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Discussion of: Financial Integration, Macroeconomic Volatility and Welfare

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The Issue

- What are the consequences of changes international financial integration?

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Answers from EH model

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What can we learn about financial integration and our models about financial integration?

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In EH model MRS $\simeq$ C, thus more integration leads to higher consumption co-movement (from 0 to 0.73), but not necessarily output co-movement

Financial Integration and co-movement: evidence

Table 2. Correlations with "World" Macroeconomic Aggregates
(Medians for each group)

	Full Sample	Period		
	1960–99	BW	Common Shocks	Globalization
Output				
Full sample	0.18	0.11	0.20	0.03
	[0.04] ***	[0.04] **	[0.06] ***	[0.06]
Industrial countries	0.52	0.19	0.39	0.46
	[0.05] ***	[0.13]	[0.12] ***	[0.11] ***
Developing countries	0.10	0.09	0.18	-0.01
	[0.03] ***	[0.04] **	[0.07] **	[0.05]
MFIs	0.12	0.02	0.18	0.02
	[0.05] **	[0.06]	[0.12]	[0.09]
LFIs	0.09	0.09	0.18	-0.03
	[0.04] **	[0.07]	[0.10] *	[0.10]
Consumption				
Full sample	0.12	0.02	0.14	-0.03
	[0.04] ***	[0.05]	[0.06] **	[0.06]
Industrial countries	0.45	0.06	0.33	0.57
	[0.06] ***	[0.08]	[0.08] ***	[0.12] ***
Developing countries	0.02	-0.03	-0.02	-0.08
	[0.03]	[0.06]	[0.06]	[0.04] *
MFIs	0.04	0.06	-0.03	-0.03
	[0.06]	[0.09]	[0.08]	[0.14]
LFIs	0.01	-0.03	0.04	-0.08
	[0.05]	[0.10]	[0.09]	[0.07]

Financial Integration and co-movement: lessons

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- The EH model (as many others) predicts a strong relation between financial integration and consumption co-movement.
- Support for this implication is limited
- Main problem is the strong link between MRS and consumption (also not supported by pricing data)
- Next: look at the evidence using more sophisticated MRS

Financial Integration and Volatitilty

Macro Volatility = Volatility of Underlying Shocks + Amplification

- In EH model (as in many others) shocks do most of the work.
- Small role of financial integration (Volatility of output goes from 0.77% to 0.84%
- Evidence from financial crises suggest a link between financial integration and shocks itself (in Mexico and Argentina large drops in TFP)

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- Next: explore models with the volatility of shocks can depend on integration

Financial Integration and Welfare

- In EH the gains of going from FA to BE are 0.006% of lifetime consumption
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Why?

- Shocks to non tradable cannot (by assumption) be shared
- Shocks to tradables are trend stationary (AC = 0.7)
- Business Cycle Shocks are small (Lucas)

Is Financial Integration irrelevant?

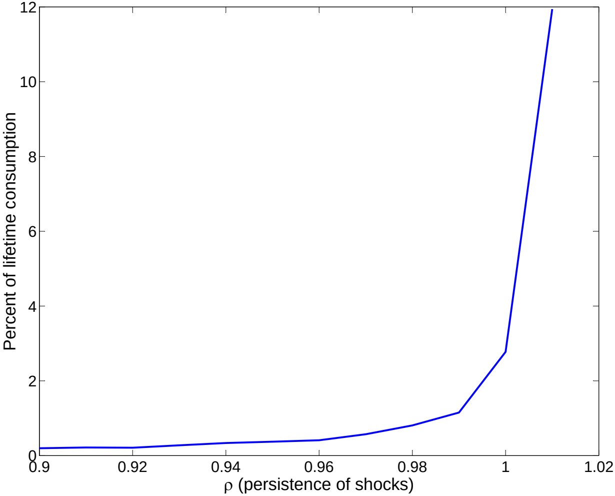
- Not if it affects trend growth (Obstfeld, 1994)
- Not if offers individuals (as opposed to countries) better insurance opportunities (Davis, Nalewaik and Willen, 2001)
- Not if shocks are not trend stationary (Aguiar and Gopinath, 2005)

Gains from holding a world portfolio

$$
\begin{aligned}
y_{it} &= \rho y_{it-1} + \varepsilon_{it} \\
u(y_{it}) &= \frac{1}{1-\sigma}(y_{it})^{1-\sigma} \\
\sigma &= 2, \sigma_{\varepsilon} = 0.02, \beta = 0.99 \\
&\quad \text{200 countries, 200 periods}
\end{aligned}
$$

- If ρ is close to 1 shocks cannot be insured with a simple bond
- Welfare impact of stock market financial integration can be very large!

Gains from holding a world portfolio v/s a country portfolio



What next

If gains are so large is then very important to study optimal portfolio diversification (EH, 2005)

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Next: why does not capital flow from poor (and unstable) countries to rich (and stable) countries?