

The Great Recession: Divide between Integrated and Less Integrated Countries

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This is an unusual and intriguing paper that combines theory and empirical analysis in surprising and novel ways.

Specifically, the authors provide.....

- A theory of panics in a multi-country setting
 - Extends the work of Bacchetta and van Wincoop (2014)
 - The panics are not due to wealth effects arising from asset-price bubbles
 - The panics are due to rational, self-fulfilling expectations about future real variables
 - Trade intensity is the critical integration variable
 - No role for financial integration, at least so far

The empirical analysis

- finds a role for a nonlinear effect related to the level of economic integration, as in the model, which is intriguing, because...
- A large and growing literature finds few ex ante variables that robustly explain the pattern and depth of recessions around the world
- This paper finds that dummy variables representing integration thresholds is significant in explaining economic performance during the Great Recession

The empirical approach

The countries most strongly hurt by the Great Recession were those that were most ‘integrated’ through financial and trade linkages to other countries

GOAL: Estimate a threshold based on

- Trade openness: $(\text{exports} + \text{imports}) / \text{GDP}$
- Financial openness: $(\text{external assets} + \text{external liabilities}) / \text{GDP}$

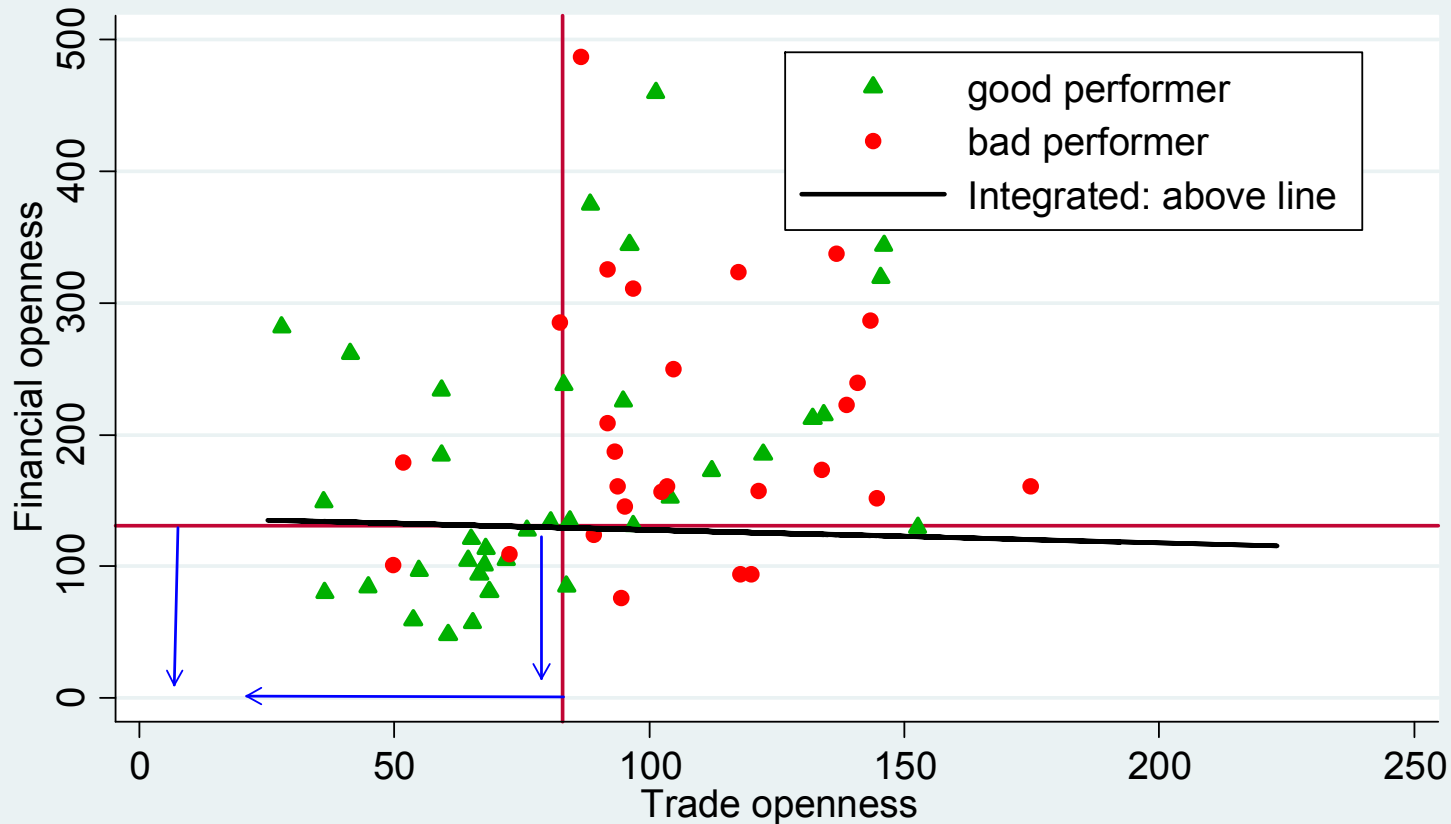
that separates countries into two regions:

- more integrated
- less integrated

The ‘joint integration’ that combines trade openness and financial openness:

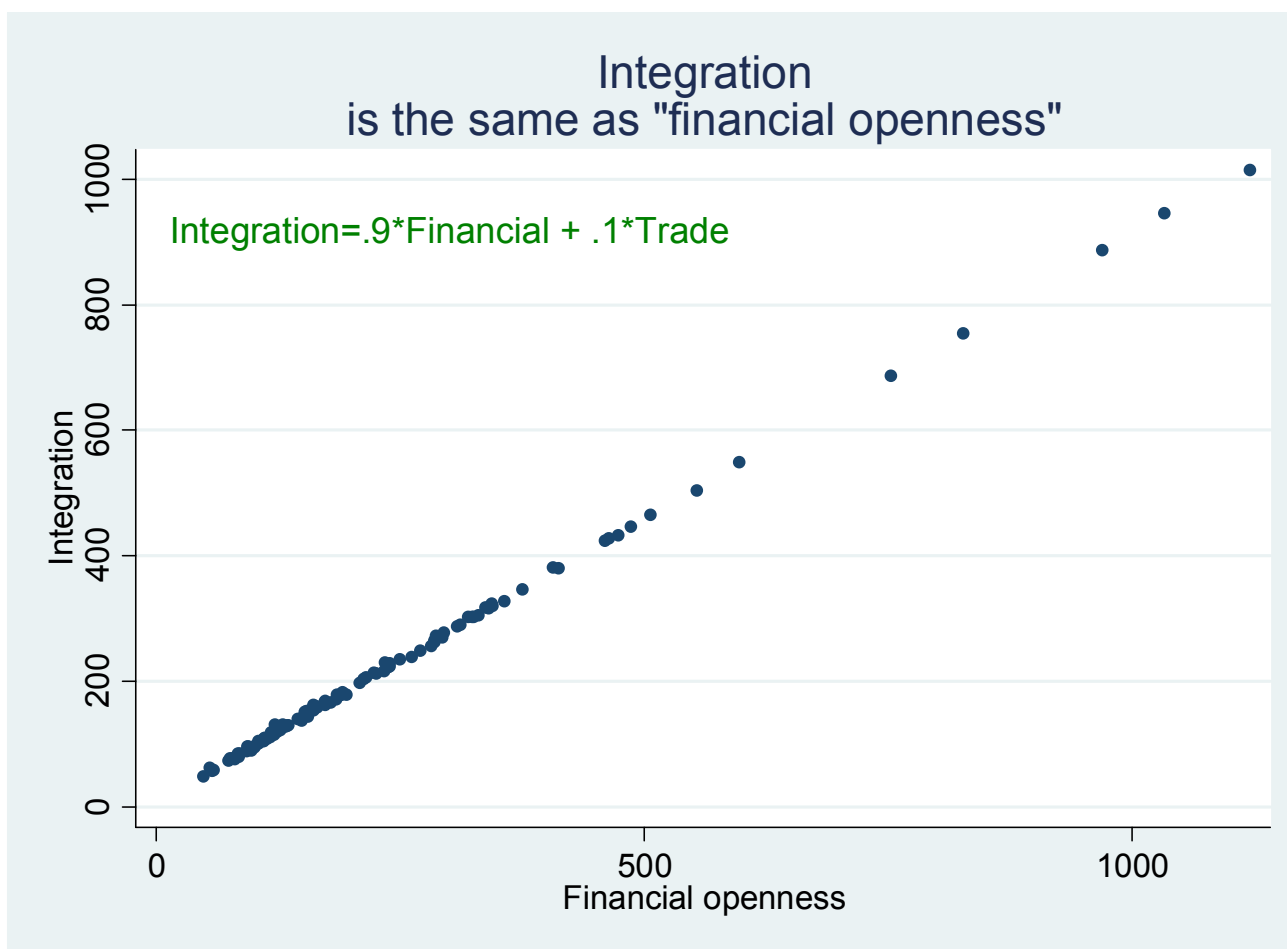
$$\begin{aligned} \textit{Integration} &= \alpha \times \textit{Trade Openness} \\ &+ (1 - \alpha) \times \textit{Financial Openness} \end{aligned}$$

The key step: Find the line that does the best possible job of separating “good” performers from “bad” performers



The dummy variables define a region with a lot of good performers and few bad performers.

These cutoff points were 'calibrated' to do the best possible job with this sample.



Trade is not important for the “joint openness” variable; not an empirical problem, but it does mean that the theory, which emphasizes trade linkages, is not closely linked to the empirics

Policy implications:

- Integration with other countries is a terrible idea
- Nearly all countries are too integrated
- The worst kind of integration is “financial integration”
- **Reduce external assets and liabilities, or risk coordinated disaster.**



Wait a minute...is that really our best advice?



“Financial integration” is not the same thing as a high ratio of external assets and liabilities relative to GDP, although it is defined this way in many papers.

It sounds more policy-relevant to call this “financial integration”, but it is less misleading, and more helpful, just to say “a high ratio of external assets and liabilities relative to GDP”

Why should this predict panic equilibria?

Financial integration should mean

- the absence of barriers, as in Chinn and Ito's (ongoing) careful measure of measurable barriers.
- That world-wide portfolio diversification can reduce consumption risk
- that countries can smooth consumption in the face of temporary income shocks

Should Norway reduce its widely diversified, enormous, sovereign wealth fund, in order to be on safer ground in the event of panic?

In conclusion:

- This paper represents a thought-provoking combination of theory and empirics
- However, a return to trade and financial (near) autarky cannot be seriously proposed as good policy
- The paper's main message must therefore be:

With greater international linkages comes a greater responsibility to anticipate and manage situations in which many countries face coordinated risk