International Financial Integration and Increasing Demand for International Liquidity

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Since the second half of the 1990s, international capital flow has enlarged tremendously. Specifically, gross foreign assets and liabilities relative to GDP has increased rapidly, with the increase in gross cross-holdings of assets (Lane and Milesi-Ferretti, 2003). Lane and Milesi-Feretti call this phenomenon *increasing international financial integration*. On the other hand, the U.S. current account deficit has grown tremendously since 1998, both as a percentage of the GDP and in nominal value. It reached 670 billion dollars or 5.7% of the GDP in 2004.

Is it accidentally that the U.S. current account deficit began to grow rapidly around 1998 just after the international financial integration had started to proceed? Although a number of authors analyze the effect of international financial integration on the adjustment of global imbalances and stress the so-called valuation effect, few authors recognize the relationship between the expansion of the global balance sheet and the origin of the U.S. current account deficit. This paper investigates the effects of the international financial integration on demand for international liquidity and on the current account balances.

We imagine a simple story: a gross increase in international capital flow may stimulate global demand for liquid asset denominated in U.S. dollar, or the international liquidity, which is in turn connected with an increase in deficit of the U.S. current account balance. We examined the possibility of this story by investigating basic accounting identities.

First, we investigated the effects of an exogenous increase in international liquidity demand which is not directly caused by international financial integration. If an increase in the ratio of international liquidity to the overall external asset brings about a capital loss on the existing non-liquidity external asset, a current account surplus is needed after the shock to keep the ratio of net external asset to GDP constant under some condition. Both the probability that a surplus is needed and the extent of the surplus would get larger, as international financial integration deepens, or as the sum of gross external asset and debt positions swells.

Second, we examined the effects of an endogenous increase in international liquidity demand caused by international financial integration. Along the target net external asset position, the current account of a net creditor country tends to be in surplus, while that of a net debtor country tends to be in deficit. This asymmetric outcome is caused by the sign of the valuation effect on the existing net external asset. Deepening of international financial integration strengthens the valuation effect, and thus also intensifies the asymmetric movements of the current account.

By combining these analyses, the following conclusion can be attained. As for a net creditor country, it is very likely that international financial integration would move the current account towards in a surplus and enlarge surpluses along an increasing trend of international liquidity demand. As for a net debtor country, it depends on which of the two effects acts more strongly whether the current account moves into surplus or not with a growing integration of the international financial market. Further increases in the current account surplus of the ex-ante net creditor countries since the end of 1990's may reflect the rapid growth of international financial integration. The sharp reversals in the current account of the East Asian economies, most of which have been net debtors, might be partly resulted from an abrupt increase in demand for international liquidity after the Asian Crises.

Reference:

Lane Philip R. and Gian Maria Mlesi-Ferretti (2003) "International Financial Integration," *IMF Staff Papers*, Vol.50 (Special Issue), pp.82-113.