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Financial integration, entrepreneurial risk and global dynamics ☆

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Abstract

How does financial integration impact capital accumulation, current-account dynamics, and cross-country inequality? We investigate this question within a two-country, general-equilibrium, incomplete-markets model that focuses on the importance of idiosyncratic entrepreneurial risk—a risk that introduces, not only a precautionary motive for saving, but also a wedge between the interest rate and the marginal product of capital. Our contribution is to show that this friction provides a simple explanation for the emergence of global imbalances, a resolution to the empirical puzzle that capital often fails to flow from the rich or slow-growing countries to the poor or fast-growing ones, and a set of policy lessons regarding the intertemporal costs and benefits of capital-account liberalization.

JEL classification: E13; F15; F41

Keywords: Financial integration; Capital-account liberalization; Incomplete markets; Idiosyncratic risk; Entrepreneurship; Current-account deficits; Global imbalances

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1. Introduction

The last two or three decades have been characterized by significant liberalization of international capital flows. This, in turn, appears to have facilitated the rise of significant global imbalances—a large foreign debt on the side of the United States along with vast currency reserves and big positive holdings of US Treasury securities on the side of emerging countries such as China. Furthermore, whereas the standard neoclassical paradigm predicts that capital should be flowing from the rich to the poor, or from the least-growing to the fastest-growing countries, the empirical evidence often suggests the opposite direction of capital flows (Gourinchas and Jeanne [29]).

These observations, and more generally the themes of financial integration and global imbalances, have motivated a large body of research.[2] In this paper, we contribute to this growing literature by studying the global macroeconomic effects of financial integration in the presence of a certain market friction—uninsurable idiosyncratic entrepreneurial risk.

Our focus on this friction is motivated, not only by the fact that entrepreneurship is of obvious empirical relevance, but also by the observation that this friction can play a crucial role in capital accumulation and productivity growth. Indeed, this friction introduces both a precautionary motive for saving, as entrepreneurs seek to self-insure against the idiosyncratic risk in their income, and a wedge between the interest rate and the marginal product of capital, as entrepreneurs require a (private) risk premium in compensation for the risk they face in their entrepreneurial activity. Furthermore, this wedge is likely to vary across countries, with, say, entrepreneurs in China presumably enjoying less risk sharing and hence facing a higher wedge than those in the United States. Our contribution is to show how cross-country differences in this wedge may help explain a number of stylized facts—such as the persistence of cross-country inequality, the emergence of global imbalances, and the failure of capital to flow from the rich or slow-growing countries to the poor or fast-growing ones—while also providing a distinct set of policy lessons regarding the dynamic effects of capital-account liberalization.[3]

Preview of model. We conduct our theoretical exercise within a tractable, general-equilibrium, incomplete-markets model. There are two economies (countries), each of which is populated by a continuum of households (families). Each family includes a worker and an entrepreneur. The worker supplies his labor in the domestic labor market; the entrepreneur runs a private business that operates a constant-returns-to-scale technology, employs labor from the domestic labor market, and uses the capital stock owned by her family. All households can freely trade a safe asset, but can diversify only a fraction of the idiosyncratic shocks hitting their private firms. The two countries differ in the magnitude of the uninsurable risk—with the "North" enjoying better risk-sharing possibilities and hence less risk than the "South"—but are otherwise identical.

[2] See, for example, Aoki, Benigno, and Kiyotaki [8], Blanchard, Giavazzi, and Sa [11], Boyd and Smith [12], Broner and Ventura [13], Caballero, Farhi, and Gourinchas [15], Engel and Rogers [23], Fogli and Perri [24], Gertler and Rogoff [25], Gourinchas and Jeanne [28], Gourinchas and Rey [30], Hausmann and Sturzenegger [31], Hunt and Rebucci [34], Kraay and Ventura [36], Lane and Milesi-Ferretti [39], Lucas [41], McGrattan and Prescott [43], Mendoza, Quadrini, and Rios-Rull [45,46], Obstefeld and Rogoff [49], Prasad, Rajan, and Subramanian [52], Reinhart and Rogoff [54], and Song, Storesletten, and Zilibotti [58].

[3] Borrowing constraints, although not explicitly considered here, are complementary sources of a wedge between the "external" and the "internal" return to capital. This offers a useful re-interpretation of our contribution. As it will become clear, our key results hinge on the properties that the aforementioned wedge is positive and decreasing with wealth—properties that may hold whether the wedge originates in idiosyncratic risk or in borrowing constraints.