What do we Learn about Contagion Channels
From Decomposing Country Equity Portfolios?

Comments on Chinn and Forbes

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Good Stuff!

• An enormous effort in terms of both data and estimation

• Comprehensive coverage of different channels for contagion
  
  o Do trade (direct and indirect), bank lending and FDI simultaneously

  o Nice (for Eichengreen-Rose and Glick-Rose) that trade does well.

  o Mystery that indirect (third-country) trade does so poorly.
Disappointments

• Basically weak empirical results on channels of transmission
  
  o Very unstable results
  
  o “Old-fashioned” channels message somewhat hard to believe for many

• Would like even more channels (market cross-holdings)
  
  o Severe data problems
Concern #1: Country Factors

- How important is the omission of country factors from first-stage empirical model?
  - Critical to purge all common shocks in first stage; otherwise common shocks will look like contagion
- Would country factors be correlated with contagion?
  - Open question in practice.
• Long international finance tradition implies that country factors are critical (often dominate sectoral/international factors)

Solnik (p 130): “The behavior of the domestic market is by far the most important factor affecting individual stock returns; on the average, this factor explains 42% … world and industrial factors explain 18% and 23% …”

- Can be remedied by shifting to firm-level data, adding country effects (Forbes, 2000)
Concern #2: Frequency

• High frequency makes global factors (oil, gold, …) in first stage all financial; no macroeconomic variables (inflation, output, etc.) exist at all.

  o Good for “denominator” issues, worse for numerators

  o One reason for second stage fit problems?
Minor Issues

• Would like more controls in second stage
  o Exchange Rate Regime?
  o Other gravity-like controls

• Some over-kill with the tech, given weak results

• Slight overstatement of result, given poor fits in second stage

• There’s got to be a better way to present statistical data than these tables