Whence Policy? Government Policies, Finance, and Economic Integration

Discussion by John Hassler, IIES, Stockholm University

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- Logic behind latter two is a conjecture that financial markets and government are substitutes – globalization increases relative cost of publicly provided insurance.
- Allow differences in GP-> policy,openness depending on legal origin - *French*, *English*, *German* and *Scandinavian*.

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- GP affects index of financial liberalization positively everywhere.
- GP tends to affect government size negatively – much stronger effect (5 times) in countries with Scandinavian rather than English legal origin.
- GP tends to affect social expenditures positively (Rodrick effect) – except in countries with Scandinavian legal origin where it is negative!

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  - government size strongly decreases FD.
  - openness decreases (weakly) financial development.

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- Identifying assumption that globalization pressure does not affect financial development directly passes over-identification test but still a little hard to swallow. E.g., lower shipping cost may affect composition of trade, pushing financial development.

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  - Scandinavian model not trade-unfriendly, why small effect on trade and large negative on govt size and negative on policy?.
  - Effect on policy via openness.
- Alternative model– globalization drives convergence in policies. Scandinavian countries expanded government and social expenditures early, now bigger need to undo a bit of this. Likewise, they early adopted an export oriented growth policy. Convergence not allowed in the specification (would require initial conditions as regressors).