“Comments on Capital Controls: Growth vs. Stability?”

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1. Summary

2. Modeling issues

3. Policy issues

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Basic punch line

- If external finance is needed to fund production, market incompleteness can lead to production distortions.
- Under-production raises relative prices of the scarce good. So raising production with debt finance moves the terms of trade to undo this scarcity.
- Debt financing, after a big shock, can lead to a fire-sale
- So there is a tradeoff between alleviating under-production and creating vulnerability to the big shocks.

Which MM assumptions to break?

- Investors and firms can trade the same set of securities at competitive market prices equal to the present value of their future cash flows
- There are no taxes, transactions costs, or issuance costs associated with security trading
- A firm's financing decisions do not change the cash flows generated by its investments, nor do they reveal new information about them.

Is banning equity sales enough or should they put in banks explicitly?

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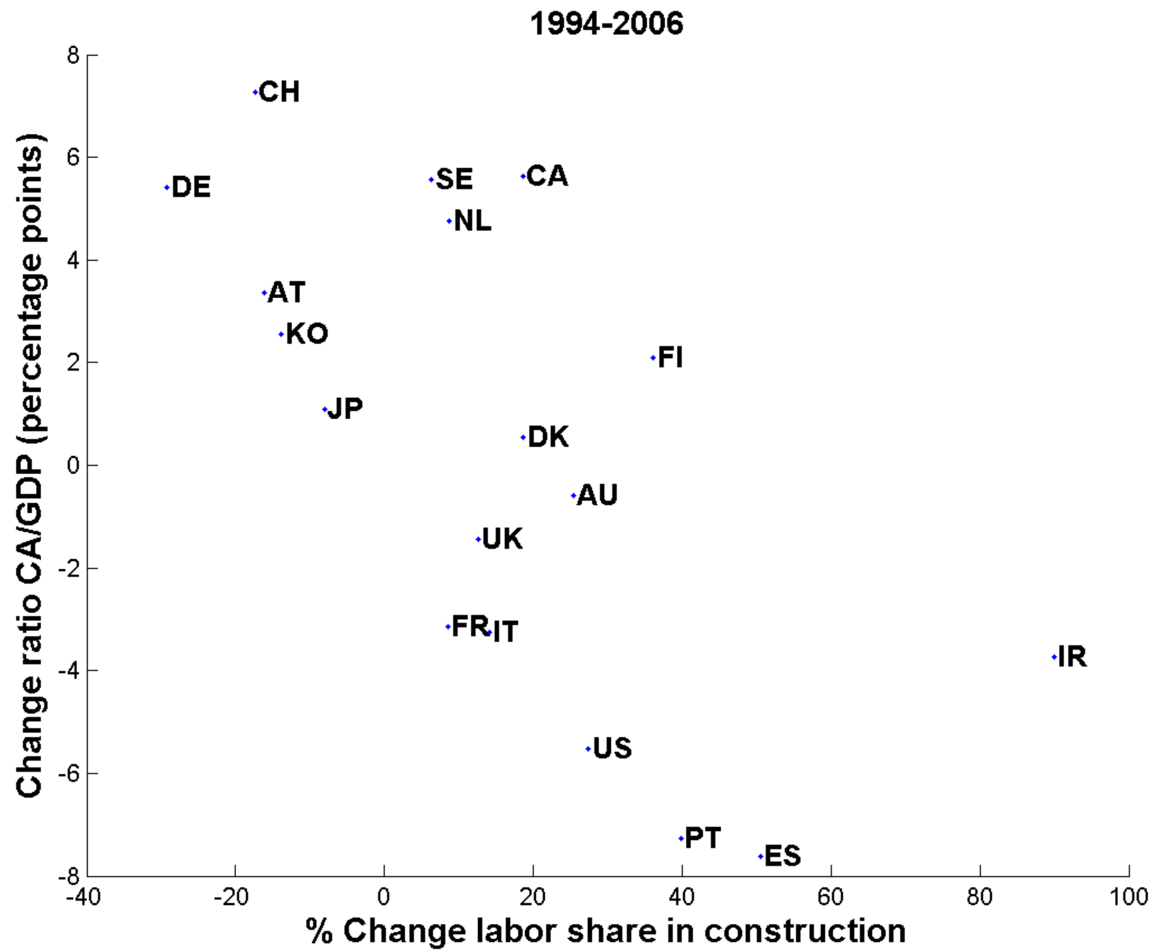
Other MM violations?

- Short term debt services a disciplinary role – maturity structure of lending is ENDOGENOUS.
- Bank financing is special so **deleveraging is costly**
- Contract enforcement is imperfect so lending must be collateralized; corollary, **land** is the best collateral
- Default is **privately optimal**, but imposes additional costs on the counter-party.

Greece's Weighted average maturity of new borrowing:

Year	Weighted Average Maturity in Years
2001	8.54
2002	8.55
2003	7.22
2004	6.85
2005	10.46
2006	10.47
2007	13.25
2008	10.96
2009	5.66
2010	3.68
2011	2.36
2012	16.53



Source: Pedro Gete

"Housing Markets and Current Account Dynamics"

Georgetown University Working Paper

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Welfare analysis with incomplete markets?

- Hot money often drives up non-tradable goods prices (e.g. land) rise. So the terms of trade externality is a bit special.

- Relieving the liquidity constraint is usually going to be welfare improving – this seems pretty general.

- The costs of financial instability are harder to assess. Will be sensitive to the knock-on costs of defaults.

- If debt relief if good, then isn't unilateral default good too?

Meta-conjecture about policy implications

- It is helpful to sort the net effect of MM violations into **two classes of models**
  - Gambling/Too Big to Fail etc, with OVER investment
  - Liquidity constraints with UNDER investment

- With overinvestment, regulations and policies will almost always constrain the gambling and make the investor/gambler worse off
  - Savers might benefit anyway, so it might be desirable

- With under underinvestment, you MIGHT alleviate the liquidity constraint and make both savers and investors better off.

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