

(Inter-state) Banking and (Inter-state) Trade: Does Real Integration Follow Financial Integration?

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Second draft: May 3, 2010

Abstract

We examine whether financial sector integration leads to real sector integration through trade. Our conjecture is that banking integration between two regions leads to higher trade flows between them. In our stylized model, this happens because banks with presence in the two regions are better able to assess risks and charge the appropriate premiums for trade-related projects pertinent for the two markets; whereas the same banks charge higher average interest rates for projects that involve trade to other markets from which these banks are absent. We use the deregulation of the inter-state banking in the U.S. as a natural experiment to test the implication of our theory model with the state-level Commodity Flow Survey data. Our empirical evidence indicates that there is a trade channel associated with the finance-growth nexus. Based on difference-in-differences estimates, we find that the trade share of state-pairs that have opened their banking market to each other's financial institutions increases by 14% over a ten year period relative to the trade shares of state-pairs that did not. This increase in trade flows is due to actual bank integration following deregulation: based on instrumental variables estimates, we calculate that an increase in bank integration from zero to 2.28%, the mean of the data, increases trade in the range of 15% to 25%. These magnitudes are probably lower bound estimates for financial barriers in international trade, given that the international financial system is much less integrated than the U.S. financial system.

JEL: F10, F15, G21, G28, R12

Keywords: inter-state trade, inter-state banking deregulation, finance-growth nexus

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