Volatility in International Financial Market Issuance: The Role of the Financial Center

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Summary

The explosion of capital flows to emerging markets in the early and mid-1990s and their reversal following the crises in Asia, Latin America, and the transition economies have reignited a heated debate on the benefits and drawbacks of financial globalization. Many argue that globalization has gone too far and that international capital markets have become extremely erratic. They further argue in favor of the imposition of controls on the capital account to reduce the volatility of capital flows and limit the impact that financial turmoil has on real economic activity.

In this paper, we examine further whether, in fact, international capital markets have become more erratic. In particular, we look at the behavior of volatility of primary gross issuance in international financial markets since 1980. We look at both emerging economies and industrial countries. We show that, although international issuance has experienced several episodes of booms and busts, over the last thirty years there has been a substantial reduction in the degree of market volatility over the long run. Markets are more stable now than they were at the beginning of the 1980s, thus providing a rationale for the elimination of controls on capital flows.

We also show that the time-varying volatility of issuance in international financial markets can be explained in part by real and financial developments in the financial center. In particular, the lower volatility of U.S. monetary policy and interest rates has significantly contributed to stabilize the pattern of issuance in financial markets throughout the world. Interestingly, we also find that shocks in the financial center explain a large share of volatility of mature-economy issuance in international markets. In contrast, most of the volatility of the emerging-periphery issuance in international markets is explained by domestic factors. This result agrees with the findings of the literature on financial crises, which indicate that financial turmoil in emerging economies is mainly triggered by domestic and financial vulnerabilities and not by external shocks**.** From a policy point of view, the implications of our findings appear to be significant. In particular, our results indicate that more stable monetary policies in mature economies have contributed not only to more stable economies in industrial countries but also to less erratic international financial markets. Nevertheless, our results for emerging economies suggest that in order for these economies to gain continuous access to international capital markets, they should address domestic vulnerabilities.