Comments on Philip Lane

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Philip Lane's paper is quite a judicious evaluation of the role played by financial globalization in the way the crisis developed and spread. I have little to add to it. In these brief comments, I want to broaden his discussion in a couple of directions.

To begin with, I want to make the point that a broader evaluation of financial globalization has to take into account its effect over the entire cycle, including any possible growth effects, and not just the crisis. After all, it is possible that financial globalization's downsides are more than compensated by its growth-boosting impact over the longer term.

Indeed, the original argument for financial globalization was that it would accomplish precisely that. It would equalize marginal returns to capital around the world, transfer saving from rich to poor countries, and enhance growth and convergence. In addition, it would offer investors an improved risk-return trade-off through portfolio diversification. And it would contribute to enhanced risk sharing and consumption smoothing across countries. It is interesting that these arguments have receded to the background, in large part because the accumulating evidence has not been kind to them.

The more recent arguments in support of financial globalization are based largely on second-best reasoning. But like all second-best arguments, they tend to cut both ways. It is probably true that financial globalization improves financial competition and financial intermediation, and that is generally a good thing. But what about the argument that it enhances fiscal discipline? Surely, this argument relies too much on the view that financial markets are rational and take a long-term view. There are in fact too many cases where they have enabled profligate governments to go on a spending spree for longer than would be the case otherwise. Similarly, the "collateral benefits" argument that posits financial globalization enhances the rule of law, governance, and institutional quality is equally suspect. Many economists now believe that financial liberalization and globalization have enabled financial interests to capture political systems, with pernicious effects on the quality of governance.

Philip Lane is clear on some of the other ways in which financial globalization aggravates market distortions. It can exacerbate bubbles or excessive risk-taking through leverage, originating from a poor regulatory environment at home or inadequate monetary policies. Poor regulation plus large cross-border flows create the perfect storm. Once the crisis begins to unfold, financial globalization exacerbates balance-sheet externalities and systemic risk driven by the feedback between asset prices and aggregate demand. Globally, it exacerbates the costs of the institutional incompleteness of the world economy – the lack of global deposit insurance, an international lender of last resort, common regulatory and bankruptcy regimes.

Developing and emerging market economies pose further complications. We know that capital inflows and the attendant appreciation of real exchange rates is a serious problem for such economies. In my own work, I have shown that competitive real exchange rates are important not just for short-term macroeconomic balance, but also for longer term growth. When investment and growth prospects are depressed by low private returns to tradables – whether due to market or government failures – easy availability of foreign finance is in fact a handicap rather than a blessing. Investment-demand constrained economies respond to capital flows very differently from credit-constrained economies.

In light of all this, it is not surprising that we find little evidence of any growth benefits from financial openness. This is confirmed in the latest meta-analysis conducted by Jeanne, Subramanian, and Williamson in a forthcoming monograph for the Peterson Institute.

How should policy makers respond to all these complications and uncertainties? Here I find it useful to distinguish between two frames of reference, the first-best and the second-best.

Policy makers with a first-best mind-set put the emphasis on removing the pre-existing market imperfections that create the second-best complications. Their list of recommendations revolves around improving macroeconomic policies and financial regulations and erecting the requisite global regulations and institutions. The trouble with this approach is that it lacks realism in light of both the practical and substantive difficulties in fixing these problems. In particular, the experience of the eurozone should be a cautionary tale on the likelihood of building the transnational governance needed to run an integrated financial system.

Policy makers with a second-best mind-set accept that many of the pre-existing distortions and complications cannot be removed. So they are willing to restrain cross-border finance directly. Capital controls and capital-account regulations become part of the arsenal of policies deployed to discipline financial markets. There are of course many questions here too. Can capital controls be administered without causing even worse problems elsewhere? What kind of controls work better?

This debate reminds me of the debate over gun control in the United States. Gun control opponents are fond of saying: “guns don’t kill people; people kill people.” What they mean by this is that we should intervene only on the relevant margin -- individual misbehavior -- by punishing offenders, but otherwise not restrict the circulation of guns. This is precisely the first-best approach. Gun control proponents, on the other hand, say: “since we cannot perfectly monitor and discipline behavior, and social costs of missing the targets are high, we need to control guns directly.” So they are willing to condone bans on some transactions, including those that would be ex post efficient, as they judge the total benefits to society would be positive. They are applying second-best reasoning.

I would hazard the guess that most economists who debate financial globalization would be on the side of gun control advocates.