Comments on Session 1

Susan Minushkin
CIDE

The two papers presented in this session address four interrelated topics: financial liberalization, capital flows, economic growth, and financial stability. The papers provide preliminary answers to two broad questions: How far advanced is financial liberalization? What are the consequences of this liberalization?

The first paper, by Quispe-Agnoli and McQuerry, explores these questions at the domestic level. The second paper, by Fernandez-Arias and Panizza, has an external focus. Yet both suggest very similar conclusions that can be stated in their most general form: Neither states nor international organizations have finished their work on financial market liberalization, and further reforms at the domestic and international levels are needed.

These comments begin with some suggestions for Quispe-Agnoli and McQuerry's index of financial deepening. Assembling a twenty-year data set for five countries in Latin America is a very impressive accomplishment, particularly given data scarcity and reliability problems in many developing countries. Ideally, the data set would be extended to all Latin American countries. Nevertheless, the authors provide an important new data set that builds on previous work.

However, one can question whether this index really measures what it purports to measure. The authors connect financial depth to financial liberalization without specifying why liberalization implies depth or vice versa. They also do not demonstrate this relationship empirically. What the authors do offer is a new index of financial depth to complement existing indices that measure liberalization. In this respect, the authors contribute to the literature on financial liberalization by examining the overlooked domestic side of the liberalization's effects rather than emphasizing the international causes and effects of financial liberalization as is common in most research on the topic. The author's index opens the way to tests of their implicit hypothesis that financial liberalization causes increases in financial depth.

One can also question some of the indicators in the index. For instance, the authors use the average annual nominal interest rate to measure the regulatory framework in each country. The authors explain that this indicator can measure whether the financial system was restrictive or not in a given year. However, there are many other interesting and relevant aspects of a restricted regulatory framework that need to be included in such a measure. Yet quantifying a regulatory framework is fraught with difficulties. Furthermore, if the authors are also trying to measure the external aspects of financial liberalization, as they claim, numerical indicators may also be difficult. One can measure capital inflows and outflows. However, flow data provide information on the attractiveness of a particular country to investors, not whether the country liberalized its financial system. Just as it's possible to throw a party that no one attends, it is also possible that a country liberalizes its financial system but does not attract capital inflows. This example illustrates the difficulty of establishing a relationship between a numerical measure of financial depth with qualitative changes in regulations. The regulatory changes can be quantified—restrictive or liberal—but the causal mechanism hypothesized is via capital flows, which depend on much more than changes in regulations.

The final comment that I have about the first paper concerns the institutional variables. I think it's important to include these types of variables, but I am not sure that the variables chosen are the correct ones although they are variables commonly used in political science. In many cases, I would argue that what investors are looking for is stability in economic conditions and in the application of law. Rather than using indicators such as a change in executive, the authors might look at some democracy or other rule of law measures such as indices of civil and political liberties, transparency, and corruption.

Moving to the authors' results, we see that capital outflows have a negative effect on financial depth for the panel as a whole. The country data show a relationship between economic growth and depth for Mexico, Chile, and Argentina but not for Brazil or Peru. This odd result may be partially explained by the time period used in the analysis. It is here, in the authors' finding on capital flows, growth, and depth, that the two papers can be usefully integrated. The Fernandéz-Arias and Panizza paper offers us some ideas about why, on one hand, capital outflows are significant for the panel as a whole but individual country data show economic growth being important for some of the countries and not others.

One of the main findings of Fernandéz-Arias and Panizza is that growth in Latin America is significantly influenced by capital flows. External influences that reduce these flows will probably dampen or kill off growth in Latin America. The most intriguing argument in this paper is that emerging market governments, including those of Latin America, may not be to blame for this situation. The authors argue that the rise in the spread for emerging market debt securities is not the result of flawed government policies. They demonstrate that spreads have risen for all high-yield securities, including those of corporate issuers in wealthy countries. Thus, the rise in emerging market bond is not a country- or region-specific problem that can be attributed to flawed policy; rather, it is an asset class problem for all high-yield issuers. Unfortunately, this asset class problem reduces capital flows to Latin America and as a result reduces rates of economic growth. Latin American growth suffers because of its sensitivity to capital flows.

This argument is what links the two papers. The Quispe-Agnoli and McQuerry paper demonstrates a positive relationship between economic growth and financial depth for at least three of the countries and a negative effect of capital outflows on financial depth. If capital outflows are being determined by external factors common to all high-yield issuers and capital outflows lower growth rates in Latin America, as argued by Fernandéz-Arias and Panizza, then external factors common to all high-yield issuers may be what is preventing Latin American countries from achieving the economic growth and financial depth they expected from financial liberalization as well as inhibiting economic growth. This is an interesting area for further research.

Finally, the authors of both papers open the door to arguments that rapid capital outflows are a problem that need some type of regulatory solution. Quispe-Agnoli and McQuerry suggest that some types of restrictions on these flows might be a recommended policy option for some of the countries. Fernandéz-Arias and Panizza do not make any such suggestion; however, they do point to the need for regulatory reforms on outflows from developed countries, such as special regulations depending on asset class. The benefit of the Fernandéz-Arias/Panizza idea is that it would avoid the problems of reimposing capital controls while addressing some of the negative growth effects of rapid capital outflows.

These two papers provide an intriguing complement to each other regarding the role of capital flows and financial development in Latin America. Capital flows are affecting financial depth as well as economic growth. If, as the Fernandez-Arias/Panizza paper suggests, economic growth is strongly influenced by flows and flows are strongly influenced by external factors, then we may need to reconsider exactly what the benefits of external financial liberalization are as well as how and when Latin American countries can capture these benefits.