

FINANCIAL GLOBALIZATION AND THE GOVERNANCE OF DOMESTIC FINANCIAL INTERMEDIARIES

Thierry Tressel
International Monetary Fund

Thierry Verdier
Paris-Jourdan Sciences Economiques (PSE)
and University of Southampton

Abstract

We model a small open economy in which both domestic financial intermediaries and entrepreneurs face incentive constraints, as in Holmstrom and Tirole (1997), to study the general equilibrium impact of various types of capital inflows on the efficiency and governance of domestic banks. Banks have an advantage in monitoring firms, but the latter can collude with banks and offer side-payments to reduce the intensity of monitoring. Opening up to international capital flows makes domestic banks' capital scarcer relative to uninformed capital, thus increasing the relative cost of monitoring. We show that capital account liberalization has ambiguous effects on the governance of the domestic financial system by sometimes increasing firms' incentives to collude with banks. We characterize the conditions under which governance is more likely to deteriorate after opening up the capital account, and discuss the effects on investment, productivity and output. We also analyze the effects of foreign direct investment in the corporate and banking sectors. Stylized facts are consistent with the predictions of the model. (JEL: G21, F34, O16)