Financial Integration, Excess Consumption Volatility, and the World Real Interest Rate*

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Abstract

This study investigates the reason for increased consumption volatility with deeper financial integration in emerging market economies by developing a small open, endowment economy model with an occasionally binding borrowing constraint, accompanied by a time-varying world real interest rate. Calibration exercises show that a deeper financial integration provides a better opportunity for smoothing consumption against income shocks. Meanwhile, the foreign borrowing limit becomes more sensitive to changes in the world real interest rate, resulting in higher foreign debt and consumption volatility. Thus, financial integration would make consumption more vulnerable to the world real interest rate changes in emerging market economies.

Keywords: Financial Integration, Excess Consumption Volatility, Emerging Market Economy, World Real Interest Rate, Occasionally Binding Borrowing Constraint

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