



# Financial development and the choice of trade partners



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## ABSTRACT

What determines the choice of countries' trade partners? We show theoretically and empirically that financial market imperfections affect the number and identity of exporters' destinations. Bigger economies with lower trade costs are more attractive markets because they offer higher export profits. This generates a pecking order of destinations such that firms serve all countries above a cut-off level of market potential. Credit constraints, however, raise this cut-off above the first best. Financially more advanced nations thus have more trade partners and go further down the pecking order, especially in sectors that rely heavily on the financial system. Our results provide new, systematic evidence that countries follow a hierarchy of export destinations, that market size and trade costs determine this hierarchy, and that financial frictions interact importantly with it. This has policy implications for the effects of cross-border linkages that depend on the number and identity of countries' trade partners.

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## 1. Introduction

For many developing countries, international trade contributes significantly to aggregate output and economic growth. Exporting provides access to a bigger consumer market, enabling firms to expand production, increase domestic employment and reap higher profits. This can in turn boost firms' productivity by allowing them to benefit from scale economies under existing manufacturing practices, as well as to invest in innovation and technology upgrading. The very exposure to international know-how and the frequent use of imported inputs in production for foreign countries can mediate productivity spillovers across borders. Aside from raising income levels and growth rates, exporting can also reduce volatility over time. By diversifying across multiple consumer markets, exporters may be able to hedge fluctuations in country-specific demand and insure against downturns at home.

These arguments suggest that being able not only to export more, but also to sell to more destinations matters for aggregate welfare. In practice, successful economies indeed boast high exports to many destinations. For example, countries with more trade partners in 1985 exported substantially more over the next 10 years (Fig. 1). They attained faster average annual growth in both exports and GDP per capita (Fig. 2a and b). They also experienced less volatility, as reflected in lower standard deviations of these growth rates over time (Fig. 3a and b). As the regressions in Appendix Table A.1 show, these correlations are not driven by cross-country differences in initial export volumes in 1985. While faster growth in the number of export destinations

is not associated with faster income or export growth in the raw data (Fig. 4a and b), it is when catch-up effects are taken into account in regressions controlling for initial trade activity (Appendix Table A.1).

These patterns indicate that it is important to understand what determines countries' ability to establish more trade links. Among other things, financial development appears strongly positively correlated with exporters' destination count (Fig. 5).

This paper examines the effect of financial market imperfections on the number and characteristics of exporters' trade partners. Because market size and trade costs vary across countries, bigger economies with lower trade costs are relatively more profitable export targets. This generates a pecking order of destinations based on their market potential. In the absence of credit constraints, firms export to all

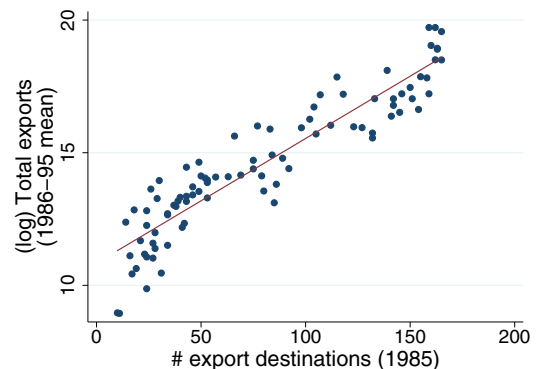


Fig. 1. Export partners and total exports. Slope (t-stat) of the fitted line: 0.047 (23.1).  $N = 90$ .

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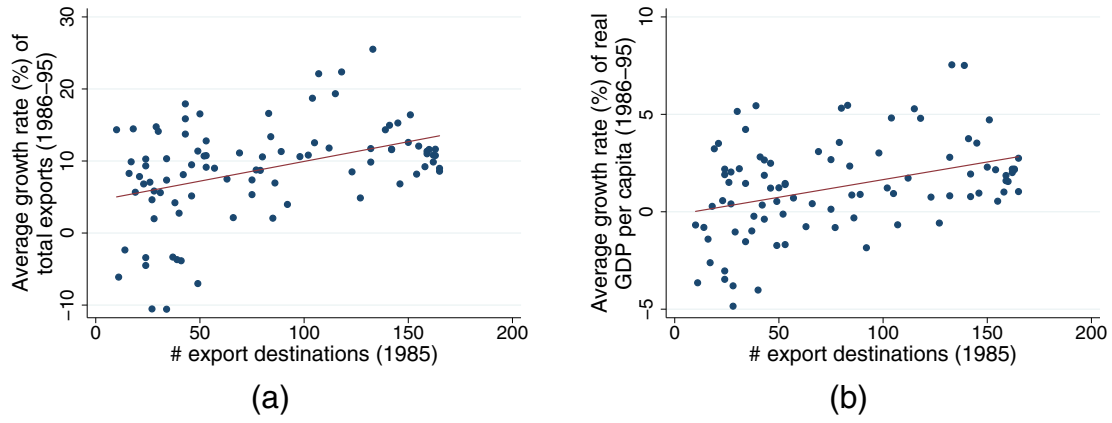


Fig. 2. (a) Export partners and growth rate of total exports; (b) export partners and growth rate of GDP per capita. Slope (t-stat) of the fitted line: (a) 0.054 (4.2); (b) 0.018 (3.8).  $N = 90$ .

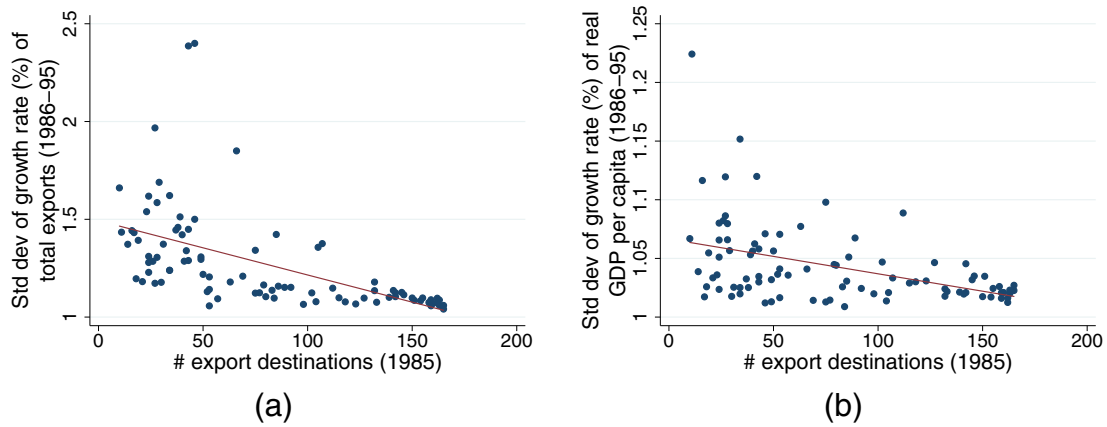


Fig. 3. (a) Export partners and std. dev. of growth rate of total exports; (b) export partners and std. dev. of growth rate of GDP per capita. Slope (t-stat) of the fitted line: (a)  $-0.003 (-6.2)$ ; (b)  $-0.0003 (-4.6)$ .  $N = 90$ .

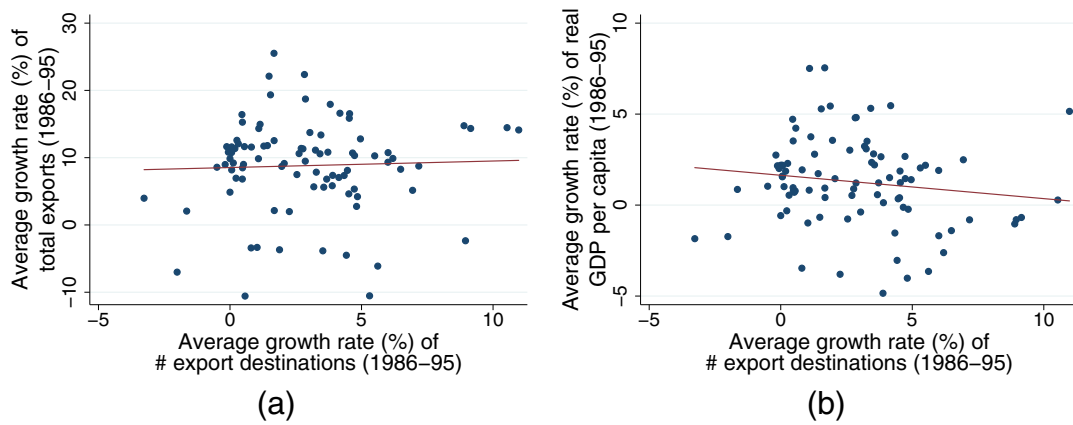


Fig. 4. (a) Growth rate of number of export partners and growth rate of total exports; (b) growth rate of number of export partners and growth rate of real GDP per capita. Slope (t-stat) of the fitted line: (a) 0.097 (0.37); (b)  $-0.128 (-1.37)$ .  $N = 90$ .

destinations above a cut-off level of market potential. Financial frictions, however, raise this cut-off and prevent firms from serving some markets that they would otherwise have entered in the first best. Financially developed nations thus have more trade partners and go further down the pecking order of destinations, especially in sectors that rely more heavily on the financial system.

We study these questions formally by extending the theory developed in Manova (2013). In the model, heterogeneous firms incur trade costs in each market they enter. They face liquidity problems

and require outside funding for a fraction of these costs, which they can raise by pledging collateral. Financial contracts are imperfectly enforced and creditors face default risks. Producers are thus unable to pursue all profitable export opportunities because they have limited access to capital. Instead, companies optimally add destinations in decreasing order of profitability until they exhaust their financial resources. Aggregating across firms, this implies that credit constraints restrict countries' number of trade partners to suboptimal levels and change the composition of these trade partners.

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