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Literature Survey on Global Financial Cycle and its implications for Emerging Economies

Shikha Malhotra

Research Scholar, Jain (Deemed-to be university)

Bangalore, India

and

Dr Chaya Bagrecha

Professor (Finance), CMS Business School-Jain (Deemed-to be university)

Bangalore, India

Abstract

Over the past few decades, there is a dramatic increase in financial globalization. In the light of the presence of a global financial system, where many developing and emerging economies are increasingly financially integrated with the world markets, the existing literature has outlined the presence of Global Financial Cycle. Global financial Cycle is related to the simultaneous co-movement of international capital flows, asset prices and credit growth at the global level. This is influenced by the US monetary policy decisions because of the importance of US dollar as a currency in the international financial markets and the role of US as a hegemon because of its relative size. The existence of such cycle can potentially have real implications for individual countries.

The extensive survey of the extant literature on Global financial Cycle and its implications have been studied in this Paper. The role of Global financial cycle in driving the international capital flow movements to advanced and emerging economies have been discussed and documented in the existing literature. But there is a renewed interest in understanding the linkage between financial variables and macro-economic development in the individual countries. The study on the role of Global financial cycle in influencing the financial and real economic development in Emerging Market Economies is still scarce. This study is carried out to make a comprehensive evaluation of Global Financial Cycle and its implications for the economies of emerging markets.

Keywords: Global financial Cycle, Emerging Market Economies, Capital flows, Asset prices, Business Cycle.

1. Introduction

After the onset of intense globalization process in mid-1980s, the strength of financial variables in influencing the economies has increased. The increased financial integration among the world markets has shifted the debate on presence of a phenomenon called Global Financial Cycle (GFCy). This accounts for the simultaneous movement of international capital flows, asset prices and credit growth across the boundaries. This cycle is influenced by monetary policy decisions by the Federal Reserve. When there is an easing of a monetary policy by Fed, the financial investors will move their capital to the emerging markets in the search of a higher yield. This was particularly evident after the global financial crisis (2007-09). The rates of interest were slashed by the US government to deal with crisis and to increase the aggregate demand. Most of the investors withdrew their money and parked in emerging economies where rates of interests were attractive. This is a conventional mode of monetary policy. When unconventional monetary policy measures like quantitative easing were undertaken by the Fed after the global financial crisis, there was an abundant supply of liquidity in the system. Rates of interests had hit zero lower bound in advanced economies like the US and money crossed the boundaries in search of a higher yield. Emerging Markets received abundant supply of flows during that period. But when announcements were made by Fed in 2013 for rolling back of quantitative easing measures, money immediately flew back to the advanced economies in anticipation of higher yields and safe investment havens. This creates an environment of high-risk aversion of the investors in the markets and is indicated by high VIX (Volatility Index published by Chicago Board of Exchange). VIX is considered the proxy of a global financial cycle in the existing literature (Rey, 2013; Cerruti et al.,2017)

Rey (2013) had given a definition of a global financial cycle as

Global financial cycles are associated with surges and retrenchments in capital flows, booms, and busts in asset prices and crisis and are characterized by large co-movement in asset prices, gross flows, and leverage.

As per the author (Rey, 2013), changes in the monetary policy of center economy (US) and global risk aversion of investors would drive the GFCy, leading to swings in capital flows asset prices and credit growth globally. The US monetary policy decisions play a significant role in shaping the global financial conditions through the leverage of global banks and significant role of dollar in the international markets. The variations in capital flows and credit growth in the emerging markets due to decisions made by advanced economies like US would have several repercussions in the form of disruption in their credit and business cycles. It would make difficult for policymakers to take any decisions regarding domestic conditions by ignoring global trends; for example, a decision regarding a flexible exchange rate regime and an independent monetary policy (M Habib et al.,2019).

2. Review of Literature

The impact of global financial factors on domestic monetary policy decisions has increased for open Emerging Market Economies after the greater integration of these markets with the world markets. The GFCy has the capacity to influence financial conditions in EMEs through various channels (Rey 2013, 2015). The most prominent channel of that spillover effect is capital flows channel which is extensively discussed in the existing literature (Rey, 2013; Cerutti et al., 2017, M Habib et al., 2019). Rey (2013) had postulated that there is an increase in gross flows to EMEs when VIX is low (global volatility is low) and there is an increase in reversal of these flows from the EMEs when VIX is high (global volatility is high). Forbes and Warnock (2012) and Bruno and Shin (2013) had emphasized the same with surges in gross inflows with the lowering of the VIX.

There are two main dimesons of this phenomenon called GFCy. First is Capital flows and other one is asset price inflation. The biggest challenge is to understand the manifestation of this cycle in EMEs. The cyclical nature of the financial flow movements has many denominations which are explained in the literature like Surges, reversals, retrenchment, bonanza, waves or international financing cycles) (Forbes and Warnock, 2012; Scheubel B et al., 2018). The expansion and contraction of external financing in the form of international capital flows to emerging economies is attributed to the global financial cycle. The determinants for the same outlined in the existing literature are interest rates of countries issuing currencies like US and risk appetite of the investors in the international financial markets (Rey, 2013, 2015). These factors explain the variations in the movements of capital flows of all the categories to EMEs.

Nier et al (2014) studied and concluded that when VIX is high (during the period of financial stress), there is a sudden outflow of capital flows from emerging markets to the advanced countries. The fundamental aspects of any country do not play a much role in these situations. On the other hand, when VIX is low, there is no impact of global factors in explaining the variations of capital flow movements to EMEs and domestic fundamentals only play a dominant role in such situations.

Cerutti et al (2017) contested the idea of global financial cycle explaining the variations in the capital flow movements to a sample of 85 counties, both advanced and emerging economies. They concluded that global financial cycle does not explain more than 25% of the variation in capital flow movements to these economies. But they did not emphasize on the disaggregated capital flows like portfolio flows, cross border loans and foreign direct investments separately. Habib et al (2019), on the other hand, concluded that global stock market factor (a proxy of global financial cycle) explains the variations in other investments (this type comprises of global banks' leverage) for a sample of emerging economies.

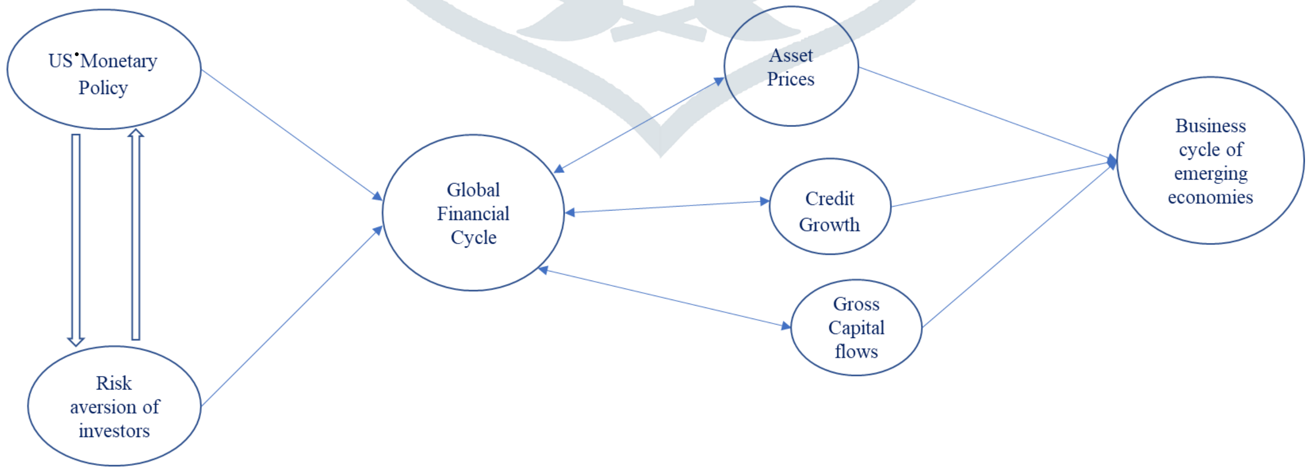
Concerning the other part, the determinants of global financial cycle also impact the asset prices across the globe be it stock prices, prices of bonds and property prices. The dynamics of asset prices inflation can be related to capital flows. The assets can be categorized in three parts; monetary, financial and real. These include the influence of global financial cycle on nominal exchange rates, stock market returns, housing prices, and GDP of EMEs.

Andaiyani et al (2017) explains that contribution of global financial cycle in explaining the variation in credit growth in ASEAN-4 countries, is more than explaining the variation in stock prices and housing prices in the long term (more than 5 years).

The above studies indicate that global financial cycle, triggered by change in monetary policy decisions by the Federal Reserve and the risk aversion of investors, has the capacity to influence the monetary, financial and real conditions in the emerging markets. The implications of global financial cycle for the emerging markets are an important topic of study which is not extensively explored in the existing literature. The studies related to that are still scarce.

3. Implications for the Emerging Economies.

The existing research on the impact of the GFCy on EMEs is still scarce and inconclusive. The existing literature has focused on the determinants of the global financial cycle and the impact of GFCy on capital flow movements across boundaries. There is an increased amount of capital flow movements to EMEs after the global financial crisis. The increased reliance on foreign capital in an emerging country is a manifestation of liberalization and financial integration with the world markets. As there are several benefits of foreign capital, most emerging Asian economies have adopted liberalized policies since the 1990s and have received an increased amount of foreign capital of \$ 25.035 billion per year in 2000 to \$ 199.698 billion per year in 2020 (World Economic Outlook database IMF 2020). This availability of foreign credit amplifies the credit growth in domestic economies of the emerging markets through the 'risk taking' channel of global financial institutions (Borio et al., 2012). The increased receipt of capital flows in the economies induces domestic currency appreciation. This in turn strengthens the balance sheet of the financial institutions (those who borrow in foreign currency as domestic currency appreciation increases the value of their assets) and thereby reduces their credit risk and thus risk premium. These greater amounts of inflows can be used to increase the credit in the domestic economies, esp. when credit conditions are relaxed (Agenor and Silva, 2018). Excessive credit creation in any economy, more than which can be absorbed by it, often results in the financial crisis (Reinhart and Rogoff, 2009; Aikman et al., 2014). The impact of global financial variables on domestic conditions of emerging economies has increased post global financial crisis (Dees, 2016). The global credit cycle and its synchronization with domestic credit cycles of the domestic economies of emerging markets can have a strong influence on the disruption of the business cycles of EMEs. Prabheesh et al (2021) explained that global financial cycle and global credit cycle do have a direct impact on domestic business cycle in India through risk taking channel of global financial institutions. If global conditions are volatile then there is a risk of disruption of business cycle of the emerging markets which can have repercussions for their consistent growth.



4. Conclusion

Assessing the role of global financial cycle and its transmission to real economic conditions of the emerging markets is very important. Financial factors played a lesser role in influencing the macro-economic conditions in EMEs, before the crisis period. But their influence has strongly increased after the global financial crisis. This can be attributed to the changing dynamics of monetary policy decisions by the advanced countries after the global financial crisis. The spillover effect of those policies and the interdependence of real, monetary and financial variables globally is being studied post the crisis period only. Understanding the dynamics of real-financial linkage by only including the credit cycle will not fully explain the global financial cycle. Borio (2012) had rightfully iterated that considering the situation of increased financial globalization for the last few decades, it is not possible to understand the business fluctuations and the policy challenges in the respective countries without understanding the full financial cycle. As inclusion of credit variable significantly improves the modelling of studying the linkage between financial and real factors (XU, 2012), It is very important to include the asset prices like stock prices and property prices also. Suitable policy responses to real-financial linkage can be arrived at for the respective countries only after all the variables are included in the model under study. Therefore, international transmission of global financial shocks to real economic activity of emerging markets is not explored in the existing literature. Factors other than asset prices and credit can also be included in the model to understand the linkage. For example, capital openness of the countries, trade openness, foreign reserves built to fight the crisis situation and external debt. These factors can differentiate an economy's vulnerability towards global shocks from the economy which has sound macro-economic fundamentals. This will help in arriving at suitable policy actions.

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