



Capital market liberalization: Optimal tradeoff and bargaining delay



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ABSTRACT

Host and investing countries are faced with a tradeoff between growth and volatility arising from capital flows. The host country seeks capital inflows for high growth, yet worries about accompanying volatility so much that it limits capital market opening due to its financial weakness. However, the investing country solicits quick and safe returns from capital outflows by requesting wide foreign openness. It is often observed that one side's push for opening encounters the other side's reluctance. We examine how this conflict of interest is resolved for international compromise equilibrium through sequential bargaining between the two sides with private valuations of capital flows. We find that openness bargaining can end up with strategic delay after information revelation. This finding sheds light on certain puzzles in international finance.

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1. Introduction

International financial integration is neither a necessary nor a sufficient condition for successful growth performance (Prasad, Rogoff, Wei, & Kose, 2007). Yet a well-documented relationship between growth and volatility (Ramey & Ramey, 1995) is associated with such integration and hence worth serious attention (Bumann, Hermes, & Lensink, 2013). This relationship is non-linearly negative (Gu & Huang, 2011), and has persisted for several decades as shown in Fig. 1 (covering 162 countries over 1970–2007). Although a few existing studies address growth or volatility issues,¹ there is as yet no theoretical work to analyze the effects of financial integration on the growth-volatility relationship (Kose, Prasad, & Terrones, 2006). We attempt to provide a general theoretical model for those effects.

A key notion in this paper is that capital flows are a risky opportunity of growth for countries involved. We use a mean-variance framework to model the link of the volatility-growth relationship to financial integration. While a large literature

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¹ Gorinchas and Jeanne (2002), Abiad (2003), Baldwin (2003), Winters (2004), Caballero and Cowan (2006), and Martin and Ray (2006).

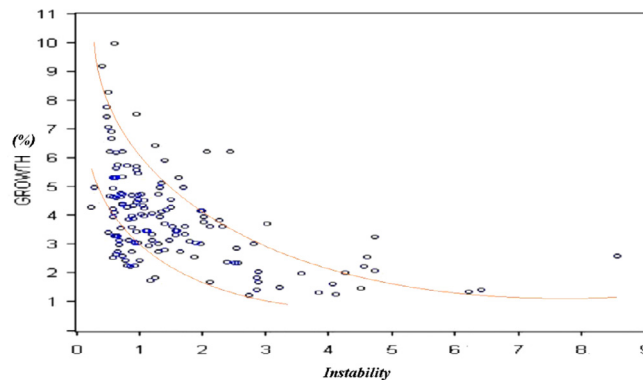


Fig. 1. Correlation between volatility and growth across countries.

on financial crises tries to identify their costs to capital-importing countries (Wyplosz, 2002), proponents of integration do not fully appreciate the pressure that they have put on those countries to liberalize their weak capital markets (Stiglitz, 2004). We take into account such pressure by viewing the risk of volatility as important as the benefit of growth.

It is important to understand policy inconsistencies between two sides of capital flows. While internal politics may prompt capital market liberalization (Abiad & Mody, 2005; Aizenman & Noy, 2003), pressures for financial opening arise more often from multinational firms, international institutions, and even foreign governments (Dorn, 2006). Advanced countries seem impatient about foreign openness (NYT, 1999), and developing countries are pushed headlong into liberalization (Rodrik, 1998; Stiglitz, 2003). Given the frequent surge in financial turbulence (Caballero, 2010), developing countries may tighten their capital controls or revoke their market opening (Edwards, 2012; Gu & Sheng, 2010).

Several recent papers are related to financial integration policy. Pasriccha (2012) finds that emerging economies learning lessons from crises tend to use the slowdown type of capital controls (e.g., regulatory barriers) rather than the direct tightening of capital inflows (e.g., transaction taxes). Ito (2006) finds that wider financial openness can be beneficial to capital inflow countries only if their legal development is sufficient and their trade openness is also wide. Ding and Jinjarak (2012) deliver a similar message that the size of capital flows in a country is positively related to its income level (as a proxy for its development level). A few other authors show that capital controls are effective to equity flows but not to FDI (foreign direct investment) flows (Campion & Neumann, 2004; Chen & Chang, 2015; Noy & Vu, 2007).

We develop an international portfolio choice model (IPCM), and check its empirical validity based on cross-country aggregate data plots as in Fig. 1. While other IPCMs analyze micro-based tradeoffs between return and risk for private investors (Gourinchas, 2006; Obstfeld, 2007; Tille & van Wincoop, 2010), our IPCM examines the portfolio of capital flows (real vs. financial) chosen by policymakers in accordance with macro-oriented tradeoffs between growth and volatility. The merit of this model is that it treats behavioral patterns of investing and host countries on an equal footing.

A game-theoretic approach (Admati & Perry, 1987; Cramton, 1992; Rubinstein, 1982) is employed in this paper to discuss the conflict of interest between host and investing countries. One country's push for foreign countries' financial liberalization may encounter their reluctance. In fact, most countries in the world still maintain some forms of barriers to capital flows (Edison & Warnock, 2008). There is no serious study of the reasons behind this fact, and our paper fills such a literature gap. Country optimum for either capital inflows or outflows cannot be independently achieved without international negotiation. We formulate this issue as a bargaining game that leads to compromise equilibrium and hence to an internationally compatible growth-volatility relationship.

Only a few papers use bargaining models to deal with financial integration issues. For example, Fahrholz (2007) applies this approach to negotiations between Central/Eastern European countries (CEECs) and the European Union (EU) for internal monetary integration. The result from her study is that a CEEC, applying for the European Monetary Union (EMU) membership while having to take pecuniary assistance from current EU members, must wait until its financial system becomes mature. In this case, bargaining is on an optimal delay because those CEECs have no means at present to manage financial liberalization risks associated with portfolio capital flows within the EMU.

Our work explains why the relationship between growth and volatility is negative for both sides of capital flows,² why the conflict of interest arises between the two sides, and why domestic financial efficiency must be strengthened before capital market opening (McKinnon, 1991; Mishkin, 2007). We also explain in a dynamic setting how different valuations of financial integration as private information affect the bargaining equilibrium of international concession (Gu & Dong, 2009). Our explanations can be used to derive useful implications for policy making. The results in this paper can also be used to account for some puzzling facts observed in international finance.

² As a comprehensive outcome of individual country tradeoffs and international bargaining interactions, this relationship plotted in Fig. 1 is as important to the global economy as is the Phillips curve to a national economy. While the Phillips curve acts as cornerstones of monetary economics (already well-studied), the growth-volatility relationship can serve as building blocks for the economics of financial integration (still under-studied).

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