Discussion: Financial Globalization and Risk Sharing: Welfare and the Optimality of Open Markets by Trzcinka and Ukhov

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Research question

- Is it always optimal for a country to open its financial markets to foreigners?

- Part of broader research literature: how does opening financial markets affect asset prices and welfare?

- Main result: It is not always optimal for a country to open its financial markets to foreigners.

- Application: Theoretical guidance for the following important question:
  - When should a country impose capital controls and when should it relax them?

Model summary

- 1 period, 2-date model
- Consider 2 countries: domestic (d) and foreign (f).
- Continuum of agents in each country, all with CARA utility over intermediate consumption:

$$-e^{-ac_0} - \delta E[e^{-a\tilde{c}_1}]. \tag{1}$$

  - absolute risk aversion is a.
- Each domestic agent h receives endowment $\tilde{e^h}$

$$\tilde{e}^h = \bar{e}^h + b_d^h \tilde{f}_d + \tilde{\varepsilon}_d^h \tag{2}$$

- Each foreign agent h receives endowment $\tilde{e^h}$

$$\tilde{e}^h = \bar{e}^h + b_f^h \tilde{f}_f + \tilde{\varepsilon}_f^h \tag{3}$$

Completely segmented markets—Autarchy

- Domestic agents can only trade in domestic assets. Foreign agents can only trade in foreign assets.

- Assets are in zero net supply

Domestic assets

- Risky asset, with date-1 payoff, $\tilde{z}_d$:

$$\tilde{z}_d = \overline{z}_d + \beta_d \tilde{f}_d + \tilde{\varepsilon}_d \tag{4}$$

- Riskless storage technology with gross return R_d

- **Participation costs**
  - Fixed cost of k_d to a domestic agent for trading in domestic risky asset

Partially liberalized markets—incomplete markets

- Domestic risky asset is available to foreign agents
- Foreign risky asset is *not* available to domestic agents
- Only domestic (foreign) agents can use the domestic (foreign) riskless storage technology

Welfare Analysis—Intuition

- Before partial liberalization, those agents who participate share risks amongst one another.

- All agents have CARA preferences with the same risk aversion—the optimal allocations of each of the participating agents will be the same:
  - their mean endowment.

- What happens when domestic risky assets can be traded with foreigners?

- Suppose the foreigners want to purchase domestic securities. Those domestic agents who can improve their welfare by selling domestic securities will benefit. Domestic agents who want to buy domestic securities will lose out.

Questions

- How important are participation costs for this result?
  - Devreux and Saito (1997)—no participation costs—show that partial liberalization can decrease welfare in one country.
  - Ellul (1995)—going from incomplete to less incomplete markets can increase/decrease welfare.

Summary

- Concrete framework – a good thing when looking at difficult questions
- Interesting results
- Opening a country's financial market can decrease its welfare

References