Living with Financial Globalization: Interest-Rate Linkages

By Steven J. Davis

International financial linkages offer the potential for large economic benefits while presenting major risks and difficult policy challenges. The recent Asian Monetary Policy Forum features a thoughtful paper on the policy challenges by Maury Obstfeld. He considers the capacity of emerging market economies (EMEs) to use monetary policy and macroprudential tools to moderate the domestic effects of global financial forces.

In thinking about this issue, a first order of business is to recognize the power of global financial forces to create and amplify stresses in EME financial systems and to rock their economies. Even EMEs with strong growth records, persistent current-account surpluses, and relatively sturdy financial systems are vulnerable to the potentially disruptive effects of these forces. Global financial forces affect EMEs through multiple channels. I consider interest-rate linkages in this post.

Mobile financial capital transmits financial conditions internationally through term and risk premia in interest rates that, in turn, affect asset values and the cost of funds in the domestic economy. As a vivid example, the following chart highlights the effects of the Global Financial Crisis (GFC) on the borrowing costs of businesses in South Korea. As the GFC intensified after August 2008, borrowing costs rose sharply for Korean businesses, more so for those with lower credit
ratings. These higher borrowing costs restrained investment spending and hiring activity by Korean businesses.

Korean Borrowing Spreads

![Graph showing Korean Borrowing Spreads]


It’s worth recalling a few of the dramatic events that unfolded during September 2008. Mounting losses on mortgages and mortgage-related securities and guarantees compelled the U.S. government to place Fannie Mae and Freddie Mac in conservatorship on 7 September. Lehman Brothers filed for bankruptcy on 15 September, roiling financial markets worldwide. A day later, losses on its Lehman debt holdings caused the Reserve Primary Money Fund to “break the buck,” triggering a widespread run on money market funds. The Fed and the Treasury soon responded with unprecedented policy actions to stem the panic and shore up
U.S. money market funds. On 17 September, the U.S. government seized control of AIG, a massive insurance company, to head off what policymakers saw as a potentially catastrophic failure. A week later, the FDIC closed Washington Mutual in the largest commercial bank failure in U.S. history.

As this short recitation of events reminds us, the United States and its financial system were the epicenter of the GFC. Global financial linkages quickly transmitted the shocks associated with these events to borrowing costs in South Korea and other countries. The capacity of Korean policymakers to mute or offset these developments was limited, and their economies suffered for it.

Obstfeld provides evidence that monetary policy affords EMEs some ability to moderate the effects of external shocks on shorter-term domestic interest rates. Longer-term rates, however, are less responsive to domestic monetary policy and more subject to global financial conditions, even in EMEs that operate with flexible exchange rate systems. Thus, shocks and developments that originate elsewhere can sharply raise the cost of funds in the domestic economy, as illustrated in the chart, and drive asset valuations downward.

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