CHAPTER 1

Introduction

The world has become more integrated, not just through trade but through financial flows. Financial integration offers many benefits but also poses risks. This observation in turn points to the question of how best to benefit from greater financial integration while limiting adverse effects. A complicating factor in improving the benefit-cost tradeoff from financial integration is that banks often play a central role in intermediating these flows. Banks behave in ways that differ from those predicted by textbooks of atomistic participants in financial markets. In addition, they are subject to uncoordinated regulatory and political forces that are and hard to predict.

In this report, we draw on the growing body of evidence on cross-border capital flows in an effort to better understand their effects in practice. Building on this analysis, we suggest ways in which policy should be adapted to reap the benefits of the flows while minimizing their costs. While bank flows cannot be studied in isolation, our analysis and policy recommendations focus on banks, as they intermediate a substantial fraction of cross-border capital flows, are highly volatile, and pose specific regulatory and policy challenges.

The textbook case for financial integration is well known. It allows capital to flow from capital-rich to capital-poor economies, where returns should be higher. These flows complement limited domestic saving in capital-poor countries and reduce their cost of capital, thus boosting investment and growth. Financial integration can also help cushion the impact of adverse shocks, since consumption can be smoothed by external borrowing even if incomes are volatile, while capital flows can help to sustain investment. Financial integration can provide risk diversification by allowing residents to transfer domestic risks to foreign investors while gaining exposure to foreign investment opportunities.

In addition, financial flows may have "collateral" or indirect benefits. Foreign direct investment (FDI) can bring new technologies, along with managerial and organizational expertise, to the receiving country. International investors tend to demand more transparency and better governance of local firms. By providing risk-bearing capital, financial integration can help domestic firms specialize, fostering faster productivity growth. Monitoring by international investors can discipline macroeconomic policies, encouraging governments to pursue sustainable fiscal policies and enlightened prudential strategies. These indirect benefits of financial openness thus promise faster economic growth.

Even diehard proponents of liberalized, open financial markets make some allowance for a