

This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Financial Markets Volatility and Performance in Emerging Markets

Volume Author/Editor: Sebastian Edwards and Márcio G. P. Garcia, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-18495-1

Volume URL: <http://www.nber.org/books/edwa05-1>

Conference Date: December 1-3, 2005

Publication Date: March 2008

Title: Links between Trade and Finance: A Disaggregated Analysis

Author: Joshua Aizenman, Ilan Noy

URL: <http://www.nber.org/chapters/c4773>

Links between Trade and Finance: A Disaggregated Analysis

Joshua Aizenman and Ilan Noy

1.1 Introduction and Overview

Traditional analysis of open developing countries viewed trade and financial integrations as two independent margins of openness. Accordingly, trade integration deals with “real issues” related to export orientation versus import substitution, whereas financial integration deals with “financial issues” related to the degree to which the domestic capital market is segmented from foreign ones. Yet recent research suggests that the two margins of openness are interrelated in various hidden channels. Examples of these links include market pressures through, for example, the need for trade financing and political economy considerations that may have an impact both on trade flows and through that on the degree of financial repression.

The market pressure channel follows the logic of arbitrage—segmentation implies gaps across borders in relative prices or returns, providing profitable opportunities. Goods smuggling may be viewed as endogenous outcome of costly enforcement of commercial policy. Similarly, trade misinvoicing may be viewed as an endogenous outcome of costly enforcement of financial segmentation, linking trade and financial integrations—in this case, greater trade openness will increase *de facto* financial openness (see Aizenman and Noy [2004] for further discussion).

A political economy channel is exemplified by Rajan and Zingales

Joshua Aizenman is a professor of economics at the University of California, Santa Cruz, and a research associate of the National Bureau of Economic Research. Ilan Noy is an assistant professor of economics at the University of Hawaii, Manoa.

We would like to thank Sebastian Edwards, Márcio G. P. Garcia, Maria Cristina Terra, Thierry Verdier, and the IASE-2005 Rio conference participants for their useful comments. Any errors are ours.

(2003), who propose an interest group theory of financial development whereby incumbents oppose financial development because it breeds competition. In these circumstances, the incumbents' opposition will be weaker when an economy allows both cross-border trade and capital flows. They predict that country's domestic financial development should be positively correlated with trade openness and identify the time varying nature of this association.

Other theoretical models that connect trade openness with financial factors also exist. Do and Levchenko (2004, 2006), for example, develop a two-sector trade model in which one sector is more financially intensive, and cross-border financial flows depend on the size of this sector. They conclude that in the country that uses this sector more intensively (the rich country), opening up to trade will result in more financial flows and a deeper financial system (the opposite is true for the other country). Rose and Spiegel (2004) develop a model of sovereign lending and suggest that if a credible threat to reductions in trade is what sustains sovereign lending, then one should observe more lending occurring between countries whose trade links are stronger. Petersen and Rajan (1997) focus on trade credits and investigate theoretically and empirically what firm characteristics will drive an increased usage of trade credits to finance trade transactions.

Most papers that do distinguish between different types of financial flows, however, do not investigate their impact on trade flows (e.g., Smith and Valderrama 2006). Several projects, though, focus on the theoretical links between foreign direct investment (FDI) and trade openness; Swenson (2004), for example, examines whether FDI and trade flows are complements or substitutes. She suggests a theory to support her findings of complementarities at a high level of data aggregation and substitution effects at the product level. Aizenman and Noy (2006), on the other hand, propose a theory of links that describe dynamic complementarities, both from FDI to trade and from trade to FDI.

A number of recent empirical papers have begun to examine the differences between the determinants of trade flows and financial flows. For example, Eaton and Tamura (1994) compare the determinants of Japanese and U.S. trade and foreign investment, while Guerin (2006) compares a gravity model for trade with similar gravity models for FDI and portfolio flows. Guerin (2006) builds on a growing literature that uses gravity models to empirically examine the determinants of financial flows focusing exclusively on FDI and portfolio flows (e.g., Portes, Rey, and Oh 2001; Razin, Rubinstein, and Sadka 2003; Wei 2000).¹ Interestingly, these papers typically do not examine the links between the financial flows and trade flows but rather compare their determinants and find similar specifications fit

1. For a survey of this literature, see Blonigen (2005).

both trade and financial flows. Another branch in this literature examines the joint effect of both financial and trade flows on a third variable as, for example, in Kose, Prasad, and Terrones (2006) investigation of their impact on output growth volatility. A different strand investigates and compares the determinants of different types of financial flows without investigating their relationship to trade flows (e.g., Daude and Fratzscher 2006). A recent survey of the literature on financial openness and its causes and effects is Kose et al. (2006).

In recent works we have looked at the degree to which the data is consistent with the presence of two-way feedbacks between trade and financial openness. We adopted a reduced form approach, where we tested the presence of two-way intertemporal linkages between trade and financial *de facto* openness. The results are reported in Aizenman and Noy (2004), where we confirm the presence of almost symmetric intertemporal feedbacks between trade and financial openness and in Aizenman and Noy (2006), where we report significant intertemporal feedbacks for FDI and goods trade. Following Bekaert, Harvey, and Lumsdaine's (2002) distinction between market liberalization (*de jure*) and market integration (*de facto*), we also found asymmetric importance of *de jure* measures of openness—trade policy has a robust effect on trade openness, but financial restrictions seem to have no significant impact on *de facto* financial openness.

This paper extends our previous analysis—having established the presence of strong two-way intertemporal feedbacks between trade and financial openness, we now examine the strength of the intertemporal feedbacks between disaggregated measures of trade and financial openness in developing countries. Specifically, we disaggregate the current account into trade in goods (split between manufacturing, metals/ores, fuel, and foodstuffs), services, and income. Similarly, we disaggregated the financial account into FDI, loans, equity, and trade credit. Such disaggregation provides us with more detailed information about the possible channels at work.

Among the interesting patterns we uncover, we observe systematic changes between the 1980s and the 1990s. Most financial flows in and out of developing countries have taken the form of loans. Yet these financial flows are the only type of flows that have decreased between the two decades. We thus see a growing importance to developing countries of portfolio flows and especially of FDI. The trade statistics do not present a clear temporal trend toward an increase from the 1980s to the 1990s. While services trade has increased, goods trade has seen a corresponding decrease. Once the information for trade in goods is disaggregated by type of good, we observe that manufacturing trade has increased dramatically, while trade in fuels has seen a dramatic decline as percent of domestic output. Investigating the patterns of the correlation coefficients between disaggregated financial openness measures and the trade openness measures re-

veals a significant correlation of FDI flow measures with goods and services trade and a very strong correlation between openness to trade in goods and trade in services.

Next, we looked at the impact of lagged disaggregated trade on disaggregated financial measures, allowing for macroeconomic controls. While past average trade in goods appears to be correlated with FDI and loan flows, this is not the case for the equity and trade credits measures. Trade in incomes is positively correlated with FDI, reflecting the repatriation of profits from foreign investments. Interestingly, and less expectedly, trade in services is negatively correlated with all the four measures of financial flows—while it is statistically significant only for the FDI and equity measures. For the subaccounts for goods trade, we observe that trade in foodstuffs is positive and statistically important for FDI flows, as is the measure for metals/ores trade. We conclude by tracing the reversed link—the impact of lagged disaggregated financial on disaggregated trade measures, allowing for the same macroeconomic controls. Interestingly, gross domestic product (GDP) per capita is negatively correlated with trade openness for goods and services (with the coefficient for goods trade three times as big as the one for services). We also observe a positive coefficient for the budget surplus, the inflation measure, the U.S. interest rate and the degree of democracy. In all those results, the control variables are more strongly associated with goods trade than with trade in services. Corruption is negatively and significantly associated with goods trade. Foreign direct investment openness is associated with trade openness, with the impact twice as large for goods trade than for trade in services. This impact is also much larger than the other various measures of financial openness (equity, loans, and trade credits). The coefficients on loan flows are negatively and typically statistically significant, while equity flows are positively associated only with goods trade. The measure of trade credits is never statistically significant.

Section 1.2 describes the data, section 1.3 discusses the methodology and results in more detail, and section 1.4 concludes.

1.2 Data

We include all nondeveloped countries and territories for which all data are available in the 2001 edition of the World Bank's *World Development Indicators*. Most of the data on the financial subaccounts are typically available only from the early 1980s, while the political data we require is available only up to 1998. Our data set, therefore, covers the years 1982 to 1998.

Blonigen and Wang (2004), among others, argue that pooling developed and developing countries in empirical studies of this type is inappropriate and likely to lead to misleading results. In previous work, we also found that industrialized/developed countries appear to be different from devel-

oping countries as the nature of financial flows for these groups is different (Aizenman and Noy 2006). For example, FDI inflows into developed countries might be mostly of horizontal FDI, while those into developing countries might be of vertical FDI. We thus focus our empirical investigation on developing countries only.

The developed economies deleted from the set are those economies that were members of the Organization for Economic Cooperation and Development (OECD) in 1990. We also exclude island economies from our estimations as these are often used as offshore banking centers, and their level of de facto openness to financial flows is often dramatically different from other countries with similar income levels. The sixty countries included in the data set are Algeria, Argentina, Bangladesh, Belize, Bolivia, Botswana, Brazil, Cambodia, Cameroon, Chile, China, Colombia, Costa Rica, Ivory Coast, Ecuador, Egypt, El Salvador, Gabon, Gambia, Ghana, Guatemala, Guyana, Honduras, India, Indonesia, Israel, Jamaica, Jordan, Kenya, Korea, Malaysia, Mauritius, Mexico, Morocco, Mozambique, Nepal, Nicaragua, Nigeria, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, the Philippines, Senegal, Sierra Leone, South Africa, Sri Lanka, Swaziland, Syria, Tanzania, Thailand, Togo, Tunisia, Turkey, Uganda, Uruguay, Venezuela, Zambia, and Zimbabwe. Our sample is further restricted by the availability of data for some years.

We measure gross financial flows (de facto financial openness) as the sum of total capital inflows and outflows (in absolute values) measured as a percent of GDP. Capital flows are the sum of FDI, portfolio flows, trade credits, and loans. We construct an openness index for each one of these four components and briefly describe them in the following. The data on financial flows is taken from the International Monetary Fund's (IMF's) Balance of Payments Statistics data set and are exactly analogous to the standard measure of commercial openness (sum of exports and imports as percent of GDP).

We subdivide the standard measure of commercial openness into openness for trade in goods, trade in services, and trade in incomes following the classification adopted by the World Bank.² We further divide trade in goods into openness measures for trade in foodstuffs, in fuel, in manufacturing, and in metals/ores. This data is from the World Bank's *World Development Indicators*. We provide descriptive statistics in tables 1.1 to 1.3.

Table 1.1 presents averages for financial and trade openness for the 1980s and 1990s across geographical regions, while table 1.2 presents the financial and trade openness indexes disaggregated by type (FDI, loans,

2. Trade in income (net income) "refers to receipts and payments of employee compensation for nonresident workers, and investment income (receipts and payments on direct investment, portfolio investment, and other investments and receipts on reserve assets)." *World Bank Development Indicators 2005*. For a skeptical discussion of the measurement of trade in services, see Lipsey (2006).

Table 1.1 Openness—Descriptive statistics by region

	Financial openness		Trade openness	
	1980s	1990s	1980s	1990s
Developing countries	5.43	8.63	56.1	60.9
OECD countries	9.31	16.79	73.0	70.3
East Asia	8.47	16.53	55.9	72.0
Latin America	6.05	8.15	60.9	64.0
Other ^a	4.89	7.10	54.6	58.9
All	6.96	10.35	58.4	61.8

^aOther includes Africa (north and sub-Saharan), the Middle East, and South Asia.

Table 1.2 Openness—Descriptive statistics by type

	1980s	1990s
<i>Financial openness</i>		
FDI	1.71	3.44
Trade credits	1.49	1.68
Portfolio flows	1.18	2.20
Loans	5.97	5.44
<i>Trade openness</i>		
Trade in incomes	9.14	9.07
Trade in services	20.79	22.76
Trade in goods	66.31	61.69
Manufacturing	28.84	37.78
Foodstuffs	13.42	11.19
Fuels	24.09	9.82
Metals/ores	2.98	2.46

Sources: Data for financial flows is from the *Balance-of-Payments Statistics*. Data for trade flows is from the *World Development Indicators*.

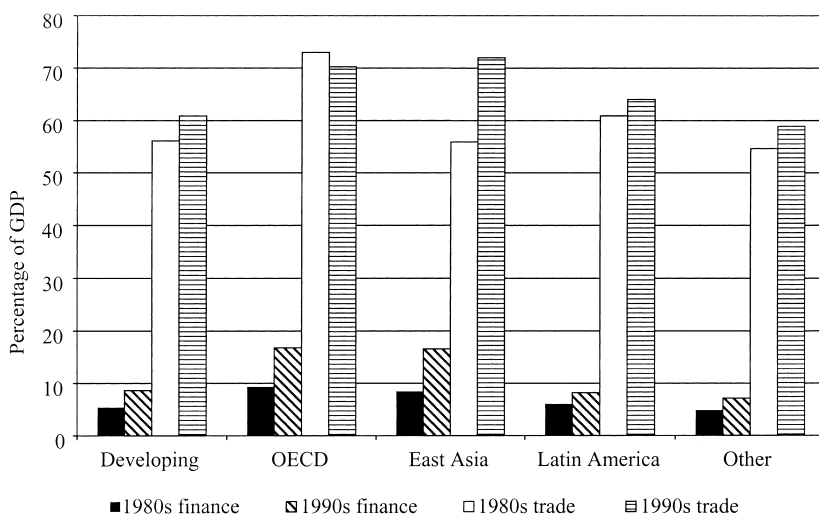
Note: The table presents averages of sum of inflows of outflows (by types) as percent of GDP.

trade credits, and equity flows for the financial measures and goods, services, and incomes for the trade measures). A number of noteworthy observations are obtained from these tables, summarized in figure 1.1. First, the degree of financial and trade openness is universally larger during the 1990s than it was in the previous decade, although the degree of difference differs substantially across geographical regions. The OECD countries and the countries of East Asia were the most open to financial flows, and the least financially open groups are sub-Saharan Africa, the Middle East and North Africa (MENA) countries, and South Asia.

Secondly, when financial openness is disaggregated by type, we observe that most financial flows in and out of developing countries have taken the form of loans. Yet these financial flows are the only type of flows that have

Table 1.3 Correlations for trade and financial flows by type

	Equity flows	Trade credits	Loan flows	FDI flows	Trade goods	Trade in services	Trade in incomes
Equity flows	1	0.06	0.40	0.23	0.21	0.23	0.26
Trade credits		1	0.02	0.18	0.07	0.07	0.02
Loan flows			1	0.15	0.13	0.21	0.72
FDI flows				1	0.60	0.55	0.22
Trade in goods					1	0.87	0.30
Trade in services						1	0.38
Trade in incomes							1


Fig. 1.1 Openness Indexes

decreased between the two decades. We thus see a growing importance to developing countries and portfolio flows and especially of FDI. The trade statistics do not present a clear temporal trend toward an increase from the 1980s to the 1990s. While services trade has increased (from about 21 percent to 23 percent of GDP), goods trade has seen a corresponding decrease (from about 66 percent to 62 percent). Once the information for trade in goods is disaggregated by type of good, we observe that manufacturing trade has increased dramatically (from 29 percent to 39 percent), while trade in fuels has seen a dramatic decline (from 24 percent to 10 percent of GDP).³

3. At the very least, part of the reason for this decline is average lower oil prices during the 1990s. The figures for trade in foodstuffs and in metals/ores were fairly constant between the two decades.

Table 1.3 presents correlation coefficients between the financial openness measures and the trade openness measures disaggregated by types of flows. The notable correlations are a significant correlation of FDI flow measures with goods and services trade (0.60 and 0.55, respectively) and a very strong correlation between openness to trade in goods and trade in services (0.87).

Because results from all the estimation procedures described in the following will be biased if any of the relevant series has a unit root, we are also required to establish stationarity. We conduct the common Phillips-Perron (1981) test for unit roots for the financial openness variables as well as the trade openness measures. Results are presented in table 1.4. We easily reject the existence of unit root in all cases.

In our multivariate estimations, we include several control variables that are described in the following. This list is based on our previous research on financial openness (Aizenman and Noy 2004). In order to ensure our results are not driven by a ‘missing variables’ bias, we include a host of macroeconomic control variables. In all regressions we use per capita GDP (measured in PPP dollars), a domestic interest rate spread (from a world rate of interest),⁴ and a weighted average of G3 growth rates. In an initial specification, we also included the government’s budget surplus (as percent of GDP), the inflation rate (CPI), a world interest rate (U.S. one-year T-bill rate), GDP (in \$1995), and government consumption (as percent of GDP). None of these were significant, and all were dropped from the specifications we report. The macroeconomic data are taken from the World Bank’s *World Development Indicators* and the International Monetary Fund’s *International Finance Statistics*. Details are in the appendix.

For the political-economy determinants of financial openness, we include in our empirical investigation two political and institutional measures, an index of the political regime in place, and a measure of corruption. Our democracy index is taken from the Polity IV project and ranges from -10 (fully autocratic) to +10 (fully democratic).⁵ In addition, following the work of Wei (2000) and Dreher and Siemers (2003), we examine whether corruption matters for the degree of openness. We use a measure of corruption that is taken from the *International Country Risk Guide*. The data are available in monthly observations. We obtain annual observations from 1982 onward by averaging the monthly data points for each year. This

4. We measure the spread between a domestic deposit rate and the IMF’s special drawing rights (SDRs) interest.

5. The “Polity IV database includes annual measures for both institutionalized democracy (DEMOC) and autocracy (AUTOC). A third indicator, POLITY, is derived simply by subtracting the AUTOC value from the DEMOC value; this procedure provides a single regime score that ranges from +10 (full democracy) to -10 (full autocracy)” (Marshall and Jaggers 2000, 12). We use the POLITY variable in our regressions. For further discussion, see Aizenman and Noy (2004).

Table 1.4 Phillips-Perron test for unit root

Financial openness index	
FDI	-123.8***
Loans	-863.8***
Equity	-500.3***
Trade credits	-293.5***
Trade openness index for:	
Services	-123.7***
Incomes	-181.4***
Goods	-331.6***

Note: The table lists the z -statistic for ρ .

***Denotes statistical rejection of the unit-root hypothesis. All rejections are significant at the 1 percent level.

index ranges from -6 (low probability/risk of encountering corruption) to 0 (high risk of corruption).⁶

As the theoretical discussion in Aizenman and Noy (2004) suggests, one of the determinants of de facto financial openness should be the legal impediments to financial flows (de jure financial openness). Accordingly, we also include in our multivariate analysis a binary measure for restrictions on the capital account taken from the IMF’s *Annual Report on Exchange Arrangements and Exchange Restrictions*.⁷

1.3 Methodology and Results

1.3.1 Causality from Trade to Capital Flows

In order to investigate whether past trade openness Granger-causes FDI gross flows, we start by positing a linear structure for the determination of the level of financial openness, whereby⁸

$$(1) \quad FO_{it}^Q = \alpha_i + \beta_1 \mathbf{X}_{it} + \beta_2 \overline{\mathbf{CO}_{it-1}^T} + \varepsilon_{it}$$

The dependent variable (FO_{it}^Q), financial openness for country i at time t and type Q (FDI, loans, trade credits or equity), is assumed to be dependent on separate country intercepts, a vector \mathbf{X}_{it} of macroeconomic and

6. Two other political variables that were initially included but later dropped due to their insignificance were a measure of political risk (from the *International Country Risk Guide* data) and a measure of government unity (taken from the World Bank’s *Database of Political Institutions 2000*).

7. This binary measure is the only internationally comparable measure of de jure financial openness available for a large sample of countries and over the entire sample period. Ideally, separate measures for the degree of de jure openness of the capital account to the various types of flows (FDI, loans, equity flows, etc.) should be used. These are unavailable for historical data.

8. See Granger (1969) and Sims (1972) for a definition of G-causality.

political and institutional control variables, a vector of average lagged trade openness measure (\overline{CO}_{it-1}^T) for country i , time t and type T (goods, services, etc.), and an error term. The null hypothesis that we investigate, in this case, is that past trade openness (in goods, services, and incomes) has no observed causal effect on the different types of financial flows.

Because we do not find any evidence of autocorrelation, lagged values of FO_{it}^o are not included in the model's specification. In order to examine the suitability of fixed versus random assumption for the country-specific effects, we examine the standard Hausman chi-square statistic for the benchmark regressions. The statistic, at 28.5, 16.1, 39.6 and 40.3 for columns (1) to (4) of table 1.5, reject the null of uncorrelated errors necessary for an unbiased random-effects estimation. We therefore conduct all estimations with a fixed effects specification.

Table 1.5 Estimation of various financial openness indexes

	FDI (1)	Loans (2)	Equity (3)	Trade credits (4)
Per capita GDP	0.44*** (5.80)	0.58* (1.66)	0.46*** (2.94)	0.15*** (2.87)
Budget surplus (% of GDP)	-0.01 (0.47)	-0.09 (1.26)	-0.01 (0.28)	0.01 (1.17)
Inflation (CPI)	0.04 (1.32)	-0.28** (2.21)	-0.01 (0.15)	0.01 (0.53)
U.S. Treasury bill rate	0.03 (0.48)	0.38 (1.32)	-0.10 (0.69)	0.12*** (2.51)
Democratic regime	-0.02 (0.47)	-0.34** (2.37)	-0.06 (0.79)	-0.01 (0.30)
Corruption	0.12 (0.81)	0.45 (0.64)	0.06 (0.17)	0.09 (0.85)
The 1990s	0.43 (1.50)	2.55** (1.99)	0.85 (1.24)	-0.06 (0.26)
Trade openness in: ^a				
Services	-0.11*** (3.22)	-0.09 (0.57)	-0.20** (2.21)	-0.03 (1.16)
Incomes	0.02** (1.94)	-0.03 (0.58)	0.01 (0.40)	0.01 (0.88)
Goods	0.02*** (3.60)	0.36*** (11.95)	0.00 (0.17)	0.00 (0.96)
Estimated autocorrelation	0.23	0.05	0.10	0.02
No. of observations	652	723	472	378
Adjusted R^2	0.58	0.48	0.28	0.59

Notes: t -statistics for all variables are given in parentheses. The LHS variable is the sum of financial inflows and outflows by type (as percent of GDP). Estimation using least squares with country-fixed effects. For definitions of variables, see appendix.

^aAverage for $t - 1, \dots, t - 4$.

***Significant at the 1 percent level.

**Significant at the 5 percent level.

*Significant at the 10 percent level.

The adjusted R^2 in table 1.5 is between 0.28 and 0.59; these depend on the specific dependent financial openness indicator used with estimation having the highest explanatory power for the FDI and trade credits regressions (columns [1] and [4]). For our control variables in table 1.5, we find that the coefficient for per capita GDP is always positive and statistically significant—that is, an increase in domestic per capita GDP of PPP\$1000 will facilitate 0.15 to 0.58 percentage points increase in the volume of gross financial flows (as percent of GDP) with the weakest impact for trade credits. The coefficient for the budget surplus is typically negative but never statistically significant. Inflation appears to play a statistically significant role only in its impact on openness to loans (a higher inflation implies less loan flows). The U.S. interest rate appears to have a significantly positive affect only on trade credit flows, while the political nature of the governing regime impacts loan flows. Corruption is always statistically insignificant (this is an interesting result as corruption was statistically correlated with aggregate financial openness as reported in Aizenman and Noy [2004]). A dummy variable for the 1990s is positive and significant for loans estimation (column [2]). Almost all of the results described in the preceding for the control variables in table 1.5 also hold for the estimations presented in table 1.6—the magnitudes of the coefficients are very similar and only occasionally do the significance levels change.

For our variables of interest, the trade openness measures for trade in services, incomes, and goods, the results for the different dependent variables (the financial openness measures) are quite different. While past average trade in goods appears to be correlated with FDI and loan flows, this is not the case for the equity and trade credits measures. Trade in incomes is positively correlated with FDI—this is not surprising as part of this measure included the repatriation of profits from foreign investments. Interestingly, and less expectedly, trade in services is negatively correlated with all the four measures of financial flows—while it is statistically significant only for the FDI and equity measures.

In table 1.6, we separate our measure of goods trade into openness measures for trade in foodstuffs, fuels, metals/ores, and manufacturing. As reported before, the other macroeconomic and political control variables are also included in these specifications, and the results are consistent with the previous table. The explanation of the model improves somewhat with the model best explaining FDI openness (an R^2 of 0.65).

In table 1.6, we observe that the result for trade in services remains negative, while the result for trade in incomes changes somewhat with statistical significance now only apparent for the loans measure. For the subaccounts for goods trade, we observe that trade in foodstuffs is positive and statistically important for FDI flows, as is the measure for metals/ores trade. The trade in fuels measure is statistically significant and negative for the FDI and loans measures. This is unsurprising considering fuel's role as an input in the production process and the high variability of its price.

Table 1.6 Estimation of various financial openness indexes: Subaccounts for goods trade

	FDI (1)	Loans (2)	Equity (3)	Trade credits (4)
Per capita GDP	0.30*** (2.72)	0.49 (0.85)	0.50** (1.99)	0.06 (0.91)
Budget surplus (% of GDP)	-0.03 (1.22)	-0.05 (0.40)	0.01 (0.17)	0.11 (0.48)
Inflation (CPI)	-0.03 (0.87)	-0.36** (2.04)	-0.02 (0.25)	-0.02 (0.72)
U.S. Treasury bill rate	0.00 (0.05)	0.49 (1.13)	-0.06 (0.31)	0.17*** (3.11)
Democratic regime	-0.05 (1.23)	-0.52*** (2.70)	-0.08 (0.91)	-0.03 (0.74)
Corruption	0.21 (1.07)	1.29 (1.25)	0.12 (0.27)	0.11 (0.86)
The 1990s	0.71** (1.97)	2.55 (1.38)	1.00 (1.14)	-0.20 (0.87)
Trade openness in: ^a				
Services	-0.17*** (3.57)	-0.21 (0.86)	-0.17 (1.35)	0.04 (1.02)
Incomes	0.01 (0.81)	0.34*** (9.07)	0.01 (0.51)	-0.01** (2.50)
Goods				
Foodstuffs	0.25*** (3.49)	0.51 (1.50)	0.04 (0.18)	-0.02 (0.40)
Fuel	-0.11*** (4.07)	-0.29** (2.15)	-0.01 (0.18)	-0.04 (1.36)
Metals/ores	0.30** (2.40)	1.02 (1.51)	0.10 (0.26)	-0.25* (1.81)
Manufacturing	0.02 (1.47)	-0.01 (0.15)	-0.01 (0.14)	0.02 (1.25)
Estimated autocorrelation	0.19	0.02	0.08	0.12
No. of observations	490	522	395	261
Adjusted R^2	0.65	0.48	0.26	0.49

Note: See table 1.5 notes.

^aAverage for $t - 1, \dots, t - 4$.

***Significant at the 1 percent level.

**Significant at the 5 percent level.

*Significant at the 10 percent level.

1.3.2 Causality from Capital Flows to Trade

We already suggested that causality might also run from past financial openness to present trade openness, and we therefore estimate the opposite specification:

$$(2) \quad \mathbf{CO}_{it}^T = \gamma + \delta_1 \mathbf{X}_{it} + \delta_2 \overline{FO_{it-1}^O} + \eta_{it},$$

where the dependent variable is now the trade openness index (for goods or services), while on the independent variables are the set of control and

various measures of average past (last four years) of financial openness (FDI, loans, equity, and trade credits). The measures for trade credits and portfolio flows are not reported for many countries, so we subsequently drop them in the specifications reported in columns (2) and (4) and thus increase the sample size significantly. We use the same assumptions, methodology, definition of variables, and samples as before. Results are reported in table 1.7.

Interestingly, in all the specifications for table 1.7, GDP per capita is negatively correlated with trade openness for goods and services (with the coefficient for goods trade three times as big as the one for services). Besides that we observe a positive coefficient for the budget surplus, the inflation measure, the U.S. interest rate, and the degree of democracy. In all

Table 1.7 Reverse specifications

	Services (1)	Services (2)	Goods (3)	Goods (4)
Per capita GDP	-0.40*** (2.31)	-0.38*** (3.00)	-1.44*** (2.90)	-1.44*** (4.23)
Budget surplus (% GDP)	0.01* (1.72)	0.00 (0.25)	0.03* (1.63)	0.00 (0.45)
Inflation (CPI)	0.06 (0.85)	0.14*** (2.92)	0.35* (1.62)	0.62*** (4.87)
U.S. Treasury bill rate	0.06 (0.34)	0.04 (0.39)	0.92* (1.72)	0.52* (1.79)
Democratic regime	0.13 (1.28)	0.08* (1.60)	1.79*** (6.27)	0.81*** (5.93)
Corruption	0.57 (1.52)	-0.11 (0.43)	-3.80*** (3.50)	-1.82*** (2.68)
The 1990s	1.46* (1.59)	1.55*** (3.34)	3.31 (1.26)	5.87*** (4.70)
Financial openness in: ^a				
FDI	0.67*** (2.54)	0.05 (0.39)	1.36* (1.80)	1.80*** (4.94)
Loans	0.00 (0.03)	-0.04** (2.10)	-0.50*** (7.06)	-0.38*** (7.92)
Equity	-0.03 (0.32)		0.63** (2.05)	
Trade credits	-0.49 (0.86)		0.18 (0.11)	
Estimated autocorrelation	0.84	0.58	0.55	0.56
No. of observations	192	620	192	620
Adjusted R^2	0.96	0.91	0.98	0.96

Note: See table 1.5 notes.

^aAverage $t - 1, \dots, t - 4$.

***Significant at the 1 percent level.

**Significant at the 5 percent level.

*Significant at the 10 percent level.

those results, the control variables are more strongly associated with goods trade than with trade in services. Corruption is negatively and significantly associated with goods trade, while trade openness is higher for the 1990s also in a multivariate framework.

For our variables of interest, perhaps unsurprisingly FDI openness is again associated with trade openness, with the impact twice as large for goods trade. This impact is also much larger than the other various measures of financial openness (equity, loans, and trade credits). The coefficients on loan flows are negatively and typically statistically significant, while equity flows is positively associated only with goods trade. The measure of trade credits is never statistically significant.

1.4 Concluding Remarks

In this paper, we studied the intertemporal feedbacks between disaggregated measures of trade and financial openness. Our results are consistent with the notion that, for many developing countries in recent years, there has been an increase in FDI flows and trade in manufacturing and services and that these are linked. Overall, the increase in financial openness we observe has also been associated with a decline of the importance of loans and an increase in the importance of equity and FDI flows. As the increase in financial openness is positively associated with GDP per capita, the positive association between greater financial openness and the increase in the importance of equity relatively to loans is consistent with Diamond (1984).⁹ Somewhat surprisingly, we failed to detect the importance of trade credit, potentially because of underreporting—especially when trade credits are associated with imports that are financed by foreign producers.¹⁰

9. Diamond's (1984) approach explains the role of bank intermediation in financing capital formation in the presence of significant monitoring costs, showing the optimality of issuing unmonitored debt, which is subject to liquidation costs. The delegated monitor is a financial intermediary because it borrows from small investors (depositors), using unmonitored debt (deposits) to lend to borrowers (whose loans it monitors).

10. See Petersen and Rajan (1997) for further analysis of the possibility that trade credit are supplied by the party that has better access to the capital market.

Appendix

Table 1A.1 Data sources

Variable	Description	Source
KTOTAL	Sum of capital inflows and outflows (% of GDP)	IMF-BOP statistics
FDITOT	Sum of FDI inflows and outflows (% of GDP)	IMF-BOP statistics
TRADTOT	Sum of trade credit inflows and outflows (% of GDP)	IMF-BOP statistics
LOANTOT	Sum of loan inflows and outflows (% of GDP)	IMF-BOP statistics
EQTOT	Sum of portfolio inflows and outflows (% of GDP)	IMF-BOP statistics
TRADG	Sum of exports and imports (% of GDP)	WB-WDI
SERVG	Sum of service exports and imports (% of GDP)	WB-WDI
GOODG	Sum of goods exports and imports (% of GDP)	WB-WDI
INCOMG	Sum of trade in incomes (% of GDP)	WB-WDI
FUELG	Sum of trade in fuels (% of GDP)	WB-WDI
MANUG	Sum of trade in manufacturing (% of GDP)	WB-WDI
FOODG	Sum of trade in footstuffs (% of GDP)	WB-WDI
METALG	Sum of trade in metals and ores (% of GDP)	WB-WDI
GDPPCPP	GDP per capita, PPP (current international \$)	WB-WDI
DLCPI	Inflation, consumer prices (annual %)	WB-WDI
BDGTG	Overall budget deficit (% of GDP)	WB-WDI
USTBILL	Interest rate on U.S. Treasury bill	IMF-IFS
CORRUPT	Level of corruption ^a	PRS: International Country Risk Guide
POLITY2	Political regime type ^b	POLITY IV project
KKCCAR	Binary measure for current or capital account restrictions	IMF-EAER

Notes: IMF-BOP statistics = IMF's *Balance-of-Payments Statistics*. WB-WDI = World Bank's *World Development Indicators*. IMF-IFS = IMF's *International Finance Statistics*. IMF-EAER = IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions*, extended to 1998 by Glick and Hutchison (2005).

^aThis index runs from -6 (low probability/risk of encountering corruption) to 0 (highly corrupt).

^bThe index runs between -10 (fully autocratic) to +10 (fully democratic).

References

- Aizenman, J., and I. Noy. 2004. Endogenous financial and trade openness: Efficiency and political economy considerations. NBER Working Paper no. 10496. Cambridge, MA: National Bureau of Economic Research, April.
- . 2006. FDI and trade. *Quarterly Review of Economics and Finance* 46 (3): 317–37.
- Bekaert, G., C. R. Harvey, and R. L. Lumsdaine. 2002. Dating the integration of world equity markets. *Journal of Financial Economics* 65:203–47.
- Blonigen, B. A. 2005. A review of the empirical literature on FDI determinants. NBER Working Paper no. 11299. Cambridge, MA: National Bureau of Economic Research, May.
- Blonigen, B. A., and M. Wang. 2004. Inappropriate pooling of wealthy and poor countries in empirical FDI studies. NBER Working Paper no. 10378. Cambridge, MA: National Bureau of Economic Research, March.

- Daude, C., and M. Fratzscher. 2006. The pecking order of cross-border investment. ECB Working Paper Series no. 590. Frankfurt, Germany: European Central Bank, February.
- Diamond, D. W. 1984. Financial intermediation and delegated monitoring. *Review of Economic Studies* 51 (3): 393–414.
- Do, Q. T., and A. A. Levchenko. 2004. Trade and financial development. Paper presented at LACEA 2004, San José, Costa Rica.
- . 2006. Comparative advantage, demand for external finance, and financial development. World Bank Policy Research Working Paper no. 3889. Washington, DC: World Bank, April.
- Dreher, A., and L. Siemers. 2003. The intriguing nexus between corruption and capital account restrictions. University of Konstanz, Konstanz, Germany; and Ruprecht-Karls-University, Heidelberg, Germany. Unpublished Manuscript.
- Eaton, J., and A. Tamura. 1994. Bilateralism and regionalism in Japanese and U.S. trade and direct foreign investment patterns. *Journal of Japanese and International Economies* 8:478–510.
- Glick, R., and M. Hutchinson. 2005. Capital controls and exchange rate instability in developing economies. *Journal of International Money and Finance* 24:387–412.
- Granger, C. W. J. 1969. Investigating causal relationships by econometric methods and cross-spectral methods. *Econometrica* 34:424–38.
- Guerin, S. S. 2006. The role of geography in financial and economic integration: A comparative analysis of foreign direct investment, trade and portfolio investment flows. *World Economy* 29 (2): 189–209.
- Kose, M. A., E. S. Prasad, K. Rogoff, and S.-J. Wei. 2006. Financial globalization: A reappraisal. IMF Working Paper no. WP/06/189. Washington, DC: International Monetary Fund, August.
- Kose, M. A., E. S. Prasad, and M. E. Terrones. 2006. How do trade and financial integration affect the relationship between growth and volatility? *Journal of International Economies* 69:176–202.
- Lipsey, R. E. 2006. Measuring international trade in services. NBER Working Paper no. 12271. Cambridge, MA: National Bureau of Economic Research, June.
- Marshall, M., and K. Jaggers. 2000. Polity IV project—Political Regime Characteristics and Transitions, 1800–1999: Data Set and Users' Manual. University of Maryland. Manuscript.
- Petersen, M. A., and R. G. Rajan. 1997. Trade credits: Theories and evidence. *Review of Financial Studies* 10 (3): 661–91.
- Portes, R., H. Rey, and Y. Oh. 2001. Information and capital flows: The determinants of transaction in financial assets. *European Economic Review* 45:783–96.
- Rajan, G. R., and L. Zingales. 2003. The great reversals: The politics of financial development in the 20th century. *Journal of Financial Economics* 69 (1): 5–50.
- Razin, A., Y. Rubinstein, and E. Sadka. 2003. Which countries export FDI, and how much? NBER Working Paper no. 10145. Cambridge, MA: National Bureau of Economic Research, December.
- Rose, A. K., and M. M. Spiegel. 2004. A gravity model of sovereign lending: Trade, default, and credit. *IMF Staff Papers* 51:50–63. Washington, DC: International Monetary Fund.
- Sims, C. 1972. Money, income and causality. *American Economic Review* 62:540–52.
- Smith, K. A., and D. Valderrama. 2006. The composition of capital flows when emerging market firms face financing constraints. U.S. Naval Academy and Federal Reserve Bank of San Francisco. Unpublished Manuscript.
- Swenson, D. L. 2004. Foreign investment and the mediation of trade flows. *Review of International Economies* 12 (4): 609–29.

Wei, S.-J. 2000. How taxing is corruption on international investors? *The Review of Economics and Statistics* 82 (1): 1–11.

Comment Maria Cristina Terra

This paper investigates empirically the interrelations between disaggregated measures of trade and financial openness. Trade flows are disaggregated into services, incomes, and goods, with a further disaggregation of goods flows into foodstuffs, fuel, metal/ores, and manufacturing. Financial openness, on its turn, is disaggregated into foreign direct investment (FDI), loans, equity, and trade credits. Each of these financial flow measures is regressed onto an average of four lagged periods of the trade measures and a set of macroeconomic and political variables used as controls. Analogously, trade in goods and in services are used alternatively as dependent variables in regressions using the same controls as the financial openness regressions, but including the lagged averages of the financial openness measures.

The paper uncovers some interesting feedback patterns between disaggregated trade and financial flows. It is very interesting the captured impact of past trade in goods on the FDI and loans flow and its lack of impact on the equity and trade credits measures. Also interesting is the fact that trade in income has a significant impact only on FDI.

The authors substantially revised their original work, for this is a very different paper from the one on which I commented in the conference. The original paper included two models to motivate the two-way feedbacks between financial and trade openness, and the empirical investigation was based only on aggregate measures of the trade and financial openness variables. Most of my comments on the original paper questioned whether the models chosen really captured the most relevant aspects of trade and financial openness issues concerning developing economies. They also discussed the link between the models presented and the empirical investigation carried out in the paper.

The authors chose to suppress the theoretical models from the paper and to focus on the empirical study. A theoretical framework, however, is crucial to guide the choice of control variables. Without it, the paper lacks a justification for the chosen empirical formulation, which also impairs the interpretation of the results. This seems especially important in this case, as most of the control variables coefficients turned out to be not significant.

Maria Cristina Terra is a professor in the Graduate School of Economics, Fundação Getúlio Vargas, Rio de Janeiro, and executive director of the Brazilian Society of Econometrics.

For example, per capita GDP has a positive and significant impact on trade credits and on loans in the regression with aggregated trade flows in goods, but the coefficient becomes zero when trade in goods is disaggregated. Were the regressions based on a theoretical framework, maybe we could have some hint on how to interpret this intriguing result.

All the regressions estimated, each one using a different disaggregated measure of trade and financial openness as dependent variables, use the same macro and political variables as controls. A theoretical model could indicate whether one should use different control variables for the different types of flows. As an example, the degree of financial deepening of an economy, a variable that was not included in the regressions, may have an impact on the magnitude of the financial flows, but no effect on the size of trade flows.

The original version of the paper had included variables of trade and financial restrictions in the regressions. This yielded the interesting result that the *de jure* restrictions on trade affected trade volumes, while those on financial transactions had no impact on financial flows. Unfortunately, these variables were not included in this new version.

Given that the objective of the paper is to explore the two-way feedbacks between trade and financial openness, it would be useful to have a framework that explored their channels. Here are some of the possible links that could be explored. On the one hand, FDI may foster trade in goods when it generates intrafirm trade between the subsidiaries of a multinational company or when a company chooses one country to concentrate production, trading final goods and inputs the others. On the other hand, trade in goods may provide the collateral for financial transactions, thereby encouraging more financial flows. Note that the very trade in goods does generate financial transactions, given that trade is not based on goods' exchanges. Finally, the fact that countries with higher international trade have higher stakes in international markets improves the expectations about a sound interaction between the government and the international financial market. This should also yield trade as an engine to promote more financial transactions.

Comment Thierry Verdier

The purpose of this paper is to consider empirically the relationships between various disaggregated measures of trade and financial openness in developing countries and to show that there are important two-way causal-

Thierry Verdier is a scientific director of Paris-Jourdan Sciences Économiques (PSE), and director of studies at the School for Advanced Studies in Social Sciences (EHSS).

ity effects between these flows. On the one hand, trade flows are disaggregated into services, incomes, and goods (with a further disaggregation into foodstuffs, fuel, metal/ores, and manufacturing). On the other hand, financial openness is disaggregated into foreign direct investment (FDI), loans, equity, and trade credits. The authors provide first regressions of each of these financial flow measures on an average of four lagged periods of the trade measures, controlling for standard macroeconomic variables (per capita GDP, budget surplus, inflation, U.S. Treasury bill rate) and some political or governance variables (index of democratic regime, corruption). The authors then consider the reverse causality from financial flows to trade flows and, therefore, analogously regress trade flows in goods and services on the lagged averages of the financial openness measures, using the same macroeconomic and political controls as in the financial openness regressions.

Doing this, the authors discuss interesting causality patterns between trade and financial flows. Most notable is the fact that past trade in services has a negative effect on FDI flows, while trade in goods has a positive impact on FDI flows. As well (and quite surprisingly), there is no significant effect of past trade flows on equity and trade credits measures (see tables 1.5 and 1.6). On the other hand, past FDI flows have a positive effect on trade in services and goods, while past loans flows, on the contrary, seem to affect negatively current trade flows in goods and services (table 1.7).

This current piece of work is a very different paper from the one that was presented (and commented on!) in the conference. The original paper included an important theoretical section (with two models motivating the interactions between financial and trade openness) and an empirical section based on aggregate measures of the trade and financial openness variables for least-developed countries (LDC) and developed economies. Because of this, the comments I made on the original paper were focused on addressing the positive dimensions and the limits of the theoretical approach illustrating some channels of interactions between trade and financial openness. Then I was also discussing the links between the theoretical models and the empirical part of the paper.

In the current version, there is no theoretical framework and the paper is essentially about an empirical discussion of the relationships for developing countries between trade and financial flows at some disaggregated level. Let me say that I feel a bit disappointed by the new orientation of the paper. While I clearly recognize the effort to consider more disaggregated flow variables and uncover interesting results, I remain somewhat frustrated not to have an adequate theoretical framework to tell me a story providing an interpretation of these results.

As a matter of fact, many correlations provided by the regressions remain without much economic explanation. For instance, why is it that trade in services affects negatively FDI flows (table 1.6), while on the con-

trary, FDI flows seem to have a positive effect on trade in services (table 1.7)? As well, why is it that trade flows do not seem to have an effect on trade credits nor that trade credits have an effect on trade flows? Clearly, the paper would have gained much with a theoretical framework providing an interpretation of these puzzling results.

Similarly, a theoretical approach would have been useful to assess the significance and causality of some of the control variables used in some of the regressions. For instance, corruption seems to affect negatively trade flows in goods (table 1.7), but can't we explain this result by some reverse causality that less trade in goods implies less competition in the domestic markets and therefore more corruption (as emphasized, for example, by Ades and Di Tella in their work on the links between trade and corruption)?

Finally, a theoretical framework could have provided interesting avenues to discuss the policy implications of the two-way causality uncovered here between trade flows and financial flows. The usual presumption is that trade integration is good (because of the associated gains from trade inside the country), while financial integration may bring instability and volatility problems. Hence, one should have "free trade" and controls on capital accounts. Related to this, however, people have this whole discussion on the degree of effectiveness of controls on trade flows versus financial flows and the difference between *de jure* and *de facto* restrictions. The present paper suggests that it might indeed be difficult to separate trade integration from financial integration, generating therefore interesting trade-offs on the policy to adopt for international integration. A conceptual framework to assess normatively these dimensions is certainly something that needs to be done to fully appreciate the importance of the "nonseparability" between trade flows and financial flows.