

# Financial Market Globalization and Asset Price Bubbles

Naoki Yago\*

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## Abstract

The recent boom-bust cycles of asset prices are characterized by massive in- and out-flows of foreign speculative investments. To explain this phenomenon, we develop a two-country model of rational bubbles with asymmetric degree of financial development. We show that financial market globalization facilitates the emergence of bubbles when the domestic financial market is either over- or underdeveloped relative to foreign ones, while globalization prevents bubbles when domestic pledgeability is in a middle range. Furthermore, we also identify a two-way feedback relationship between capital flows and bubbles: capital inflow facilitates bubbles, and bubbles, in turn, promote capital inflow.

*Keywords:* Financial globalization, Asset bubbles, Credit friction

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\*Graduate School of Economics, The University of Tokyo, 7-3-1, Hongo, Bunkyo-ku, Tokyo 113-0033, Japan (e-mail: yago-naoki097@ecc.g.u-tokyo.ac.jp). I would like to thank my advisor, Tomoyuki Nakajima, for his guidance and insightful comments. I have also greatly benefited from the continuous discussions with Kosuke Aoki and Tomohiro Hirano. I would also like to acknowledge the helpful comments from Levent Altinoglu, Katsuhito Iwai, Nobuhiro Kiyotaki, So Kubota, Alberto Martin, Toan Phan, José Scheinkman, Francis Warnock, and the participants to the Aoki Seminar. All remaining errors are mine.