

Globalization and Risk Sharing, by
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1. Mexican experience with globalization since the 1990's

- 1994: NAFTA is put in place
- 1994: Crisis, no Tesobono rollover
- 2006: Issued a catastrophe bond recently, first time ever for developing country

Broner and Ventura ask:

Relation between globalization and welfare?

2. Broner and Ventura's main point:

Today governments cannot discriminate between nationals and foreigners carrying out trade in international financial markets, as opposed to the 1980's

An economist/practitioner's view

Peter Garber (1998):

“(...) derivatives can be used to evade risk-control or prudential regulation, circumvent capital controls, drive the dynamics of currency instabilities, and obscure true risk positions and thereby undermine the usefulness of balance of payments capital account categories.”

3. Goals of the paper

2.1 Study effect of sovereign risk on asset markets under no discrimination assumption

Sovereign risk:

If government cannot commit to enforcement, then it has an incentive not to enforce payments from nationals to foreigners

No discrimination assumption:

Government chooses to enforce all payments or none

2.2 Study effect of globalization on risk sharing

Globalization:

More goods become tradable across countries

4. The model

A continuum of goods: exogenous fraction of tradable goods

Sets of inhabitants of Home and Foreign countries, who live 2 periods

An individual component of endowments: role for domestic risk sharing

A regional component: role for international risk sharing

Logarithmic utility: provides analytic results

Governments:

Maximize average utility of domestic residents under

- No commitment
- No discrimination between nationals and foreigners

5. Results

3.1 Fear versus temptation

Government faces trade-off: Destroy domestic risk sharing versus defaulting on foreigners

3.2 Globalization can lower welfare

Two forces:

- Given set of states with enforcement E , globalization makes more goods tradable, leading to more international risk sharing
- More international transactions lead to higher incentive not to enforce payments, destroying domestic and international risk sharing

6. Testing the model

Stochastic endowments $y_{is}(z) = \phi_{is}(z)\phi_s^{j(i)}(z)y_s^W(z)$

Individual component $\phi_{is}(z)$,

Regional component $\phi_s^{j(i)}(z)$,

government behavior and globalization degree τ lead to predictions on:

- Set of states with enforcement E
- Asset holdings x_{is}
- Consumption $c_{is}(z)$

Consumption volatility and globalization in the data

Levchenko (2005) cites Kose, Prasad and Terrones (2003), who find:

- Period 1960-1999, sample of developing countries
- Financial openness (gross capital flows/GDP) associated with increase in consumption volatility / income volatility
- True up to a certain level of financial openness; beyond, financial openness does seem to lower consumption volatility

Alternative way to find effects of globalization: Trade agreements

- What is a large increase in τ in the real world? Focus on trade agreements and measure changes in consumption volatility
- Has risk sharing become larger in Europe with integration process? Kalemli-Ozcan, Sorensen and Yosha (2004) find such evidence

7. Extending the model

a) Production versus endowments

b) How to model globalization: Outsourcing? Offshoring?
How do results change?

c) Why have many governments removed barriers to trade in goods and assets, if this can have negative effect on welfare? Endogenize lowering of tariffs (higher τ)