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Chapter Author: Giancarlo Corsetti

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Comment

Giancarlo Corsetti, European University Institute, Rome III, and CEPR

What Does the Paper Do?

This is a timely and extremely well-written paper emphasizing the risks of liberalizing capital flows among countries at different levels of financial development, when financial structure differences persist after liberalization.

The architecture of the model is (deceptive) simple, providing an elegant and instructive development of models after Bewley (1986) and Ayagari (1994), in an open economy context. The world consists of two countries. In each country, agents can accumulate capital and have access to a nonstochastic production technology. However, their endowment of labor in efficient units is subject to idiosyncratic shocks, which are Markov and independently distributed across individuals. Hence, each individual has a clear incentive to trade in financial assets either to insure against individual risk, or, if markets are incomplete, to smooth consumption. In the model, financial markets are assumed to be incomplete and plagued by credit frictions: agents are restricted to trade in nonstate contingent bonds only subject to a borrowing constraint, which may differ across countries, but not across residents within a country. Because of limits to their ability to borrow, agents engage in precautionary savings—in good times they store away some extra assets for the bad times when the constraint may prevent them to borrow efficiently.

National differences in financial development are modeled by assuming country-specific differences in the borrowing constraint: residents in the country with the least developed financial markets face a tighter constraint. Now, as is well understood, saving rates are higher the tighter the borrowing constraint is. Hence, under financial autarky (i.e., before liberalization), the economy with the least developed financial market has a higher saving rate, a higher capital stock, and a lower

equilibrium interest rate, relative to the other country. After liberalization, there will be interest rate convergence: capital will move to the country with more developed financial markets, corresponding to the emergence of large current account imbalances, and nonzero net foreign asset positions.

The main result of the paper is that letting resources flow from the country with the least developed financial market to the country with the more advanced markets does not necessarily produce aggregate welfare gains from trade for the former. This is because, in the country with the tighter constraint and therefore the lowest interest rate under financial autarky, the new liberalized financial order brings about an increase in the cost of borrowing. As all agents face the same borrowing constraint before and after liberalization (opening up borders is assumed to produce no advantage in this respect), the adverse movement in the intertemporal terms of trade makes borrowers in this country necessarily worse off. Aggregating preferences using a welfare function that assigns equal weight to all individuals, the cumulative loss of welfare suffered by borrowers more than compensates the gains of individuals who are long in the bond market: in equilibrium, marginal utility is higher for borrowers than for lenders. For essentially the same reason, social welfare increases in the other country, where borrowers experience a favorable terms of trade movement.

The main lesson from the model emphasizes a specific reason to be concerned with freeing capital mobility to and from countries with relatively underdeveloped financial structure. To the extent that liberalization translates into higher market rates without improving credit conditions, it is bound to translate into a net loss for net borrowers, which tilts social welfare away from aggregate gains from trade.

Financial Integration and Global Imbalances

To some extent, the argument is reminiscent of a key result of standard trade theory; namely, that a factor of production—the abundant factor—is actually penalized when a country opens up to trade. Here, borrowers are the losing party. However, what makes the paper particularly relevant is that its welfare results are derived from a model that appears to fit a key stylized fact characterizing current global imbalances: the fact that, in the last decade, poorer and less financially developed countries have indeed become lenders to more developed countries, primarily the United States—with the qualification that the model

completely abstracts from other possible effective determinants of net borrowing.

As is well understood, macro models with precautionary savings provide microfoundations to the saving glut hypothesis, commonly associated to the name of Bernanke, according to which the U.S. external imbalance is essentially driven by the excess of national saving over investment, which (for many a reason) is generated by the rest of the world. Contributing to the ongoing debate in theory and policy about the causes and consequences of the current global imbalances, here is a paper that adds a relevant welfare dimension to this debate, stressing a likely negative consequence from the saving glut.

One could easily speculate that this paper would not have been written had emerging market economies kept borrowing as they used to do up to the end of the 1990s. It would have been a net loss. Even observers who may feel uncomfortable with the saving glut hypothesis, and/or would like to see a better analysis of the policies underlying the net saving imbalances across the world, should appreciate the main point of the paper. Independently of the specific predictions about net foreign asset dynamic, the paper has the merit of stressing issues that (if only indirectly) are crucial in the ongoing process of financial globalization.

Asymmetries in the Process of Liberalization and Deregulation

The ongoing integration process is indeed asymmetric, with the liberalization of capital flows proceeding faster than convergence/integration in the structure, regulation, and functioning of financial markets and financial intermediaries. In this respect, it is useful to distinguish between liberalization of capital flows, and deregulation of domestic markets. As recent experience shows, domestic deregulation is to a large extent a misnomer: the removal of rules and controls limiting financial markets development and the initiatives of domestic intermediaries is only one side of the process. The other side of it consists in reforms and policies creating a firm and effective regulatory framework favoring competition, safeguarding stability, containing fraud and misconduct by financial firms, as well as ruling out inefficient risk-taking, which ultimately translates into large contingent public liabilities.

The risks of liberalization without sound deregulation (i.e., without improving institutions and governance) has already been pointed out by analyses of the crisis in South East Asia (see, e.g., Corsetti, Pesenti, and Roubini 1999; Burnside, Eichenbaum, and Robelo 2004). An impor-

tant part of the literature on this crisis has attributed it to a fundamental inconsistency between a policy of financial liberalization/deregulation and the presumption that private projects would be guaranteed by the government. This inconsistency resulted in the financial crisis driven by overborrowing, clearly creating the need for a policy correction.

In the context of the model presented in the paper, policy inconsistency shows up as regards to the extent to which the parameter a^i, determining the size of the financial constraint on households' decision, can or needs to vary as a consequence of liberalization. As a matter of fact, some may find the assumption that differences in national financial frictions survive the creation of a worldwide market for bonds unappealing—a point stressed by other discussants of related works by the same authors (see Mendoza, Quadrini, and Ríos-Rull 2007). In an integrated market, it is far from obvious that borrowing constraints be strictly related to an agent's nationality (or residence).

A relaxation of the borrowing constraint would clearly improve households' welfare, counteracting the negative implications of the interest rate rise. Observe that the issue at stake in this respect is quite different from the question: which change in the parameter a^i in the second country would undo the negative consequences of liberalization? Obviously, the author could easily perform a numerical exercise of this type, but its reduced-form nature would make its results not very interesting. We should keep in mind that the model has been written with a different and well-specified goal: to stress the possibility of welfare-reducing liberalization for a given state of asymmetric financial development.

Toward a Theory of Liberalization and Domestic Markets Development

Understanding endogenous market developments in response to globalization is a different matter. One may expect more work to be devoted to this topic in the near future, in macro as well as in political economy, industrial organization, or dynamic public finance. Indeed, there are a number of different angles to tackle the issue, which could ultimately lead to self-contained models of the interaction between liberalization and deregulation.

An example of these different angles is provided by Karel Mertens (2005), working on cross-border banking mergers. Mertens' idea is that different countries have banking sectors that are characterized by a dif-

ferent ability to monitor projects. This is so for historical reasons, but also reflects different stages of economic and market development. Realistically, the efficiency of the banking sector is lower in poorer countries. What happens when, as a consequence of liberalization, banks can lend and/or merge across borders?

Mertens distinguishes between two different forms of cross-border banking integration. In the first one, cross-border mergers translate exclusively into transfers of financial resources: banks lend to each other across borders, with net financial resources flowing from the rich to the poor countries. Yet the monitoring capacity of local banks is the same as before liberalization. The alternative form of integration also involves some transfer of project-monitoring capacity. After liberalization, the monitoring capacity of the banking sector located in the poorest countries improves, as a result of foreign direct investment (FDI) in the banking sector.

Also in Merten's framework, one can easily derive examples of negative gains from trade following liberalization. The reason is that, without transfers of banking technology, a larger flow of resources from countries with good monitoring capacity to countries with poor monitoring capacity raises the bankruptcy rate in the financially weaker economies, to such an extent that national welfare declines. This outcome is instead not possible if the country with weaker intermediaries fully benefits from a transfer in banking technology. Yet the choice between types of mergers/FDI is not endogenous in the model.

The model by Mertens (2005) is quite different from the one by Mendoza, Quadrini, and Ríos-Rull, as financial frictions are specified as adverse selection in the credit market. Yet it is apparent that the main message goes in the same direction, contributing to a much-needed wider survey on the effects of financial liberalization.

Concluding Remarks

I conclude by observing that the welfare result in the paper may provide yet another argument to the critics of current macroeconomic policies in Asia, insofar as it raises doubts about the wisdom of pursuing large external surpluses when these surpluses result from inefficient levels of precautionary savings. However, this argument deemphasizes the role of exchange rate and stabilization policies, which in many policy circles are held responsible for the current imbalances. From the vantage point

of the model in the text, pursuing a revaluation of the renminbi and other Asian currencies can be expected to have little or no impact on global and domestic imbalances, unless it affects the roots of excess savings.

Rather, one can read the paper as suggesting a call for reforms that should either foster financial markets development or strengthen social insurance institutions in the surplus countries. An alternative interpretation, as a call for slowing-down financial market integration, is also possible. But not many would consider this route feasible, let alone desirable.

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