Does the Number of Countries in an International Business Cycle Model Matter?

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2019. 4
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I would like to thank Cheol-Keun Cho, Nam Gang Lee, Byoung Hoon Seok, and seminar participants at the Bank of Korea for helpful comments. All remaining errors are my own.
Contents

I. Introduction .................................................................................................................. 1

II. Analytical Investigation Using a Simple Model ............................................................ 6

III. Quantitative Analysis Using a More General Model ................................................ 17

IV. Conclusion .................................................................................................................. 28

References ......................................................................................................................... 30

Appendix ........................................................................................................................... 32
Does the Number of Countries in an International Business Cycle Model Matter?

Until the 1990s, standard models with two large open economies (i.e. the U.S. and Europe) provided plausible representations of the world economy. However, with the emergence of many countries such as China since then, this approach no longer seems reasonable. In line with this change to the global economic environment, there also have been changes in cross-country correlations: the output correlation between the U.S. and Europe has risen, and their consumption correlation has slightly fallen. Accordingly, this paper adds many countries to a standard model to show that doing so can capture the transition in the cross-country correlations. By analytical investigation, I first show that as the number of countries in a simple model increases, the output correlation rises and the consumption correlation falls. A quantitative analysis with a more general model also shows that when the model has more countries, it yields a higher output correlation and a smaller consumption correlation.

Keywords: International business cycles, Number of countries, n-country model, Output correlation, Consumption correlation

JEL Classification: F40, F41, F44
I. Introduction

Until the 1990s, modeling the world economy with two large open economies (i.e. the U.S and Europe) as in standard international business cycle models seemed to be reasonable and plausible, since their weight in the world economy was substantial.\(^1\) Typical international business cycle models with two large open economies, however, seem to be no longer appropriate, as many developing countries such as Brazil, China, India, and Russia have emerged as global players since the 1990s. As a consequence, it has become an almost impossible mission to explain international business cycles with two-country models. Surprisingly, nevertheless, most international business cycle models are still sticking to two symmetric countries in their models (or three countries, on rare occasion). This paper constructs two international business cycle models with many countries to consider this change in the global economic environment. Both the analytical investigation with a simple model and the quantitative analysis with a more general model show that adding many countries to the models helps to explain key international business cycle statistics. Specifically, doing so increases the cross-country output correlation and decreases the cross-country consumption correlation in the models. 

Explaining international business cycle comovements, in particular cross-country output and consumption correlations, is one of the central topics in international macroeconomics. The first paper on this is Backus, Kehoe and Kydland (1992, BKK). BKK construct a symmetric two-country real business cycle model with a single consumption good and complete markets, and show that their model generates a negative output correlation between the two countries and

\(^1\) During the 1960s the combined weight of the U.S. and E.U. in the world economy was around 67% in terms of GDP, according to World Bank data. Since the 1990s, however, their combined weight has continuously decreased, and during the period 2010-2017 it was about 45%.
a very high cross-country consumption correlation close to 1. However, from the data the cross-country output correlation is positive and higher than the cross-country consumption correlation, which is also positive. These discrepancies between the data and standard models' predictions are called the “quantity anomaly.”

Motivated by the seminal work of BKK, many papers have tried to tackle this puzzle. For example, Baxter and Crucini (1995, BC) assume incomplete markets and highly persistent productivity shocks (i.e. unit-root productivity shocks) that do not spill over from one country to the other.

Some papers have tried to explain the merely high cross-country output correlation (i.e. business cycle synchronization) in the data. All these papers, however, have had only limited success in explaining international business cycle comovements. Specifically, even in papers that successfully eliminated the quantity anomaly, the cross-country output correlation was too low compared to the data or the cross-country consumption correlation was negative. Meanwhile, in papers that succeeded in generating high output correlation, the quantity anomaly survived. Regardless of their success or failure, all these studies consider only two countries in their models. This paper tries to address this shortcoming in the literature by considering many countries in a standard international business cycle model.

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2) Alternatively, the “international consumption correlation puzzle” or the “BKK puzzle.”


Table 1. Correlations with the U.S.

<table>
<thead>
<tr>
<th>Country</th>
<th>Output correlation</th>
<th>Consumption correlation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>0.33</td>
<td>0.58</td>
</tr>
<tr>
<td>Canada</td>
<td>0.74</td>
<td>0.77</td>
</tr>
<tr>
<td>Denmark</td>
<td>0.64</td>
<td>0.68</td>
</tr>
<tr>
<td>France</td>
<td>0.43</td>
<td>0.62</td>
</tr>
<tr>
<td>Germany</td>
<td>0.61</td>
<td>0.38</td>
</tr>
<tr>
<td>Italy</td>
<td>0.40</td>
<td>0.48</td>
</tr>
<tr>
<td>Japan</td>
<td>0.59</td>
<td>0.49</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.49</td>
<td>0.45</td>
</tr>
<tr>
<td>Spain</td>
<td>0.30</td>
<td>0.27</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.42</td>
<td>0.61</td>
</tr>
<tr>
<td>U.K.</td>
<td>0.67</td>
<td>0.77</td>
</tr>
<tr>
<td>Europe</td>
<td>0.47</td>
<td>0.52</td>
</tr>
</tbody>
</table>

Notes: Statistics are based on detrended data using the Hodrick-Prescott filter. All series are in logarithms. The statistics for Europe are the GDP-weighted averages of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, the Netherlands, Norway, Spain, Sweden, Switzerland, Turkey and the U.K. The GDP-weights are computed using nominal GDP denominated in U.S. dollars from the IMF World Economic Outlook. The source of output and consumption is the OECD Quarterly National Account.

Due to the rapid changes in the global economic environment since the 1990s, international business cycles may have changed as well. The output and consumption correlations between the U.S. and major countries during the pre-1990 and the post-1990 periods are shown in Table 1. Although the directions of changes in the correlations slightly differ among countries, the output correlations have generally increased and the consumption correlations have roughly decreased in the post-1990 period compared to the pre-1990 period. In particular, the output correlation between the U.S. and Europe (I focus on the correlations between the U.S. and Europe, as do most studies including BKK) has risen from 0.47 to 0.52, and the consumption correlation between them has slightly decreased from 0.35 to 0.33.5)

---

5) The reason why the changes in the correlations are not very large may stem from the fact that China, the largest country among those who have emerged since the 1990s, is maintaining capital controls, and international capital movements are important in the changes, as we will see later.
These changes in international business cycles since 1990 may result from the fact that during the pre-1990 period the world economy was able to be approximately represented by two large open economies (the U.S. and Europe), but during the post-1990 period representing the world economy with the two countries has become difficult as many countries have emerged as global players. Therefore, the number of countries in international business cycle models may matter, and we hence may need to consider models with many countries, rather than typical models only with two countries, to capture these changes in international business cycles in the data.

To explain, in the standard symmetric two-country model with a single consumption good and complete markets, such as that in BKK, a positive productivity shock to a country (say $A$) leads to an increase in its output. Since $A$ becomes more productive due to the shock, resources (i.e. capital that is mobile across countries) in the other country (say $B$) are shifted to $A$, causing a fall in $B$'s output. Hence, in the two-country economy, the outputs of $A$ and $B$ are negatively correlated. However, suppose that the model includes three countries (say $A$, $B$ and $C$). A positive productivity shock to $A$ will make $A$ become more productive than $B$ and $C$, and thus $A$ will draw capital from $B$ and $C$. Nonetheless, since $A$ has one more country (i.e. $C$) to draw resources than in the two-country model, the capital of $B$ and $C$ will fall by less than in the two-country case. Consequently, in response to the positive productivity shock to $A$, the output of $B$ and $C$ will go down by less compared to the two-country model, which will enable the cross-country output correlation to be higher. In short, it would be expected that the higher the number of countries in an international business cycle model, the higher the cross-country output correlation.

As for the cross-country consumption correlation, in the standard two-country model with complete markets (BKK's model), when a positive productivity shock hits $A$, its households increase their consumption by some, but not all, of the rise in its output. This is
because under complete markets households want to smooth consumption by sharing some of the increased output with $B$ in exchange for the same share when a positive productivity shock hits $B$. Hence, consumption in $B$ goes up, which causes a very high cross-country consumption correlation. In the three-country case, however, $A$ has one more country (i.e. $C$) to share its increased output than in the two-country case. Therefore, $A$ will share a smaller amount of its increased output with each country to smooth consumption. Accordingly, the consumption of $B$ and $C$ will increase by less than in the two-country model, which will bring about a lower cross-country consumption correlation. Alternatively, if there are many countries, the weight of $A$ in the world economy will fall, meaning that positive productivity shocks to $A$ will bring about a smaller fall in the world price of the consumption good. The smaller decrease in the world price will lead to a smaller increase in real wages (the relative price of leisure to the price of the consumption good) in $B$ and $C$, if other factors are constant, which will enable consumption in $B$ and $C$ to go up by less compared to those in the two-country case. Hence, the cross-country consumption correlation will become lower.

The main goal of this paper is to show that in line with the changes in the global economic environment and international business cycles in the data since the 1990s, the higher the number of countries in an international business cycle model, the higher the output correlation and the lower the consumption correlation the model produces, and thus the quantity anomaly is also mitigated to some degree. To do so, I first conduct an analytical investigation with a simple $n$-country model. I then carry out a quantitative analysis by using a more general $n$-country model. For the quantitative analysis, I consider both complete and incomplete asset markets, and both trend stationary and unit-root productivity shocks. Consistent with the expectation, both the analytical and quantitative studies, indeed, show that as the number of countries in the two models increases, the
cross-country output correlation goes up and the cross-country consumption correlation falls.

The remainder of the paper is organized as follows. With a simple \( n \)-country model, Section II analytically shows that as the number of countries in the model increases, the cross-country output correlation increases but the cross-country consumption correlation falls. Section III provides a more general \( n \)-country model by extending the model of BC for a quantitative analysis, and shows that the simulation results of the model are consistent with the analytical results in Section II. The simulation results for various asset market structures and productivity shock processes are also presented in Section III. Section IV concludes.

II. Analytical Investigation Using a Simple Model

In this section, I analytically investigate whether a simple \( n \)-country model with more countries generates a higher cross-country output correlation and a lower cross-country consumption correlation. To explore the economic mechanism for the differential cross-country correlations depending on the number of countries in the model, I then study the impulse responses of several variables in the model. Specifically, I show that as the number of countries in the model increases, the output of country \( j \) decreases by less in response to a positive productivity shock to country \( i, \ i \neq j \), whilst the consumption of country \( j \) increases by less in response to the same shock.

1. The simple model

The simple model is based on the models of BKK and BC. For simplicity, I assume that capital is fixed. Therefore, it should be

6) Since omitting capital and investment substantially simplifies the analysis, this assumption is frequently used in many analytical studies.
noted that there are some discrepancies between the explanations in this section and the previous. Other features of the model are the same as those of BKK and BC. Specifically, the world economy consists of \( n \geq 2 \) countries, there exists a single consumption good, and asset markets are complete, which means that individuals in the model are free to trade any state-contingent asset they wish. I assume symmetry across countries as usual in the standard international business cycle literature. Hence, the impulse responses of all variables in all countries, with the exception of country \( i \), to a productivity shock to country \( i \) and the cross-country correlations for all variables for all country pairs are equal.

Equilibrium of the simple \( n \)-country model can be found by carrying out a standard Lagrangian problem, as specified below:

\[
\max_{C_i, L_i, N_t, W_t, P_t} \mathcal{L} = \mathbb{E}_0 \sum_{t=0}^{\infty} \beta^t \left[ \sum_{i=1}^{n} \frac{1}{n} U^i(C_i^t, L_i^t) + \sum_{i=1}^{n} \frac{1}{n} W_t^i (1 - L_i^t - N_t^i) \right. \\
\left. + P_t \sum_{i=1}^{n} \frac{1}{n} (A_i^i N_t^{i-\alpha} - C_t^i) \right],
\]

where superscript \( i = 1, 2, \cdots, n \) denotes countries and \( U^i(C_i^t, L_i^t) = \left( \frac{C_i^\gamma L_i^{1-\gamma}}{\gamma} \right)^{\gamma} \). \( E \) is the expectations operator, \( C_i^t \) is consumption, \( L_i^t \) is leisure, \( N_t^i \) is time allocated to work, and \( A_i^i \) is total factor productivity. \( W_t^i \) and \( P_t \) are Lagrangian multipliers. These multipliers have natural interpretations: \( W_t^i \) is the wage rate and \( P_t \) is the price of the consumption good. Finally, the real wage rate, an additional variable of our interest, can be defined by \( W_t^i / P_t \).

Productivity follows an AR(1) process as usual:

\[
\Delta_t = \Omega \Delta_{t-1} + \epsilon_t,
\]

where \( \Delta_t = [\ln A_t^1, \ln A_t^2, \cdots, \ln A_t^n]' \) and \( \Omega \) is an \( n \times n \) matrix of coefficients.
Does the Number of Countries in an International Business Cycle Model Matter?

Let \( e = [e_1, e_2, \ldots, e_n]' \) be the innovation to \( A_t \). For simplicity of the model, I further assume that the off-diagonal elements of \( \Omega \) are all zero, i.e. shocks do not have international spillovers, and that all diagonal elements of \( \Omega \) have the same value of \( \varrho \in (0, 1] \). The correlations between shocks \( \rho_A \) are the same for all country pairs and \( \rho_A > 0 \).

The first-order conditions for this Lagrangian problem are

\[
P_t = \mu C_t^{\rho-1} L_t^{(1-\rho)},
\]

\[
W_t = (1 - \mu) C_t^{\rho-1} L_t^{(1-\rho)-1},
\]

\[
W_t^i = (1 - \alpha) P_t A_t^i N_t^i,
\]

\[
0 = 1 - L_t^i - N_t^i,
\]

\[
\sum_{i=1}^{n} A_t^i N_t^{i-\alpha} = \sum_{i=1}^{n} C_t^i.
\]

These first-order conditions can be combined to obtain:

\[
C_t^{\rho-1} L_t^{(1-\rho)} = C_t^{\rho-1} L_t^{(1-\rho)}, \quad j \neq i,
\]

\[
(1 - \mu) C_t^i = (1 - \alpha) \mu L_t^i A_t^i N_t^{i-\alpha},
\]

\[
\sum_{i=1}^{n} Y_t^i = \sum_{i=1}^{n} A_t^i N_t^{i-\alpha} = \sum_{i=1}^{n} C_t^i.
\]

The corresponding log-linearized forms of equations (8)-(10) are

\[
\chi \hat{C}_t^i - \xi \hat{N}_t^i = \chi \hat{C}_t^j - \xi \hat{N}_t^j, \quad j \neq i,
\]

\[
\hat{C}_t^i = \hat{A}_t^i - \varphi \hat{N}_t^i,
\]

\[
\sum_{i=1}^{n} \hat{Y}_t^i = \sum_{i=1}^{n} \{ \hat{A}_t^i + (1 - \alpha) \hat{N}_t^i \} = \sum_{i=1}^{n} \hat{C}_t^i.
\]
with $\chi = \mu\gamma - 1$, $\xi = \frac{N\gamma(1 - \mu)}{1 - N}$ and $\varphi = \alpha + \frac{N}{1 - N}$. The hatted variables denote the log-deviations of the variables from their steady state values, and the variables without time subscript refer to their steady state values. Due to the symmetry, each variable has the same steady state value across countries, i.e. $W_i^t = W$, $Y_i^t = Y$, $C_i^t = C$ and $N_i^t = N$ for all $i$.

Finally, the equations for the real wage and its log-linearized form can be written as:

\begin{equation}
W_t^i = \frac{W_t^i}{P_t} = \frac{1 - \mu}{\mu} \frac{C_t^i}{1 - N_t^i} = (1 - \alpha)A_t^i N_t^i, \tag{14}
\end{equation}

\begin{equation}
\tilde{w}_i^t = \tilde{W}_t^i - \tilde{P}_t = \tilde{C}_t^i + \frac{N}{1 - N} \tilde{N}_t^i = \tilde{A}_t^i - \alpha \tilde{N}_t^i. \tag{15}
\end{equation}

### 2. Solution of the model

I solve the system of the above linear equations by applying the method of undetermined coefficients. The policy rules for the jump variables in the model are\(^7\)

\begin{equation}
C_t^i = C + C \left( (1 - \kappa\varphi) \tilde{A}_t^i + \kappa\frac{\varphi}{n} \sum_{i=1}^{n} \tilde{A}_t^i \right), \tag{16}
\end{equation}

\begin{equation}
N_t^i = N + N \left( \kappa \tilde{A}_t^i - \kappa \frac{n}{n} \sum_{i=1}^{n} \tilde{A}_t^i \right), \tag{17}
\end{equation}

with $\kappa = \frac{\chi}{\xi + \chi\varphi}$. Since $\tilde{Y}_t^i = \tilde{A}_t^i + (1 - \kappa) \tilde{N}_t^i$, $\tilde{Y}_t^i = (1 + (1 - \alpha)\kappa) \tilde{A}_t^i - (1 - \alpha)$

\begin{equation}
\frac{\kappa}{n} \sum_{i=1}^{n} \tilde{A}_t^i. \text{ By using } \tilde{Y}_t^i = \frac{Y_t^i - Y}{Y}, Y_t^i \text{ can be written as}
\end{equation}

\(^7\) See Appendix A for details.
\[ Y_i^j = Y + Y \left\{ (1 + (1 - \alpha)\kappa)\hat{A}_i^j - (1 - \alpha)\frac{n}{n-1} \sum_{i=1}^{n} \hat{A}_i^j \right\}. \] (18)

Since capital is fixed in this simple model, the price of the consumption good and the real wage are important in understanding output and consumption fluctuations. We thus need to obtain policy rules for those variables. Substituting equations (16) and (17) into equations (3) and (15) gives the policy rules for the two additional variables of interest \((P_i^j\) and \(w_i^j\):

\[ P_i = P + P \left\{ (\chi - \kappa(\chi\varphi - \xi))\hat{A}_i^j - \kappa(\chi\varphi - \xi)\frac{n}{n-1} \sum_{i=1}^{n} \hat{A}_i^j \right\}, \] (19)

\[ w_i^j = w + w \left\{ (1 - \kappa\varphi + \frac{N}{1-N}\kappa)\hat{A}_i^j - \kappa(\varphi - \frac{N}{1-N})\frac{n}{n-1} \sum_{i=1}^{n} \hat{A}_i^j \right\}. \] (20)

3. Cross-country correlations

Before obtaining the functional forms of the cross-country consumption and output correlations in the model, we need to find the functional forms of variances of those variables, since the functional forms of the correlations contain the variances.

\(\sigma_C^2\), \(\sigma_Y^2\), and \(\sigma_A^2\) denote the variances of consumption, output and productivity, respectively. Note that due to the symmetry, they are equal for all \(i\). Taking the variances of equations (16) and (18) and using \(cov(A_i^i, A_i^j) = \rho_A \sigma_A^2\) for all \(i\) and \(j\) \((i \neq j)\) give the expressions of \(\sigma_C^2\) and \(\sigma_Y^2\):

\[ \sigma_C^2 = C^2 \sigma_A^2 \left\{ \left(1 - \frac{(n-1)\kappa\varphi}{n} \right)^2 + (n-1)\left(\frac{\kappa\varphi}{n} \right)^2 + 2(n-1)\left(1 - \frac{(n-1)\kappa\varphi}{n} \right)\frac{\kappa\varphi}{n} \rho_A + (n-1)(n-2)\left(\frac{\kappa\varphi}{n} \right)^2 \rho_A \right\}, \] (21)
As for the cross-country consumption correlation, we can obtain the functional form of it by using equation (16). Denote $\rho_{i,j}$ for all $i$ and $j$ ($i \neq j$) the cross-country correlation of consumption. To find out the functional form of $\rho_{i,j}$, we first obtain $\text{cov}(C_i, C_j)$ from equation (16), and then take the variance of $C_i + C_j$. By using the definition of correlation, $\rho_{i,j} = \frac{\text{cov}(C_i, C_j)}{\sigma_i \sigma_j}$ and $\text{cov}(C_i, C_j) = \rho_{i,j} \sigma_i^2$, (23)

$\rho_{i,j} = \frac{C_i^2 \sigma_j^2}{2 \sigma_j^2} f(n) - 1,$

where $f(n) = 2(1 + \rho_A) \left(1 - \frac{2(n-2)\kappa \varphi}{n}\right)^2 + (n-2) \left(\frac{2\kappa \varphi}{n}\right)^2 \left(1 + (n-3)\rho_A\right) + 4(n - 2) \left(1 - \frac{2(n-2)\kappa \varphi}{n}\right) \frac{2\kappa \varphi}{n} \rho_A$. (24)

**Proposition 1.** Under any reasonable parameterization, as the number of countries $n$ grows in the model, the cross-country consumption correlation $\rho_{i,j}$ falls.

Differentiating equation (23) with respect to $n$ gives

$$\frac{\partial \rho_{i,j}}{\partial n} = \frac{\kappa \varphi \rho_A (2(n-2)(\kappa \varphi - 1)^2 - (n-1)(\rho_A - 1)^2}{n(\kappa \varphi - 2)(\rho_A - 1) - (\kappa \varphi - 2)(\rho_A - 1) - \kappa \varphi (\kappa \varphi - 2)(\rho_A - 1)}.$$  

Under the standard parameterization, $\mu = 0.34, \gamma = -1, \alpha = 0.36, \rho_A = 0.258$ and $\varphi = 0.906$, which are the same parameter values used in
Does the Number of Countries in an International Business Cycle Model Matter?

Accordingly, \(N = 0.2479\), \(\varphi = 0.6897\), \(\chi = -1.34\), \(\xi = -0.2176\) and \(\kappa = 1.1736\). Since \(\kappa \varphi (\kappa \varphi - 2) < 0\), \(\frac{\partial \rho_C}{\partial n} < 0\). That is, the more countries the model has, the lower the cross-country consumption correlation it generates.

With regard to the cross-country correlation of output \((\rho_{Y_i, Y_j} = \rho_Y \text{ for all } i \neq j)\), obtaining \(Y_i^t + Y_j^t\) from equation (18), taking the variance of \(Y_i^t + Y_j^t\) and using the definition of correlation

\[
(\rho_Y = \frac{\text{cov}(Y_i^t, Y_j^t)}{\sigma_Y \cdot \sigma_Y}) = \frac{\text{cov}(Y_i^t, Y_j^t)}{\sigma_Y^2}
\]

and \(\text{cov}(Y_i^t, Y_j^t) = \rho_Y \sigma_Y^2\) give the explicit expression of \(\rho_Y\):

\[
\rho_Y = \frac{Y^2 \sigma_A^2}{2 \sigma_Y^2} g(n) - 1, \quad (25)
\]

where

\[
g(n) = 2(1 + \rho_A) \left[ 1 + (1 - \alpha) \left( \frac{n - 2}{n} \right) \right]^2 + (n - 2)(1 - \alpha) \left( \frac{2\kappa}{n} \right)^2 (1 + (n - 3)\rho_A) - 4(n - 2)(1 - \alpha) \left[ 1 + (1 - \alpha) \left( \frac{n - 2}{n} \right) \right] \frac{2\kappa}{n} \rho_A.
\]

**Proposition 2.** Under the standard parameterization, the cross-country output correlation \(\rho_Y\) goes up as the number of countries \(n\) increases.

We can obtain the derivative of \(\rho_Y\) with respect to \(n\) by using equation (25).

\[
\frac{\partial \rho_Y}{\partial n} = \left[ \kappa (\alpha - 1)(\kappa (\alpha - 1) - 2)(\kappa (\alpha - 1) - 1)^2 (\rho_A - 1)^2 \right] n \left[ \kappa (\alpha - 1) \times (\kappa (\alpha - 1) - 2)(\rho_A - 1) - \kappa (\alpha - 1)(\kappa (\alpha - 1) - 2)(\rho_A - 1) \right]^{-2} \quad (26)
\]

Since under the standard parameterization \(\kappa (\alpha - 1)(\kappa (\alpha - 1) - 2) > 0\), \(\frac{\partial \rho_Y}{\partial n} > 0\). Hence, when there exist more countries in the model, its
cross-country output correlation is higher.

To sum up, in this section, it is analytically shown that if there are many countries in a simple \( n \)-country international business cycle model, the cross-country correlation of consumption becomes lower, whilst the cross-country correlation of output becomes higher compared to the case in which only two countries exist as in the standard models. These analytical results clearly show that international business cycle models should include many countries in order to properly explain international business cycles after the 1990s.

4. Impulse responses

In this section, I study the impulse responses of the model to understand how it can generate lower cross-country consumption correlation and higher cross-country output correlation as the number of countries in the model \( n \) grows. The impulse response of a variable \( z_{i+h} \), \( h \geq 0 \) in period \( t+h \) to a productivity shock to country \( j \) in period \( t \), \( e^j_t \) is defined by \( \frac{\partial z^i_{t+h}}{\partial e^j_t} \). It can be obtained by using the policy rules and the first-order conditions in the previous section.

Proposition 3. Under any reasonable parameterization, in response to a positive productivity shock to country \( j \), the price of the consumption good \( P_t \) falls by less as the number of countries \( n \) increases.

Differentiating equation (19) with respect to \( e^j_t \) and using
\[
\frac{\partial A^i_t}{\partial e^i_t} = \frac{\partial e^i_t}{\partial e^i_t} = \rho_A \quad \text{and} \quad \frac{\partial A^j_t}{\partial e^j_t} = \frac{\partial e^j_t}{\partial e^j_t} = 1 \quad \text{for all } i \text{ and } j \quad (i \neq j),
\]
which can be obtained from equation (2), yield the impulse response of \( P_{t+h} \) to \( e^j_t \):
\[
\frac{\partial P_{t+h}}{\partial e^j_t} = P^h \left\{ \chi \rho_A + \frac{\kappa (\chi \varphi - \xi)(1 - \rho_A)}{n} \right\}. \tag{27} \]
Both \( \chi \rho_A \) and \( \kappa (\chi \varphi - \xi)(1 - \rho_A)/n \) are negative under the standard parameterization. Hence, \( \frac{\partial P_{t+h}}{\partial e_i^j} < 0 \). That is, since a positive productivity shock to country \( j \) leads to an increase in its production of the consumption good, the price of the consumption good falls. Furthermore, because \( \kappa (\chi \varphi - \xi)(1 - \rho_A) \) is negative, \( \frac{\partial}{\partial n} \left( \frac{\partial P_{t+h}}{\partial e_i^j} \right) = -P_0 \kappa (\chi \varphi - \xi)(1 - \rho_A)/n^2 > 0 \), which means that when there are more countries in the model, the price goes down by less in response to a positive productivity shock to country \( j \). Recall that the more countries in the model, the less weight of an individual country in the world economy. Therefore, when more countries exist in the model, the effect of positive productivity shocks to a certain country on the price becomes weaker.

**Proposition 4.** Under the standard parameterization, if the model has more countries, a positive productivity shock to country \( j \) leads to a smaller increase in the real wage in country \( i \) \( w_i^i \).

By differentiating equation (20) with respect to \( e_i^j \), we can obtain the impulse response of \( w_i^i \) to \( e_i^j \):

\[
\frac{\partial w_{i+h}}{\partial e_{i}^{j}} = w_0^h \left\{ \rho_A + \frac{\kappa (1 - \rho_A)(\varphi - N/(1 - N))}{n} \right\}.
\]

(28)

Since all terms on the right-hand side of equation (28) are positive under the standard parameterization, \( \frac{\partial w_{i+h}}{\partial e_{i}^{j}} > 0 \). This is mainly because \( w_i^i \) is a decreasing function of the price of the consumption good \( P_i \) \( (w_i^i = W_i^i/P_i) \) and \( P_i \) falls in response to a positive productivity shock to country \( j \). Simply, the real wage is the relative price of leisure to
the price of the consumption good in this model. Hence, in response to the shock decreasing $P_t$, $w^i_t$ rises. Moreover, using equation (28), we can find
\[
\frac{\partial}{\partial m} \left( \frac{\partial w^i_{t+h}}{\partial e^j_t} \right) = -w^h \kappa (1 - \rho_A) (\varphi - N/(1 - N))/n^2 < 0,
\]
meaning that, as $n$ rises, $w^i_t$ goes up by less in response to a positive productivity shock to country $j$. This is because when there are more countries in the model, a positive productivity shock to country $j$ leads to a smaller fall in $P_t$ (Proposition 3).

**Corollary 1.** Under any reasonable parameterization, as the number of countries $n$ increases, the rise in the consumption in country $i$ $C^i_t$ becomes smaller in response to a productivity shock to country $j$.

A positive productivity shock to country $j$ causes a rise in the real wage in country $i$ $w^i_t$ (i.e. a fall in the relative price of the consumption goods), and the natural response is an increase in consumption, which can also be seen in equations (14) ($w^i_t = \frac{1 - \mu}{\mu} \frac{C^i_t}{1 - N^i_t}$) showing that $C^i_t$ is an increasing function of $w^i_t$. Alternatively, since for consumption smoothing individuals in the more productive country (country $j$) share some of the additional output with households in less productive countries including country $i$, $C^i_t$ goes up. Furthermore, because a large $n$ causes a smaller rise in $w^i_t$ according to Proposition 4, $C^i_t$ increases by less when there exist more countries in the model.\(^8\)

---

\(^8\) More precisely, differentiating equation (16) with respect to $e^j_t$ gives
\[
\frac{\partial C^i_{t+h}}{\partial e^j_t} = Q^h \left\{ \rho_A + \frac{\kappa \varphi (1 - \rho_A)}{n} \right\}. 
\]
Since $\kappa \varphi (1 - \rho_A) > 0$ under the standard parameterization, \(\frac{\partial C^i_{t+h}}{\partial e^j_t} > 0\) and
\[
- Q^h \frac{\kappa \varphi (1 - \rho_A)}{n^2} \text{ and } Q^h \kappa \varphi (1 - \rho_A) > 0,
\]
which means \(\frac{\partial}{\partial n} \left( \frac{\partial C^i_{t+h}}{\partial e^j_t} \right) < 0\).
Corollary 2. Under standard parameterization, the more countries the model has, the smaller the fall in labor input in country \( i \) \( N_i^j \) generated by a positive productivity shock to country \( j \).

Although a rise in the relative price of leisure \( w_i^j \) leads households in country \( i \) to increase \( C_i^j \) and to decrease \( L_i^j \) (i.e. raise \( N_i^j \)), a rise in \( w_i^j \) without a sufficient increase in productivity \( A_i^j \) results in a fall in labor demand. That is, labor input in country \( i \) \( N_i^j \) is a decreasing function of \( w_i^j \) and an increasing function of \( A_i^j \) from equation (14) \( (w_i^j = (1 - \alpha)A_i^jN_i^{-\alpha}) \). Hence, \( N_i^j \) falls, since \( w_i^j \) goes up and \( A_i^j \) does not increase enough to offset the negative impact of the rise in \( w_i^j \) on \( N_i^j \).

Putting it differently, since households in country \( j \) transfer some of the additional output to individuals in less productive countries including country \( i \) so as to smooth consumption when a positive productivity hits country \( j \) (as already noted), the shock brings about a fall in labor input in less productive countries. Proposition 4 shows that when there are more countries in the model, \( w_i^j \) rises by less in response to a positive productivity shock to country \( j \). As a consequence, as the number of countries \( n \) grows in the model, \( N_i^j \) decreases by less following the shock.9)

Corollary 3. Under any reasonable parameterization, when there are more countries in the model, output in country \( i \) \( Y_i^j \) rises by more or falls by less in response to a productivity shock to country \( j \).

9) More accurately, by using equation (17) \( \frac{\partial N_i^{j+1}}{\partial c_i^j} = N_i^\delta \frac{\kappa(p_A - 1)}{n} \). Since \( (p_A - 1) < 0 \) under the standard parameterization, \( \frac{\partial N_i^{j+1}}{\partial c_i^j} < 0 \). Therefore, \( \frac{\partial}{\partial N_i} \left( \frac{\partial N_i^{j+1}}{\partial c_i^j} \right) = -N_i^\delta \kappa(p_A - 1)/N^2 > 0 \).
It is easy to show that Corollary 3 holds by using the production function \( Y_i^i = A_i^i N_i^i (1 - \alpha) \) and Corollary 2. The former shows that output in country \( i \) \( Y_i^i \) is an increasing function of labor input in country \( i \) \( N_i^i \). The latter shows that as the number of countries in the model \( n \) rises, \( N_i^i \) falls by less. Hence, if the model has more countries, \( Y_i^i \) goes up by more or down by less.\(^{10}\)

In short, as the number of countries in the model \( n \) grows, a positive productivity shock to country \( j \) leads to a larger rise or a smaller fall in the output of country \( i \) \( Y_i^i \) and a smaller rise in the consumption of country \( i \) \( C_i^i \). As a result, the model with more countries generates a higher output correlation and lower consumption correlation compared to the model with less countries, which enables the model with many countries to mitigate the quantity anomaly to some degree. These results are consistent with our initial expectation in the previous section.

### III. Quantitative Analysis Using a More General Model

In this section, I provide a quantitative analysis using a more general model than the simple model used in the analytical investigation. This section shows that, even in a more general model, a higher number of countries \( n \) is associated with a higher cross-country correlation of output but a lower cross-country correlation of consumption, consistent with the analytical results with the simple model in the previous section.

\(^{10}\) Differentiating equation (18) with respect to \( \epsilon_i \) gives \[ \frac{\partial Y_i^i + \kappa}{\partial \epsilon_i} = Y_i^i \left( \kappa \frac{(1 - \alpha)(1 - \rho_A)}{n} \right) \]. Since \( \rho_A \) is positive and \( \kappa \frac{(1 - \alpha)(1 - \rho_A)}{n} \) is positive, the sign of \[ \frac{\partial Y_i^i + \kappa}{\partial \epsilon_i} \] depends on the relative size of \( |\rho_A| \) and \[ \kappa \frac{(1 - \alpha)(1 - \rho_A)}{n} \]. Nevertheless, \[ \frac{\partial}{\partial m} \left( \frac{\partial Y_i^i + \kappa}{\partial \epsilon_i} \right) = Y_i^i \kappa (1 - \alpha)(1 - \rho_A)/n^2 > 0 \] because the term \[ \kappa (1 - \alpha)(1 - \rho_A) > 0. \]
Specifically, I extend the standard two-country international business cycle model of BC to an \( n \)-country model.

1. **The model**

The model\(^{11}\) in this section is a streamlined version of the models of BKK and BC. Specifically, I eliminate the variable representing the level of purely labor-augmenting technical change in the production function from the complete market model of BC.\(^{12}\) The main difference between this model and the BC model is the number of countries. That is, the model of BC has two symmetric countries, while this model has \( n \geq 2 \) symmetric countries.

The preferences for a representative household in each country are described by the following utility function:

\[
E_0 \sum_{t=0}^{\infty} \beta^t U^i\left(C^i_t, L^i_t\right),
\]

where \( U^i\left(C^i_t, L^i_t\right) = \left(\frac{C^i_t L^{i-\gamma}_t}{\gamma}\right)^\gamma \) and \( 1 - L^i_t - N^i_t = 0 \).

The production function in each country is Cobb-Douglas:

\[
Y^i_t = A^i_t K^i_t N^{i-\alpha}_t.
\]

The productivity follows an AR(1) process:

\[
A_t = \Omega A_{t-1} + e_t,
\]

where \( A_t = [\ln A^1_t, \ln A^2_t, \cdots, \ln A^n_t]' \) and \( \Omega \) is an \( n \times n \) matrix of coefficients. The innovation to \( A_t \) is \( e_t = [e^1_t, e^2_t, \cdots, e^n_t]' \).

---

11) The notation used in this section is the same as that in Section \( II \).
12) I also simulate the model with incomplete markets later in this section.
Capital accumulates according to

\[ K_{t+1}^i = (1 - \delta)K_t^i + I_t^i - \frac{\phi}{2} \left( \frac{I_t^i}{K_t^i} - \delta \right)^2 K_t^i. \] (32)

World output is allocated to consumption and investment:

\[ \sum_{i=1}^{n} Y_t^i = \sum_{i=1}^{n} (C_t^i + I_t^i). \] (33)

Competitive equilibrium can be found by solving a planning problem:

\[ \max E_0 \sum_{t=0}^{\infty} \beta^t \sum_{i=1}^{n} \frac{1}{n} U(C_t^i, L_t^i), \] (34)

subject to equations (32) and (33), and \( 1 - L_t^i - N_t^i = 0.13 \)

I also follow BKK and BC in assigning the parameter values of the model. Table 2 shows the parameter values. For the coefficient matrix \( \Omega \), I assume that off-diagonal elements are all zero and that all diagonal elements have the same value of 0.906. The standard deviation of the innovation \( e_t^i \) is set to 0.00852 for all countries. The correlation between all innovation pairs is set to 0.258.

<table>
<thead>
<tr>
<th>Table 2. Parameter values</th>
</tr>
</thead>
<tbody>
<tr>
<td>( \beta )</td>
</tr>
<tr>
<td>0.99</td>
</tr>
</tbody>
</table>

13) See Appendix B for the first-order conditions for this problem.
14) Although this assumption is mainly for the stationarity and simplicity of the model, many studies find that the off-diagonal elements are close to zero (for details, see Kollmann (1996), Kehoe and Perri (2002), Dmitriev and Roberts (2012), etc.).
15) I also simulate the model with unit-root productivity shocks later in this section.
2. Results

This section presents the business cycle statistics, mainly the cross-country consumption and output correlations, that the model generates according to various values of \( n \). Then the responses of the several variables of country \( i \) (say country 1) to a productivity shock to country \( j \) (say country 2) when \( n = 2, 3, 4 \) are presented to study the mechanism of changes in the cross-country correlations.

2.1 Cross-country correlations

The cross-country correlations of output and consumption that are generated by the model according to the various values of the number of countries in the model \( n \) are presented in Figure 1. Consistent with the analytical investigation with the simple model in Section 2 and our initial expectation, Figure 1 clearly shows that the more countries the model has, the higher the cross-country correlation of output and the lower the cross-country correlation of consumption. Specifically, the cross-country output correlation is concave in \( n \), and hence as \( n \) increases, the slope of (a) in Figure 1 falls. In contrast, the cross-country consumption correlation is convex in \( n \), and therefore the slope of (b) in Figure 1 becomes flatter as \( n \) rises.

![Figure 1. Cross-country correlations](image-url)

Note: The correlations are the models’ population moments for the Hodrick-Prescott filtered results.
In a nutshell, these results are the same as the analytical results in Section 2 and consistent with our initial expectation. Furthermore, they suggest that adding many countries to international business cycle models helps mitigate the quantity anomaly to some degree as well.

**Table 3. Business cycle statistics**

<table>
<thead>
<tr>
<th>Statistics</th>
<th>Data</th>
<th>Two-country</th>
<th>Three-country</th>
<th>Four-country</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>S.D. relative to GDP in the U.S.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumption</td>
<td>0.83</td>
<td>0.31</td>
<td>0.28</td>
<td>0.27</td>
</tr>
<tr>
<td>Investment</td>
<td>3.25</td>
<td>2.77</td>
<td>2.78</td>
<td>2.78</td>
</tr>
<tr>
<td>Employment</td>
<td>0.89</td>
<td>0.52</td>
<td>0.54</td>
<td>0.55</td>
</tr>
<tr>
<td>Net exports over GDP</td>
<td>0.28</td>
<td>0.20</td>
<td>0.22</td>
<td>0.23</td>
</tr>
<tr>
<td><strong>Correlations in the U.S.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consumption and GDP</td>
<td>0.88</td>
<td>0.88</td>
<td>0.86</td>
<td>0.85</td>
</tr>
<tr>
<td>Investment and GDP</td>
<td>0.93</td>
<td>0.98</td>
<td>0.98</td>
<td>0.97</td>
</tr>
<tr>
<td>Net exports over GDP and GDP</td>
<td>−0.53</td>
<td>0.50</td>
<td>0.56</td>
<td>0.59</td>
</tr>
<tr>
<td>Saving and investment</td>
<td>0.90</td>
<td>0.97</td>
<td>0.97</td>
<td>0.97</td>
</tr>
<tr>
<td><strong>Cross-country correlations</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Output</td>
<td>0.52</td>
<td>0.07</td>
<td>0.11</td>
<td>0.13</td>
</tr>
<tr>
<td>Consumption</td>
<td>0.33</td>
<td>0.84</td>
<td>0.81</td>
<td>0.79</td>
</tr>
<tr>
<td>Investment</td>
<td>0.43</td>
<td>0.05</td>
<td>0.10</td>
<td>0.12</td>
</tr>
</tbody>
</table>

Notes: S.D. denotes standard deviations. The statistics in the data are based on detrended data using the Hodrick-Prescott filter. Saving is output minus private consumption minus government consumption. The cross-country correlations in the data are for the U.S. and Europe during Q1 1990-Q3 2018. The data for investment (gross fixed capital formation), employment (employed population) and net exports are all from the OECD. The figures in the third, fourth and fifth columns are the models’ population moments for the Hodrick-Prescott filtered results.

Although I focus on the cross-country output and consumption correlations, I briefly explain how other primary business cycle statistics change according to various values of $n$. The business cycle statistics that models with $n = 2, 3, 4$ produce are given in Table 3. Overall, as the number of countries in the model $n$ increases, the business cycle statistics the model yields become closer to the post-1990 data: the standard deviations of investment, employment and net
exports over GDP relative to GDP, the correlation between investment and GDP, and the cross-country correlations of output, consumption and investment all improve. Nevertheless, the standard deviation of consumption relative to GDP, and the correlations between consumption and GDP and between net exports over GDP and GDP become worse as \( n \) rises.\(^{16}\)

### 2.2 Impulse responses

In order to understand how the model generates different values of the cross-country output and consumption correlations as \( n \) changes, this section presents the responses of the variables of interest in country 1 to a positive one-standard-deviation productivity shock to country 2.

**Figure 2. Responses of variables in country 1 to a positive productivity shock to country 2**

![Diagram showing responses of variables](image)

The responses of consumption and the real wage in country 1 and the price of the consumption good to a positive productivity shock to country 2 are given in Figure 2. They help understand how the cross-country consumption correlation falls as \( n \) rises. As shown in the

---

\(^{16}\) The correlation between saving and investment becomes slightly lower and closer to the data as \( n \) increases. The fall in the correlation, however, is not noticeable. Moreover, as BC noted, saving defined as output minus consumption (basic saving) may not be a good measure of true saving.
previous section, when the model has more countries, the weight of country 2 declines in the world economy. Thus when \( n \) is large, the price of the consumption good decreases to a lesser extent following the shock to country 2, which in turn brings about a smaller rise in the real wage in country 1. More intuitively, under complete markets households in country 2 (the more productive country) share some of the additional output with individuals in less productive countries such as country 1, and consumption in country 1 therefore goes up. If the model has many countries, there are more countries with which households in country 2 can share, which leads them to share a smaller amount of the additional output with individuals in each country. As a result, consumption in country 1 goes up by less. Figure 2 clearly show this mechanism.

Figure 3. Responses of variables in country 1 and world real interest rate to a positive productivity shock to country 2
Does the Number of Countries in an International Business Cycle Model Matter?

Figure 3 shows the responses of output, labor and capital in country 1 and world real interest rate to a positive productivity shock to country 2, which helps understand the mechanism by which the cross-country output correlation goes up when \( n \) is large. Consistent with the analytical results, the output of country 1 goes down by less in response to the shock when the model has more countries, since the shock leads to smaller decreases in labor and capital. To explain, when \( n \) is large, the real wage in country 1 rises by less (see (c) in Figure 2), which leads labor demand to fall to a lesser extent. Since the world real interest rate is the intertemporal price of consumption \( \frac{P_t}{\beta E_t[P_{t+1}]} \) and the price falls by less in the case of a large \( n \), the world real interest rate increases by less for the first several periods in response to the shock as \( n \) rises. Hence, when \( n \) is big, capital in country 1 falls by less. Alternatively, thanks to the shock, country 2 becomes more productive compared to the other countries, and thus it draws capital (mobile factor) from the other countries. When the model has more countries there are more countries from which country 2 draws capital, and thus there is a smaller fall in capital in country 1 following a positive productivity shock to country 2. As a consequence, output in country 1 drops by less as Figure 3 shows.

In short, in the model, which is an \( n \)-country version of BC’s model, when there are many countries, a positive productivity shock to one country brings about a smaller decrease in output in the other countries, resulting from smaller falls in labor and capital in those countries compared to the case with two countries. It also results in a smaller rise in consumption in the other countries, which is attributed to a smaller fall in the price of final goods and a smaller increase in the real wage compared to the two-country case. These responses to the shock enable the cross-country output correlation to be higher and the cross-country consumption correlation to be lower than when the model includes only two countries. Finally, these results are consistent with the analytical results using the simple model in the previous section and our initial
expectation. From these results, we can infer that the number of countries in an international business cycle model matters and we should favor models with many countries to properly explain international business cycles after the 1990s.

3. Further experiments

In this section, I conduct several further experiments regarding the persistence of productivity and the structure of asset markets. This is because BC emphasizes that random walk productivity (unit-root in productivity) and restricting asset markets (incomplete markets) are important in explaining cross-country consumption and output correlations. I thus consider random walk productivity in the model and incomplete markets where asset trade is restricted to bonds only.

3.1 Complete markets with random walk productivity

The cross-country output and consumption correlations generated by the models with complete markets and random walk productivity according to changes in values of $n$ are shown in Figure 4. Consistent with the results in the previous section, as $n$ rises, the cross-country output correlation goes up and the cross-country consumption correlation falls.

Figure 4. Cross-country correlations under complete markets with unit-root shocks

![Graph showing cross-country correlations](image)

Note: The correlations are the models’ population moments for the Hodrick-Prescott filtered results.
3.2 Incomplete markets with trend stationary productivity

If we restrict asset trade to noncontingent bonds only, then the budget constraint for each country in period $t$ is

$$P_t^B b^i_{t+1} + C_t^i + I_t^i = Y_t^i + b_t^i,$$

(35)

where $b_t$ denotes the bond and $P_t^B$ is the price of the one-period discount bond. Since the net supply of bonds is zero, the bond market clearing condition is

$$\sum_{i=1}^{n} \frac{1}{n} b_t^i = 0.$$

(36)

The first-order conditions for the model with incomplete markets are provided in Appendix B.

Figure 5. Cross-country correlations under incomplete markets with trend stationary shocks

![Graph](Image)

Note: The correlations are the models' population moments for the Hodrick-Prescott filtered results.

Figure 5 provides the cross-country output and consumption correlations produced by the models with incomplete markets and trend stationary productivity under various values of $n$. The
cross-country output correlation increases and the cross-country consumption correlation decreases when the model has more countries, which is consistent with the earlier results.

3.3 Incomplete markets with random walk productivity

Finally, I consider a model with incomplete markets and random walk productivity. In contrast to the previous results, the cross-country output correlation falls and the cross-country consumption correlation rises as $n$ increases. To explain, in the bond economy agents can smooth consumption using only bonds. That is, when a positive productivity shock hits a certain country, less productive countries accumulate bonds to smooth consumption, and hence their consumption falls and their labor supply rises (i.e. their output goes up). As already discussed, when the model has more countries, the weight of each county in the world economy becomes lower. In the case of a large $n$, the price of the bond $P_t^B$ falls by less in response to a positive productivity shock to a certain country, which leads less productive countries to accumulate fewer bonds. As a consequence, when $n$ is large, their consumption falls by less and their output increases by less, which brings about a higher cross-country consumption correlation and a lower cross-country output correlation than when $n$ is small.

Nevertheless, the model generates more reliable cross-country correlations when $n$ is large. Specifically, when $n = 2$ the cross-country output correlation is 0.55, when $n = 15$ it is 0.44, and it is 0.52 in the data. Hence, as $n$ grows the correlation that the model yields becomes slightly worse compared to the data. The cross-country consumption correlation, however, improves to a great degree as $n$ increases. In the case of $n = 2$ the correlation is -0.20, in the case of $n = 15$ it is 0.09, and it is 0.33 in the data.
Figure 6. Cross-country correlations under incomplete markets with unit-root shocks

(a) Output correlation

(b) Consumption correlation

Note: The correlations are the models’ population moments for the Hodrick-Prescott filtered results.

Ⅳ. Conclusion

This paper first shows that since the 1990s the key international business cycle statistics in the data have changed with the emergence of a number of countries as additional global players: the cross-country output correlation between the U.S. and Europe increased and the cross-country consumption correlation between them slightly fell. In order to capture these changes, this paper constructs international business cycle models with many countries, rather than with two countries only. Both the analytical investigation with the simple model and the quantitative study with the more general model show that the number of countries in international business cycle models matters in explaining the changes. Specifically, adding many countries raises the cross-country correlation of output and decreases the cross-country correlation of consumption in line with the changes, which also helps to mitigate the quantity anomaly to some degree.

Although this paper shows that considering many countries in international business cycle models is very useful, there is still room for improvement. This paper only considers standard models with a
single consumption good. Hence, considering differentiated consumption goods, non-traded goods and the distribution sector may explain international business cycles better, since many studies have argued that these elements are useful in explaining international business cycles. Finally, if we introduce monetary and fiscal policies into the \( n \)-country model in this paper, it would be possible to analyze the spillover effects of foreign policies on domestic economy more accurately since the model explains international macroeconomic interactions better than standard two-country models. Even though including these elements would be interesting, I leave this for future research.
References


Appendix

A. Finding policy functions

First consider the case of \( n = 2 \). Then the corresponding log-linearized forms of equations (11)-(13) are

\[
\begin{align*}
\chi \hat{C}^1_t - \xi \hat{N}^1_t &= \chi \hat{C}^2_t - \xi \hat{N}^2_t, \\
\hat{C}^1_t &= \hat{A}^1_t - \varphi \hat{N}^1_t, \\
\hat{C}^2_t &= \hat{A}^2_t - \varphi \hat{N}^2_t, \\
\hat{A}^1_t + (1 - \alpha) \hat{N}^1_t + \hat{A}^2_t + (1 - \alpha) \hat{N}^2_t &= \hat{C}^1_t + \hat{C}^2_t,
\end{align*}
\]

with \( \chi = \mu \gamma - 1 \), \( \xi = \frac{N \gamma (1 - \mu)}{1 - N} \) and \( \varphi = \alpha + \frac{N}{1 - N} \).

I guess the following laws of motion for \( \hat{C}^1_t \) and \( \hat{N}^1_t \):

\[
\begin{align*}
\hat{C}^1_t &= \eta^1_1 \hat{A}^1_t + \eta^2_1 \hat{A}^2_t, \\
\hat{C}^2_t &= \eta^1_2 \hat{A}^1_t + \eta^2_2 \hat{A}^2_t, \\
\hat{N}^1_t &= \nu^1_1 \hat{A}^1_t + \nu^2_1 \hat{A}^2_t, \\
\hat{N}^2_t &= \nu^1_2 \hat{A}^1_t + \nu^2_2 \hat{A}^2_t.
\end{align*}
\]

Inserting the above in equation (A.1) yields

\[
\begin{align*}
\chi (\eta^1_1 \hat{A}^1_t + \eta^2_1 \hat{A}^2_t) - \xi (\nu^1_1 \hat{A}^1_t + \nu^2_1 \hat{A}^2_t) &= \chi (\eta^1_2 \hat{A}^1_t + \eta^2_2 \hat{A}^2_t) - \xi (\nu^1_2 \hat{A}^1_t + \nu^2_2 \hat{A}^2_t).
\end{align*}
\]

This equation should hold at all points in the state-space, i.e. for all combinations of \( \hat{A}^1_t \) and \( \hat{A}^2_t \). Setting \( \hat{A}^2_t = 0 \) gives
\( \chi \eta_1^1 \hat{A}_t^1 - \xi \nu_1^1 \hat{A}_t^1 = \chi \eta_2^1 \hat{A}_t^1 - \xi \nu_2^1 \hat{A}_t^1. \) \hfill (A.10)

And setting \( \hat{A}_t^1 = 0 \) gives

\( \chi \eta_1^2 \hat{A}_t^2 - \xi \nu_1^2 \hat{A}_t^2 = \chi \eta_2^2 \hat{A}_t^2 - \xi \nu_2^2 \hat{A}_t^2. \) \hfill (A.11)

By equations (A.10) and (A.11),

\[ \begin{align*}
\chi \eta_1^1 - \xi \nu_1^1 &= \chi \eta_2^1 - \xi \nu_2^1, \\
\chi \eta_1^2 - \xi \nu_1^2 &= \chi \eta_2^2 - \xi \nu_2^2.
\end{align*} \] \hfill (A.12)-(A.13)

Similarly, inserting the guesses in equations (A.2) and (A.3), and setting \( \hat{A}_t^2 = 0 \) and \( \hat{A}_t^1 = 0 \) gives

\[ \begin{align*}
\eta_1^1 &= 1 - \varphi \nu_1^1, \\
\eta_2^1 &= - \varphi \nu_1^1, \\
\eta_1^2 &= 1 - \varphi \nu_2^1, \\
\eta_2^2 &= - \varphi \nu_2^1.
\end{align*} \] \hfill (A.14)-(A.17)

Inserting the guesses in equation (A.4), and setting \( \hat{A}_t^2 = 0 \) and \( \hat{A}_t^1 = 0 \) yields

\[ \begin{align*}
1 + (1 - \alpha) \nu_1^1 + (1 - \alpha) \nu_2^1 &= \eta_1^1 + \eta_2^1, \\
1 + (1 - \alpha) \nu_1^2 + (1 - \alpha) \nu_2^2 &= \eta_1^2 + \eta_2^2.
\end{align*} \] \hfill (A.18)-(A.19)

We have eight unknown coefficients (\( \eta_1^1, \eta_1^2, \eta_2^1, \eta_2^2, \nu_1^1, \nu_1^2, \nu_2^1 \) and \( \nu_2^2 \)) and eight equations (equations (A.12)-(A.19)) and thus we can solve for the coefficients of the policy rules. Specifically, the coefficients are...
with $\kappa = \frac{X}{\xi + \chi \varphi}$. Finally, the policy rules are

\[
\begin{align*}
\hat{C}_t^1 &= (1 - \kappa \varphi) \hat{A}_t^1 + \frac{\kappa \varphi}{2} (\hat{A}_t^1 + \hat{A}_t^2), \\
\hat{C}_t^2 &= (1 - \kappa \varphi) \hat{A}_t^2 + \frac{\kappa \varphi}{2} (\hat{A}_t^1 + \hat{A}_t^2), \\
\hat{N}_t^1 &= \kappa \hat{A}_t^1 - \frac{\kappa}{2} (\hat{A}_t^1 + \hat{A}_t^2), \\
\hat{N}_t^2 &= \kappa \hat{A}_t^2 - \frac{\kappa}{2} (\hat{A}_t^1 + \hat{A}_t^2).
\end{align*}
\]  

(A.20)  

(A.21)  

(A.22)  

(A.23)

Similarly, we can obtain the policy rules when $n = 3$. They are

\[
\begin{align*}
\hat{C}_t^1 &= (1 - \kappa \varphi) \hat{A}_t^1 + \frac{\kappa \varphi}{3} (\hat{A}_t^1 + \hat{A}_t^2 + \hat{A}_t^3), \\
\hat{C}_t^2 &= (1 - \kappa \varphi) \hat{A}_t^2 + \frac{\kappa \varphi}{3} (\hat{A}_t^1 + \hat{A}_t^2 + \hat{A}_t^3), \\
\hat{C}_t^3 &= (1 - \kappa \varphi) \hat{A}_t^3 + \frac{\kappa \varphi}{3} (\hat{A}_t^1 + \hat{A}_t^2 + \hat{A}_t^3), \\
\hat{N}_t^1 &= \kappa \hat{A}_t^1 - \frac{\kappa}{3} (\hat{A}_t^1 + \hat{A}_t^2 + \hat{A}_t^3), \\
\hat{N}_t^2 &= \kappa \hat{A}_t^2 - \frac{\kappa}{3} (\hat{A}_t^1 + \hat{A}_t^2 + \hat{A}_t^3), \\
\hat{N}_t^3 &= \kappa \hat{A}_t^3 - \frac{\kappa}{3} (\hat{A}_t^1 + \hat{A}_t^2 + \hat{A}_t^3).
\end{align*}
\]  

(A.24)  

(A.25)  

(A.26)  

(A.27)  

(A.28)  

(A.29)

Therefore, we can generalize the policy rules when there are $n$ countries.
\( \hat{C}_t^i = (1 - \kappa \varphi) \hat{A}_t^i + \frac{\kappa \phi}{n} \sum_{i=1}^{n} \hat{A}_t^i, \quad (A.30) \)

\[ \hat{N}_t^i = \kappa \hat{A}_t^i - \frac{\kappa}{n} \sum_{i=1}^{n} \hat{A}_t^i. \quad (A.31) \]

By using \( \hat{z}_t = \frac{z_t - z}{z} \), equations (A.30) and (A.31) can be written as

\[ C_t^i = C^i + C \left( (1 - \kappa \varphi) \hat{A}_t^i + \frac{\kappa \phi}{n} \sum_{i=1}^{n} \hat{A}_t^i \right), \quad (A.32) \]

\[ N_t^i = N + N \left( \kappa \hat{A}_t^i - \frac{\kappa}{n} \sum_{i=1}^{n} \hat{A}_t^i \right). \quad (A.33) \]

**B. First-order conditions of the model in the quantitative analysis**

The economy of the model with complete markets in the quantitative analysis is described by the following equations together with the equations for the disturbance to technology:

\[ P_t = \mu C_t^{\varphi \mu - 1} L_t^{\varphi (1 - \mu)}, \text{ for } i = 1, 2, \cdots, n, \quad (B.1) \]

\[ W_t^i = (1 - \mu) C_t^{\varphi} L_t^{\varphi (1 - \nu) - 1}, \text{ for } i = 1, 2, \cdots, n, \quad (B.2) \]

\[ W_t^i = (1 - \alpha) P_t A_t^i K_t^n \hat{N}_t^{i - \alpha}, \text{ for } i = 1, 2, \cdots, n, \quad (B.3) \]

\[ P_t = \lambda_t^i \left( 1 - \phi \left( \frac{I_t}{K_t^i} - \delta \right) \right), \text{ for } i = 1, 2, \cdots, n, \quad (B.4) \]

\[ \lambda_t^i = \beta E_t \left[ \lambda_{t+1}^i \left( -\phi \frac{I_{t+1}}{K_{t+1}^i} + \frac{2}{K_{t+1}^i - \delta} \right)^2 + \delta \left( \frac{I_{t+1}}{K_{t+1}^i} - \delta \right) \frac{I_{t+1}}{K_{t+1}^i} + (1 - \delta) \right] \quad (B.5) \]

\[ + \alpha \beta E_t \left[ P_{t+1} A_{t+1}^i K_{t+1}^{i - 1} N_{t+1}^{i - \alpha} \right], \text{ for } i = 1, 2, \cdots, n, \]
Does the Number of Countries in an International Business Cycle Model Matter?

\[ 0 = 1 - L^i_t - N^i_t, \text{ for } i = 1, 2, \cdots, n, \]  
\[ (B.6) \]

\[ K^i_{t+1} = (1 - \delta)K^i_t + \frac{\phi}{2} \left( \frac{I^i_t}{K^i_t} - \delta \right)^2 K^i_t, \text{ for } i = 1, 2, \cdots, n, \]  
\[ (B.7) \]

\[ \sum_{i=1}^{n} A^i_t K^{\kappa^i_t}_t N^{\kappa^i_t-\alpha}_t = \sum_{i=1}^{n} (C^i_t + \tilde{I}^i_t). \]  
\[ (B.8) \]

where \( P_t, W^i_t \) and \( \lambda^i_t \) are Lagrangian multipliers.

The economy of the model with incomplete markets is described by equations (B.2) and (B.6)-(B.8), and by the following equations together with the equations for the disturbance to technology:

\[ P^i_t = \mu C^i_t L^{(0-\mu)}_t, \text{ for } i = 1, 2, \cdots, n, \]  
\[ (B.9) \]

\[ W^i_t = (1 - \alpha)P^i_t A^i_t K^{\kappa^i_t}_t N^{\kappa^i_t-\alpha}_t, \text{ for } i = 1, 2, \cdots, n, \]  
\[ (B.10) \]

\[ P^i_t = \lambda^i_t \left\{ 1 - \phi \left( \frac{\tilde{I}^i_t}{K^i_t} - \delta \right) \right\}, \text{ for } i = 1, 2, \cdots, n, \]  
\[ (B.11) \]

\[ \lambda^i_t = \beta E_t \left[ \lambda^i_{t+1} \left\{ - \frac{\phi}{2} \left( \frac{\tilde{I}^i_{t+1}}{K^{\kappa^i_{t+1}}_t} - \delta \right)^2 + \delta \left( \frac{\tilde{I}^i_{t+1}}{K^{\kappa^i_{t+1}}_t} - \delta \right) \frac{\tilde{I}^i_{t+1}}{K^{\kappa^i_{t+1}}_t} + (1 - \delta) \right\} \right] \]  
\[ + \alpha \beta E_t \left[ P^i_{t+1} A^i_{t+1} K^{\kappa^i_{t+1}-\alpha}_{t+1} N^{\kappa^i_{t+1}-\alpha}_{t+1} \right], \text{ for } i = 1, 2, \cdots, n, \]  
\[ (B.12) \]

\[ P^B_t = \beta E_t \left[ \frac{P^i_{t+1}}{P^i_t} \right], \text{ for } i = 1, 2, \cdots, n, \]  
\[ (B.13) \]

\[ \sum_{i=1}^{n} \frac{1}{n} b^i_t = 0, \]  
\[ (B.14) \]

\[ P^b_t b^i_{t+1} + C^i_t \tilde{I}^i_t = Y^i_t + b^i_t, \text{ for } j = 2, \cdots, n. \]  
\[ (B.15) \]
다국모형을 이용한 국제경기변동 분석

김명현*


핵심 주제어: 국제경기변동, 다국모형, 국가 개수, 생산 상관관계, 소비 상관관계

JEL Classification: F40, F41, F44

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<table>
<thead>
<tr>
<th>제</th>
<th>제목</th>
<th>저자</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>글로벌 금융위기 이후 주요국 통화정책 운영체계의 변화</td>
<td>김병기, 김인수</td>
</tr>
<tr>
<td>2</td>
<td>미국 장기시장금리 변동이 우리나라 금리기간구조에 미치는 영향 분석 및 정책적 시사점</td>
<td>강규호, 오형석</td>
</tr>
<tr>
<td>3</td>
<td>직간접 무역연계성을 통한 해외충격의 우리나라 수출입 파급효과 분석</td>
<td>최문정, 김근영</td>
</tr>
<tr>
<td>4</td>
<td>통화정책 효과의 지역적 차이</td>
<td>김기호</td>
</tr>
<tr>
<td>5</td>
<td>수입중간재의 비용효과를 고려한 환율변동과 수출가격 간의 관계</td>
<td>김경민</td>
</tr>
<tr>
<td>6</td>
<td>중앙은행의 정책금리 발표가 주식시장 유동성에 미치는 영향</td>
<td>이지은</td>
</tr>
<tr>
<td>7</td>
<td>은행 건전성지표의 변동요인과 거시건전성 규제의 영향</td>
<td>강종구</td>
</tr>
<tr>
<td>8</td>
<td>Price Discovery and Foreign Participation in The Republic of Korea’s Government Bond Futures and Cash Markets</td>
<td>Jaehun Choi, Hosung Lim, Rogelio Jr. Mercado, Cyn-Young Park</td>
</tr>
<tr>
<td>9</td>
<td>규제가 노동생산성에 미치는 영향: 한국의 산업패널 자료를 이용한 실증분석</td>
<td>이동렬, 최종일, 이중한</td>
</tr>
<tr>
<td>10</td>
<td>인구 고령화와 정년연장 연구 (세대 간 중첩모형(OLG)을 이용한 정량 분석)</td>
<td>홍재화, 강태수</td>
</tr>
<tr>
<td>11</td>
<td>예측조합 및 밀도함수에 의한 소비자물가 상승률 전망</td>
<td>김현학</td>
</tr>
<tr>
<td>12</td>
<td>인플레이션 동과 통화정책</td>
<td>우준영</td>
</tr>
<tr>
<td>13</td>
<td>Failure Risk and the Cross-Section of Hedge Fund Returns</td>
<td>Jung-Min Kim</td>
</tr>
<tr>
<td>14</td>
<td>Global Liquidity and Commodity Prices</td>
<td>Hyunju Kang, Bok-Keun Yu, Jongmin Yu</td>
</tr>
<tr>
<td>Page</td>
<td>Title</td>
<td>Authors</td>
</tr>
<tr>
<td>------</td>
<td>-------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------</td>
</tr>
<tr>
<td>15</td>
<td>Foreign Ownership, Legal System and Stock Market Liquidity</td>
<td>Jieun Lee, Kee H. Chung</td>
</tr>
<tr>
<td>16</td>
<td>바젤Ⅲ 은행 경기대응완충자본 규제의 기준지표에 대한 연구</td>
<td>서현덕, 이정연</td>
</tr>
<tr>
<td>17</td>
<td>우리나라 대출 수요와 공급의 변동요인 분석</td>
<td>김종규, 임호성</td>
</tr>
<tr>
<td>18</td>
<td>북한 인구구조의 변화 추이와 시사점</td>
<td>최지영</td>
</tr>
<tr>
<td>19</td>
<td>Entry of Non-financial Firms and Competition in the Retail Payments Market</td>
<td>Jooyong Jun</td>
</tr>
<tr>
<td>20</td>
<td>Monetary Policy Regime Change and Regional Inflation Dynamics: Looking through the Lens of Sector-Level Data for Korea</td>
<td>Chi-Young Choi, Joo Yong Lee, Roisin O'Sullivan</td>
</tr>
<tr>
<td>22</td>
<td>글로벌 금리 정상화와 통화정책 과제: 2015년 한국은행 국제컨퍼런스 결과보고서</td>
<td>한국은행 경제연구원</td>
</tr>
<tr>
<td>23</td>
<td>The Effects of Global Liquidity on Global Imbalances</td>
<td>Marie-Louise Djigbenou-Kre, Hail Park</td>
</tr>
<tr>
<td>24</td>
<td>심물경기를 고려한 내재 유동성 측정</td>
<td>우준명, 이지은</td>
</tr>
<tr>
<td>25</td>
<td>Deflation and Monetary Policy</td>
<td>Barry Eichengreen</td>
</tr>
<tr>
<td>26</td>
<td>Macroeconomic Shocks and Dynamics of Labor Markets in Korea</td>
<td>Tae Bong Kim, Hangyu Lee</td>
</tr>
<tr>
<td>27</td>
<td>Reference Rates and Monetary Policy Effectiveness in Korea</td>
<td>Heung Soon Jung, Dong Jin Lee, Tae Hyo Gwon, Se Jin Yun</td>
</tr>
<tr>
<td>28</td>
<td>Energy Efficiency and Firm Growth</td>
<td>Bongseok Choi, Wooyoung Park, Bok-Keun Yu</td>
</tr>
<tr>
<td>29</td>
<td>An Analysis of Trade Patterns in East Asia and the Effects of the Real Exchange Rate Movements</td>
<td>Moon Jung Choi, Geun-Young Kim, Joo Yong Lee</td>
</tr>
<tr>
<td>30</td>
<td>Forecasting Financial Stress Indices in Korea: A Factor Model Approach</td>
<td>Hyeongwoo Kim, Hyun Hak Kim, Wen Shi</td>
</tr>
</tbody>
</table>

Geun-Young Kim · Hail Park · Peter Tillmann

Pass-Through of Imported Input Prices to Domestic Producer Prices: Evidence from Sector-Level Data

JaeBin Ahn · Chang-Gui Park · Chanho Park

Spillovers from U.S. Unconventional Monetary Policy and Its Normalization to Emerging Markets: A Capital Flow Perspective

Sangwon Suh · Byung-Soo Koo


Jaebeom Kim · Jung-Min Kim

The Relation Between Monetary and Macroprudential Policy

Jong Ku Kang

From Firm-level Imports to Aggregate Productivity: Evidence from Korean Manufacturing Firms Data

JaeBin Ahn · Moon Jung Choi

자유무역협정(FTA)이 한국 기업의 기업내 무역에 미친 효과

전봉걸 · 김은숙 · 이주용

The Relation Between Monetary and Macroprudential Policy

Jong Ku Kang

조세피난처 투자자가 투자 기업 및 주식 시장에 미치는 영향

정호성 · 김순호

주택실거래 자료를 이용한 주택부문 거시 건전성 정책 효과 분석

정호성 · 이지은

Does Intra-Regional Trade Matter in Regional Stock Markets?: New Evidence from Asia-Pacific Region

Sei-Wan Kim · Moon Jung Choi

Liability, Information, and Anti-fraud Investment in a Layered Retail Payment Structure

Kyoung-Soo Yoon · Jooyong Jun

Testing the Labor Market Dualism in Korea

Sungyup Chung · Sunyoung Jung

북한 이중경제 사회계정행렬 추정을 통한 비공식부문 분석

최지영
제2016-15 Divergent EME Responses to Global and Domestic Monetary Policy Shocks Woon Gyu Choi ⋅ Byongju Lee ⋅ Taesu Kang ⋅ Geun-Young Kim

16 Loan Rate Differences across Financial Sectors: A Mechanism Design Approach Byoung-Ki Kim ⋅ Jun Gyu Min

17 근로자의 고용형태가 임금 및 소득 분포에 미치는 영향 최충 ⋅ 정성엽

18 Endogeneity of Inflation Target Soyoung Kim ⋅ Geunhyung Yim

19 Who Are the First Users of a Newly-Emerging International Currency? A Demand-Side Study of Chinese Renminbi Internationalization Hyoung-kyu Chey ⋅ Geun-Young Kim ⋅ Dong Hyun Lee

20 기업 취약성 지수 개발 및 기업 부실화에 대한 영향 분석 최영준


제2017-1 가계부채가 소비와 경제성장에 미치는 영향 - 유량효과와 저량효과 분석 - 강종구

2 Which Monetary Shocks Matter in Small Open Economies? Evidence from SVARs Jongrim Ha ⋅ Inhwan So

3 FTA의 물가 안정화 효과 분석 곽노선 ⋅ 임호성

4 The Effect of Labor Market Polarization on the College Students’ Employment Sungyup Chung

5 국내 자영업의 폐업률 결정요인 분석 남윤미

6 차주별 패널자료를 이용한 주택담보대출의 연체요인에 대한 연구 정호성

7 국면전환 확산과정모형을 이용한 콜금리 형태 분석 최승문 ⋅ 김병국
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>9</td>
<td>신용공급 충격이 재화별 소비에 미치는 영향</td>
<td>김광환·최석기</td>
</tr>
<tr>
<td>10</td>
<td>유가가 손익분기인플레이션에 미치는 영향</td>
<td>김진용·김준철·임영준</td>
</tr>
<tr>
<td>11</td>
<td>인구구조변화가 인플레이션의 장기 추세에 미치는 영향</td>
<td>강환구</td>
</tr>
<tr>
<td>12</td>
<td>종합적 성원여건을 반영한 과다부채 가계의 리스크 요인 분석</td>
<td>이동진·한진현</td>
</tr>
<tr>
<td>13</td>
<td>Crowding out in a Dual Currency Regime? Digital versus Fiat Currency</td>
<td>KiHoon Hong·Kyounghoon Park·Jongmin Yu</td>
</tr>
<tr>
<td>14</td>
<td>Improving Forecast Accuracy of Financial Vulnerability: Partial Least Squares Factor Model Approach</td>
<td>Hyeongwoo Kim·Kyunghwan Ko</td>
</tr>
<tr>
<td>15</td>
<td>Which Type of Trust Matters?: Interpersonal vs. Institutional vs. Political Trust</td>
<td>In Do Hwang</td>
</tr>
<tr>
<td>16</td>
<td>기업특성에 따른 연령별 고용행태 분석</td>
<td>이상욱·권철우·남윤미</td>
</tr>
<tr>
<td>17</td>
<td>Equity Market Globalization and Portfolio Rebalancing</td>
<td>Kyungkeun Kim·Dongwon Lee</td>
</tr>
<tr>
<td>18</td>
<td>The Effect of Market Volatility on Liquidity and Stock Returns in the Korean Stock Market</td>
<td>Jieun Lee·KeeH.Chung</td>
</tr>
<tr>
<td>19</td>
<td>Using Cheap Talk to Polarize or Unify a Group of Decision Makers</td>
<td>Daeyoung Jeong</td>
</tr>
<tr>
<td>20</td>
<td>패스트트랙 기업회생절차가 법정관리 기업의 이자보상비율에 미친 영향</td>
<td>최영준</td>
</tr>
<tr>
<td>21</td>
<td>인구고령화가 경제성장에 미치는 영향</td>
<td>안병권·김기호·육승환</td>
</tr>
<tr>
<td>22</td>
<td>고령화에 대응한 인구대책: OECD사례를 중심으로</td>
<td>김진일·박경훈</td>
</tr>
</tbody>
</table>
제2017-23  인구구조변화와 경상수지  김경근 ⋅ 김소영
24  통일과 고령화  최지영
25  인구고령화가 주택시장에 미치는 영향  오강현 ⋅ 김솔 ⋅ 윤재준 ⋅ 안상기 ⋅ 권동휘
26  고령화가 대외투자에 미치는 영향  임진수 ⋅ 김영래
27  인구고령화가 가계의 자산 및 부채에 미치는 영향  조세형 ⋅ 이용민 ⋅ 김정훈
28  인구고령화에 따른 우리나라 산업구조 변화  강종구
29  인구구조 변화와 재정  송호신 ⋅ 허준영
30  인구고령화가 노동수급에 미치는 영향  이철희 ⋅ 이지은
31  인구 고령화가 금융산업에 미치는 영향  윤경수 ⋅ 차재훈 ⋅ 박소희 ⋅ 강선영
32  금리와 은행 수익성 간의 관계 분석  한재준 ⋅ 소인환
33  Bank Globalization and Monetary Policy Transmission in Small Open Economies  Inhwan So
34  기존 경영자 관리인(DIP) 제도의 회생기업 경영성과에 대한 영향  최영준
35  Transmission of Monetary Policy in Times of High Household Debt  Youngju Kim ⋅ Hyunjoon Lim

2  What Drives the Stock Market Comovements between Korea and China, Japan and the US?  Jinsoo Lee ⋅ Bok-Keun Yu
3  Who Improves or Worsens Liquidity in the Korean Treasury Bond Market?  Jieun Lee
<table>
<thead>
<tr>
<th>No.</th>
<th>Title</th>
<th>Author(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Establishment Size and Wage Inequality: The Roles of Performance Pay and Rent Sharing</td>
<td>Sang-yoon Song</td>
</tr>
<tr>
<td>2</td>
<td>가계대출 부도요인 및 금융업권별 금융취약성: 자영업 차주를 중심으로</td>
<td>정호성</td>
</tr>
<tr>
<td>3</td>
<td>직업훈련이 청년취업률 제고에 미치는 영향</td>
<td>최충⋅김남주⋅최광성</td>
</tr>
<tr>
<td>4</td>
<td>재고투자와 경기변동에 대한 동학적 분석</td>
<td>서병선⋅장근호</td>
</tr>
<tr>
<td>5</td>
<td>Rare Disasters and Exchange Rates: An Empirical Investigation of Korean Exchange Rates under Tension between the Two Koreas</td>
<td>Cheolbeom Park⋅Suyeon Park</td>
</tr>
<tr>
<td>6</td>
<td>통화정책과 기업 설비투자 - 자산가격경로와 대차대조표경로 분석 -</td>
<td>박상준⋅육승환</td>
</tr>
<tr>
<td>7</td>
<td>Upgrading Product Quality: The Impact of Tariffs and Standards</td>
<td>Jihyun Eum</td>
</tr>
<tr>
<td>8</td>
<td>북한이탈주민의 신용행태에 관한 연구</td>
<td>정승호⋅민병기⋅김주원</td>
</tr>
<tr>
<td>9</td>
<td>Uncertainty Shocks and Asymmetric Dynamics in Korea: A Nonlinear Approach</td>
<td>Kevin Larcher⋅Jaebeom Kim⋅Youngju Kim</td>
</tr>
<tr>
<td>10</td>
<td>북한경제의 대외개방에 따른 경제적 후생 변화 분석</td>
<td>정혁⋅최창용⋅최지영</td>
</tr>
<tr>
<td>11</td>
<td>Central Bank Reputation and Inflation–Unemployment Performance: Empirical Evidence from an Executive Survey of 62 Countries</td>
<td>In Do Hwang</td>
</tr>
<tr>
<td>12</td>
<td>Reserve Accumulation and Bank Lending: Evidence from Korea</td>
<td>Youngjin Yun</td>
</tr>
<tr>
<td>13</td>
<td>The Banks' Swansong: Banking and the Financial Markets under Asymmetric Information</td>
<td>Jungu Yang</td>
</tr>
<tr>
<td>2018 -17</td>
<td>E-money: Legal Restrictions Theory and Monetary Policy</td>
<td>Ohik Kwon ⋅ Jaevin Park</td>
</tr>
<tr>
<td>18</td>
<td>글로벌 금융위기 전후 외국인의 채권투자 결정요인 변화 분석: 한국의 사례</td>
<td>유복근</td>
</tr>
<tr>
<td>19</td>
<td>설비자본재 기술진보가 근로유형별 임금 및 고용에 미치는 영향</td>
<td>김남주</td>
</tr>
<tr>
<td>20</td>
<td>Fixed–Rate Loans and the Effectiveness of Monetary Policy</td>
<td>Sung Ho Park</td>
</tr>
<tr>
<td>21</td>
<td>Leverage, Hand–to–Mouth Households, and MPC Heterogeneity: Evidence from Korea</td>
<td>Sang–yoon Song</td>
</tr>
<tr>
<td>22</td>
<td>선진국 수입수요가 우리나라 수출에 미치는 영향</td>
<td>최문정 ⋅ 김경근</td>
</tr>
<tr>
<td>23</td>
<td>Cross–Border Bank Flows through Foreign Branches: Evidence from Korea</td>
<td>Youngjin Yun</td>
</tr>
<tr>
<td>24</td>
<td>Accounting for the Sources of the Recent Decline in Korea’s Exports to China</td>
<td>Moon Jung Choi ⋅ Kei–Mu Yi</td>
</tr>
<tr>
<td>25</td>
<td>The Effects of Export Diversification on Macroeconomic Stabilization: Evidence from Korea</td>
<td>Jinsoo Lee ⋅ Bok–Keun Yu</td>
</tr>
<tr>
<td>26</td>
<td>Identifying Uncertainty Shocks due to Geopolitical Swings in Korea</td>
<td>Seohyun Lee ⋅ Inhwan So ⋅ Jongrim Ha</td>
</tr>
<tr>
<td>27</td>
<td>Monetary Policy and Income Inequality in Korea</td>
<td>Jongwook Park</td>
</tr>
<tr>
<td>28</td>
<td>How the Financial Market Can Dampen the Effects of Commodity Price Shocks</td>
<td>Myunghyun Kim</td>
</tr>
<tr>
<td>30</td>
<td>Do Korean Exports Have Different Patterns over Different Regimes?: New Evidence from STAR–VECM</td>
<td>Sei–Wan Kim ⋅ Moon Jung Choi</td>
</tr>
<tr>
<td>31</td>
<td>기술진보와 청년고용</td>
<td>심명규 ⋅ 양희승 ⋅ 이서현</td>
</tr>
</tbody>
</table>
| 제2018-32 | 북한지역 장기주택수요 및 연관
주택건설투자 추정 | 이주영 |
| 33 | 기업규모간 임금격차 원인 분석 | 송상윤 |
| 34 | 우리나라 고용구조의 특징과 과제 | 장근호 |
| 35 | 창업의 장기 고용효과: 시군구 자료 분석 | 조성철⋅김기호 |
| 36 | 수출입과 기업의 노동수요 | 음지현⋅박진호⋅최문정 |
| 37 | 청년실업의 이력현상 분석 | 김남주 |
| 38 | 노동시장 이중구조와 노동생산성:
OECD 국가들 중심으로 | 최충⋅최광성⋅이지은 |
| 39 | 한국과 일본의 청년실업 비교분석 및
시사점 | 박상준⋅김남주⋅장근호 |
| 40 | 노동시장의 이중구조와 정책대응:
해외사례 및 시사점 | 전병유⋅황인도⋅박광용 |
| 41 | 최저임금이 고용구조에 미치는 영향 | 송현재⋅임현준⋅신우리 |
| 42 | 최저임금과 생산성:
우리나라 제조업의 사례 | 김규일⋅육승환 |
| 43 | Transmission of U.S. Monetary Policy
to Commodity Exporters and Importers | Myunghyun Kim |
| 44 | Determinants of Capital Flows in the
Korean Bond Market | Soohyon Kim |
| 45 | Central Bank Credibility and Monetary Policy | Kwangyong Park |
| 46 | 통화정책이 자본유출입에 미치는 영향:
행태방정식 분석 | 이명수⋅송승주 |
<table>
<thead>
<tr>
<th>제2018–47</th>
<th>Commodities and International Business Cycles</th>
<th>Myunghyun Kim</th>
</tr>
</thead>
<tbody>
<tr>
<td>제2019–1</td>
<td>Deciphering Monetary Policy Board Minutes through Text Mining Approach: The Case of Korea</td>
<td>Ki Young Park · Youngjoon Lee · Soohyon Kim</td>
</tr>
<tr>
<td>2</td>
<td>The Impacts of Macroeconomic News Announcements on Intraday Implied Volatility</td>
<td>Jieun Lee · Doojin Ryu</td>
</tr>
<tr>
<td>3</td>
<td>Taking a Bigger Slice of the Global Value Chain Pie: An Industry-level Analysis</td>
<td>Chong-Sup Kim · Seungho Lee · Jihyun Eum</td>
</tr>
<tr>
<td>4</td>
<td>Trend Growth Shocks and Asset Prices</td>
<td>Nam Gang Lee</td>
</tr>
<tr>
<td>5</td>
<td>Uncertainty, Attention Allocation and Monetary Policy Asymmetry</td>
<td>Kwangyong Park</td>
</tr>
<tr>
<td>6</td>
<td>Central Bank Digital Currency and Financial Stability</td>
<td>Ohik Kwon</td>
</tr>
<tr>
<td>7</td>
<td>은행의 수익 및 자산구조를 반영한 통화정책 위험선호경로</td>
<td>김의진 · 정호성</td>
</tr>
<tr>
<td>8</td>
<td>혁신기업에 대한 산업금융 지원: 이론모형 분석</td>
<td>강경훈 · 양준구</td>
</tr>
<tr>
<td>9</td>
<td>가계부채 제약하의 통화정책: 2주체 거시 모형(TANK)에서의 정량적 분석</td>
<td>정용승 · 송승주</td>
</tr>
<tr>
<td>10</td>
<td>Alchemy of Financial Innovation: Securitization, Liquidity and Optimal Monetary Policy</td>
<td>Jungu Yang</td>
</tr>
<tr>
<td>11</td>
<td>Measuring Monetary Policy Surprises Using Text Mining: The Case of Korea</td>
<td>Youngjoon Lee · Soohyon Kim · Ki Young Park</td>
</tr>
<tr>
<td>12</td>
<td>Tracking Uncertainty through the Relative Sentiment Shift Series</td>
<td>Seohyun Lee · Rickard Nyman</td>
</tr>
<tr>
<td>13</td>
<td>Intra-firm and Arm’s Length Trade during the Global Financial Crisis: Evidence from Korean Manufacturing Firms</td>
<td>Moon Jung Choi · Ji Hyun Eum</td>
</tr>
<tr>
<td>제2019–14</td>
<td>특허자료를 이용한 우리나라 지식전파의 지역화 분석</td>
<td>이지홍 ⋅ 남윤미</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>15</td>
<td>Overhead Labour and Skill–Biased Technological Change: The Role of Product Diversification</td>
<td>Choong Hyun Nam</td>
</tr>
<tr>
<td>16</td>
<td>Does the Number of Countries in an International Business Cycle Model Matter?</td>
<td>Myunghyun Kim</td>
</tr>
</tbody>
</table>