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Abstract:

Existent literature is by no means conclusive on the effects of trade finance on trade and the economy. We propose a suitable framework to explore the linkages between international trade and finance based on an international real business cycle model where firms require external finance to import and can be financially constrained. We find that credit shocks do affect the dynamic properties of the economy and they have the potential to cause significant deviations in trade and economic performance. The trade-to-GDP ratio falls following a negative credit shock, as the shock reduces the capability of firms to purchase foreign intermediate goods, thereby reducing efficiency and production. However, it forces a demand substitution towards domestic intermediate goods that limits GDP deterioration. We also find that financially developed countries trade more, are richer and more stable in terms of GDP and consumption, consistence with the empirical evidence. Finally, the model sheds light on persistent contradictions between theoretical business-cycle and their empirical counterparts, namely, the consumption/output anomaly and the volatility of consumption, imports and terms of trade relative to GDP.

Keywords:

Trade finance; credit constraint; great trade collapse; RBC

JEL Classification: F10, F40, E30