Rethinking the Effects of Financial Liberalization

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Comments

A Skeptical View of Financial Liberalization

- Growth gains are uncertain
- Consumption volatility increases
- Crises are more frequent

A More Optimistic View

- Levchenko, Ranciere, Thoenig (2008)
- No long run growth effects but permanent level effect.
- Increase in growth volatility
- Welfare analysis: for volatility costs to overturn the level of income effect , one need
  - Very High Risk Aversion
  - Very Persistent Income Shocks

Heterogeneity and the Case for a new theory

- Threshold Effects in the Benefits of Financial Liberalization.
- IMF (2007): “Reaping the Benefits of Financial Globalization”

A new theory of financial liberalization

- Sovereign Risk
  - Incentives not to enforce claims to foreign residents
- No discrimination in Enforcement
- Interconnection between International and Domestic Capital Markets
- Core of the Model.
  - Heterogeneity in Productivity
  - Shortage in capital
  - Borrowers and Savers
  - Endogenous Enforcement

Initial Steps

- **A. Pure Domestic Financial Markets**
  - Capital Shortage
- **B. Financial Liberalization with Commitment**
  - First Best
- **C. Financial Liberalization with Sovereign Risk and Discriminatory Enforcement**
  - higher investment, high volatility (enforcement risk)
  - Domestic Financial Markets is **insulated** from international financial market
  - Welfare A < Welfare C< Welfare B

Non Discriminatory Enforcement

- At face value: Controversial Assumption
  - The Icelandic Crisis of 2008 (Iceland vs. UK depositors)
  - Lehman Brothers (US vs. European Claimants)
- But a core element of good institutions.
- Discriminatory Enforcement can be turned around.
- Interdependence between Domestic and International Capital Markets

Enforcement Trade-off

- Enforcement
  - No default on domestic savers
- No Enforcement
  - reduces payoffs of domestic borrowers
- Enforcement
  - Improves distribution of income “spread the wealth around”
- Enforcement More Likely
  - Smaller capital leverage
  - Higher productivity dispersion
- Question: Multiple Equilibria?
  - Enforcement Expectations and Enforcement Decisions

Discriminatory vs. Non Enforcement

- Higher consumption volatility both aggregate and individual. Lower welfare for some.
- Domestic risk-sharing is destroyed!
- Discussion of key parameters
  - Capital Shortage.
  - Quality of institution: some exogenous parameter (PI): not at all insightful!
  - Why? Because what is interesting is **endogenous institution**, that is decision to enforce when there is option not too.

Interaction between domestic and international risk sharing

- Limited Participation to international capital markets.
  - Levchenko (2005): Self-enforcing domestic risk-sharing contract with asymmetric outside option.
  - Gaytan-Ranciere (2004): Entrepreneurs/Workers, projects choice and labor income volatility
  - Thesmar-Thoenig (2008): Firms with Diversified Ownership and Domestic Family Firms.