Discussion of

"Globalization and Risk Sharing"

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Main Question and Approach

- What is the effect of globalization on risk sharing?
- Standard views:
  - Frictionless markets: both at home and internationally
  - Sovereign debt literature: no commitment internationally, but (implicitly) frictionless markets at home
  - This paper: same enforcement domestically and internationally, but actual enforcement is an endogenous variable

Main Result

- On one hand, in states of the world when a country is "rich," there is the usual temptation to default.
- On the other hand, the cost of default is that domestic risk sharing breaks down.
  - At a given level of "globalization," this tradeoff determines the extent of risk sharing
  - More globalization can increase the relative scope of international risk sharing, which can have the perverse effect of destroying both international and domestic risk sharing.

Sketch of the Argument

- Two-period endowment economy; symmetric countries, log utility
- Some scope for both purely domestic and international risk sharing
- Key Broner-Ventura assumption about default: not enforcing international repayment breaks all domestic payments also
- Minimum number of states of the world required for the argument: 4; minimum number of agents in the world: 4

Endowments

		States			
		H rich		H poor	
Home	H1	A(1+η)(1+ω)	A(1+η)(1-ω)	A(1-η)(1+ω)	A(1-η)(1-ω)
	H2	A(1+η)(1-ω)	A(1+η)(1+ω)	A(1-η)(1-ω)	A(1-η)(1+ω)
Foreign	F1	A(1-η)(1+ω)	A(1-η)(1-ω)	A(1+η)(1+ω)	A(1+η)(1-ω)
	F2	A(1-η)(1-ω)	A(1-η)(1+ω)	A(1+η)(1-ω)	A(1+η)(1+ω)

- A=mean consumption of each agent and the economy as a whole
- η=aggregate (internationally insurable risk)
- ω=idiosyncratic (domestically insurable risk)

Risk Sharing

- Note: perfect insurance attainable in this world
- If the rich country defaults, the poor country does also – same as in the paper, though requires some additional assumptions here
- As a result, in this economy there is either perfect risk sharing or none at all
- The rich country will be tempted to default to consume the high aggregate shock $\eta>0$

Risk Sharing (cont'd)

- Welfare with no default: *ln(A)*
- Welfare with default for the rich country:

$$\ln(A)+\ln(1+\eta)+\frac{1}{2}\left[\ln(1+\omega)+\ln(1-\omega)\right]$$

- Therefore, default if and only if:

$$\ln(1+\eta)+\frac{1}{2}\left[\ln(1+\omega)+\ln(1-\omega)\right]>0$$

- Key intuition: more likely to default if the aggregate shock is high relative to the loss of domestic risk sharing
- NB: never "default" if the international markets are closed

"Calibration"

- What is the relative importance of η vs ω?
  - η is the risk that is not insurable domestically = business cycle volatility
  - ω is the risk that is insurable domestically = individual earnings volatility
- In the US, over the period 1960-2004, the variance of detrended log GDP per capita is 0.0006784 → η=0.0260
- In the US, the variance of individual-level wages is 0.43 (Gottschalk and Moffitt, 1994) → ω=0.5762

→ not worth it to default on international payments if it stops domestic risk sharing

Taxonomy of Assumptions and Alternatives

1. Frictionless markets: both at home and internationally
2. Sovereign debt literature: no commitment internationally, but (implicitly) frictionless markets at home
3. Broner-Ventura: same enforcement domestically and internationally, but actual enforcement is an endogenous variable – ***policymaker view***
4. Attanasio-Rios-Rull (2000): no commitment domestically, commitment internationally
   - Introducing international insurance makes agents less willing to cooperate domestically – risk sharing breaks down
   - Levchenko (2005) version: some agents have access to international markets, others do not; aggregate and distributional consequences
   - ***institutions view***

Conclusion

- "All frictionless models are alike; every model with frictions is different from all others"

  – Lev Tolstoy, *Anna Karenina*

- What are we trying to explain?
  - Behavior of macro variables (consumption correlations, procyclical CA, etc.)?
  - Domestic financial development?
  - Distributional consequences of globalization within/across countries?
  - The world in general or cross-country differences?