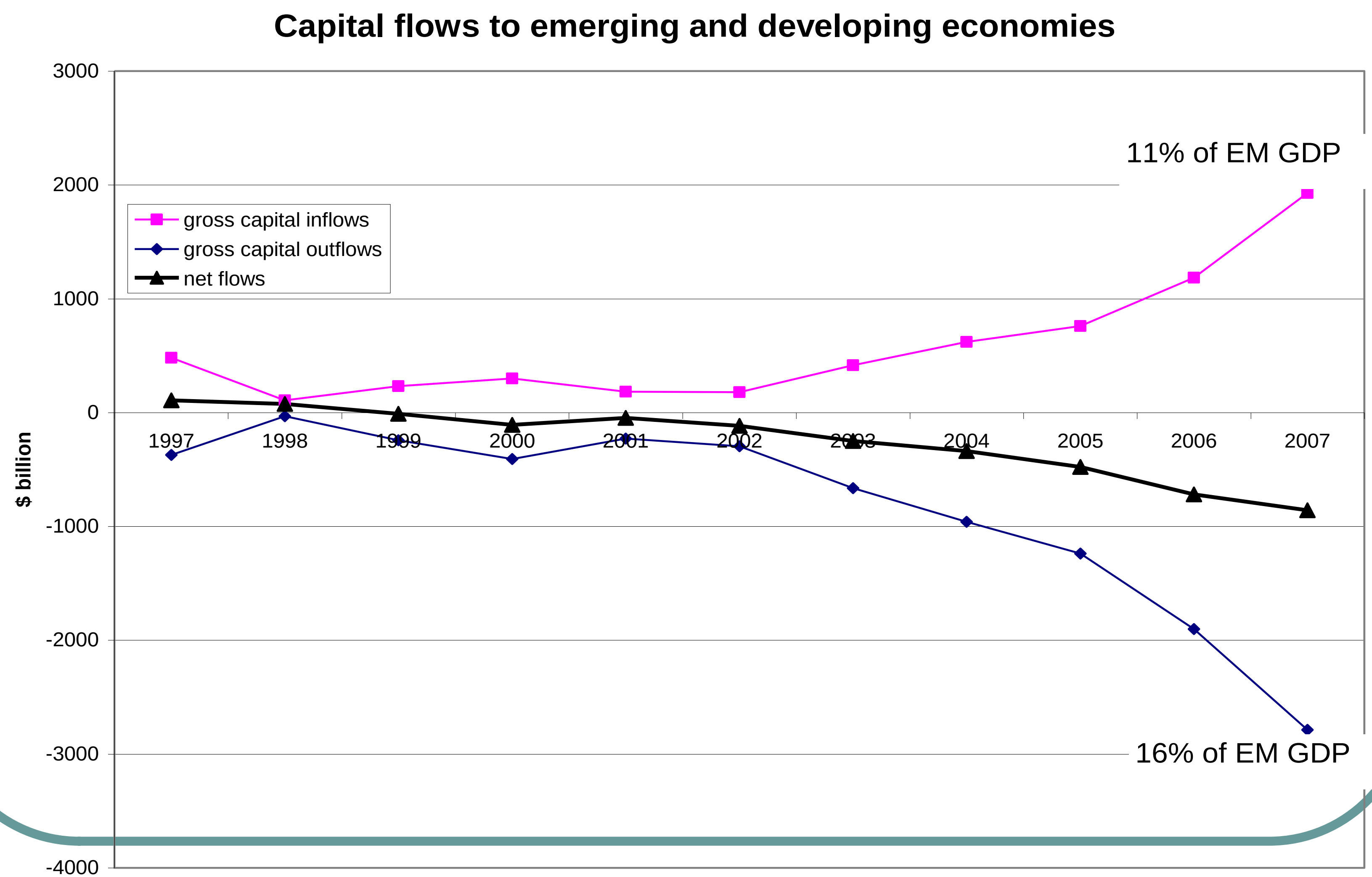
Benefits of financial globalization

- In theory (which assumes first-best setting), financial globalization should contribute to:
  - Increased investment
  - Better risk sharing (consumption smoothing)

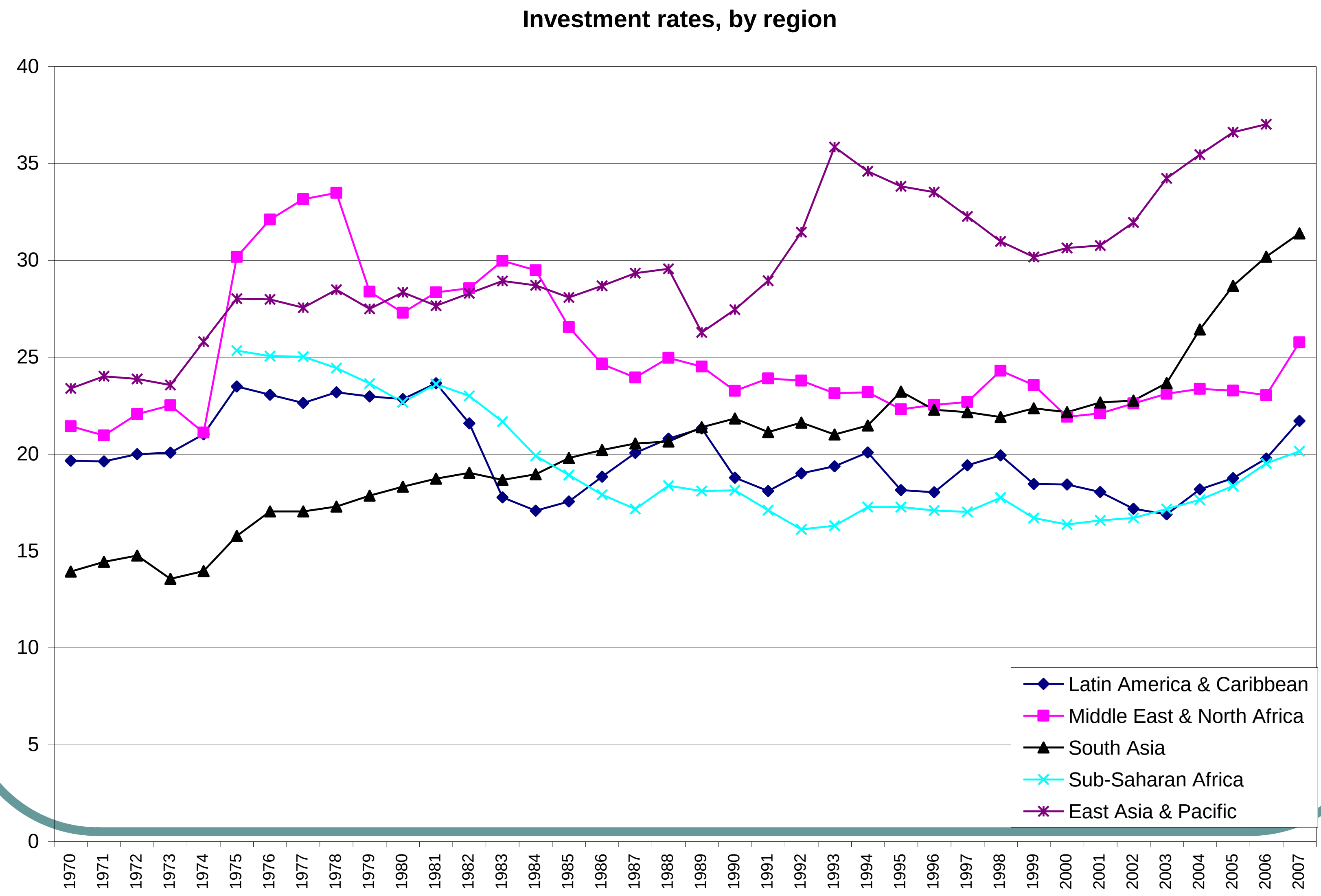
Observed outcomes

- But these theoretical consequences of financial globalization have <u>not</u> been evident in developing countries. Instead, we see:
  - Capital flows in the wrong direction
  - Not much improvement in investment rate
  - Reduced risk sharing (higher correlation b/w consumption growth and domestic income growth)
  - Procyclical of capital flows
  - More prominent financial crises
  - Stronger contagious effects in bad times
  - Countries accumulated tremendous amounts of reserves to self-insure.

Outcomes:
Small net flows, often in the “wrong” direction

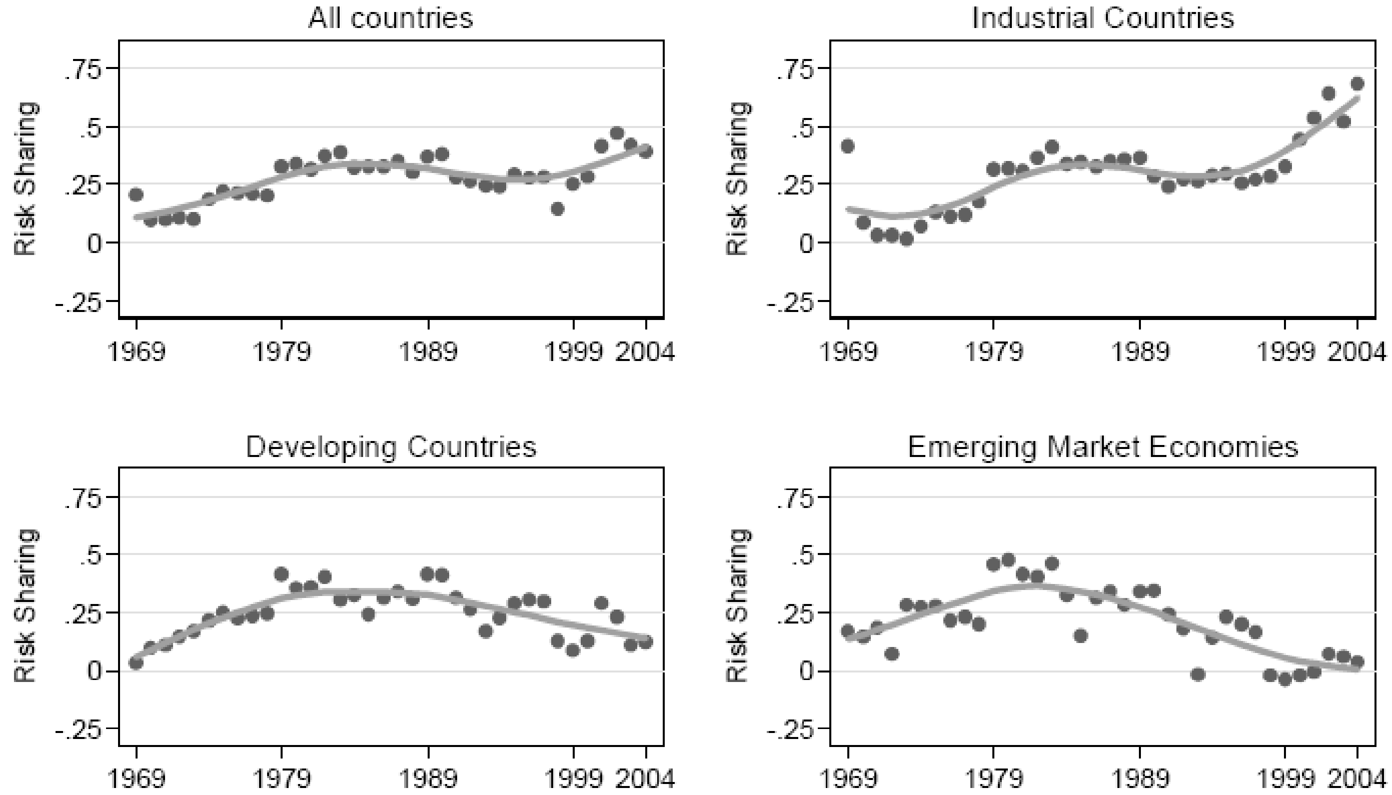


Outcomes: investment



Outcomes:
Risk diversification and consumption smoothing

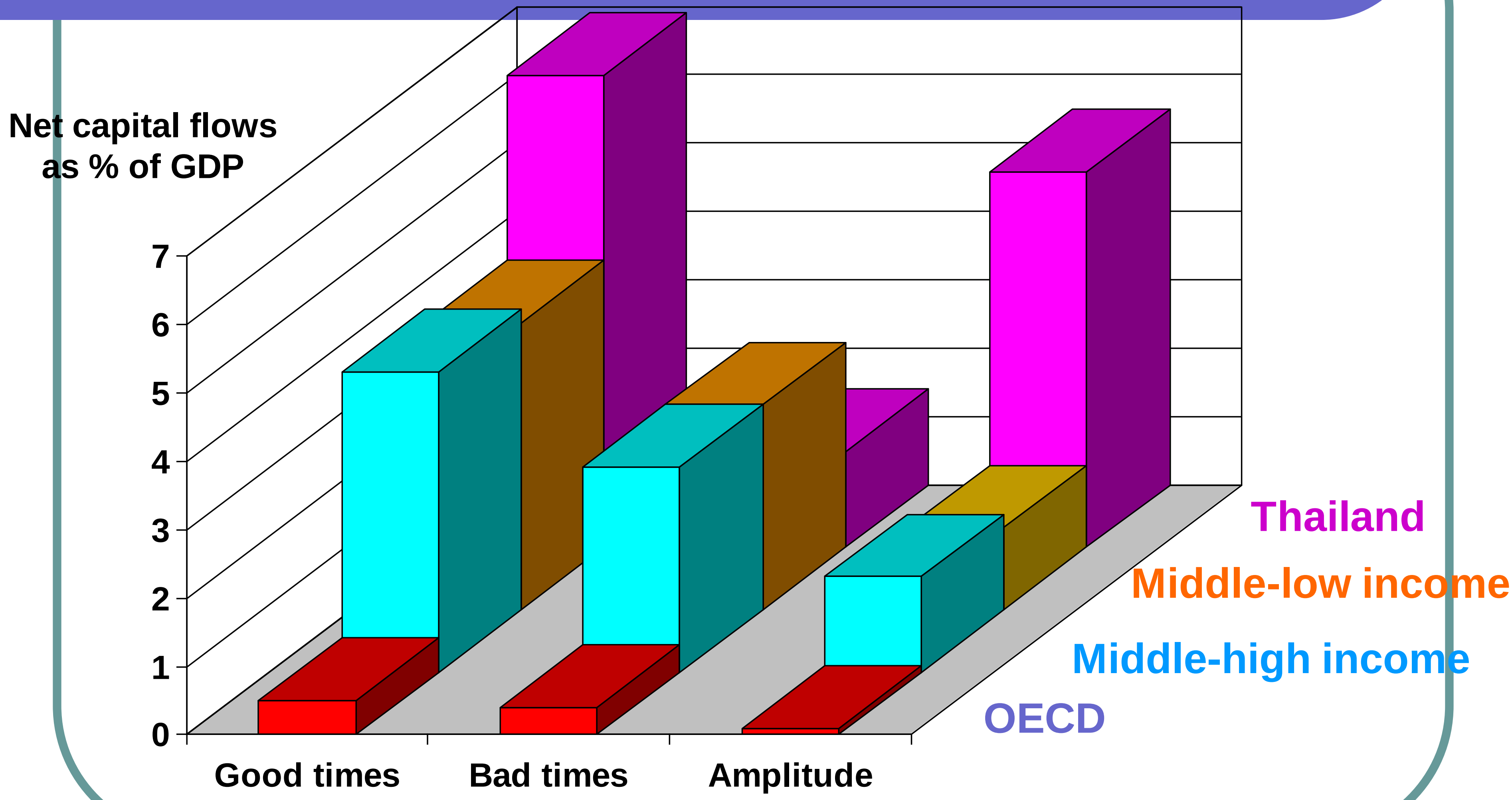
Figure 6. Risk Sharing--Time-Series Regressions



*Notes: World aggregates are calculated using industrial-country data. Nine-year rolling window, medians for each group of countries. The continuous line indicates the HP filter trend. Emerging Market Economies are part of the group of Developing Countries.

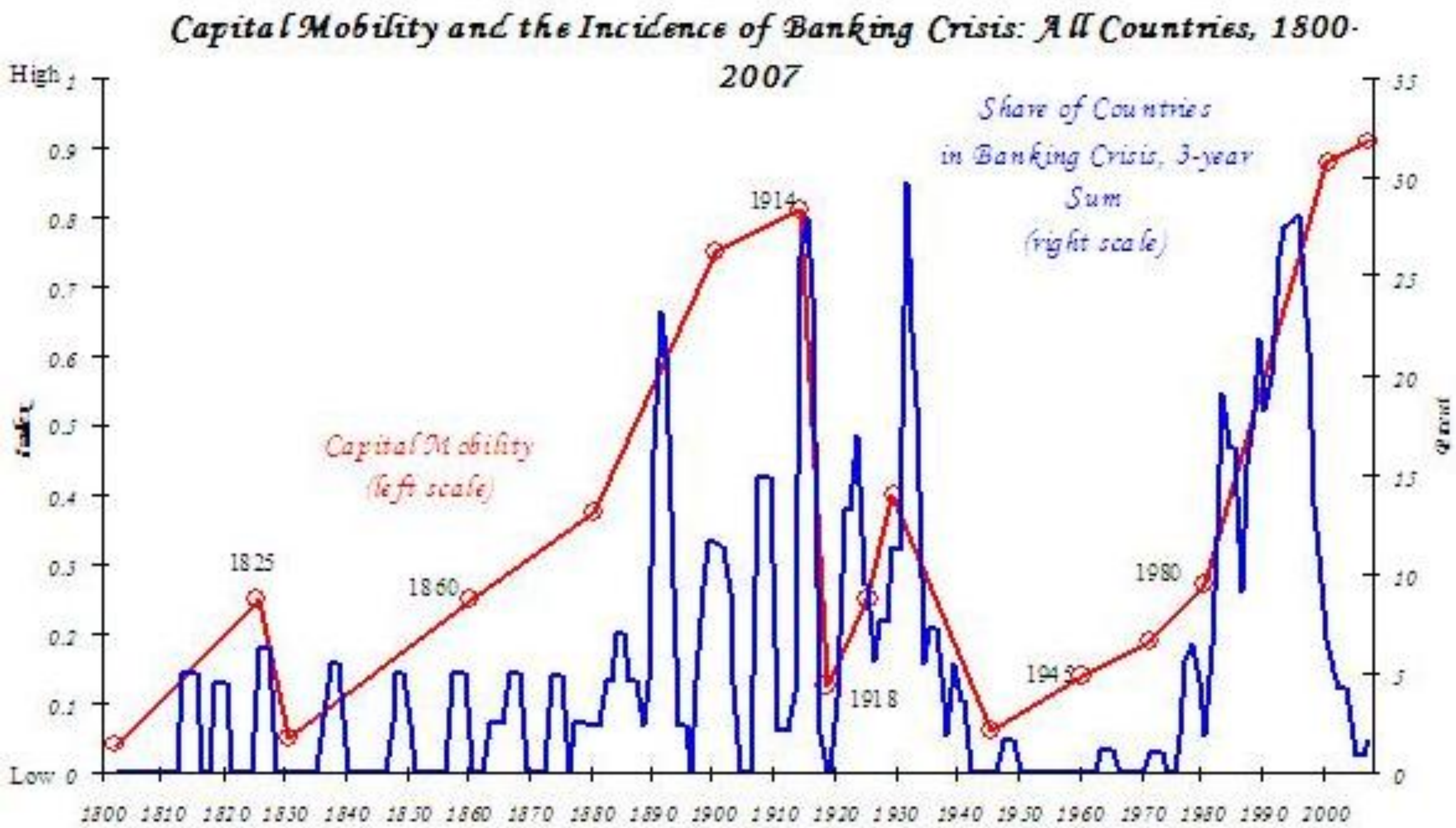
Source: Kose et al. (2007)

Procyclical nature of capital flows



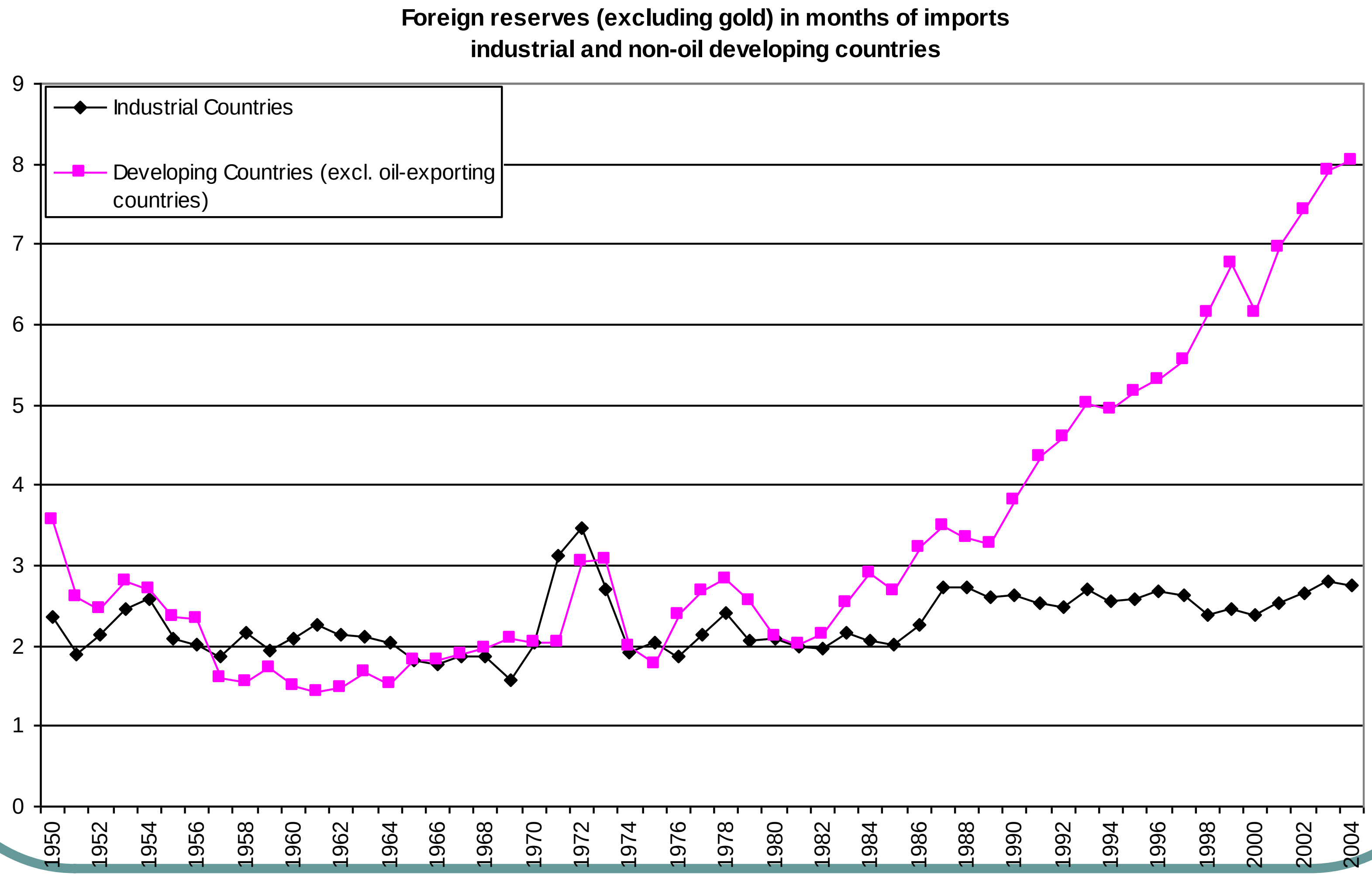
Source: Chai-anant and Disyatat (2007).

Capital mobility and crisis



Source: Reinhart (2008), “Eight hundred years of financial folly”

Outcomes: costly self-insurance



Plausible reasons for why globalization does not seem to keep to its promises

- This is because we operate in a "second-best" environment:
  - Imperfect or sub-optimal financial markets due to:

    1) <u>Domestic market imperfections</u>

       - Information asymmetries
       - Principal-agent problems
       - Systemic externalities

    2) <u>Political fragmentation of the world economy</u>

       - Sovereign risks
       - No global regulator
       - No international lender of last resort

    3) <u>Structural transformation process in developing countries</u>

       - rely on tradables sector as engine of growth
       - capital inflows → overvaluation of RER → deteriorate tradables

Policy implications

- The second-best complications are not easily removable
- Thus, policy makers might consider throwing in “sand in the wheels of finance” *(capital account management, capital controls, direct intervention)* to the intermediation process in international flows.
- However, the right solutions will differ from country to country.
- And other potential problems associated with controls or interventions may emerge (eg. rent-seeking, corruptions)

Other benefits of foreign capital?

Better governance?

- Foreign investment does not improve corporate governance for Thai firms, especially when foreign investors are holding large stakes (Ananchotikul, 2007)
- “In terms of governance and disclosure, foreign investors do not have positive spillover on Thai firms.” (Hirankasi, 2008)

Technology spillovers?

Management skills?

Human resources?

What are potential “imperfections” in the case of Thailand? (that limits absorptive capacity for foreign resources)

- Underdeveloped financial markets (thin markets, lack of depth and breadth) with relatively low financial literacy of domestic players
- Lack of domestic demand as main engine of growth
- Weak governance (which exacerbating information asymmetry problems)
- Weak legal enforcement, Corruptions
- Lack of attractive/sustainable govt programs to support (productive) private investments
- Political uncertainty (which adds to sovereign risk)
- Relatively low outward investments, that would help counterbalance capital inflows and enhance risk diversification

- What else?

Debatable questions

• Do we need more “sand-in-the-wheels” policy? If so, what kinds?

• What else can we do to extract more benefits from being financially integrated into the world market while reducing the risk associated with it?

• Should we subscribe to the IMF’s “flexible credit line” program as a source of last-resort financing?

• Is Thailand’s FX reserve level too high? Can it really work as a self-insurance to prevent a crisis?