



[Finance and Synchronization](#)

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Non-technical summary

It is a well-known fact that financial integration has increased dramatically over the past few decades. Has this rise led to higher or lower business cycle synchronization? This paper tries to answer this question.

Theory is an imperfect guide. In the workhorse model of international real business cycles with complete markets (IRBC), financial flows exacerbate asymmetries in business cycles as they relocate efficiently to the country with highest marginal product of capital. This happens in response to country-specific shocks. The opposite happens, still in response to country-specific shocks, when the model is augmented with credit or collateral constraints. Then finance becomes a vector of contagion.

Importantly, the predictions of the IRBC model with idiosyncratic shocks and homogeneous countries are observationally equivalent to its predictions with common shocks but heterogeneous countries, for plausible parametrization of heterogeneity. This happens because common shocks have heterogeneous effects across countries. To investigate the ambiguous link between finance and synchronization in response to country-specific shocks, it is therefore important to control for common shocks that are allowed to have different effects across countries. We do that with the simplest possible approach, by means of a principal component analysis.

Conditional on common shocks, we find that finance and synchronization correlate negatively. We further show that this negative correlation is driven by a permanent feature of cross-country heterogeneity, rather than by random country-specific shocks. In contrast, conditional on well identified idiosyncratic, country-specific shocks we show that financial flows result in more synchronized business cycles in the vast majority of specifications.