Discussion of “Rising Current Account Dispersion: Financial or Trade Integration?”

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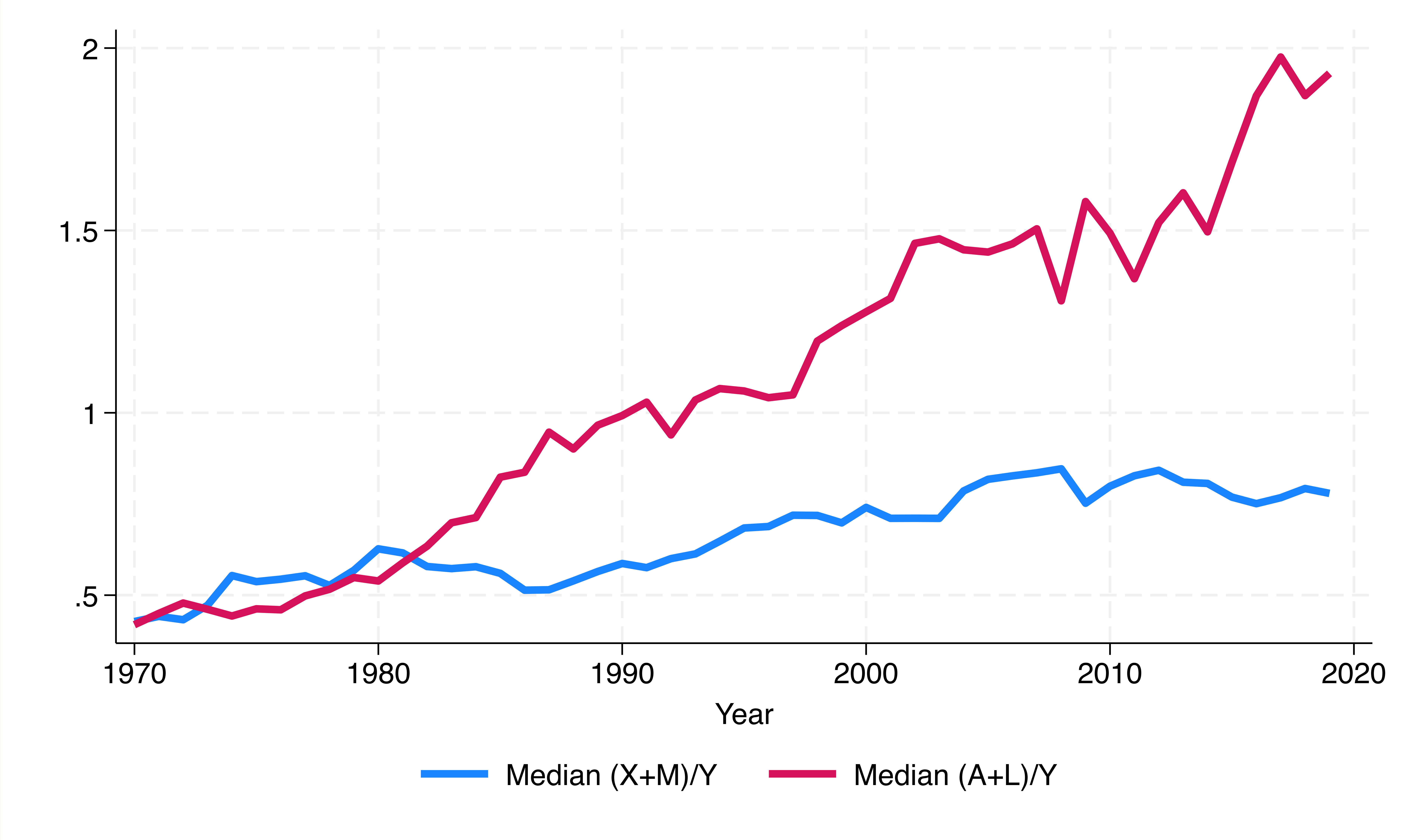
Financial or Trade Integration?

- Are the rising dispersions in trade balance due to
  1. financial integration?
  2. trade integration?
- Both stories make sense:
  1. If countries cannot trade assets, trade balance = 0
  2. If countries cannot trade goods, trade balance = 0
- ABW argue trade integration is the major driver!

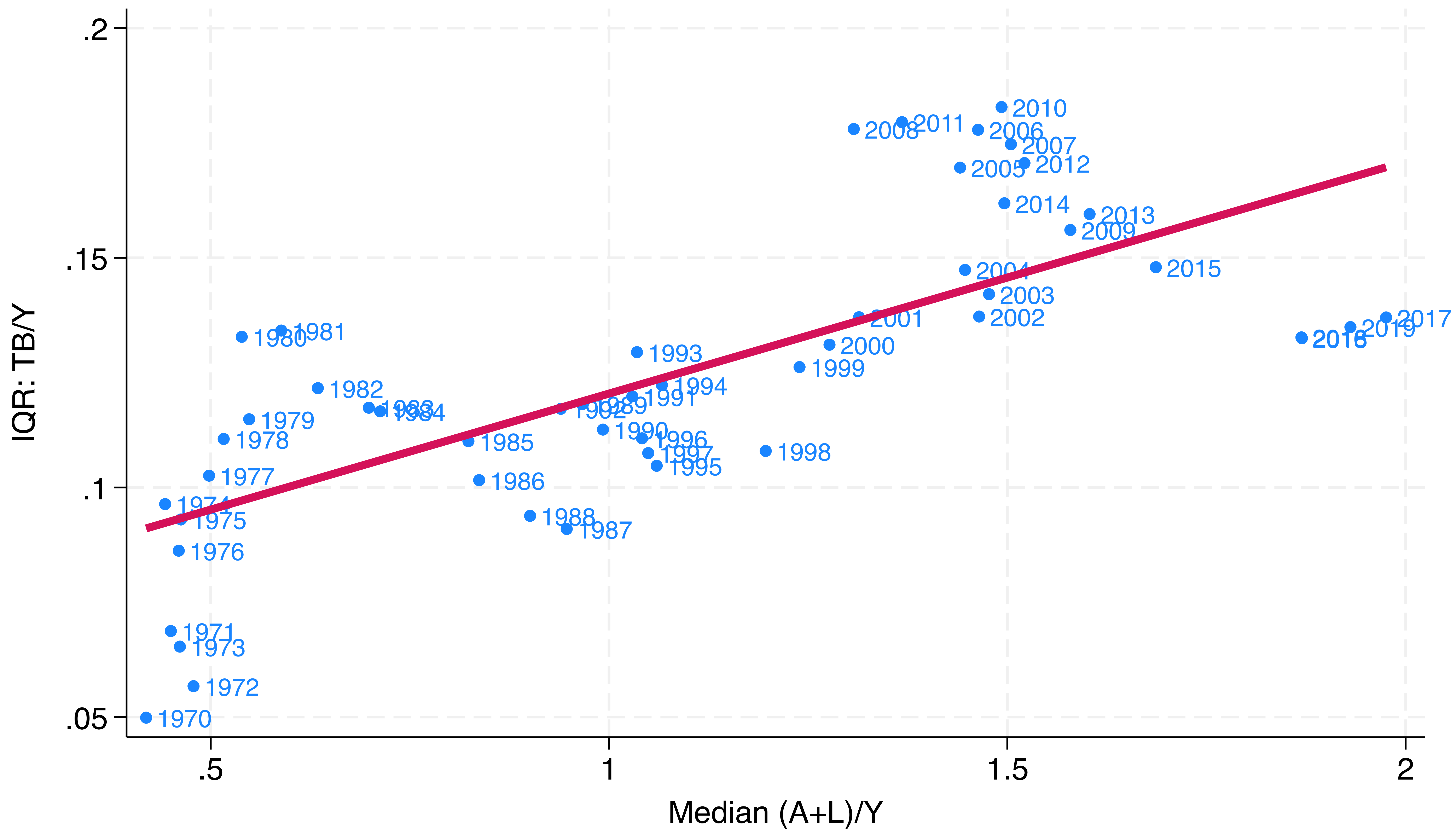
	Trade Integration	**Financial Integration (ABW)**
Counterfactual Exercise	Reduction in trade costs	Increase in asset demand elasticity
Implications for Gross Trade Flow	Increase in gross trade flows	No changes in gross trade flows

Gross Trade Flows, Gross Financial Positions



Data: Lane and Milesi-Ferretti (2007), World Bank

TB Dispersion and Gross Financial Positions



Data: Lane and Milesi-Ferretti (2007), World Bank

My Discussion

	Trade Integration	Financial Integration (My Discussion)
Counterfactual Exercise	Reduction in trade costs	Reduction in financial transaction costs
Implications for Net Trade Flow	Increase in std(TB/Y)	Increase in std(TB/Y)
Implications for Gross Trade Flow	Increase in gross trade flows	No changes in gross trade flows
Implications for Gross Financial Positions	No changes in gross financial positions	Increase in gross financial positions

Model

- N countries

- Representative household in country i:

$$\max_{\{C_{i,t}, A_{i,t+1}\}} \sum_{t=0}^{\infty} \beta^t u(C_{i,t})$$

$$\text{s.t.} \quad P_{i,t}C_{i,t} + A_{i,t} = w_{i,t}L_{i,t} + R_{i,t}A_{i,t-1}$$

- Gravity in financial flow:

$$a_{ij} = \frac{(r_j/\kappa_{ij})^{\eta}}{\sum_l (r_l/\kappa_{il})^{\eta}} A_i$$

  - $\kappa_{ij} \geq 1$: financial transaction costs (paid in units of domestic goods)
  - $\eta > 0$: asset demand elasticity
  - Many micro-foundations:

    (i) risk (Okawa-van Wincoop, 2012), (ii) idiosyncratic return (Kleinman-Redding-Liu-Yogo, 2023)
    (iii) inattention (Pellegrino-Spolaore-Wacziarg, 2023), (iv) heterogenous belief, etc

Technology

- Each country produces CES variety with EoS $\sigma > 1$
- Output is Cobb-Douglas in labor and capital (in fixed supply)
- Price of goods produced in i shipped to j:

$$p_{ij,t} = \tau_{ij,t}(w_{i,t})^{1-\alpha}(\Xi_{i,t})^{\alpha}/Z_{i,t}$$

- Rate of return on asset (capital) in country i

$$r_{i,t} = \frac{\Xi_{i,t+1} + q_{i,t+1}}{q_{i,t}}$$

- Rate of return on portfolio:

$$R_{j,t} = \sum_l (a_{jl}/A_j)(r_{l,t}/\kappa_{jl,t})$$

Rest of Equilibrium Conditions

- Euler equation:

$$u'(C_{j,t}) = \beta R_{j,t+1} \frac{P_{j,t}}{P_{j,t+1}} u'(C_{j,t+1})$$

- Factor markets clear

$$w_{i,t} L_{i,t} = (1-\alpha) \left[\sum_j \frac{(p_{ij,t})^{1-\sigma}}{\sum_l (p_{lj,t})^{1-\sigma}} P_{j,t} C_{j,t} + F_{i,t} \right], \quad \Xi_{i,t} K_{i,t} = \alpha \left[\sum_j \frac{(p_{ij,t})^{1-\sigma}}{\sum_l (p_{lj,t})^{1-\sigma}} P_{j,t} C_{j,t} + F_{i,t} \right]$$

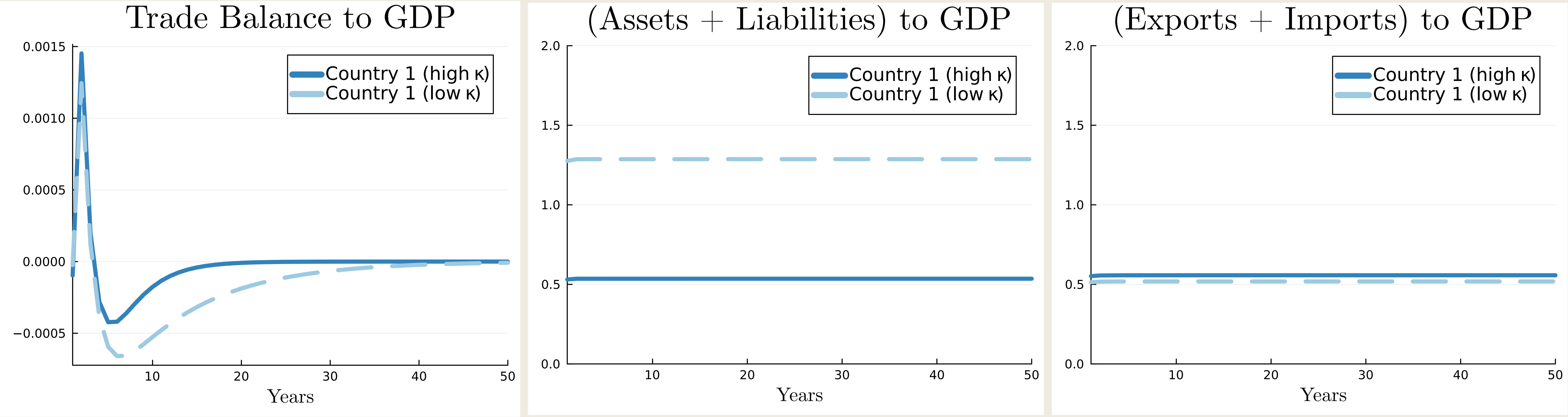
- Asset markets clear:

$$q_{i,t} K_{i,t} = \sum_j \frac{(r_{i,t}/\kappa_{ji,t})^{\eta}}{\sum_l (r_{l,t}/\kappa_{jl,t})^{\eta}} A_{j,t}$$

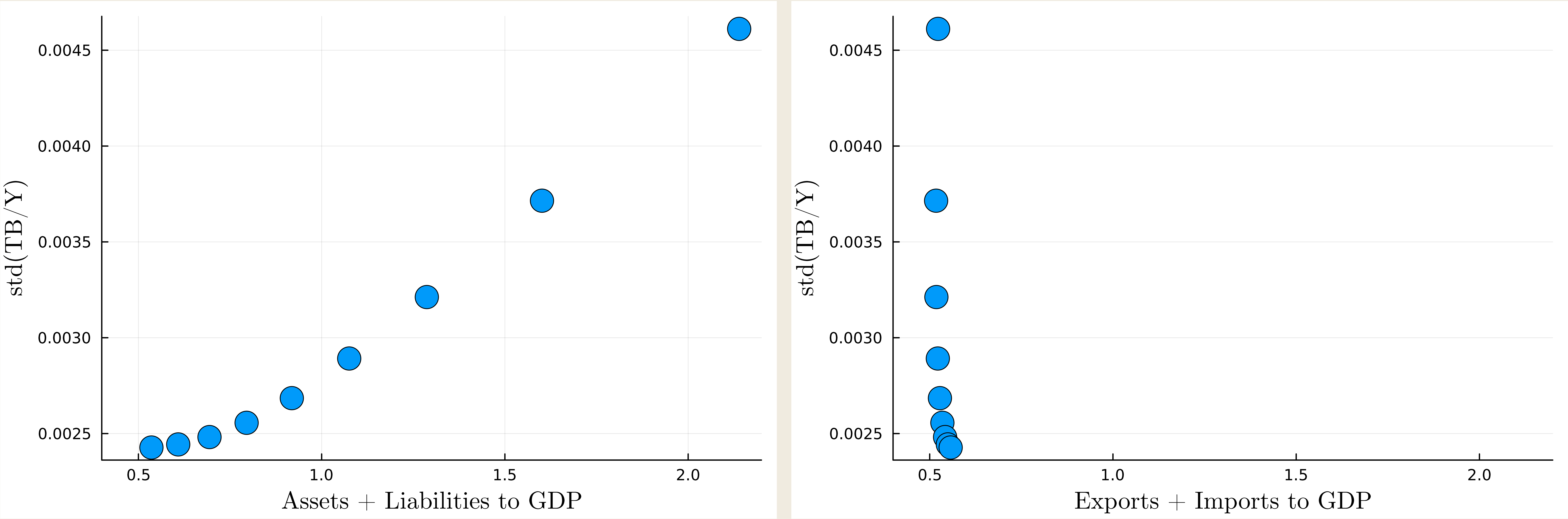
Counterfactual Exercise

- Simulate the response to productivity shock in country 1 under
  - high vs. low financial transaction costs (κ_{ij})
  - high vs. low trade costs (τ_{ij})
- As $\lim \kappa_{ij} \to \infty$ for $i \neq j$, $TB_j \to 0$ for all j
- As $\lim \tau_{ij} \to \infty$ for $i \neq j$, $TB_j \to 0$ for all j

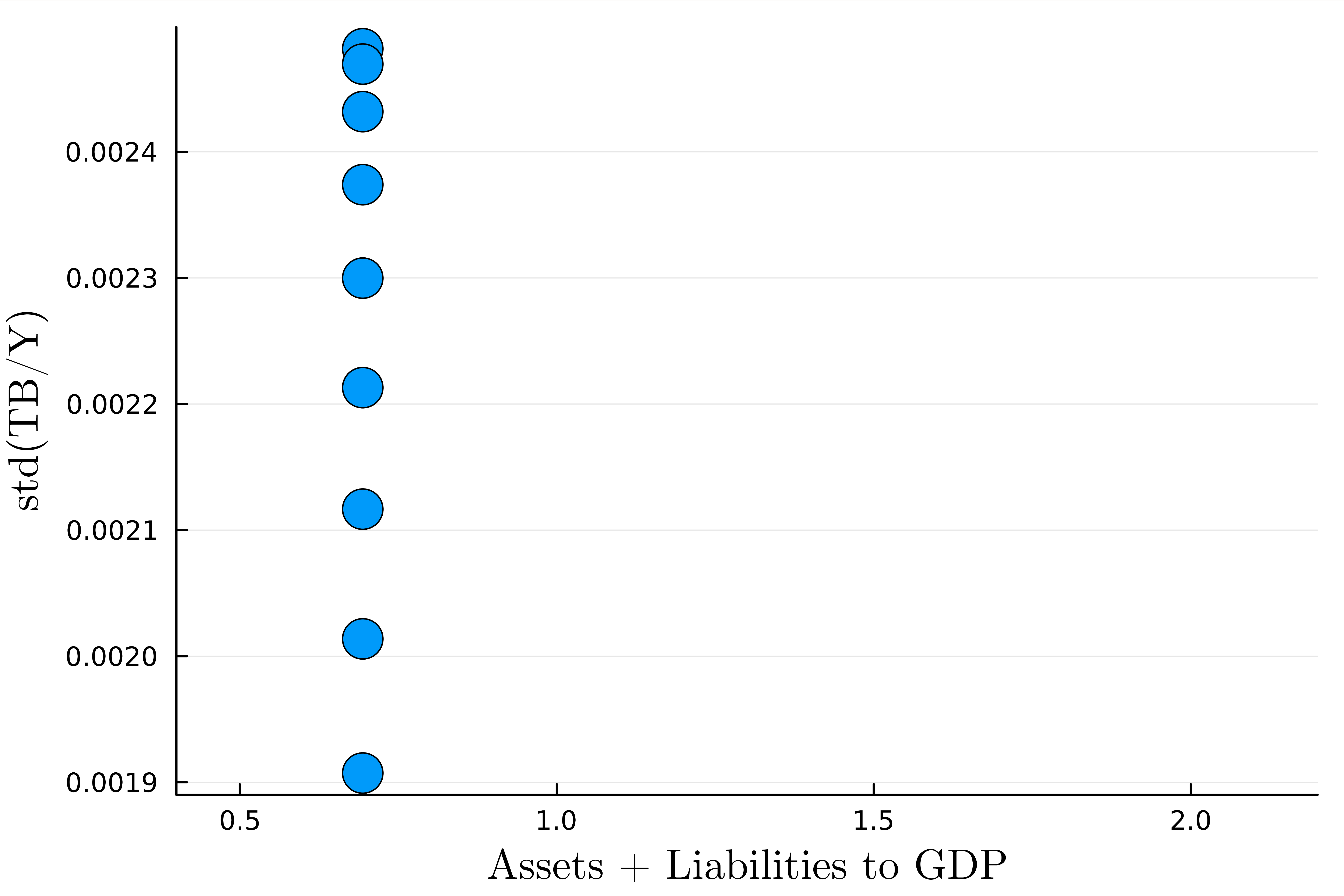
Impulse Response



Declining $\kappa \Rightarrow$ Increase in $(A + L)/Y$ & std(TB)



Declining $\tau \Rightarrow$ No Change in $(A+L)/Y$



Conclusion

- Extremely thought-provoking paper!
- I totally agree that trade integration is important for TB dispersion
- Less sure whether it is ***more*** important than financial integration
- Would like to see apple-to-apple comparison:

1. Trade integration (reduction in trade costs):
    - raises both std(TB) and $(X + M)/Y$
    - No effect on $(A + L)/Y$.
2. Financial integration (reduction in financial transaction costs):
    - raises both std(TB) and $(A + L)/Y$
    - No effect on $(X + M)/Y$.