

Gravity in International Finance

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Summary

The past decade has witnessed an explosion of papers estimating gravity equations for cross-border financial holdings. While traditionally the territory of the international trade literature, this recent application of gravity to international finance is driven by new data, a good empirical fit of financial gravity equations and a plethora of potential policy applications. However, in contrast to the trade gravity literature, the international finance gravity literature is not grounded in any theory. This can lead to both faulty estimation due to omitted variables bias and incorrect comparative statics analysis. The aim of the paper is to develop a theoretical foundation for the empirical gravity literature applied to finance. We develop a gravity specification for cross-border asset holdings that is closely analogous to that developed for goods trade, even though it is based on a very different type of theory. We show how the theory can be used to estimate international financial frictions and conduct comparative statics analysis with respect to changes in these frictions. We use a dataset for cross-border equity holdings among 24 industrialized countries to illustrate these results.