Globalization and international risk-sharing: The role of social and political integration☆

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ABSTRACT

This study explores the relationships among various dimensions of globalization (i.e., economic, social, and political) and international risk-sharing, by exploiting the KOF globalization indices over a long time horizon (1970–2014) and for several groups of countries (i.e., World; Organisation for Economic Cooperation and Development (OECD); European Union (EU); European Monetary Union (EMU); high-income economies (HI); and low and middle-income economies (LMII)). To this end, we follow a standard regression-based approach augmented by interaction terms. To date, the empirical literature has only investigated the economic and financial facets of globalization; we, on the other hand, find a significant relationship between risk-sharing and noneconomic aspects of globalization. For several groups of industrialized countries, social and political integration positively correlate with risk-sharing. The economic factor does not explain all the improvements that relate to globalization, and political integration plays a remarkable role in shaping risk-sharing opportunities, both among EMU/EU countries and on a global scale. For advanced economies, in an increasingly globalized world, political integration should be of great concern.

1. Introduction

This study looks to assess the relationship between the economic and noneconomic aspects of globalization and international risk-sharing, as measured by comovements between idiosyncratic consumption and income. The globalization process is a controversial phenomenon; the economic literature has investigated its consequences on the global economy, and derived various results and conclusions.

In a complete markets setting, international risk-sharing is the possibility of a full diversification of idiosyncratic risk—that is to say, countries can (potentially) completely smooth income and consumption across time and states of nature, and thus offset shocks to income and remain affected only by systemic risk. Therefore, theoretical predictions imply that increased market integration brought about by globalization should broaden insurance opportunities and improve risk-sharing. The literature mainly takes into

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account economic integration, even though political and social integration may be effective in improving risk-sharing. A portion of the literature recognizes that economic integration has a positive effect on the degree of risk shared (Giannone and Reichlin, 2006; Sørensen et al., 2007; Leibrecht and Scharler, 2008; Flood et al., 2012). Nevertheless, political and cultural integration have already been recognized as determinants of growth and the volatility thereof (Alesina et al., 2000, 2005). If political ties can facilitate the international enforceability of contracts, they could also increase risk-sharing, while cultural integration may prove vital in the successful conclusion of cross-border mergers and acquisitions (M&As), which constitute the main components of foreign direct investment (FDI) (Weber and Camerer, 2003; Jarnagin and Slocum, 2007; Froese et al., 2008). Moreover, politically and culturally integrated countries might share similar economic structures, and this would enable them to share risk (Ostergaard et al., 2002; DeJuan and Luengo-Prado, 2006). Therefore, political and social integration might positively correlate with risk-sharing. Indeed, the noneconomic aspects of globalization could be relevant to improvements in risk-sharing, since economic integration is often the outcome of political arrangements and social proximity. Thus, our research question is: along with economic integration, do political and social globalization play roles in smoothing idiosyncratic shocks?

One may argue that political and social integration manifest as improved economic integration. However, noneconomic dimensions of globalization have been recognized as complementary (e.g., Brou and Ruta, 2011) and do not strongly correlate with economic ones (see also de Soysa and Vadlamannati, 2011). In summary, we identify two relevant issues: i) economic, social, and political integration correlate positively but convey different information; and ii) all political and social aspects of globalization may not be captured by economic integration.

By applying a regression-based analysis augmented for interaction terms, we investigated whether a higher level of political (and/or social) integration improves risk-sharing, given a certain level of economic integration. We focused on the relationship between social/political globalization and risk-sharing, in terms of several groups of countries: World, high-income economies (HI), Organisation for Economic Cooperation and Development countries (OECD), European Union (EU) countries, European Monetary Union (EMU) countries, and low and middle-income (LMI) countries. To contribute to the debate, we followed Kose et al. (2005, 2007, 2009, 2011) and investigated this issue within the context of OECD and LMI economies; moreover, we also included in the analysis the EU and EMU, since they are particularly suitable cases in evaluating the role of noneconomic aspects of globalization. We report the results for the entire available sample (1970–2014) and for two subsamples: the preglobalization period (1970–1989), and the globalization era (1990–2014) when integration accelerated. This choice of focus allowed us to detect any significant changes that occurred in the globalization era, relative to the preglobalization period.

Over the entire sample (1970–2014), we registered a positive relationship between globalization and risk-sharing. Economic integration is beneficial to risk-sharing, even though this phenomenon attenuated over the second subsample. LMI countries, in accordance with the literature, do not seem to benefit from globalization. For several groups of countries, social and political integration correlated positively with risk-sharing. From the results derived from the model that includes the three indices of globalization, we can conclude that the economic factor does not explain all the improvements associated with globalization, and that political integration exerts a remarkable role in shaping risk-sharing opportunities in EMU/EU countries.

The main claim of this paper is that the relationship between globalization and international risk-sharing cannot be reduced solely to the economic aspects of the integration process. Globalization is a complex phenomenon that implies integration among countries, in several ways and at different levels. All these aspects tell a different story about the phenomenon, and it is vital to take all of them into account. When we account for such complexity, the new and most important finding is the recognition of the significant roles of social and political integration, which thus far has been almost ignored by economists.

The following section surveys the literature on globalization and risk-sharing and discusses the role played by social and political integration. The theoretical framework and the empirical strategy are described in Section 3. Section 4 describes the data used, as well as the measures of economic, social, and political globalization used in the empirical analyses. Estimation results are discussed in Section 5, while Section 6 concludes the paper.

2. Risk-sharing and globalization: a literature review

The most influential contributions focus on economic aspects of globalization, and this mirrors the actual form of the globalization process. Indeed, countries’ accumulation of cross-border holdings and the enlargement of the size of their external portfolios have ratified the surge of economic–financial integration among countries (Lane and Milesi-Ferretti, 2007). Moreover, the EMU—with the introduction of a common currency—serves as a unique case that is perfectly suited to investigating the impact of financial integration. These issues have probably channeled scholarly interest predominantly towards the aspect of globalization, as represented by economic and financial integration.

1 See the Appendix for the lists of countries.
2 On one hand, our choice of setting the threshold at 1990 was based on some studies in the literature that emphasize the start of globalization (due to the technological changes and the like) in the early 1990s (see, for instance, Tobin, 2000; Keohane and Nye, 2000; Dunning, 2014). On the other hand, the countries’ accumulation of cross-border holdings and the enlargement of their external portfolios helped ratify the surge of economic–financial integration among countries (Lane and Milesi-Ferretti, 2007). By looking at Fig. 1, we can easily appreciate how around 1990, the slope of the KOF index of globalization changes significantly, showing an acceleration in the globalization process.
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