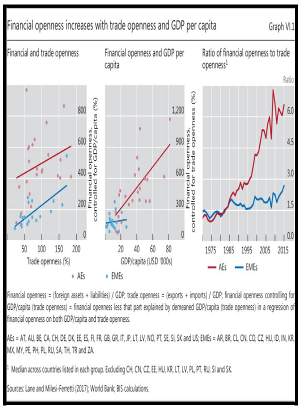
International financial integration - the limits of sovereignty

Macmillan - Economic Stability and Economic Governance in the Euro Area: What the European Crisis can Teach on the Limits of Economic Integration



Description: -
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Monetary unions.International financial integration - the limits of sovereignty
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Problems in economic integrationInternational financial integration - the limits of sovereignty
Notes: Includes bibliographies and index.
This edition was published in 1980

Filesize: 36.47 MB

Tags: #CiteSeerX #— #International #Financial #Integration, #Sovereignty, #and #Constraints #on #Macroeconomic

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Indeed, inflation targeting is not in conflict with optimal nominal debt when debt constraints are not binding.

International Financial Integration, Sovereignty and Constraints on Macroeconomic Policies

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The quantity, g t, can also be interpreted as a stochastic share of aggregate domestic demand for tradable goods that cannot be completely smoothed on international financial markets by households and firms. The incentive-compatibility condition requires authorities to be at least as well off reporting the actual state, g t, as reporting any other state. Both domestic and foreign savers can hold domestic government debt.

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Renegotiation needs to occur with positive probability only when the debt level exceeds the critical level. If this were not true, then the government could increase its primary deficit without increasing its debt.

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Doing so must lead to a lower debt limit than the limit, W Â¯, derived above and to less smoothing of taxes. In equilibrium, the willingness of bondholders to purchase outstanding debt and accept new debt issues constrains the capacity of the government to smooth the distortionary cost of taxation. A natural interpretation is that equilibrium borrowing and lending follow an implicit contract guided by standard, noncontingent debt instruments.

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By contrast, bonds indexed in commodity units or in terms of the currency of another country would need to be renegotiated and restructured explicitly when the debt limit is reached, perhaps following outright default. A main implication of the literature cited above is that nominal government bonds implement an implicit state-contingent long-term contract. These are also increasing with the value of outstanding government obligations, w t.

International financial integration. the limits of sovereignty. Llewellyn, Davi

Renegotiation is interpreted in terms of nominal and real denominated bonds, and implications are drawn about the intertemporal borrowing constraint for monetary policies, the accumulation of reserve assets, and current account sustainability.

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