Discussion of: Financial Integration, Macroeconomic Volatility and Welfare
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The Issue

What are the consequences of changes in international financial integration?
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Answers from EH model

- On co-movements: Large
- On volatility: Small and ambiguous
- On welfare: Tiny
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What can we learn about financial integration and our models about financial integration?
More financial integration implies more equalization of marginal valuations (MRS) across states and dates.
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Examples

- Complete Markets. Complete equalization of MRS across all dates and states, regardless of shock process.
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In EH model $\text{MRS} \sim C$, thus more integration leads to higher consumption co-movement (from 0 to 0.73), but not necessarily output co-movement.
## Table 2. Correlations with "World" Macroeconomic Aggregates

(Medians for each group)

<table>
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<tr>
<th></th>
<th>Full Sample</th>
<th>Period</th>
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<tr>
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<td></td>
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<td>Globalization</td>
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<td><strong>Output</strong></td>
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**Consumption**

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Main problem is the strong link between MRS and consumption (also not supported by pricing data).

Next: look at the evidence using more sophisticated MRS.
Financial Integration and Volatility

Macro Volatility = Volatility of Underlying Shocks + Amplification

- In EH model (as in many others) shocks do most of the work.
- Small role of financial integration (Volatility of output goes from 0.77% to 0.84%)
- Evidence from financial crises suggest a link between financial integration and shocks itself (in Mexico and Argentina large drops in TFP)
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- Evidence from financial crises suggest a link between financial integration and shocks itself (in Mexico and Argentina large drops in TFP)
- Next: explore models with the volatility of shocks can depend on integration
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Why?
Financial Integration and Welfare

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- From BE to HI even smaller

Why?
- Shocks to non tradable cannot (by assumption) be shared
- Shocks to tradables are trend stationary (AC = 0.7)
- Business Cycle Shocks are small (Lucas)
Is Financial Integration irrelevant?

- Not if it affects trend growth (Obstfeld, 1994)
- Not if offers individuals (as opposed to countries) better insurance opportunities (Davis, Nalewaik and Willen, 2001)
- Not if shocks are not trend stationary (Aguiar and Gopinath, 2005)
Gains from holding a world portfolio

\[ y_{it} = \rho y_{it-1} + \varepsilon_{it} \]

\[ u(y_{it}) = \frac{1}{1 - \sigma} (y_{it})^{1-\sigma} \]

\[ \sigma = 2, \sigma_\varepsilon = 0.02, \beta = 0.99 \]

200 countries, 200 periods

- If \( \rho \) is close to 1 shocks cannot be insured with a simple bond
- Welfare impact of stock market financial integration can be very large!
Gains from holding a world portfolio v/s a country portfolio

\[ \rho \] (persistence of shocks)

Percent of lifetime consumption

\[
\begin{align*}
0.9 & \quad 0.92 & \quad 0.94 & \quad 0.96 & \quad 0.98 & \quad 1 & \quad 1.02 \\
0 & \quad 2 & \quad 4 & \quad 6 & \quad 8 & \quad 10 & \quad 12
\end{align*}
\]
What next

If gains are so large is then very important to study optimal portfolio diversification (EH, 2005)
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Next: why does not capital flow from poor (and unstable) countries to rich (and stable) countries?