Discussion of Mendoza, Quadrini, and Rios-Rull's

Financial Integration, Financial Deepness, and Global Imbalances

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Overview of this paper

- Thought-provoking, carefully-executed
- Contribution to the debate on the causes and sustainability of current large global imbalances, stressing financial integration [Caballero, Farhi and Gourinchas 2006]
- Key feature is that differences in financial development across countries explain persistent capital account imbalances
  - Precautionary savings model
  - Looks at endowment risks, investment return risks
  - Quantitative work, analyzes steady states, transitions, welfare
- With incomplete financial markets, welfare consequences of capital market liberalizations are large and negative in some cases
- Explains persistent capital inflows, with lower cost of capital, for the more financially developed market.

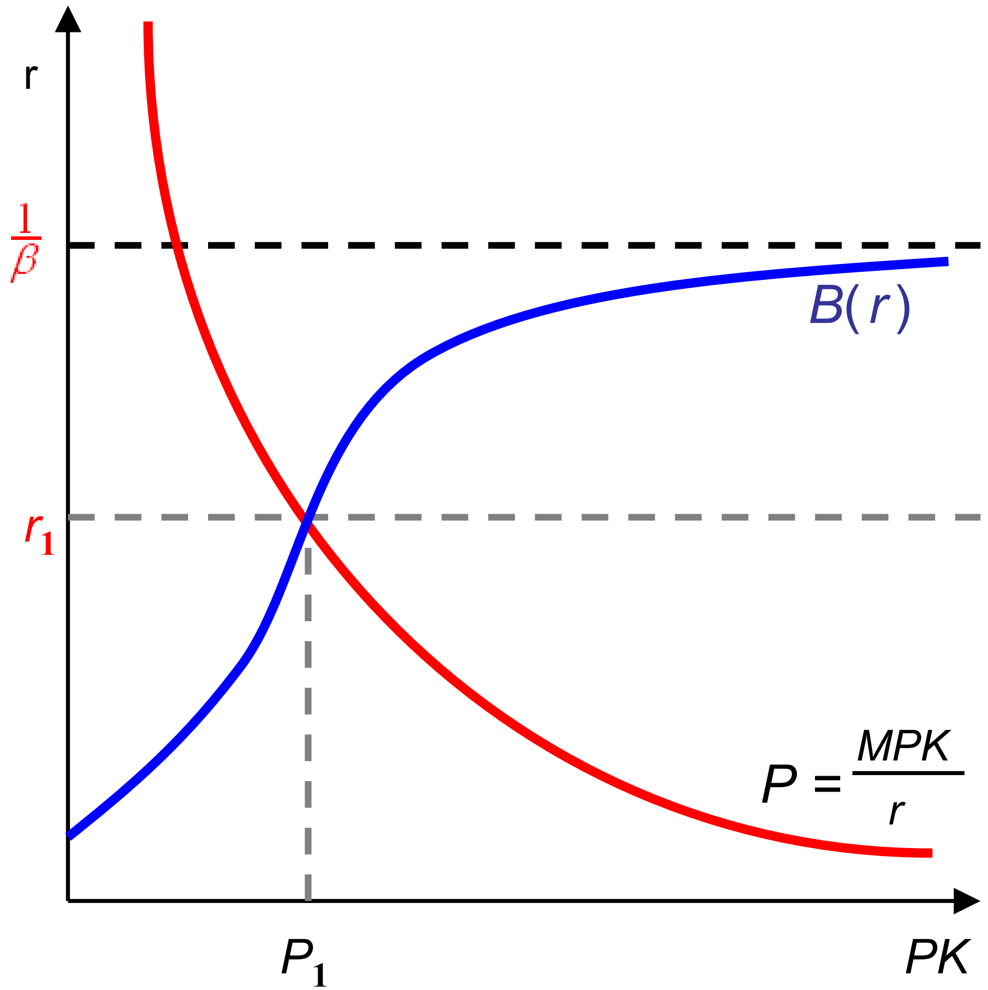
Basic concept: “financial deepness” ϕ^i

- Given shocks within a country to endowments and asset returns, ϕ^i is the extent to which agents in autarky are able to maintain smooth consumption and achieve full insurance.
- Is this really “financial deepness”? Empirical proxies used:
  - IMF index of financial market development of OECD countries
  - Capital account openness [no]
  - Domestic credit to the Private Sector [no]
- My alternative interpretation:
  - Associate the enforceability and completeness of contracts with legal & institutional development, and lack of corruption.

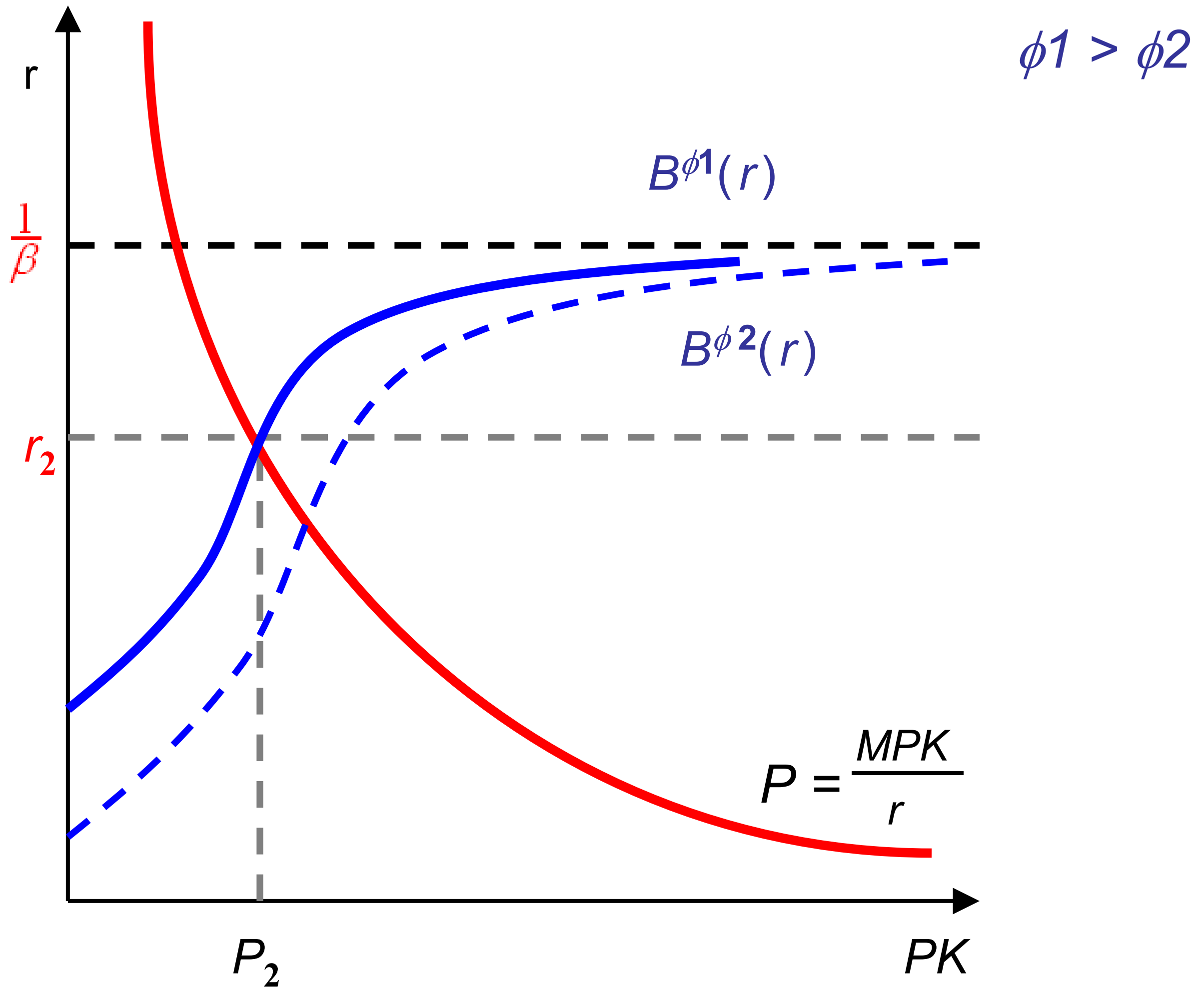
Key elements of the story

- Precautionary savings rates across countries are higher when markets are more incomplete.
- Autarky equilibria characterized by lower savings rates in financially developed markets, higher cost of capital.
- (very?) High interest rate sensitivity of savings assumed.
- ϕ^i pertains to the residency of the agent, independently of whether production takes place at home or abroad. (???)
- Financial development gaps persist.

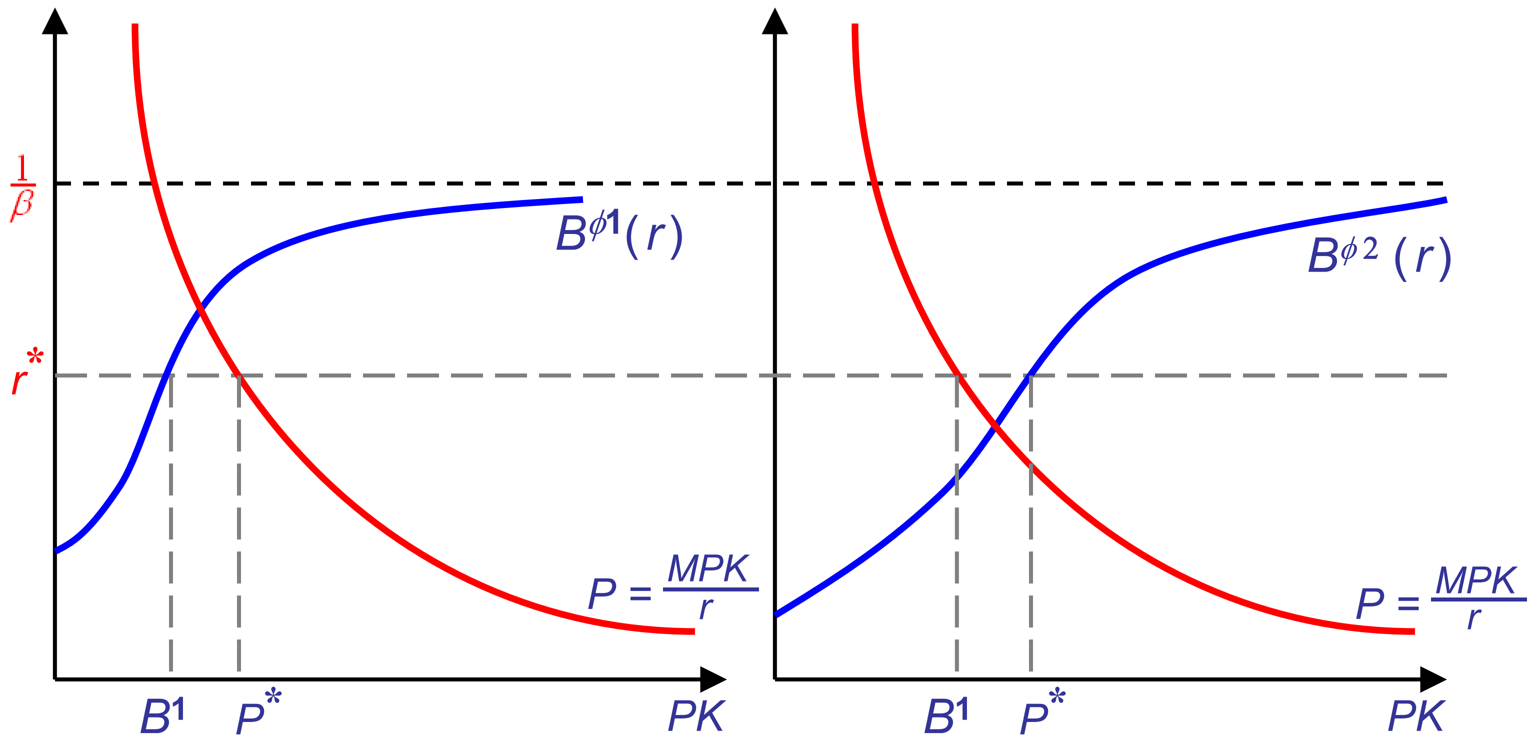
Autarky supply and demand for savings



Autarky supply and demand for savings



World Equilibrium



Thinking about Welfare effects

- Capital account liberalization leads to persistent outflows of funds from countries with under-developed financial regulation to countries with superior systems
- Financially developed country gains -- immediately better off in the sense that consumption rises right away and in early stages, and then declines gradually with payments on debt.
- Under-developed guy loses, perhaps a lot -- suffers a decline in consumption at first and then a gradual increase to a higher plateau (since it collects more on interest income from the borrower).
- Yet, puzzling that while interest rates move, there are not big differences between autarky and financial integration equilibria.
- Perhaps because savings elasticity to interest rates assumed high.

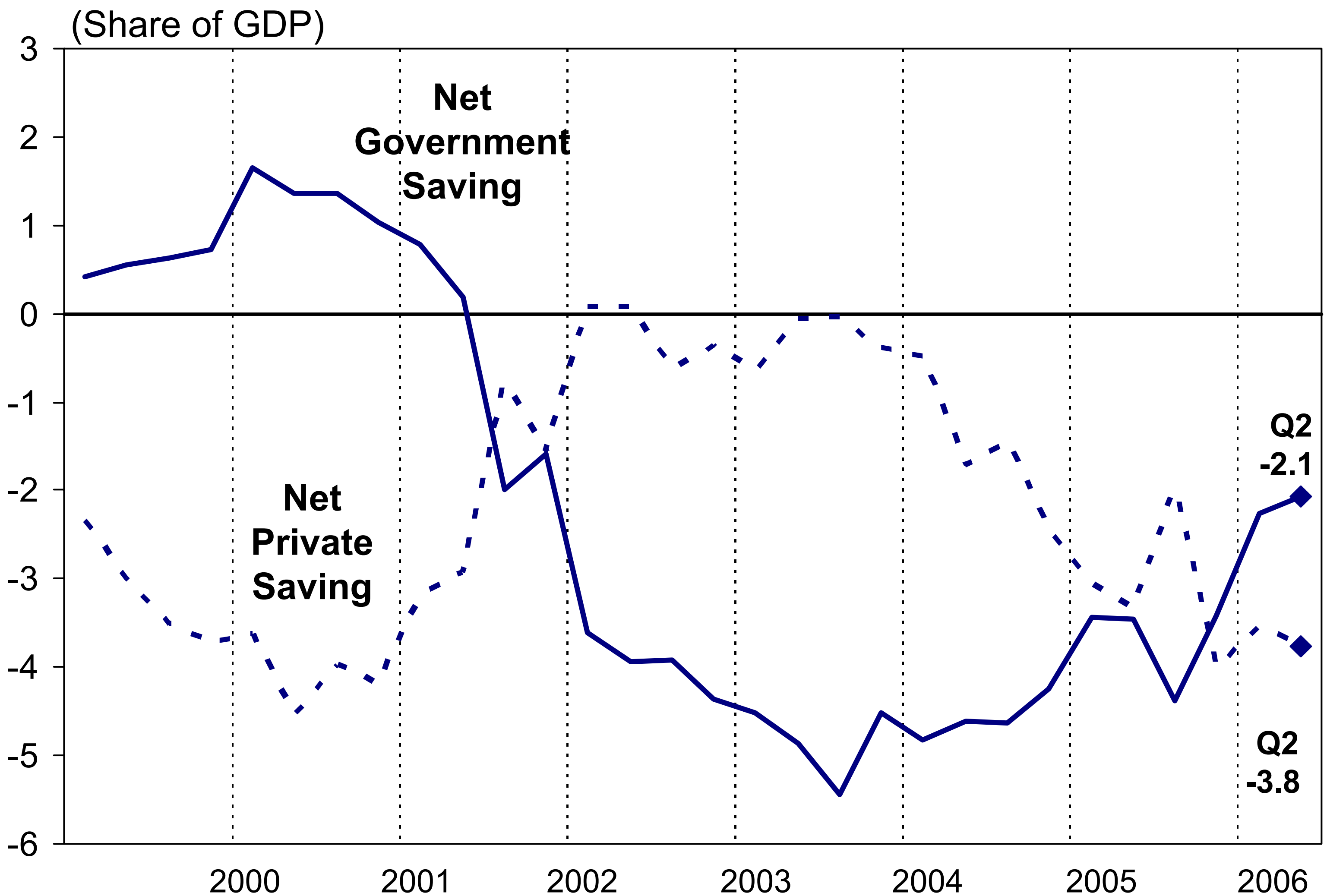
Interesting for sequencing of liberalizations

- Macro economic reforms, like capital market liberalization, reduce welfare for countries with under-developed financial markets.
- Liberalization can hurt for a long time.
- Perhaps improve institutions before opening up.

Does this model explain recent global imbalances?

- Is the U.S. net demand for funds really associated with precautionary savings motives at home and abroad?
- Are the countries supplying funds to the United States like those described in the model?
  - Are US creditors previously closed economies with corrupt and under-developed internal insurance markets? No
  - Did previously liberalized countries have a substantial decline in “the financial depth in their economies” (or increase in corruption)? Probably not.
  - Does financial development improve with openness? Yes, making the adverse consequences more transitory.

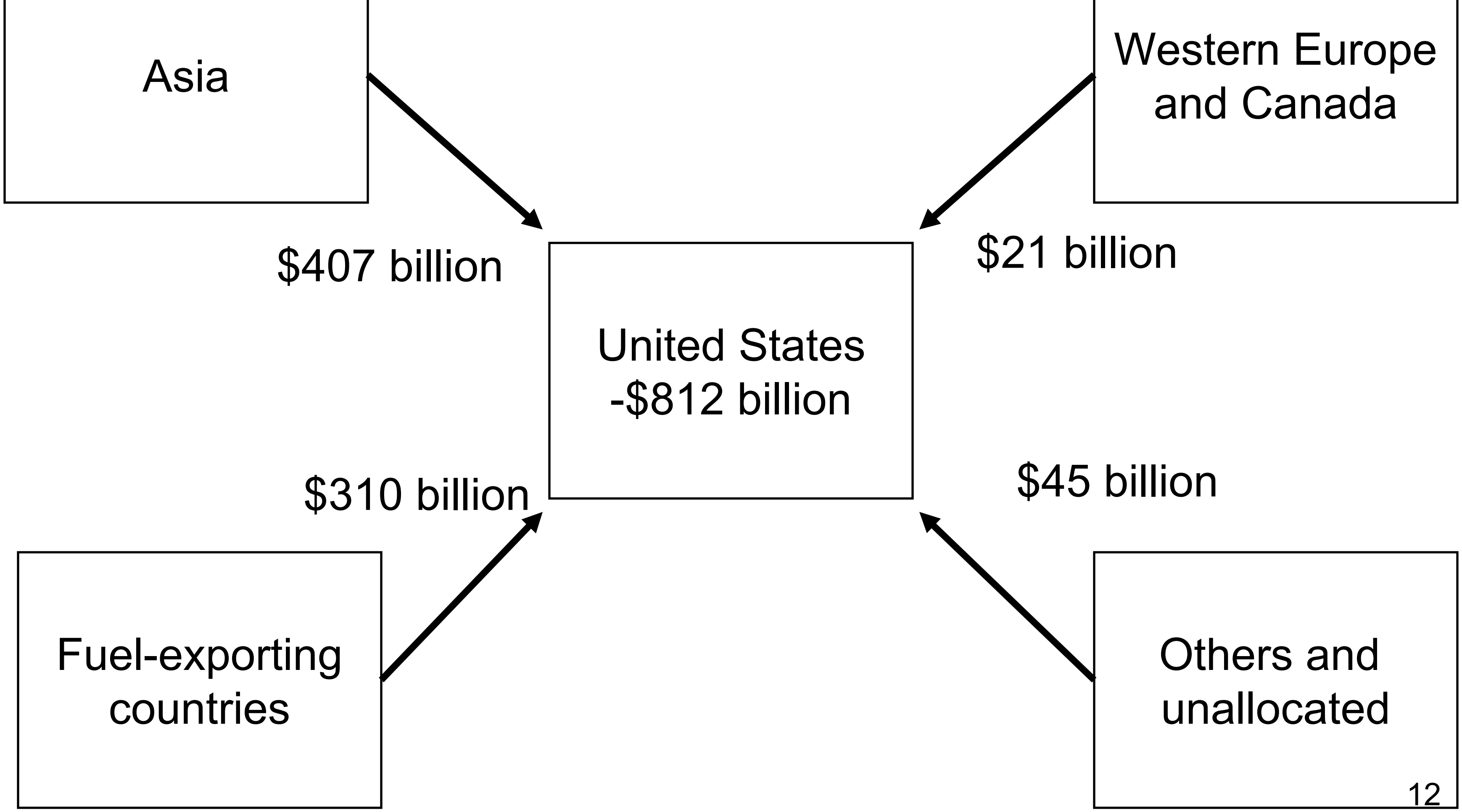
Since 2001,US government dis-saving is a large part of the US need for financing from abroad



While financially-underdeveloped regions are present in funding US imbalances, Asian countries and petrodollars are really the key suppliers of saving to the U.S

<u>2005</u>

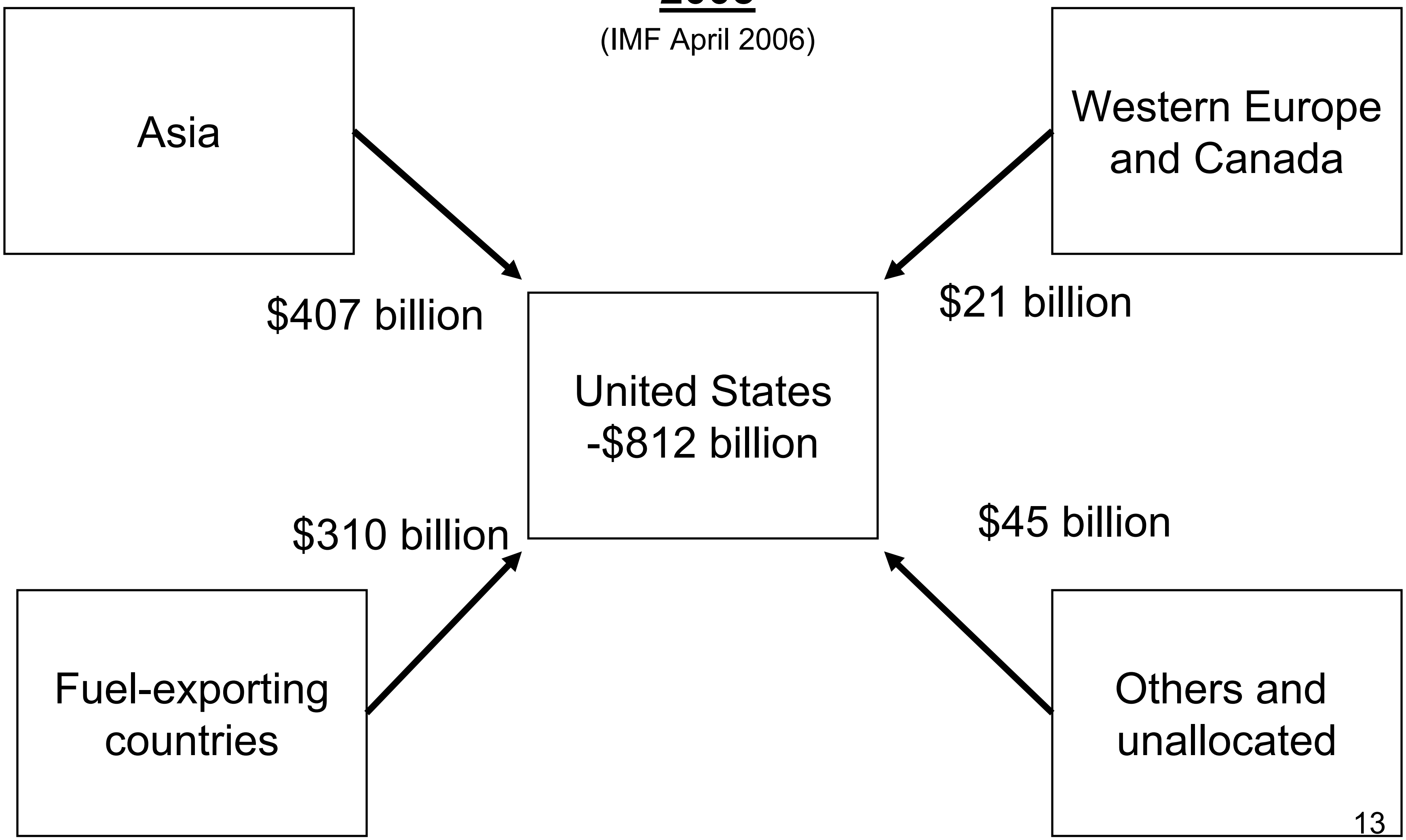
(IMF April 2006)



This supply is really official or quasi-official sector behavior (Asian Central Banks and Oil producers), so do the motives of the paper apply in this context?

2005

(IMF April 2006)



Among the key benefits of liberalizations are the regulatory improvements that occur

- Benefits of global banking for EM countries
  (2004/05 CGFS findings)
- Foreign bank entry leads to greater efficiency in local banking markets
  – Improved credit and risk allocation
  – Competition fosters development of local markets
- Knowledge transfer helps spread global best practice
- Acquired banks gain access to global capital markets

Concluding remarks

- Elegant thought-provoking paper
- Would like to see more robustness to alternative assumptions
- Paper is better pitched at explaining why capital can flow from poor to rich countries
- Provides perspective on sequencing of reform agenda: if financial sector is not sufficiently developed, capital market liberalization can lead to short term welfare losses for the liberalizer.