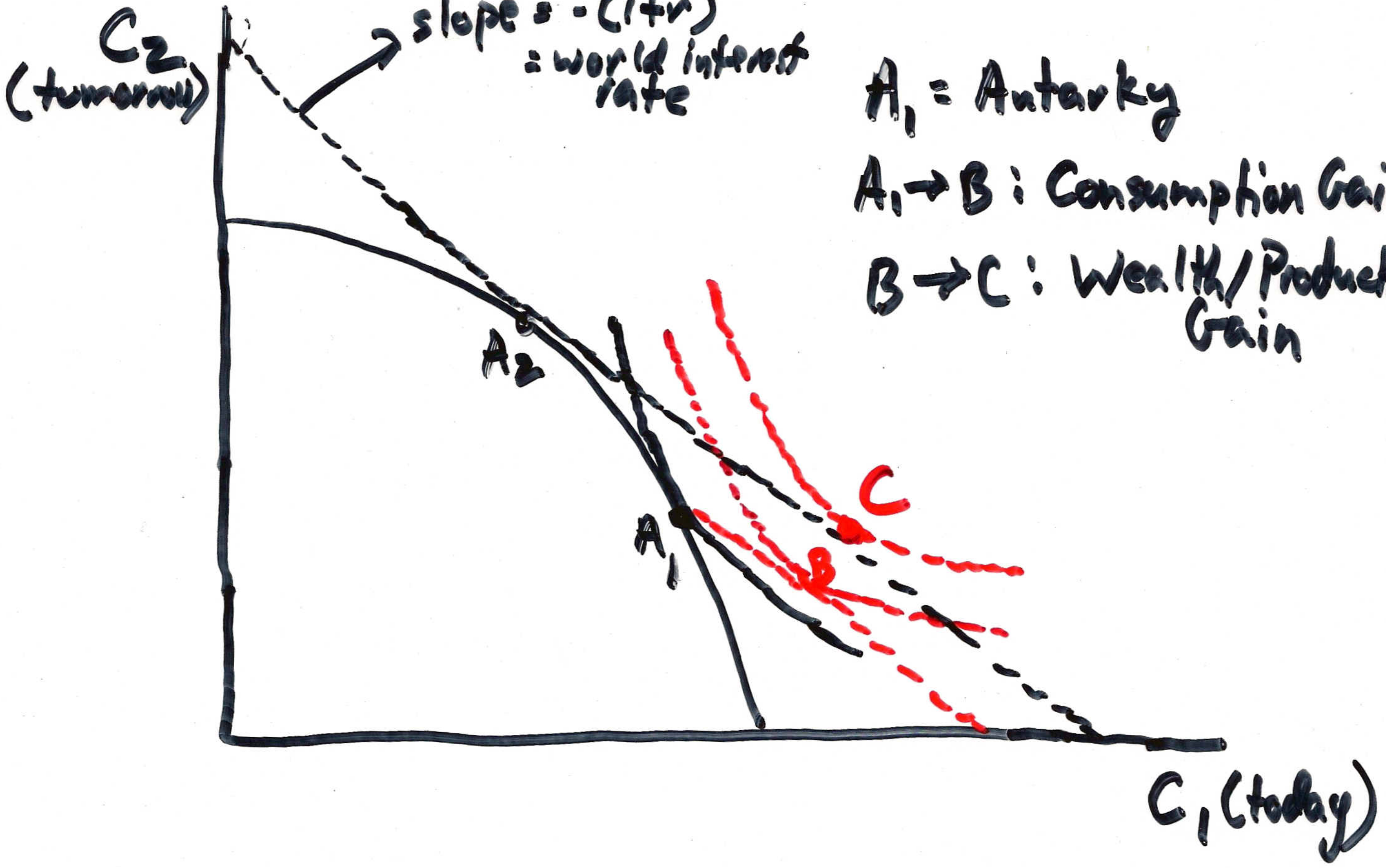
Goals: Promote the efficient allocation of resources.

Static vs. Dynamic Gains from trade.

Interpretation of Intl. Capital Flows: When countries trade assets they are implicitly trading goods across dates and across "states-of-nature" [date-state-contingent claims].

Static Efficiency Gains

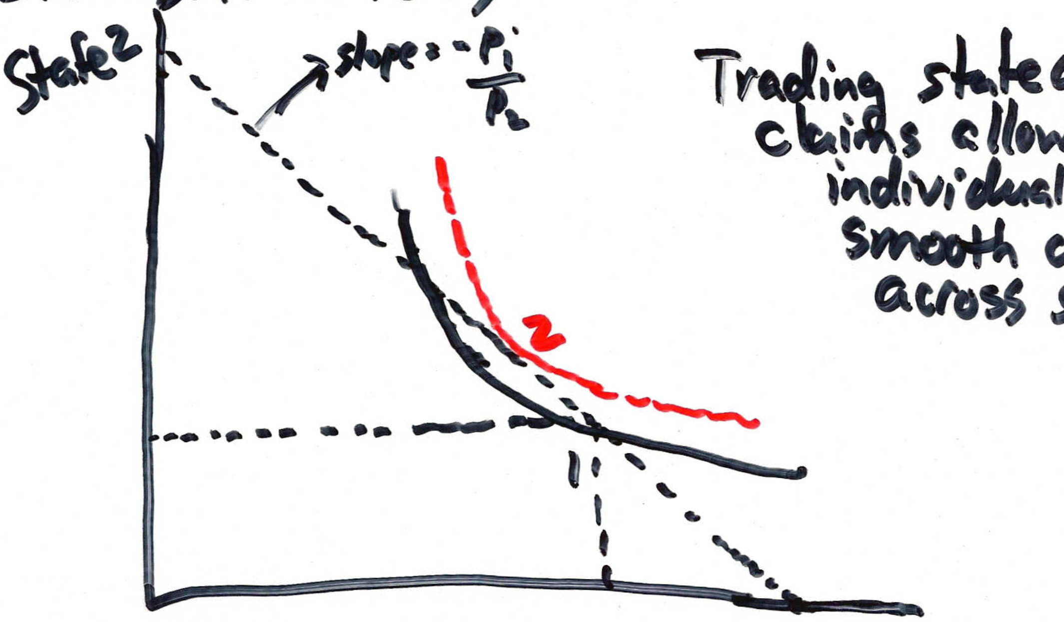


A_1 = Autarky

$A_1 \to B$: Consumption Gain

$B \to C$: Wealth/Production Gain

Same Logic works for Trade Across States (i.e., Diversification)



Trading state contingent claims allows individuals to smooth consumption across states

There could also be dynamic gains from trade that lead to <u>growth effects</u>.

1.) Technology Transfer

2.) Enhanced Competition & Innovation

3.) Diversification permits greater risk taking (higher yielding investment projects).

Sources of Financial Market Inefficiency

Previous analysis is based on the assumption that markets are efficient. What if this isn't true? Some caveats:

1.) "Theory of Second Best" - If there are pre-existing distortions in the economy, opening/liberalizing your capital markets might make things worse!

2.) Imperfect/Asymmetric Info.

Moral Hazard - Will borrowers invest the money or spend it?

Adverse Selection - Are you lending to a trustworthy person or a deadbeat?

3.) Limited Commitment/Enforcement

- Will borrowers pay back even if they can?
- What happens if they don't?

(Particular important in intl. captl. markets)

II. Causes

- What are the common elements in currency crises?

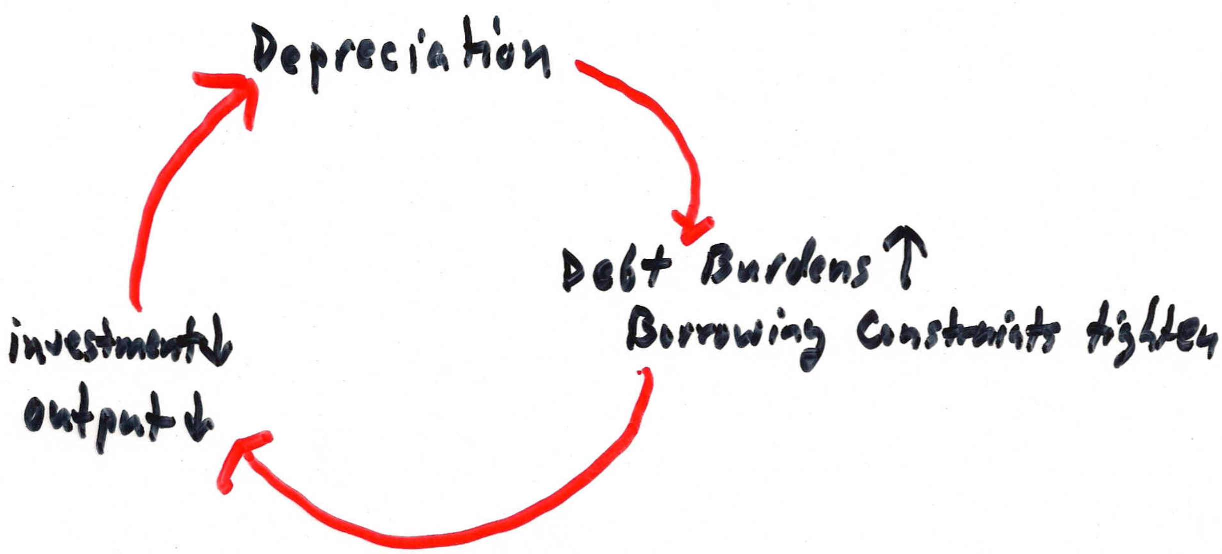
1.) Large Swings in the Current Acct., Deficit → Surplus

2.) Large Real Depreciations

3.) Large Declines in Real Output (Usually).

- Why does output often decline after a crisis?

Adverse Balance Sheet Effects (3rd Generation)



- What are the sources of contagion?

1.) Common Shocks

2.) Trade Linkages / Competitive Devaluations

3.) Portfolio Rebalancing

4.) Leverage / Liquidity Spillovers

5.) Panic / Herding

III. Prevention

Domestic

What are some purely domestic policies countries can adopt to reduce the risk of crises?

1.) Avoid Currency Mismatch / fx exposure
2.) Avoid Excessive Reliance on Short-term debt
3.) Maintain Strong Domestic Financial System [transparency]
4.) Adopt Appropriate Ex. Rate Regime [Bipolar]
5.) Sound macroeconomic policy

International

What about global/multilateral policies?

1.) Encourage Sound Natl. Economic Policy
2.) Promote Transparency
3.) Intl. Credit Lines of dubious value.

IV. Responses

Typical Response
1.) Denial
2.) Anger
3.) Bargaining
4.) Despair
5.) Acceptance

National Policies

1.) Restore Confidence!

- Transparency
- Consult with Creditors
- Monetary Restraint
- Maintain or Strengthen Social Safety Nets (Political Stability).

International Policies

1.) Coordinate Private Creditors
- Deal with "Hold-Up" Problem

2.) Provision of "Official Finance"
- Needs to case-by-case. Not automatic "Constructive Ambiguity"