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Financial development and international trade
Is there a link?

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Abstract

This paper explores a possible link between financial development and trade in manufactures. The theoretical model focuses on the role of financial intermediaries in facilitating large-scale, high-return projects and shows that economies with better-developed financial sectors have a comparative advantage in manufacturing industries. We provide evidence for this hypothesis, first proposed by Kletzer and Bardhan (Journal of Development Economics 1987;27:57–70), using a 30-year panel for 65 countries. Controlling for country-specific effects and possible reverse causality, we show that financial development exerts a large causal impact on the level of both exports and the trade balance of manufactured goods. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Among the macroeconomic variables that the empirical growth literature has identified as being highly correlated with growth performance across countries are the level of financial development and the degree of openness.[1] There is also a large literature that studies the issue of causality and the channels through which

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[1] See among others Barro and Lee (1994) and Easterly et al. (1994).

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both financial development and openness affect economic growth.[2] This paper explores a possible link between financial development and the structure of the trade balance. Specifically, it analyzes theoretically a channel through which the economy-wide level of external finance determines the trade balance in manufactures. It then assesses the empirical validity of this theoretical model in a 30-year panel of 65 countries.

This paper builds on theoretical work by Kletzer and Bardhan (1987) who show that countries with a relatively well-developed financial sector have a comparative advantage in industries and sectors that rely on external finance. We extend their work by allowing both sectors to use external finance, one being more credit intensive due to increasing returns to scale. Furthermore, we test the hypothesis derived from both Kletzer and Bardhan and our work by exploring the impact that financial development has on the structure of the trade balance, specifically, on the export share and trade balance in manufactures.

Exploring the link between financial development and trade in manufactures is interesting for several reasons. First, if we find that the level of financial development has an effect on the structure of the trade balance, this underlines the importance of financial sector development for economic development beyond its positive impact on economic growth and therefore increases the priority that financial sector reforms should have on policy makers' agendas.

Second, exploring the links between financial development and the structure of international trade also has implications for the theory of international trade. The Heckscher–Ohlin model predicts trade flows based on an economy's endowments of labor, land and physical capital. In the Ricardian model technological differences across countries explain international trade flows. This paper explores theoretically and empirically whether cross-country variance in the level of financial development helps predict trade flows, where financial services can be interpreted either as part of the production technology or as determining the level of physical capital in the economy.

Finally, a possible link between financial development and international trade has policy implications. On the one hand, reforming the financial sector might have implications for the trade balance if the level of financial development is a determinant of countries' comparative advantage. On the other hand, the effect of trade reforms on the level and structure of the trade balance might depend on the level of financial development.

While there is a large variety of possible links between financial development and international trade, this paper focuses on just one. It concentrates on the ability of the financial sector to channel savings to the private sector and therefore help overcome liquidity constraints. This enables the economy to specialize and exploit economies of scale. Economies with a better developed financial system and a

[2] For financial development, see Levine et al. (2000); for openness, see Frankel and Romer (1999).

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