Research on International Finance:

Current Account, Financial Crisis and Trilemma Policy

Abstract:

The motivation to reduce the transaction costs and uncertainty in the financial system has promoted international financial development and integration. Most countries have reaped a large steady-state welfare gain from global financial integration (Obstfeld, 1994). International financial integration has also been recognized to accelerate economic growth, regardless of the level of economic development (Edison et al., 2002). However, due to the expanded scale and globalization of the financial sector, a small disturbance may also cause a widespread chain reaction internationally. The heightened global risk and several large-scale global financial crises over the past two decades have proven the vulnerability of the current global financial system. The catastrophic damage of the contagion effect from the financial crisis in neighboring countries also induces the debate of the pros and cons of financial globalization, especially for developing countries.

Several factors contribute to the vulnerability of the global financial system. Generally, the degree of global integration is an important factor in determining the countries financial market transmission process (Ehrmann and Fratzscher, 2009). However, simultaneously, the importance of country-specific macro policy is also emphasized by some research. For example, Bekaert et al. (2013) indicated that a lax monetary policy increases domestic risk and uncertainty. Moreover, not only to bring effect to domestic country, but the national policy stabilization by one country can also benefit other countries, reducing incentives to implement credit policies in a classic free-riding problem (Dedola et al. 2013).

Against the backdrop of these heightened potential risks, financial globalization benefits a country directly by allowing a faster capital accumulation through free capital flows and reducing investors' risk through international portfolio diversifications. In addition, Kose et al. (2009) argue that the indirect effects of financial globalization on financial market development, better institutions and governance, and macroeconomic discipline are likely to be far more important than any direct impacts. So, under this background, an appropriate home country financial policy seems particularly more important than ever before. Therefore, this study focuses on recent unsolved issues in international finance, which constitute the following three subjects.

Firstly, as Obstfeld (2012) emphasized, the current account remains one of the most important policy issues in recent years. A large current account deficit is considered a

significant indicator of the financial crisis (Catao and Milesi-Ferretti 2014 and Kaminsky and Reinhart 1999). On the other hand, a persistent current account surplus can lead to a current account imbalance between domestic and partner countries, which may provoke political conflicts, like the 1980s US-Japan trade conflict and the US-China trade war in recent years. We revisit Glick-Rogoff's model, in which productivity shocks act as a key driver of current account changes, and apply the model to the fast growth BRICS countries.

Second, several large-scale financial crises have ravaged the world over the past two decades. The first was the Asian financial crisis of 1997, and the second was the global financial crisis of 2008. These financial crises have revealed the vulnerability of economic systems in both developed and developing countries. Because the determinants and impacts of financial crises vary by type of crisis and by country, it is critical to identify the determinants of each kind of crisis in various settings. At the same time, several works have reported that the type of financial structure, whether bank-based, market-based, or a combination of the two, matters for economic performance. As a combination of those previous studies, we believe that it is important to empirically test whether financial structure affects the probability of the financial crisis occurrence. In the second part, our main objective is to clarify whether and how financial structure affects the likelihood of a financial crisis and the role of capital openness within this effect.

At last, the trilemma hypothesis as a concept in international economics states that a country can only achieve two but not all three polity goals: monetary independence, exchange rate stability, and free capital movement. Several previous works have confirmed the influence of trilemma policy variables on macro-economic performance. However, under the impossible trinity hypothesis, are policymakers forced to choose only two policy goals out of monetary independence, exchange rate stability, and free capital movement to achieve an optimal solution indeed? Moreover, how can we keep the trilemma policy in an optimal situation? Around these questions, our main objective of the third part is to clarify whether, and how if yes, trilemma policy and macro-economic performance affect each other.