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” $\phi^i$

- Given shocks within a country to endowments and asset returns, $\phi^i$ 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.

• $\phi^i$ 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

\[ P = \frac{MPK}{r} \]
Autarky supply and demand for savings

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\[ \phi_1 > \phi_2 \]
World Equilibrium

\[ B^{\phi_1}(r) \]

\[ B^{\phi_2}(r) \]

\[ P = \frac{MPK}{r} \]

\[ P^* \]

\[ r^* \]
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. **2005** (IMF April 2006)

- **Asia**: $407 billion
- **Western Europe and Canada**: $21 billion
- **Fuel-exporting countries**: $310 billion
- **Others and unallocated**: $45 billion

**United States**
- **-812 billion**
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?

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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.