

**THE GLOBAL FINANCIAL SYSTEM; A SOURCE OF STRENGTH OR WEAKNESS? Paper Prepared for the Cato Institute 24<sup>th</sup> Annual Monetary Conference, November 16 2006**

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It is by now almost impossible to conceive of a world without a global financial system. To be sure, large numbers of low-income developing countries have little access to that system. But most middle-income developing countries, even some that still have capital controls of one sort or another, are increasing integrated into that system, and all of the major developed countries are fully integrated. When assessing the benefits and costs of participation, it useful to identify four forms of financial integration:

Integration of the public sector by way of sovereign borrowing, which can take two forms: the issuance of foreign-currency debt, whether under foreign or domestic law, and the issuance of local-currency debt which foreigners can purchase on the issuers home market.

Integration of the corporate sector by way of foreign direct investment, as well as cross-border borrowing and equity issues in other countries' markets.

The further integration of the corporate sector that occurs when institutional and individual investors buy and sell the stocks and bonds of other countries' firms in those countries' asset markets.

The integration of the banking sector by way of the worldwide interbank market in which they can borrow or lend temporarily – the option exercised with dire consequences by some of the East Asian countries' banks a few years ago

At a conference like this one, devoted to Fed policy in the face of crises, foreign direct investment may be the least interesting form of financial integration. Let me take a moment, however, to note how foreign direct investments, as well as long-term contractual arrangements between domestic and foreign firms, have made today's globalization different from yesterday's globalization. In earlier periods, countries

specialized in *products*. Some produced raw materials; others produced manufactured goods. Today, by contrast, countries specialize increasingly in *processes*. A large part of international trade involves intermediate goods – parts and components that will be assembled and sold thousands of miles away. This could not have happened, of course, without the revolutions in communications and transportation that we now take for granted. But the specialization in processes, rather than whole products, is in part responsible for those two revolutions – the use of aircraft, for example, to carry high-value parts from continent to continent.

I think it fair to say, moreover, that the integration of the corporate sector, by way of foreign direct investment, is not likely to threaten the stability of the international financial system, let alone the U.S. financial system. It is unfortunate, of course, that too much of the world's oil and gas production, present and future, takes place in volatile parts of the world and that the transmission of oil and gas is also vulnerable to political instability in many parts of the world. And we have already seen how that instability can pose hard problems for the Fed. It is widely agreed that a big supply shock, such as a run-up in the oil price poses an intractable problem for any central bank that seeks to maintain price stability without depressing real growth, and that is precisely the problem the Fed may face quite soon.

It is also worth noting that the gains from financial integration – the three other forms that I mentioned a few moments ago – have not been as large or widespread as many economists expected when they confronted the data. A remarkable paper by four economists, Kenneth Rogoff and three of his former colleagues at the IMF, have surveyed the very large body of research on the gains from integration – whether and to

which extent it has fostered economic growth in the developing countries.<sup>1</sup> To some significant extent that large body of research is flawed analytically; much of it, for example, relies on overly simplistic measures of the degree to which countries restrict international capital flows, and much of it also fails to distinguish between the effects of capital controls and of other institutional features of the countries under study. Let me quote their guarded conclusion in full:

A key theme that comes out of our survey of existing empirical studies is that macro-level data often do not, and perhaps cannot, offer definitive answers about the effects of financial globalization. Further research based on industry- and firm-level data as well as case studies may provide useful corroborative evidence and, often, more informative insights about the channels through which these effects operate. In the meantime, we should recognize that some of the more extreme polemical claims made about the effects of financial globalization on developing countries, both pro and con, are far less easy to substantiate than either side generally cares to admit.

Those studies that survive their scrutiny, moreover, suggest that the main gains from integration do not derive directly from the transfer of capital from rich to poor countries; they derive from the contribution of financial integration to the quality of institutions in the capital-importing countries, including improvements in corporate governance, the quality of banking supervision, and the deepening of financial markets. That finding, however, poses a conundrum. The countries that would benefit most markedly from these indirect effects of financial integration may not be able to attract much foreign capital precisely because their institutions are far too weak to attract foreign investors.

What risks, if any, may the Fed confront due to financial globalization? The risks of a major accident, another LTCM, are more likely to be home-grown, not imported from international markets. There is, however, one such risk that could perhaps be

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<sup>1</sup> M. Ayhan Kose, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei, "Financial Globalization: A Reappraisal" (manuscript, June 2006).

imported. The European Central Bank may have great difficulty dealing with a major banking crisis in the euro zone. This is not for the reason sometimes cited – that the ECB is not well-capitalized and there is no single government to guarantee its solvency. The monetary operations of the eurosystem are conducted by the national central banks, not the ECB itself, and each of them has a government to guarantee its solvency. The weakness of the ECB resides in the fact that it has no direct access to the information it may need to detect an incipient crisis. It is wholly dependent on the national central banks and on those other agencies in the euro zone that are directly responsible for bank supervision. There is, I believe an increasingly strong case for the centralization of bank supervision in the euro zone, whether by vesting it in the ECB or in some other EU body.

Several emerging-market countries are in far better shape today than they were a decade ago. Some have adopted more flexible exchange rates, including some East Asian countries, and many have accumulated far larger reserves than they held a decade ago, thanks to the very high prices of their principal exports, resulting in part from China's voracious demand for a wide range of primary products. Some have also reduced their governments' foreign-currency debts, and their banks are far less heavily reliant on short-term foreign-currency borrowing to fund domestic lending.

Nevertheless, financial integration has produced a new form of vulnerability. Foreign purchases of equities and domestic-currency debt have grown rapidly in the last few years, and foreign portfolio investments exceed direct investments in some emerging-market countries, including Brazil, India, Indonesia, Israel, Korea, the Philippines, Turkey, and Uruguay.<sup>2</sup> Any loss of confidence by holders of those claims,

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<sup>2</sup> International Monetary Fund, *International Financial Statistics*, June 2005. There are, however, long lags in the publication of the relevant data, which pertain mainly to the end of 2004.

whether due to economic or political developments within the country or a worsening of global economic conditions, could lead to sales of those claims.

The effects of an exodus of foreign investors would, of course, be different from those of a sovereign debt crisis. They would be mitigated, moreover, by a fall in the domestic-currency prices of the country's stocks and bonds, as well as a depreciation of the country's currency if its exchange rate was sufficiently flexible. But the need to contain the depreciation could greatly reduce the country's reserves and amplify the exodus of foreign investors. The form of the next emerging-market crisis might thus differ from those of the recent past, but it would be utterly unrealistic to argue, as some do, that we are unlikely to see more crises in the future.<sup>3</sup>

I come finally to the risk that resides in the way that the United States has exploited financial globalization to finance its current-account deficit and, indirectly, its budget deficit. I doubt that the main foreign holders of dollars will start to sell them merely because they believe that the dollar will fall someday soon. The Chinese, for example, have said more than once that they will not reduce their dollar holdings, although they may diversify at the margin, swapping newly acquired dollars for euros, yen, and other currencies (including, incidentally, other Asian currencies). But I do not see how we can achieve an orderly depreciation of the dollar of the size required without triggering massive dollar sales by foreign holders, including those of the OPEC countries and other official entities. Once it begins, a depreciation of that large size is apt to

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<sup>3</sup> On the possible causes and consequences of future crises, see Morris Goldstein, "What Might the Next Emerging-Market Crisis Look Like?" *Working Paper 05-7*. Washington: Institute for International Economics, which examines the likely effects of a slowdown in Chinese and U.S. import demand, a fall in commodity prices, an increase in the cost of external financing, and other shocks and assesses the vulnerability of individual emerging-market countries to those shocks. The countries he lists as being most vulnerable to two or more of the five shocks he studies are Argentina, Brazil, Hungary, Mexico, Russia, Singapore, Turkey, and Venezuela.

become a disorderly flight. The actual depreciation may indeed be larger than the one required to reduce sufficiently our current-account deficit, and it is likely to take place over a time span far shorter than the one required for the weaker dollar to afford a significant stimulus to the U.S. economy – the switching of expenditure to domestic goods. In fact, its effects on U.S. interest rates could have a depressing effect on the U.S. economy larger than the stimulus afforded by the expenditure-switching effect of the depreciation.

I do not for a moment deny that the unwinding of global imbalances requires action by others, not just the United States. I do believe, however, that we have become by absence of mind and, more importantly, absence of action, the largest single beneficiary of financial globalization, and we may have to pay a high price for that privilege.

The global financial system is a source of strength but likewise a source of risk, and thus calls for close cooperation among the world's major countries. The International Monetary Fund has thus rightly taken steps to foster close cooperation. Its new emphasis on multilateral surveillance is meant to remind the major countries that they are jointly responsible for the stability of the international financial system. Whether it will have the courage to take the next step – to propose on its own the steps that those countries must take individually – remains to be seen. The Fund cannot compel compliance, but it can and should be prepared to “name and shame” if the key countries, including our own, fail to the steps required to maintain the stability of the financial system and, indeed, the trading system.