



Financial Globalization, Economic Growth, and the Crisis of 2007–09

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This study examines the controversial question of whether financial globalization has been good or bad for global growth. Whereas economists generally agree that open trade is beneficial, they are more divided on financial openness. Although analysis is complicated by the greater difficulty of measurement (tariff levels are more easily measured than the degree of capital restriction), the same influences of static and dynamic efficiency gains apply to both trade and finance. Capital-scarce countries can obtain capital more cheaply abroad, and there are technological spillovers from foreign direct investment and productivity gains from improved domestic financial sectors.

A large body of empirical studies on this issue has emerged, especially subsequent to the East Asian financial crisis of 1998. The usual view of these studies is that they show only fragile evidence that financial openness is beneficial for growth. Cline closely examines approximately 80 studies and concludes instead that the overwhelming preponderance of evidence is that growth effects are positive, and moreover that they are sizable in magnitude. When the model estimates in the literature are normalized for comparability, the statistically significant results typically show growth gains on the order of 1½ percent annually for complete financial openness versus complete closure. Similar results are obtained for the subset of studies that focuses on direct investment, bolstering the broader conclusion. Cline argues in particular that if financial openness truly had negative or zero effect, half of the significant results should be positive and half negative; instead, they are so predominantly positive that the chances are about 300 to 1 that the effect is positive.

Even so, in part because for at least the capital-abundant industrial countries the expected growth gains would be somewhat lower (primarily productivity enhancement rather than gains from supplementing domestic capital) and in part to take fuller account of studies that have a combination of both statistically significant and insignificant results, the author applies the technique of “meta-analysis” to obtain an alternative conservative estimate of growth impacts. This approach, which weights all results by their degree of accuracy (“inverse variance”), is more frequently used in other fields (medicine, education, agriculture, psychology) than in economics. The results of the meta-analysis place the annual growth effects of complete financial openness versus closure at about one-third the level for the significant-only results, or ½ percent per year. Cline suggests that this conservative variant warrants greater weight for especially the industrial countries, in part because of theoretical expectations but also because of possible problems of “endogeneity” (cause versus effect) in the estimates.

By applying the equations from the leading models to the actual levels and trends of their financial openness variables, it is possible to calculate the realized gains from financial globalization. For the high-variant estimates, the result is that for industrial countries the degree of actual financial openness attained contributed about 0.8 percent to annual growth in the 1980s, rising to about 1 percent by the early 2000s. For emerging Asia and Latin America, the corresponding estimates were about 0.3 percentage point, rising to about 0.5 percentage point, and reflecting considerably less financial openness (and a temporary collapse for Latin America during the 1980s debt crisis). The low-variant paths are about one-third these levels. Correspondingly, a conservative (low-variant) estimate is that 9 percent of the present-day level of US GDP can be attributed to the cumulative growth benefits of financial openness over the past quarter-century and nearly as much in other industrial countries. For emerging-market economies, the conservative estimate is only about 2½ percent of present-day GDP, reflecting lesser opening but also more rapid total growth and hence greater contributions from other factors (although the high-variant at about 6 percent of GDP warrants somewhat greater weight for these capital-scarce economies). An implication is that scope remains for greater gains through more complete opening in emerging markets.

Nonetheless, many economists worry that increased vulnerability to financial crises from greater openness would cause net growth losses for emerging-market economies. Cline combines evidence from the literature on the incidence of banking and currency crises in emerging-market economies, on the one hand, and the leading measure of financial openness, on the other, and finds that crises have actually been slightly less frequent rather than more frequent in the more financially open economies. Further drawing on the literature for crisis probabilities and damages, he finds that there is only about a 5 percent chance that the probability-weighted losses from increased vulnerability to crises as a consequence of financial openness outweigh even the conservative end of the range for the long-term growth gains from financial openness.

Finally, the study considers whether the financial crisis of 2007–09 should change the basic conclusion that financial openness contributes to growth. Cline first reviews the causes and stages of the crisis, concluding that the “Murder on the Orient Express” diagnosis is the best: Several different forces all converged to create the crisis. He emphasizes the dangerous combination of the reversal in the housing bubble with misrated subprime mortgage securities, lax monetary and regulatory policies, and to a lesser extent the influence of external imbalances. He then shows that more financially open emerging-market economies did not fare worse during the global crisis than more closed economies. There was no significant difference in the extent of their declines in growth rates during the Great Recession (except for the unrepresentative case of the Baltic states) nor in the severity of their stock market collapses. He also shows that the availability of large external reserves enabled many countries to avoid a severe “financing gap” predicted by some official agencies. Overall, he suggests that financially open economies stood up to the test of a 100-year flood and hence that there is no generally applicable evidence from the crisis that emerging-market economies should lean toward more financial closure to achieve better growth results.

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