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The real effects of financial integration

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Abstract

This paper shows how correlations in GDP fluctuations rise with financial integration. Finance serves to increase international correlations in both consumption and GDP fluctuations, which explains the persistent gap between the two in the data, a “quantity puzzle”. The positive association between financial integration and GDP correlation constitutes a puzzle, as theory suggests a negative relation if anything. Nevertheless, it prevails in the data even after the effects of finance on trade and specialization are accounted for.

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1. Introduction

In theory, consumption patterns between financially integrated regions should be more synchronized than production, for two reasons. First, capital flows follow return differentials, which results in negative output correlations.¹ Second, agents consume out

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¹ Kehoe and Perri (2002) refine the argument, introducing enforcement constraints whereby capital does not flow to the high return country, lest it chooses to default. The intuition is however similar: if capital flows, it is between economies that are out of phase.

of a fully diversified portfolio, resulting in perfectly correlated consumption plans. The overwhelming rejection of this ranking in the data was famously labelled a “quantity puzzle” by Backus et al. (1994). This paper looks at the determinants of the international correlations in output and consumption to show that the main reason for the anomaly lies in the response of output correlations to financial links, not in that of consumption.

There are two prominent and non exclusive explanations to the quantity puzzle.

Hypothesis A. Capital flows are restricted, effective diversification is limited and consumption plans remain largely idiosyncratic, and less correlated internationally than GDP fluctuations.

Hypothesis B. Capital flows are governed by motives reflective of imperfect information, and tend to herd rather than respond to differentials in returns. Thus, fluctuations in output can become more rather than less synchronized between financially integrated regions.

Following the empirical tradition begun with Frankel and Rose (1998), this paper constructs a cross-section of bilateral output and consumption correlations across countries to investigate the relevance of these conjectures.

Unsurprisingly, the data suggest that financial integration results in significantly higher consumption correlations.² This result, akin to Lewis (1996), provides support in favor of Hypothesis A. The quantity puzzle is a manifestation of restrictions to capital flows, and, holding output correlations constant, the discrepancy diminishes once restrictions to capital flows are accounted for. However, the data suggest that output correlations are not invariant to financial flows, and indeed tend to rise with financial integration as under Hypothesis B. This is similar to the conclusion Frankel and Rose (1998) reached for trade flows, and has a similar interpretation in the Optimal Currency Area framework. Inasmuch as monetary union fosters financial integration, it is possible that the choice of a single currency should have ex post effects on the international synchronization of business cycles through a financial channel, and thus become endogenously optimal.

In fact, the response of output correlations is substantially larger than that of consumption, so much so that the discrepancy increases with capital flows. In the data, consumption remains less correlated than output even between financially integrated economies, not because risk-sharing and consumption correlations are low, but rather because finance synchronizes GDP fluctuations.³ While the former effect is consistent with theory, the latter is not, and holds therefore the key to the quantity puzzle. This is the paper’s main result, and a challenge for theory.

Two immediate explanations spring to mind. First, there is increasing evidence that financial flows depend on the information afforded by goods trade, and are predicted by

² A caveat is in order here. Risk sharing is strictly speaking a multilateral phenomenon, which the bilateral approach proposed here is ill-suited to evaluate. See Imbs (2005) for a discussion and a measure tailored to capturing bilateral risk sharing.

³ Heathcote and Perri (2002) find the correlation between the US and an aggregate of European countries has actually decreased over time, and associate this with heightened international financial integration in US markets. This may very well be, but the exercise is based on too few observations to draw general implications. Further, no controls are included for other influences on cycle correlations.

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