Financial globalization is a double-edged sword for emerging market economies (EMEs). It offers potentially large economic benefits and major risks.

The risks work through multiple channels. First, global financial forces transmit external shocks and financial conditions through interest-rate linkages. As a result, EMEs with open capital markets are heavily exposed to shocks and developments over which they exert little control. Second, policy decisions in other countries, principally the United States, affect interest rates and credit conditions around the world through monetary policy spillovers. Policy decisions by the Fed need not yield financial conditions that suit EMEs. Third, international capital flows bring risks and potential disruptions in other ways, as I discuss in this post.

One way is by increasing the elasticity of credit supply to the domestic economy. In a closed economy setting, the domestic credit supply restrains a borrowing binge propelled by optimism about the domestic economic outlook, whether warranted or not. As borrowing expands and bumps up against the limits of domestic supply, rising interest rates temper the credit boom. In an open economy setting, external credit adds an extra source of financing for EMEs, relaxing the restraints on a domestic credit boom and possibly setting the stage for a larger bust afterwards. The potential for capital flows to facilitate a harmful credit-boom-and-bust cycle requires careful attention by EME policy makers.
Portfolio demand shifts in rich countries are another source of risk associated with international capital flows. For example, rich-country portfolio shifts in favor of EME assets can cause a surge in gross capital inflows, with powerful effects on domestic financial conditions and asset prices. Maury Obstfeld analyzes the implications of such portfolio shifts for EME policymakers in a thoughtful paper recently delivered at the Asian Monetary Policy Forum.

“Where these portfolio shifts are accommodated through the home central bank’s intervention, the financial inflows finance foreign reserve increases. Where the central bank instead allows currency appreciation, net private claims by foreigners still rise, albeit gradually over time, due to a reduced current account balance. China’s case shows how both mechanisms can operate at once. Whether the central bank intervenes or not, domestic financial conditions are affected immediately, though the expansion effect is probably bigger when intervention occurs and causes an increase in the domestic money supply and domestic bank credit.”

These capital inflow surges can cause a range of dislocations. First, and perhaps most obviously, they create vulnerabilities to capital-flow reversals down the road. Second, by driving up real estate prices and the value of other assets that can serve as collateral for loans, capital inflow surges can fuel a domestic credit boom, raising concerns about financial stability. Third, unless fully neutralized by the central bank through foreign reserve additions, capital inflow surges place upward pressure on the exchange rate value of the domestic currency. The resulting currency appreciation reduces the competitiveness of domestic exports.
As Obstfeld remarks, countries that resist currency appreciation tend to experience greater upward pressure on asset prices and domestic credit growth.

In summary, global financial forces affect financial and economic conditions in EMEs through interest-rate linkages, monetary policy spillovers, and international capital flows. These forces present EME policy makers with complex tradeoffs in the conduct of monetary policy, exchange rate policy, and financial regulation. Obstfeld and other participants in the Asian Monetary Policy Forum provide useful insights into how EME policymakers can best manage these tradeoffs.

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