

EUROPEAN COMMISSION  
DIRECTORATE GENERAL ECONOMIC AND FINANCIAL AFFAIRS

# **Discussion of the paper ‘Does openness to international financial flows raise productivity growth?’**

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# Very interesting and plausible results

- Financial openness matters for TFP growth
- The composition of financial inflows matters: FDI and equity are TFP boosters, whereas debt is not
- The ‘absorption capacity’ of the recipient country matters: debt becomes less of a drag on TFP if financial development is more advanced
- Only beyond a certain level of financial openness are (further) increases in it beneficial (threshold effect, multiple equilibria? Big bang needed?)
- Basic results survive the robustness tests

# These findings are complementing our own

- Financial openness (debt and equity) and financial development raise the sensitivity of investment to the return on capital (itself a function of TFP)
- Financial development (*de jure* and *de facto*) raises the re-election probability of reformist governments
- Threshold effect: tight regulation of product and labour market diminishes re-election probability of reformist government

# A comment

- No distinction between convergence to the TFP frontier and impact of movements of the TFP frontier (latter more important in mature economies)
- Financial openness may interact with both as it diminishes the 'distance' from the frontier

# Suggestion for a test

The basic specification:

$$\Delta y = -\alpha y_{t-1} + \beta'FO + \dots$$

- $y_{t-1}$  to capture convergence effects
- $\alpha$  is a gauge of the speed of convergence (the larger it is, the higher the speed).

## The EU Economy 2007 Review:

- **if financial regulation is tight, the speed of convergence to the frontier declines** (in services and ICT-related industries)
- Authors could test this also for their measures of *de jure* and *de facto* financial market openness, as follows:

$$\Delta y = -\alpha y_{t-1} - \gamma FO_t \cdot y_{t-1} + \dots$$

# The EU Economy 2007 Review

Main effect confirms convergence

Interaction effect suggests tighter regulation reduces convergence

**Table 2.4.3**  
The role of regulations

	All industries		Only manufacturing sector	Only private services sector	Only ICT-related sectors
	1	2	3	4	5
TFP growth at the frontier	0.171** (3.39)	0.175** (5.82)	0.368** (4.02)	0.138** (3.97)	0.153** (7.07)
Technological gap	-0.049** (5.09)	-0.047** (5.20)	-0.042* (2.26)	-0.026** (5.13)	-0.030** (6.95)
Product market regulation	-0.002 (0.96)	-0.000 (0.01)	0.126** (3.41)	-0.008 (1.65)	0.008** (2.81)
Labour market regulation	0.008 (1.45)	-0.004 (0.79)	-0.009 (1.46)	0.002 (0.36)	0.006 (0.95)
Financial market regulation	0.005 (1.31)	-0.007 (1.43)	-0.004 (0.96)	0.009 (1.73)	0.009* (2.01)
Interaction TFP growth at the frontier with product market regulation		0.016 (0.41)	0.416** (2.73)	-0.005 (0.23)	-0.040 (0.98)
Interaction TFP growth at the frontier with labour market regulation		0.060** (2.43)	0.080** (2.12)	0.069* (1.85)	0.014 (0.35)
Interaction TFP growth at the frontier with financial market regulation		-0.078 (1.82)	-0.127** (2.80)	-0.063** (2.55)	-0.081** (2.57)
Interaction technological gap with product market regulation		-0.007 (0.90)	0.064 (1.17)	-0.013* (2.07)	0.002 (0.38)
Interaction technological gap with labour market regulation		-0.004 (0.48)	-0.007 (0.47)	-0.005 (0.81)	0.001 (0.16)
Interaction technological gap with financial market regulation		-0.009 (0.34)	-0.014 (0.97)	0.016** (2.34)	0.007* (1.89)
N. obs.	6340	6340	2929	2048	2271
R <sup>2</sup>	0.13	0.14	0.18	0.11	0.22

## The EU Economy 2007 Review:

- TFP growth at the frontier spills over to TFP growth elsewhere,
- spill-over effect becomes weaker if financial markets are more tightly regulated,
- Authors could test this for financial market openness, as follows:

$$\Delta y = \delta \Delta y_{frontier} + \varepsilon FO_t \cdot \Delta y_{frontier} + \dots$$




# The EU Economy 2007 Review

Main effect confirms spillover from frontier

Interaction effect suggests tighter regulation reduces the spillover

**Table 2.4.3**  
The role of regulations

	All industries	Only manufacturing sector	Only private services sector	Only ICT-related sectors	
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N. obs.	6340	6340	2929	2048	2271
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- Product and labour market regulation matter both for the speed of convergence to the frontier and the rate of spill-over from the frontier
  - This is implicit in this paper (assumption that financial openness prompts better regulation in financial, product and labour markets,)
  - Could be tested explicitly by including product and labour market regulation gauges in the regressions