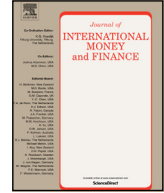




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Capital and credit market integration and real economic contagion during the global financial crisis ☆



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ABSTRACT

This study investigates the role of financial integration in the spread of global financial crisis. In particular, this study shows how the effect of the crisis on real business cycle co-movement varied for capital and credit market integration, using a sample of 58 countries in 2001–2013. During the global financial crisis, the United States – the epicenter of the crisis – experienced a severe downturn in the real economy, and other countries followed suit. We find that during the global financial crisis, the business cycle co-movements between the United States and the rest of the world were stronger when the level of capital market integration between them was higher. However, the co-movements were weaker when the level of credit market integration was higher. These findings are robust even when including investment channels, local fundamental factors, endogenous policy responses across countries, and alternative measures for financial integration and business cycle co-movements.

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1. Introduction

The cross-border holdings of international financial markets have increased remarkably since the 2000s, as shown in Lane and Milesi-Ferretti (2007) and Lane (2013). Other previous literature has confirmed the ongoing process of financial globalization, particularly among advanced economies. However, the global financial crisis (GFC) – the most serious financial crisis since the Great Depression in 1929 – has raised doubts about the benefits of financial globalization.¹ Negative shocks originating from the US financial market quickly spread globally through various channels during the GFC. Many countries experienced severe recessions following the US economic downturn.

Several studies have assessed the existence of contagion during financial crises.² Some have emphasized the role of financial linkages in contagion, arguing that financial linkages acted as the main transmission channels of cross-country shocks during financial crises in the 1990s (e.g., Baig and Goldfajn, 1999; Caramazza et al., 2004; Kaminsky and Reinhart, 2000; Van Rijckeghem and Weder, 2001). However, Lane (2013) has provided market-specific views on financial integration during the GFC. He suggests that emerging economies benefited from their “structure of international investment” as holding both liquid foreign currency and safe foreign debt assets during the GFC provided a substantial buffer. However, the portfolio profiles of many advanced economies – such as “long equity, short debt” – proved risky in the face of declining financial markets because of negative valuation effects. According to Lane (2013), we conjecture that various financial instruments – such as equities, bonds, derivatives, and loans – and their international linkages play different roles in spreading shocks across countries.³

In addition, although extensive studies on finance have focused on contagion across financial markets, relatively few have examined the transmission of negative financial shock to the real economy. Frankel and Saravelos (2012) and Rose and Spiegel (2010, 2012) approach the issue of contagion in the real economy during the GFC from a macroeconomic perspective. Kalemli-Ozcan et al. (2013a) investigate the effect of banking integration on real business cycle synchronization during the GFC. However, previous literature has not fully examined the effect of capital (equity) and credit (debt) market integration on the real economy.

Our study investigates how the effect of the GFC on real business cycle co-movement varied for capital and credit market integration for 57 countries with the United States, the origin of the GFC, during 2001–2013. When the crisis is contagious, both the origin and other countries experience economic downturn and their business cycles become more synchronized. Thus, we interpret the effect of the crisis on business cycle co-movement between the United States and the rest of the world as the degree of real economic contagion after controlling for other important determinants of business cycle co-movement. Then, we examine business cycle co-movement during the GFC with financial integration in two specific markets: capital (equity) and credit (debt).

With a simultaneous equation model that controls for endogeneity, we find that during the GFC, the business cycle co-movement between the United States and each of the other countries increased more when the United States and its partner had higher capital market integration, and decreased more when the pair had higher credit market integration. The results are robust even when including investment channels, local fundamental factors, endogenous policy responses across countries, and alternative measures for financial integration and business cycle co-movements.

Our findings provide significant evidence that correlated equity positions caused by extremely “large-scale” negative financial shock during the GFC did not buffer the transmission of the shock and rather increased business cycle co-movement. By contrast, undiminished demand for safe US debt assets during the GFC did not set off a chain reaction of debt collateral and did not amplify the negative shock.⁴

¹ Baele et al. (2004) summarize the benefits of financial integration shown in previous literature: financial integration provides greater risk sharing by diversifying portfolios, improves capital allocation and makes the financial system more efficient by reducing transaction barriers, and creates economic growth via financial development.

² Please see Claessens et al. (2001) for an excellent review of the literature on contagion.

³ For instance, Ahrend and Goujard (2014) find that different types of financial linkages have different influences on asset price co-movement during the GFC. However, the difference is that our main interest is the international business cycle whereas they focused on asset price co-movement.

⁴ This result is in line with Prasad's (2014) argument about the “rush to safety,” which shows investors' special preference for US dollar-denominated assets.

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