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Markets for risk and openness to trade: how are they related?

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Abstract

If protectionist trade policies aim to insure domestic industries against swings in world market prices, the development of financial markets could lead to trade liberalization. Likewise, trade liberalization could lead to the development of financial markets that help agents diversify the added risks. In this paper, we empirically address the hypothesis that there is a positive interdependence between financial development and liberal trade policies. We find a positive and economically significant relationship between the two, with causation running in both directions. The results are, however, somewhat dependent on the measure of trade policy being used.

Keywords: Financial markets; Trade policy; Panel data

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1. Introduction

It has long been argued that trade restrictions can be motivated by insurance considerations in the absence of full risk diversification. Examples are Corden (1974), Hillman (1977), Cassing (1980), Newbery and Stiglitz (1984), Eaton and

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Grossman (1985) and Cassing et al. (1986).[1] It follows that the development of institutions for risk diversification, for example financial markets, might reduce barriers to trade. Given the abundance of theoretical models, it is surprising that no empirical work has brought this hypothesis to the data. In this paper, we address the issue empirically and show that there exists a positive relation between openness to trade and the degree of financial sector development.

International trade brings about substantial changes in competition, technology, prices of intermediary and final goods, and in the long run even in factor endowments and the institutional features of a society. The exact outcome of trade liberalization for different individuals is therefore uncertain. Rodrik (1998) provides evidence that openness to trade also increases the permanent degree of income volatility in an economy.[2] The theoretical papers mentioned above argue that trade barriers can be welfare enhancing if private markets fail to pool such risks. Feeney and Hillman (2001a) explicitly demonstrate how asset market incompleteness can affect trade policy in a positive theory of trade liberalization. In their model, the degree of portfolio diversification determines the protectionist lobbying effort conducted by owners of sector-specific capital. If risk can be fully diversified, special interest groups have no incentive to lobby for protection and free trade will prevail. This model suggests a causal effect from financial development to trade liberalization. Another possibility is that the demand for insurance increases after liberalization, thus promoting the development of the financial sector.

In the light of this literature, we ask the question whether institutions allowing for better insurance possibilities and risk diversification within a country are positively related to a liberal trade regime. In particular, we investigate whether the development of domestic financial markets is systematically related to trade policy. Moreover, since openness to trade increases aggregate income volatility, we expect international financial integration to reduce the demand for trade protection. This hypothesis is also brought to the data. Due to the difficulties involved in measuring trade restrictions, we employ a number of different measures. The expected positive relation between financial development, both domestic and international, and openness to trade appears clearly for some indicators. For other measures, the results are weaker and only seem to apply to relatively rich countries. Causality is an important issue, albeit a difficult one to fully resolve using cross-national evidence. We find some support for a causal link from financial development to openness for trade, and some support for the opposite. These results are conditional on the indicator we use.

[1] Dixit (1987, 1989a,b) is a dissenting voice in this literature. When explicitly modeling the reasons behind the absence of insurance markets, he finds the scope for government intervention to be limited.

[2] Traca (2000) shows theoretically that we have reasons to expect trade to increase income volatility. Further empirical evidence for this view is given in Gottschalk and Moffit (1994), and Ghosh and Wolf (1997).