Comments on Philip Lane, “Financial Globalization and the Crisis”

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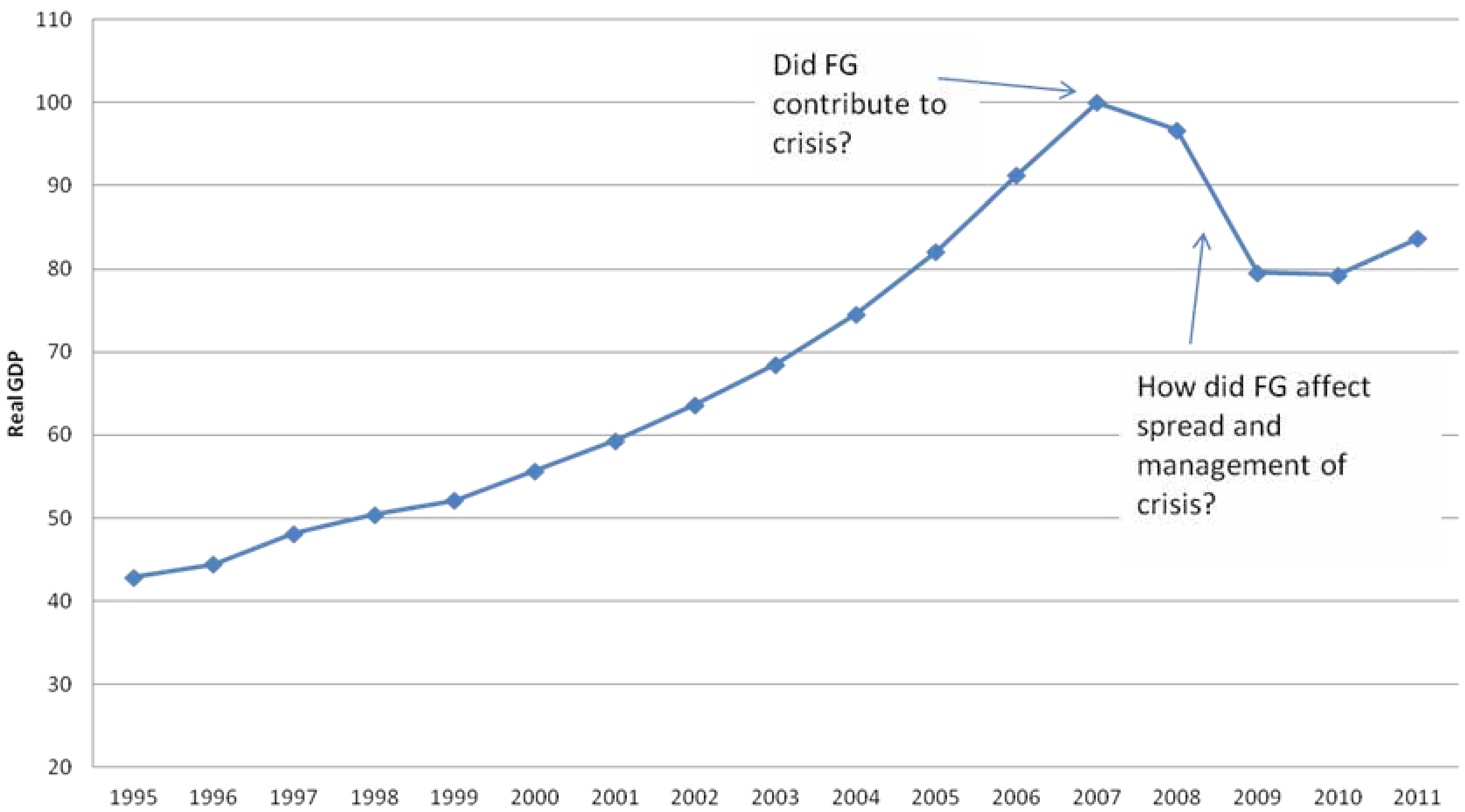
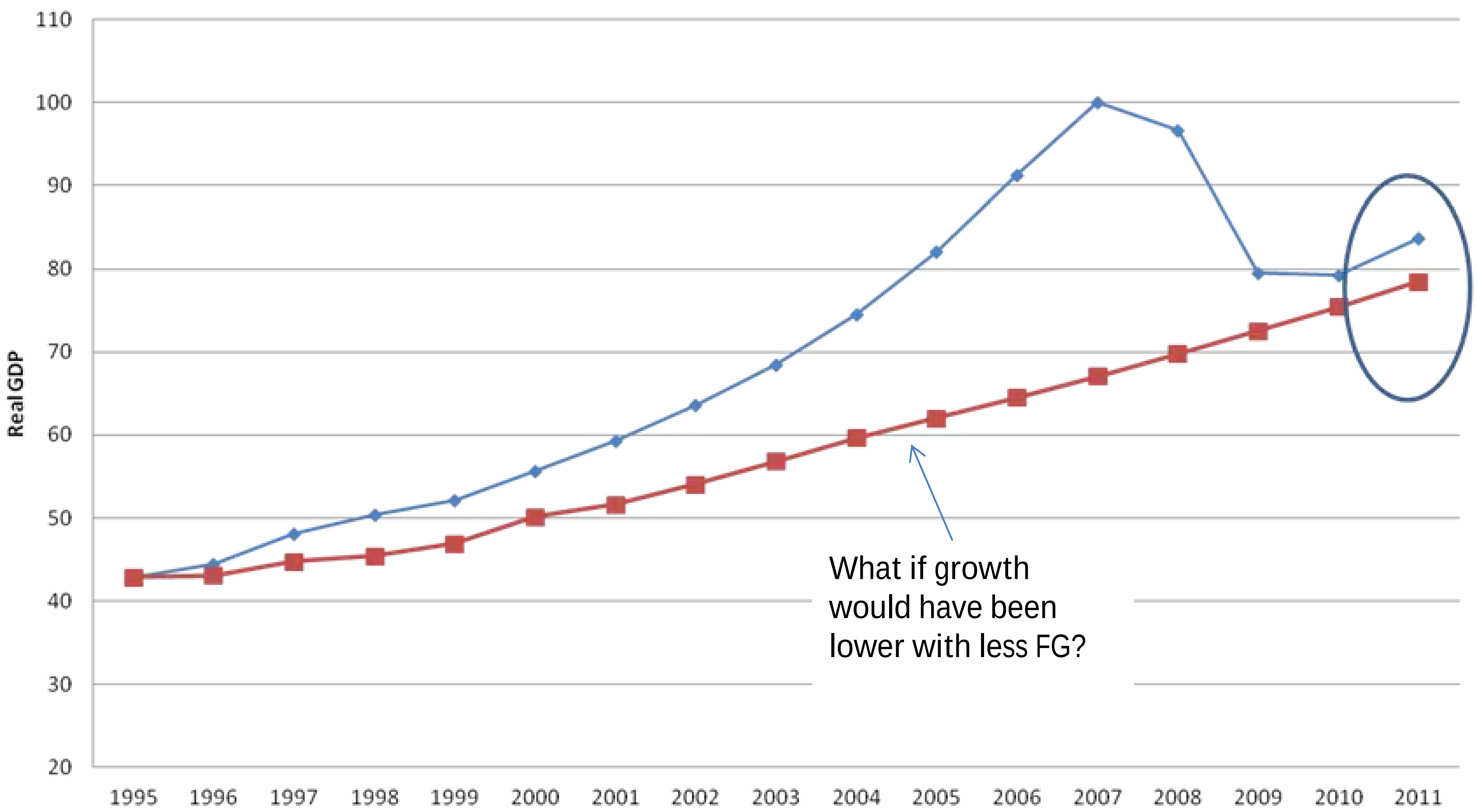
Outline

- Framing the question right
  - What is the relevant counterfactual?
- Analytics: thinking of financial globalization in second-best terms
  - Does it alleviate or exacerbate pre-existing market distortions?
- Policy: a gun-control analogy

What’s the question?



But evaluation of FG requires fuller counterfactual



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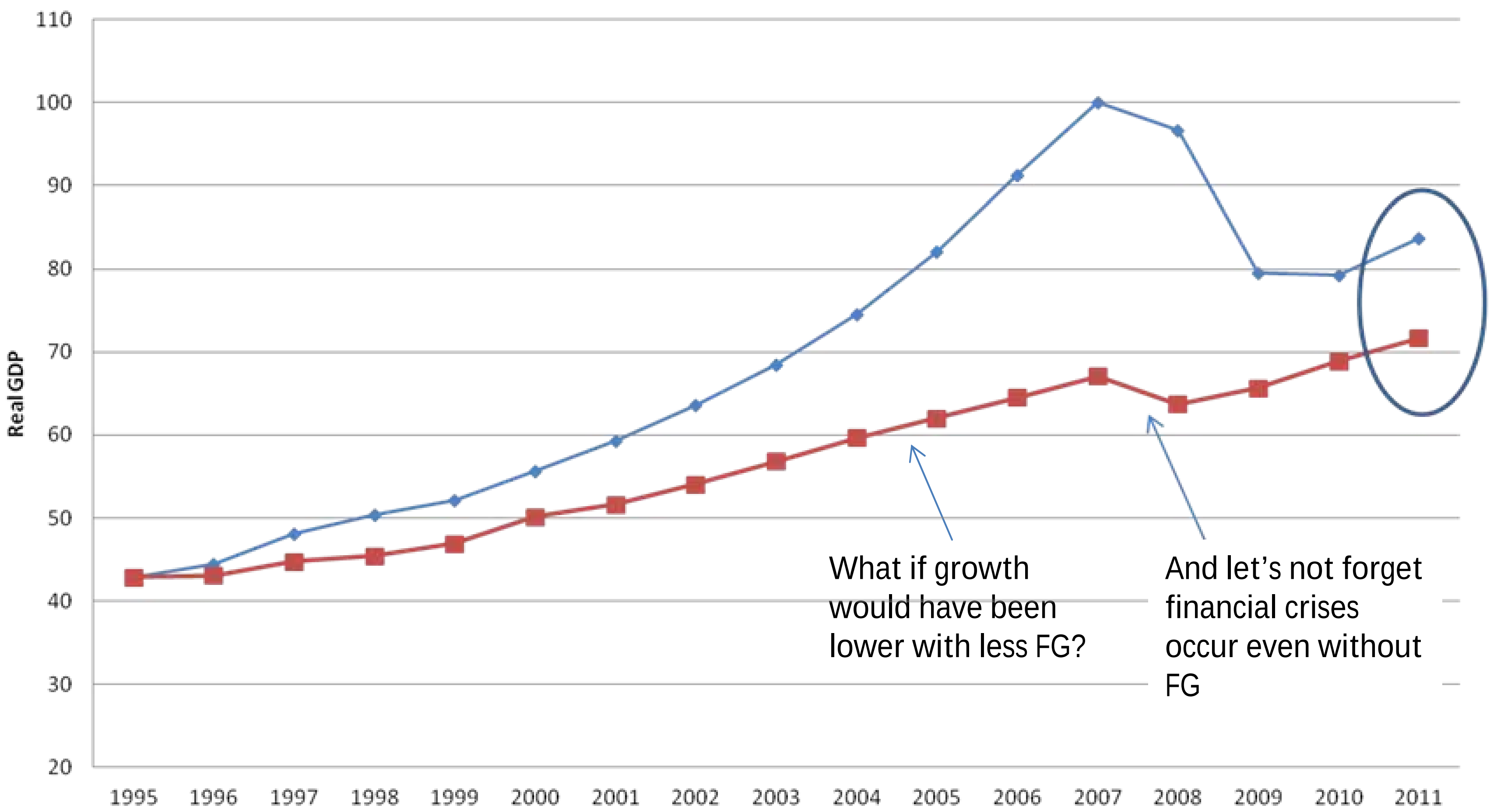


Blue line is Latvia's real GDP

Original arguments for FG

- Equalizing marginal returns to capital around the world
  – transfer saving from rich to poor countries
- Portfolio diversification
  – improved risk-return trade-off
- Consumption smoothing
  – enhanced risk sharing

These arguments have receded to the background, in large part because there has been little evidence for them.

Newer arguments for FG revolve around second-best issues

- Enhance financial competition and financial intermediation
  - probably
- Enhance fiscal discipline
  - Greece?
- Enhance rule of law, governance, institutional quality
  - “collateral benefits”?
  - but “capture by financial interests” story suggests pernicious effects on quality of governance

Second-best arguments also cut the other way

How FG can <u>aggravate</u> market distortions:

- Exacerbate problems of excessive risk-taking, leverage, bubbles originating from presence of poor regulatory environment at home
  - poor regulation + large cross-border flows => the perfect storm
- Exacerbate balance-sheet externalities, systemic risk
  - Feedback between asset prices and aggregate demand
- Exacerbate institutional incompleteness internationally
  - lack of global deposit insurance, ILLR, common regulations, bankruptcy regimes

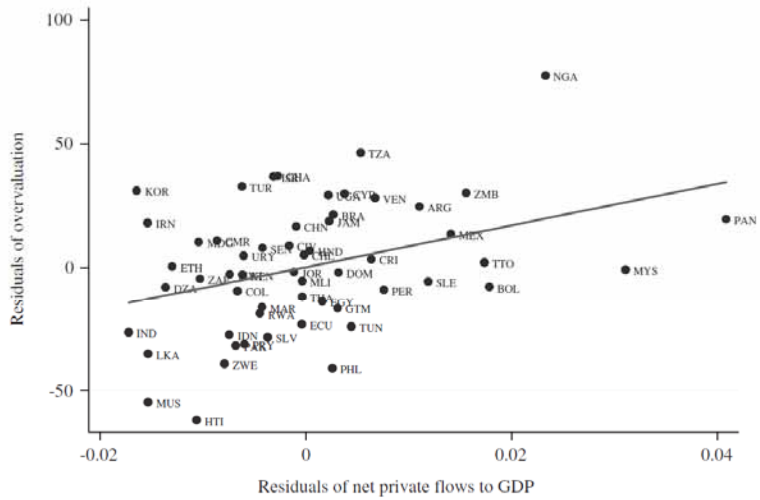
Developing and emerging market economies pose further complications

- Exacerbate (through capital inflows and currency overvaluation) low private return to tradables
  - investment-demand constrained economies respond quite differently to capital flows than credit-constrained economies

Latest meta-analysis finds no evidence of growth-promoting effects from capital-account openness (Jeanne, Subramanian, Williamson, PIIE, forthcoming).

Capital inflows appreciate the real exchange rate, which is costly for growth in developing economies

Figure 4. Overvaluation and Capital Flows, 1970–2004

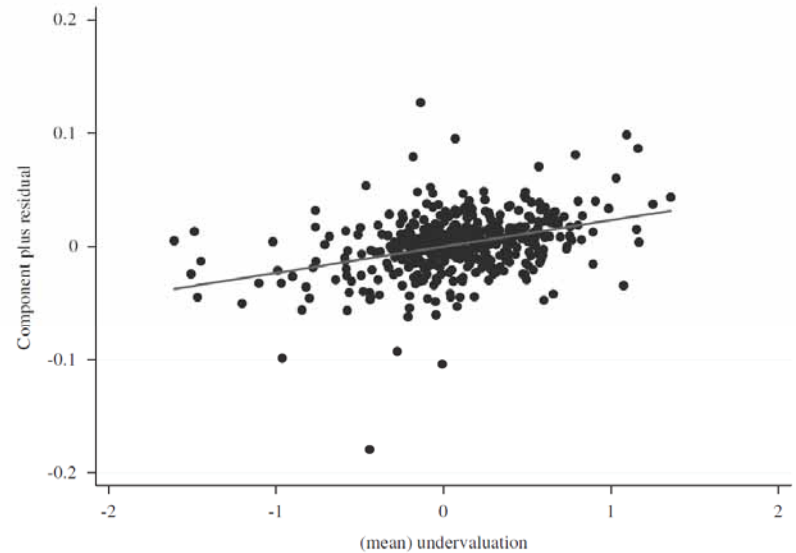


coef = 843.69269, (robust) se = 327.57615, t = 2.58

Source: Reproduced from Prasad, Rajan, and Subramanian (2007).

Note: Partial relationship between a measure of overvaluation of the real exchange rate and net private flows, comprising portfolio equity, debt, and foreign direct investment, controlling for demographics and a dummy for oil-exporting countries.

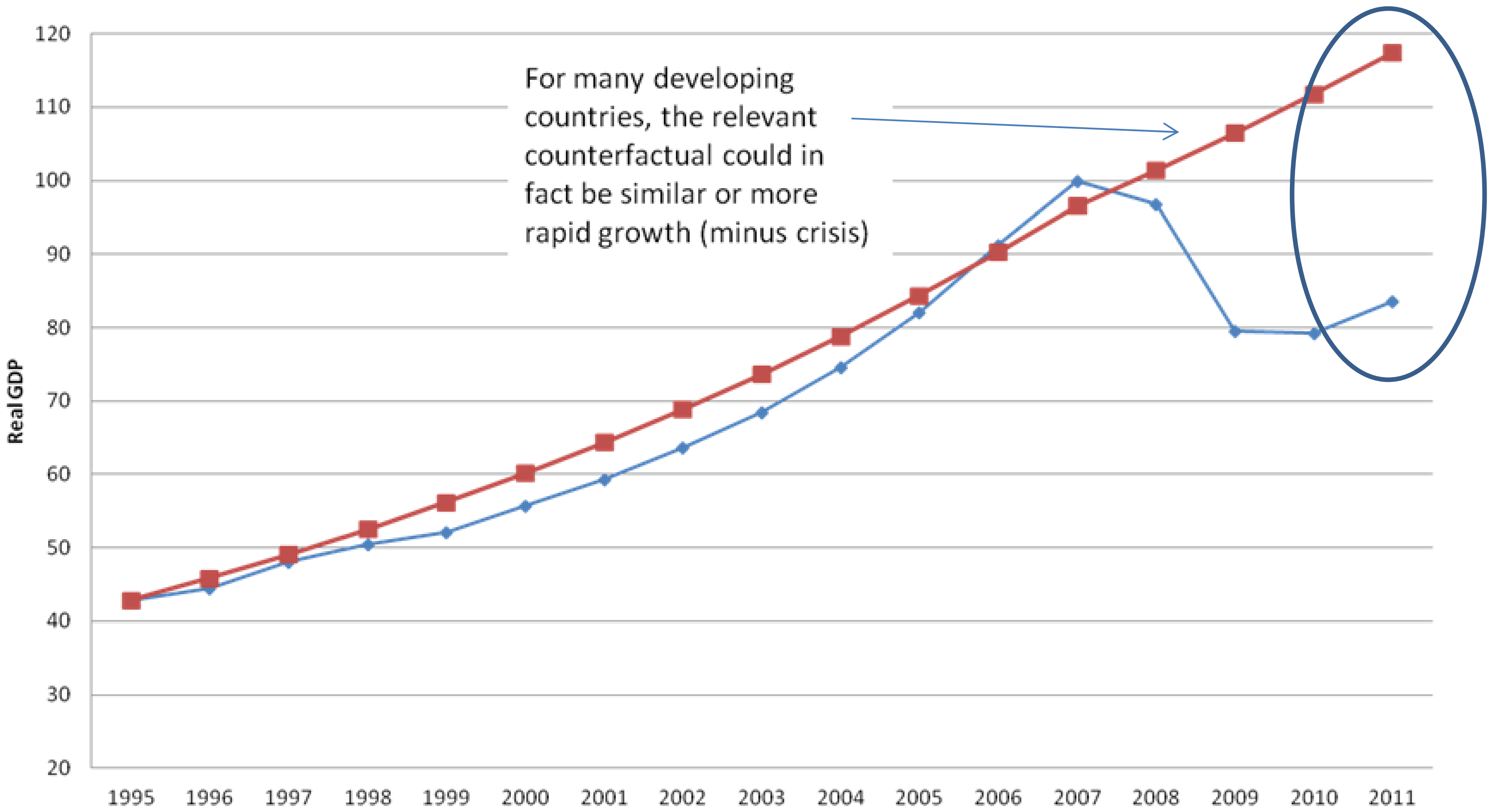
Figure 5. Economic Growth and Undervaluation of the Real Exchange Rate



Source: Based on Rodrik (2007).

Note: Partial relationship between a measure of undervaluation of the real exchange rate and growth rate of per capita GDP (controlling for initial income and country and period fixed effects). Data are for developing countries and cover a panel of 5-year averages from 1980–84 through 2000–04.

… so growth effects are on balance ambiguous



The policy response to second-best interactions: two mind-sets

- First-best mind-set: remove pre-existing market imperfections
  - improve macroeconomic policies and financial regulation
  - erect requisite global regulations and institutions
- First-best approach lacks realism in light of practical and substantive difficulties
  - the Eurozone as cautionary tale on transnational governance
- Second-best mind-set: restrain cross-border finance directly
  - can it be done?

A gun-control analogy

- Gun control opponents: “guns don’t kill people; people kill people”
  - So intervene only on the relevant margin, individual behavior, by punishing offenders
  - but do not otherwise restrict circulation of guns
- Gun control proponents: “since we cannot perfectly monitor and discipline behavior, and social costs are high, we need to control guns directly”
  - So prevent some transactions, including those that would be ex post efficient, to benefit society

Similarly, caution dictates direct regulation of cross-border flows