Financial globalization in reverse?

By Martin N. Baily and Susan Lund

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For three decades, financial globalization had seemed inevitable. New information technologies made it possible to conduct transactions halfway around the world in the blink of an eye. Savers gained the ability to diversify, while the largest borrowers could tap global pools of capital. As national financial markets grew more intertwined, cross-border capital flows rose from $0.5 trillion in 1980 to a peak of $11.8 trillion in 2007.

But the 2008 crisis exposed the dangers, with the globalized financial system's intricate web of connections becoming a conduit for contagion. Cross-border capital flows abruptly collapsed. Almost five years later, they remain 60% below their pre-crisis peak.

This pullback in cross-border activity has been accompanied by muted growth in global financial assets (despite the recent rallies in stock markets around the world). Global financial assets have grown by just 1.9% annually since the crisis, down from 7.9% average annual growth from 1990 to 2007.

Should the world be worried by this decline in cross-border capital flows and slowdown in financing? Yes and no.

After the outsize risks of the bubble years, these trends could be a sign that the system is reverting to historical norms. As we now know, much of the growth in financial assets prior to the crisis reflected leverage of the financial sector itself, and some of the growth in cross-border flows reflected governments tapping global capital pools to fund chronic budget deficits. Retrenchment of these sources of financial globalization is to be welcomed.

But not all of the current retreat is healthy. Surprisingly, emerging economies are also experiencing a slowdown; the development of their financial markets is barely keeping pace with GDP growth. Most of these countries have very small financial systems relative to the size of their economies, and, with small and medium-size enterprises (SMEs), households, and infrastructure projects facing credit constraints, they certainly have ample room for sustainable market deepening.

A powerful factor underlying the drop in cross-border capital flows is the dramatic reversal of European financial integration. Once in the vanguard of financial globalization, European countries are now turning inward.

After expanding across national borders with the creation of the euro, eurozone banks have now reduced cross-border lending and other claims within the eurozone by $2.8 trillion since the end of 2007. Other types of cross-border investment in Europe have fallen by more than half. The rationale for the euro's creation – the financial and economic integration of Europe – is now being undermined.

Current trends seem to be leading toward a more fragmented global financial system in which countries rely primarily on domestic capital formation. Sharper regional disparities in the availability and cost of capital could emerge, particularly for smaller businesses and consumers, constraining investment and growth in some countries. And, while a more balkanized financial system does reduce the likelihood of global shocks creating volatility in far-flung markets, it may also concentrate risks within local banking systems and increase the chance of domestic financial crises.

So, is it possible to "reset" financial globalization while avoiding the excesses of the past?

Successfully concluding the regulatory reform initiatives currently under way is the first imperative. That means working out the final details of the Basel III banking standards, creat-

ing clear processes for cross-border bank resolution and recovery, and building macro-prudential supervisory capabilities. These steps would go a long way toward erecting safeguards that create a more stable system.

But additional measures are needed. The spring meetings of the World Bank and the International Monetary Fund represent a pivotal moment for shifting the debate toward a second phase of post-crisis reform efforts – one that focuses on ensuring a healthy flow of financing to the real economy.

A crucial part of this agenda is the removal of constraints on foreign direct investment and foreign investor purchases of equities and bonds, which are far more stable types of capital flows than bank lending. Many countries continue to limit foreign investment and ownership in specific sectors, restrict their pension funds' foreign-investment positions, and limit foreign investors' access to local stock markets. Eliminating these barriers would increase the availability of long-term financing for business expansion.

More broadly, officials in emerging economies should restart reforms that enable further domestic financial-market development. Most countries have the basic market infrastructure and regulations, but enforcement and supervision is often weak. Progress on this front would enable equity and bond markets to provide an important alternative to bank lending for the largest companies – and free up capital for banks to lend to SMEs and consumers. Deepening capital markets would also benefit local savers and open new channels for foreign investors to diversify.

Given that Europe led the recent rise and fall of financial globalization, any effort to reset the system should focus on measures to restore confidence and put European financial integration back on track. The recent crisis in Cyprus underscores the urgency of establishing a banking union that includes not only common supervision, but also resolution mechanisms and deposit insurance.

Determining the right degree of openness is a thorny and complex issue for every country. Policymakers must weigh the risks of volatility, exchange-rate pressures, and vulnerability to sudden reversals in capital flows against the benefits of wider access to credit and enhanced competition. The right balance may vary depending on the size of the economy, the efficiency of domestic funding sources, and the strength of regulation and supervision.

But the objective of building a competitive, diverse, and open financial sector deserves to be a central part of the policy agenda. The ties that bind global markets together have frayed, but it is not too late to mend them.

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