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Economic integration, industrial specialization, and the asymmetry of macroeconomic fluctuations

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Abstract

We show empirically that regions with a more specialized production structure exhibit output fluctuations that are less correlated with those of other regions (less 'symmetric' fluctuations). Combined with the causal relation running from capital market integration to regional specialization found in an earlier study, this finding supports the idea that higher capital market integration leads to less symmetric fluctuations. This mechanism counterbalances the effect of lower trade-barriers on the symmetry of fluctuations quantified by Frankel and Rose (1998). Deriving a simple closed form expression for the gains from risk sharing for CRRA utility is an independent contribution of the present article. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Much of the debate on the desirability of economic integration centers on the degree of synchronization (symmetry) of macroeconomic fluctuations across

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countries.[1] It has been noted that economic integration itself will affect the symmetry of macroeconomic fluctuations. Frankel and Rose (1998) argue that removal of trade barriers will entail more correlated business cycles, since a higher level of trade will allow demand shocks to more easily spread across national borders. They further mention that economic integration will render policy shocks more correlated and that knowledge and technology spillovers will increase (Coe and Helpman, 1995).[2] Krugman (1993), on the other hand, claims that lower barriers to trade will induce countries to specialize more rendering output fluctuations less, not more, symmetric.[3] Fig. 1 summarizes these effects visually.

Frankel and Rose (1998) provide empirical evidence for the mechanism they propose by regressing the pairwise correlation of business cycles on bilateral trade intensity instrumented by distance for a sample of OECD countries.[4] They obtain a positive and significant coefficient which suggests that even if the effect proposed by Krugman is present in the data, it is dominated by the mechanism they describe.[5]

Our goal here is two-fold. First, we want to draw attention to yet another mechanism: economic integration will lead to better income insurance through greater capital market integration which will, *ceteris paribus*, induce higher specialization in production and more trade rendering fluctuations less symmetric across countries. Second, we establish empirically that higher specialization in production indeed translates into less symmetry of output fluctuations; see Fig. 1.

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[1] In recent years, the discussion of European monetary integration has dominated the scene. It is argued that the cost of joining a monetary union and giving up independent monetary policy will be low if countries have highly synchronized (symmetric) business cycles. See De Grauwe and Vanhaverbeke (1993) for an exposition of the main issues. Naturally, this debate builds on Mundell's (1961) classic analysis of Optimum Currency Areas.

[2] These additional mechanisms should also contribute to fluctuations becoming more symmetric following economic integration.

[3] Krugman corroborates his argument with the observation that US states are more specialized in production than European countries.

[4] It is well established empirically that trade volume increases with geographical proximity; see Table 1 in Frankel and Rose (1998).

[5] The effect suggested by Krugman operates via inter-industry trade while that proposed by Frankel and Rose applies mainly to intra-industry trade. In their analysis, Frankel and Rose use the total volume of trade instrumented by distance. Since distance affects both inter- and intra-industry trade, the positive relation between trade volume and business cycle correlation indicates that the effect suggested by Krugman is not the dominant one. Rose (2000) adds another empirical building block to the Frankel/Rose mechanism by providing cross-sectional country- and regional-level evidence that a common currency enhances the volume of trade. Canova and Dellas (1993) also study the relation of trade interdependencies and business cycles. They focus on the transmission across countries of business cycle fluctuations and obtain mixed results. They do not discuss the potential endogenous response of country-level business cycles to economic integration.

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