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THE DISTORTED EFFECT OF FINANCIAL DEVELOPMENT ON INTERNATIONAL TRADE FLOWS

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NON-TECHNICAL SUMMARY

Financial development is a major determinant of exports volume and specialization patterns. Countries with better financial institutions export more and specialize in industries that are more financially intensive. The real effects of finance are also usually considered as being conditioned by the level of economic development. Hence, improving domestic financing conditions is usually expected to benefit disproportionately more, in terms of exports, to countries where financial institutions are poorly developed and financial constraints more binding for starting exporting. This paper investigates how finance affects trade at different stages of economic development. The analysis first disentangles the effects of financial development on the extensive margin (number of trade partners) and the intensive margin (value exported to each partner) of countries' exports. This enables to capture the effects of finance on the geographical diversification of exports. Second, the methodology identifies the effects of financial development on the specialization patterns for countries that differ in the initial development of their financial institutions. Results show that financial development has only a small effect on the geographical diversification of exports. The effect of financial development on exports in financially intensive industries is the highest in middle income economies, and low otherwise. This contradicts the traditional expectation that financial development has the largest effect in countries where financial constraints are the most binding.

I start by developing a model of trade in partial equilibrium, where firms are liquidity constrained and productivity is heterogeneously distributed across firms. Financial development is positively related to the productivity of exporters. It increases both the probability that the country is exporting (the extensive margin) and the aggregate volume of exports to the trade partner (the intensive margin), especially in industries that rely more on external finance. The model predicts that the marginal effect of financial development is positively related to the initial development of financial institutions. The intuition is that most firms have a low productivity level, and these firms require a high level of financial development to start exporting. When financial institutions are poorly developed, financial development enables only few firms to start exporting, with only a small effect on aggregate exports. When financial institutions are better developed, financial development enables more firms to start exporting,

and has a larger effect on aggregate exports. The prediction that is delivered by the model therefore contradicts the traditional expectation that the marginal effect of finance decreases for higher initial development of financial institutions.

The empirical strategy is implemented using a sample of 50 exporting countries, 85 importing countries, 26 ISIC industries over the period 1990-2000. First, estimations confirm that financial development has a positive effect on both the extensive and intensive margins of countries' exports. However, more than 60% of the effect channels through the intensive margin. Second, results show that the effect of financial development on exports is closely related to the initial development of financial institutions. (i) In industries where firms rely intensively on external finance, the effect of financial development is the highest in economies characterized by an intermediate development of financial institutions, and the lowest in countries with poor or advanced financial institutions. This results in a hump-shaped relation between the marginal effect of finance on exports and the initial development of financial institutions. (ii) In industries where firms are less dependent from external finance, the marginal effect of financial development on exports is strictly decreasing for higher initial levels of development of financial institutions. Hence, while we traditionally would expect a large effect of financial development on exports in countries where financial constraints are binding, these results suggest that this is not the case when financial institutions are underdeveloped.

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