

Financial Intermediation in a Globalised World: lessons from some recent OECD analysis

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Small IFCs: Sharing perspectives and meeting the challenges
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Background: Recent OECD work on capital flows

Financial globalization can be both a blessing and a curse: good in principle but comes with vulnerabilities => How can policies and in particular structural policies be part of the response and help mitigate these risks?

Structural policies = Broad concept: financial development, financial liberalization, capital account openness, trade openness, regulatory quality, product market competition, employment protection. In countries receiving capital and countries exporting capital.

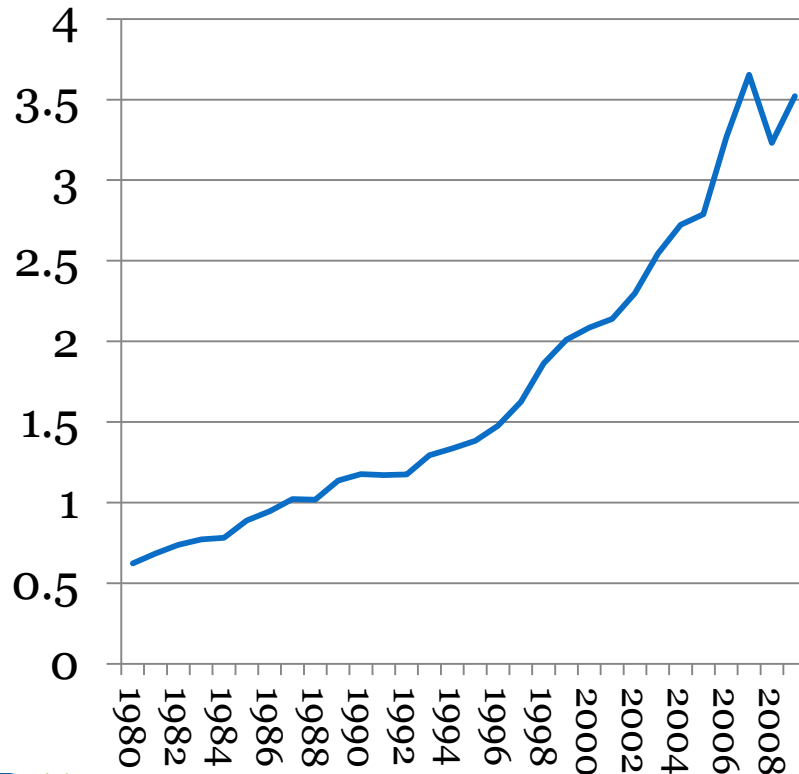
1. Impact of structural settings on size of gross and net external positions => impact of reforms on flows and imbalances
2. Impact of structural settings on the consequences of episodes of large inflow episodes (credit booms, banking or currency crisis, sudden stops) and implications for policies.

Key points of the presentation

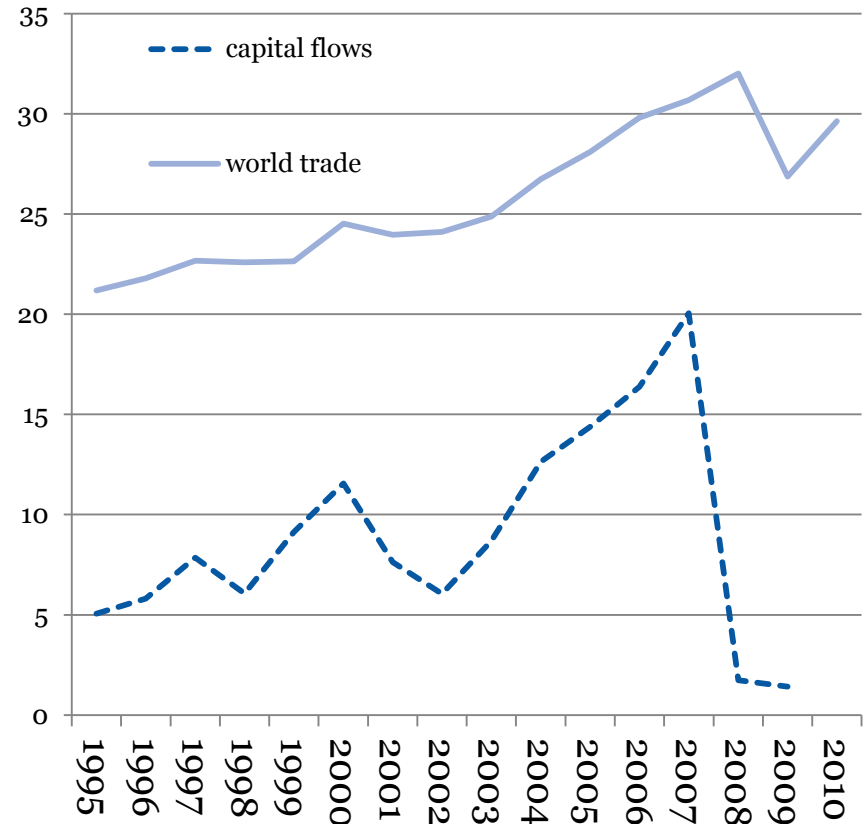
- **Capital flows in the global economy**
 - Financial globalization can be both a blessing and a curse:
Expected advantage of capital movements for the world economy and the risks associated to these flows (including recent OECD findings)
- **Impact of barriers to trade and investment**
 - Barriers tend to slow capital flows ... but especially the ones associated with lower risks for the recipient economy.
 - Capital control should only be a last resort solution, when the other options are exhausted (structural and financial reforms, sound macroeconomic policies, macro and micro prudential reforms)
- **The implications for financial centres**

Financial integration accelerated in the late 90's

**Financial integration =
World total assets and
liabilities positions as a % of
world GDP**



**International capital flows
and world trade as share of
world GDP**

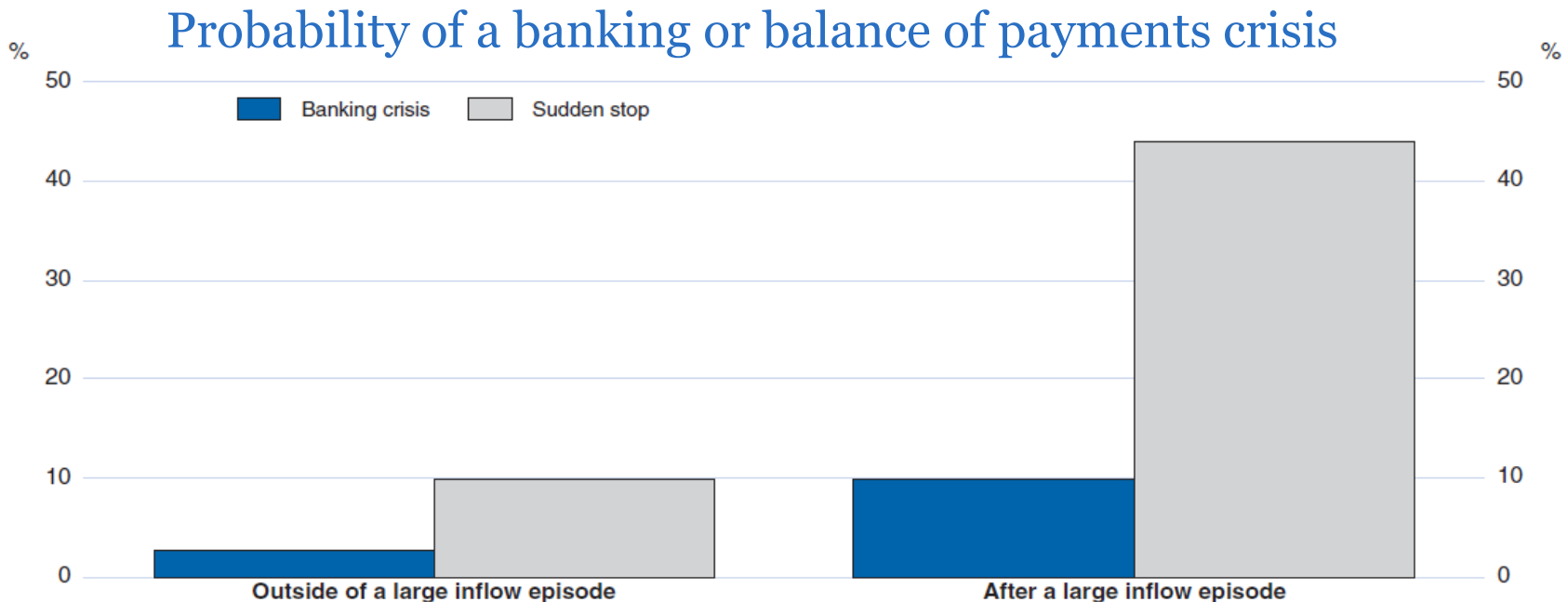


Capital flows: potential blessing

- Financial globalisation is good in principle
 - Direct effect: New investment and insurance possibilities=> better international allocation of saving and investment => support long-term income growth, employment...
 - Indirect effect: Incentives for better macroeconomic and structural policies
- But empirical evidence is very mixed

Capital flows: source of vulnerabilities and risks

- Large gross bilateral positions: fast & complex transmission of financial shocks
- Easier to finance imbalances
- Large capital inflows create macroeconomic dilemmas, ...
 - ... risk destabilize domestic financial systems, ...
 - ... and may end up in a crisis, with high economic and social costs

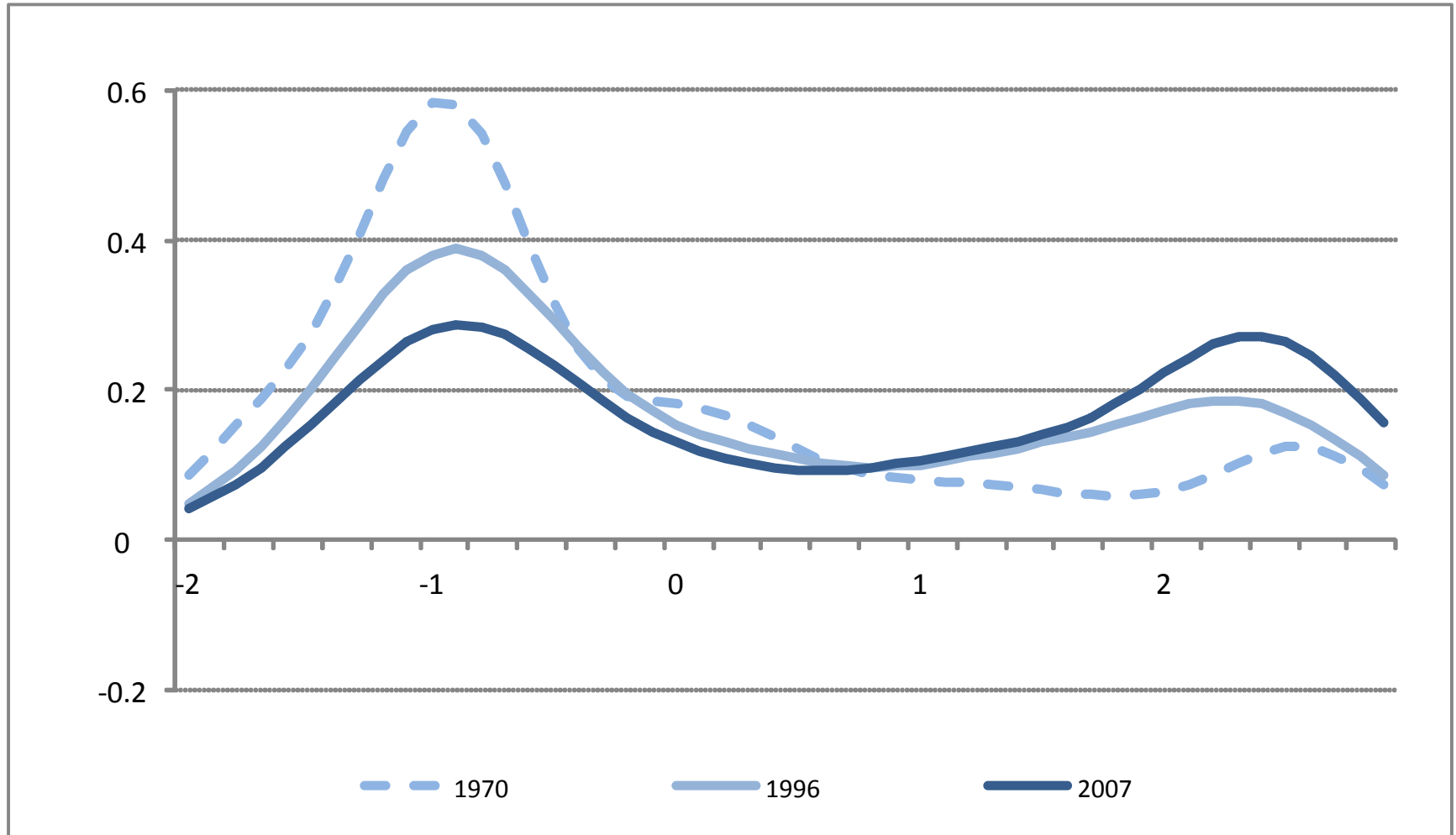


Impact of barriers

1. More barriers, less flows:

- Countries that are less open to trade tend to attract less capital foreign capital and export less capital
- Countries with less open financial markets tend to be less able to attract and absorb foreign and domestic capital and export less capital
- Trend in past decades to openness has contributed to global financial integration (accounts for 1/3 of what we can explain)

Progress in capital account openness over time



Impact of barriers

2. More barriers, not necessarily less risks:

- For a given amount of inflows, the probability of a banking crisis is higher when the country is less open to capital flows: 3 times larger in most restrictive than in most open (although caution is needed in interpreting this result).
- More barriers tend to result in a composition capital inflows skewed to more debt and less FDI. Such composition is more likely to result in domestic credit booms and is more crisis prone.
- On capital control specifically: their efficiency is still unclear and they create distortions if maintained indefinitely=> last resort and temporary solution, preferably subject to multilateral surveillance as in the framework created by the OECD Code of Liberalisation of Capital Movements.

Lessons for financial centres

- Financial centers have contributed to financial globalization and play a key role in global financial flows (account for over 10% of what we can explain, together with financial development, trade openness, capital account openness)
- Countries with a financial center tend to receive and export more debt related flows and less FDI or portfolio investment (cf. intermediation activity).
- Financial centers are not immune to sudden stops => some of the general policy advice for countries receiving large flows may apply: adopt structural setting minimizing macroeconomic distortions (competition friendly regulations, financial deepening, openness...), sound macroeconomic policies, micro and macro prudential reforms.
- There may also be lessons on where to invest.