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Comment

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The goal of this paper is to explore the sources of intra-European variation across countries and across regions in the degree of financial integration. The authors lay the groundwork for their extensive empirical investigations by laying out a benchmark model of financial integration. According to the model, risk sharing implies that a surprise increase in local production should be associated with a less-than-proportional increase in local income since some of the income gains accrue to nonlocal investors. A related implication is that, in a one-shot static allocation, capital will flow to the most productive regions, which will therefore carry net liabilities. These two predictions are investigated in the empirical work.

However, the authors recognize that capital markets do not work without frictions. In particular, they emphasize that it is important to condition the level of financial integration on institutional and cultural factors. This insight is very much in line with a wide body of evidence that has accumulated in recent years. The new evidence presented by the authors shows that the level of interregional integration indeed depends on the level of a regional confidence index, while the scale of regional integration varies across countries in a pattern that is correlated with the quality of national institutions, as captured by proxies such as government stability, rule of law, and limits on expropriation. These findings are in line with the importance of these factors along other dimensions of economic performance, but the application to capital market integration is novel and reflects innovative and high-effort data work.

While I am confident that the main results are fairly robust, this paper faces several limitations. At the theoretical level, the model is based on pooled ownership of the capital stock, with portfolio equity the only cross-border financial instrument. This matters, since cross-border trade

in debt assets and liabilities is an important element in international financial integration and the relation between output growth and the rate of return on debt holdings is complex. In particular, faster growth has an ambiguous impact on interest rates, depending on the source of the output growth. Also, the sensitivity of net investment income flows to interest rates depends on whether a country is a net creditor or net debtor. Another fundamental problem is that the return to investors may take the form of capital gains: the authors only focus on yields or dividend income. Accordingly, even if the growth process is similar across countries, the behavior of the output/income ratio may differ due to differences in the composition of the international balance sheet between debt and equity instruments. Finally, foreign direct investment (FDI) is an important type of international investment: the return on some types of FDI may be driven more by growth in the source country than by growth in the host country.

The prediction that higher productivity regions should have net liabilities is based on a one-shot cross-sectional allocation. A dynamic perspective would recognize that a rich region may choose to be a net creditor: even if current productivity is high, future returns may be better elsewhere. Moreover, a rich region that has an older demographic than other regions may have a high savings rate and be a net capital exporter. Finally, if Ricardian Equivalence fails to hold, a low-productivity region that has a high public debt may be a net debtor. In summary, the net foreign asset position of a region or country depends on several factors and must be assessed in a dynamic framework (Lane and Milesi-Ferretti 2002).

In relation to the empirical work, it is interesting to consider the differences between international data and interregional data. One key distinction is that labor mobility is much higher across regions than across national borders: a local productivity shock may be transmitted to workers across a country via its impact on countrywide labor markets, altering the incentive to risk share via capital markets. In addition, there is implicit risk sharing via national tax systems: part of the output gain in a region accrues to other regions, via revenue sharing at a national level.

In implementing the risk-sharing model, the authors regress the change in the output-income ratio over 1996 to 2003 on output growth over 1992 to 1994. While nonoverlapping periods may help in reducing endogeneity problems, the problem is that the output-income ratio over 1996 to 2003 is also influenced by post-1994 factors that are plausibly

correlated with the output growth rate over 1992 to 1994, including the output growth rate, shifts in the scale of financial globalization, and rates of return. Similar problems face the levels regression, which regresses the average output-income ratio over 1995 to 2003 on the average GDP level during 1991 to 1994, and especially the regressions of the output-income ratio over 1995 to 2003 and the net foreign asset position on the level of capital inflows over 1991 to 1994. In regard to the latter, the relation between cumulative capital inflows, the net foreign asset position, and net investment income depends on the precise composition of the international balance sheet. For instance, the sensitivity of many results to the inclusion of Ireland in the sample highlights the role of foreign direct investment. While Ireland's cumulative current account deficit is not large, its annual net investment income outflow is around 20 percent of GDP, reflecting the high measured profitability of foreign-owned plants in Ireland. A similar level of inflows in low-yielding bonds would have a quite different impact on net investment income.

Turning to the substantive results, the significant role of confidence and institutions in determining the level of financial integration is highly intriguing and begs several questions. In particular, a priority for future research should be to identify the mechanism by which these factors matter. Is it through development of the banking system or the scale of financial markets? Do multinational firms or multiregional firms within countries play an important role versus arm's length modes of financial integration? What is the role of national versus regional labor markets?

Overall, there is much to be learned from this contribution. In particular, the authors have shown the effectiveness of collecting a new and broad-ranging data set on regional financial integration, which can be further exploited in future research.