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Third thoughts on foreign capital

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If it doesn't kill you, financial globalisation will make you stronger

THE next great globalisation, according to Frederic Mishkin's new book* of that name, will be financial in character: the flow of foreign money into stocks, bonds and banking in emerging economies. A recently appointed governor of the Federal Reserve, Mr Mishkin makes a clear and compact case for cosmopolitan capital; and his footnotes (all 55 pages of them) weigh and tally a wealth of economic research. But the title of his book is a bit odd: wasn't cross-border finance the last, rather disappointing, globalisation?



That, certainly, was the verdict of a 2003 review† of the evidence by a quartet of economists (Eswar Prasad, Ken Rogoff, Shang-Jin Wei and Ayhan Kose) who looked at almost as many studies as Mr Mishkin. They found no robust proof that financial globalisation helped countries to grow more quickly. The song was not original, but the singers were impossible to ignore: all four were prominent economists at the IMF; Mr Rogoff, indeed, was the fund's chief economic adviser. It was as if the Fed's economists had failed to find any virtue in low inflation.

Now the same authors are offering another reappraisal of financial globalisation††, which Mr Prasad presented earlier this month at the IMF's annual research conference. The next globalisation is probably going to happen, he said (money has a habit of seeping across borders, whether you like it or not), and it may be great. But not for the reasons you might think.

It's not about the money

An economist's first thought on financial globalisation is straightforward: capital should be free to flow "downhill" from high-income countries where it is abundant to poorer countries where it is scarce. By importing savings from abroad, poor countries can invest more than they are able to set aside from their own meagre output. But Mr Prasad and his colleagues reckon that this direct benefit of foreign capital—the extra money it provides—is "arguably" worth less than a number of indirect ones; namely a deeper financial system, better-run companies and a more disciplined macroeconomic policy.

Thanks to the first of these indirect benefits, "financial deepening", open countries enjoy bigger, more liquid stockmarkets and a lower cost of equity. They also benefit from more sophisticated banking. Foreign lenders are often stronger and better run than their local rivals. They introduce new products and know-how and they give dissatisfied depositors somewhere else to take their custom, forcing local banks to raise their game. Moreover, foreign banks accustomed to sound regulation, prudent oversight and honest accounting in their home countries may lobby for the same things abroad.

The four authors also think that cosmopolitan capitalists can police companies and officials better than locals can. Foreign investors may have a better nose for boardroom shenanigans and a strong incentive to protect minority shareholders. A recent study of 365 firms listed on the Thai Stock Exchange by Sudarat Ananchotikul of the University of California, Berkeley, found that foreign institutional investors holding a minority stake help

to ensure that the company is run for the benefit of all its owners. (That said, when foreign companies buy controlling stakes in Thai firms, they are as keen as anyone else to exploit minority shareholders, she finds.)

Mr Prasad also highlights a third side-benefit. Capital flows should improve a country's macroeconomic stewardship by rewarding prudence and punishing profligacy. In practice, open countries do seem to achieve lower inflation—though there is scant evidence that they run smaller budget deficits.

If these indirect benefits do matter, it may explain why Mr Prasad and company failed three years ago to prove a link between the migration of capital and growth. Like other researchers, they sought to distil the impact of financial openness by straining out the influence of other factors that might lift growth—such as financial depth, institutional strength and macroeconomic stability. But if foreign capital promotes these three virtues, then the study may have inadvertently strained out much of the benefit of financial globalisation.

There is, however, “a fly in the ointment”, Mr Prasad says. Even if it has these indirect pay-offs, foreign capital can also make mischief in countries that are not ready for it. Overseas investors show little mercy to countries where public spending gets out of hand, the currency gets out of line, the banks are poorly supervised or companies rip off outside owners. Mr Prasad thus lays out several “thresholds” that emerging economies should cross before they open up. What are they? A country's financial system should be quite sophisticated, he says; its companies fairly well run; and its macroeconomic policies reasonably disciplined.

Does this list sound familiar? As Mr Prasad points out, there is an awkward paradox in his findings. His checklist of “thresholds” echoes his catalogue of “indirect benefits”. In short, the things financial globalisation strengthens are also the things a country needs to have in place in order to benefit from it.

Mr Mishkin argues that globalisation itself stimulates the reforms needed to make it work. That is often true of trade in goods, but it is sadly not always true of trade in assets. “Poorer countries must let go of the idea that financial infrastructure and wealth can be built up when the countries remain closed off to the rest of the world,” he writes. But Mr Prasad's more ambivalent take suggests poorer countries, lacking financial infrastructure, might want to hang on to that idea a bit longer.

* [“The Next Great Globalization”](#) ([Amazon.co.uk](#)). Princeton University Press, 2006.

† [“Effects of Financial Globalization on Developing Countries”](#). IMF Occasional Paper 220.

†† [“Financial Globalization: A Reappraisal”](#). IMF Working Paper WP/06/189.