EXECUTIVE SUMMARY: “Globalization and Risk Sharing” by Fernando Broner and Jaume Ventura.[1]

This paper is a theoretical study of the effects of globalization in the presence of sovereign risk, namely, the risk that countries default on their debts. Its key innovation with respect to earlier research is the assumption that countries cannot discriminate between domestic and foreign creditors when paying debts. This “non-discrimination” assumption is new since, without exception, earlier research developed in the 1980’s and 1990’s assumed instead that countries can discriminate between domestic and foreign creditors.

The non-discrimination assumption is a better description of emerging-market borrowing today:

- During the 1970’s and 1980’s, emerging-market governments borrowed almost exclusively from foreign banks using syndicated loans, while the private sector was largely shut out from international markets. This institutional setup clearly facilitates discrimination, as governments could choose not to pay foreign banks without interfering with domestic asset trade. This is the context in which the earlier literature was developed.

- But the institutional setup of emerging-market borrowing has changed dramatically in the 1990’s and 2000’s. Governments now borrow from abroad by selling bonds which are traded in increasingly deep secondary markets, while capital account liberalization now permits the private sector to access international financial markets directly or through an increasing variety of financial intermediaries. These changes in the institutional setup have made it much more difficult for governments to discriminate.

The non-discrimination assumption is crucial for the results of the theory and its policy implications:

- If a country can perfectly discriminate between domestic and foreign creditors, sovereign risk leads to market segmentation. Domestic asset trade is therefore insulated from foreign shocks. This has implications regarding the effects of globalization: (1) Goods market integration has no effect on financial markets and it is always welfare-improving, and (2) Asset market integration does not require developing deep domestic financial markets, but only requires the creation of sufficient international collateral.

- If a country cannot discriminate between domestic and foreign creditors, sovereign risk closes some asset markets but keeps those that are open global. Domestic asset trade is no longer insulated from foreign shocks. This also has implications regarding the effects of globalization: (1) Goods market integration might have negative effects on financial markets and reduce welfare, and (2) Asset market integration requires the development of deep domestic financial markets, in addition of the creation of international collateral.

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