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Betting against the state
Socially costly financial engineering

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Abstract

The central question raised in this paper is the desirability of state-contingent contracts under imperfect policy credibility. The paper shows a benchmark case in which imperfect credibility of a trade liberalization program is distorting, and the distortion is magnified by state-contingent markets. In addition, it examines the welfare implications of *gaining credibility*, concluding that, in general, more credibility is better than less, and examines the moral hazard faced by policymakers in carrying out reform in case the private sector is able to obtain insurance against its discontinuation. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

The recent financial turmoil in emerging markets after the debacle of Mexico's stabilization/reform program in December 1994 has raised many challenging questions. One of these questions is whether emerging markets would benefit from a wider use of "derivatives" and access to state-contingent contracts.[1]

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[1] A common opinion of financial analysts is that Mexico's crisis would have been cushioned if market participants were allowed to "short" the peso, i.e. borrow in pesos, presumably to hedge. As the argument goes, at the time of crisis there would have been a group of players that were contractually obligated to buy pesos, helping to prop up its value against the dollar and, thus, slow down its steep decline.

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The present paper discusses a simple analytical framework in which the key uncertainty facing the private sector is whether or not policymakers will be able or willing to carry out economic reform. This is a major challenge for reformers. Aside from the inherent difficulties of charting new waters, reformers also face a private sector that is aware of these difficulties and, thus, is sensitive to the possibility that reforms may fail. To illustrate these issues, the paper considers two types of reforms: (1) output-enhancing reform and (2) trade liberalization. The former can be thought as being associated with institutional changes that help to garner the economy's productive potential (e.g., deregulation, anti-trust legislation, privatization, etc.). On the other hand, under trade liberalization, the paper studies a situation in which the government announces a permanent reduction in import tariffs. A key assumption, however, will be that reforms are not fully credible, because the public attaches a positive probability that they will be abandoned. There is, therefore, room for state-contingent contracts, or, more specifically, contracts contingent on the maintenance of reform.[2] To sharpen the focus, the paper will abstract from any other source of uncertainty.

The model assumes that domestic residents are identical and, hence, the only risk-sharing opportunities involve foreign investors. The latter are risk neutral, while domestic residents are risk averse. Although the benchmark case is one in which both domestic residents and foreign investors exhibit the same beliefs about the implementation of reform, the paper also analyzes the implications of a discrepancy between the beliefs of these two types of agents.

The paper shows that, in all relevant cases, greater credibility of reform programs leads to higher social welfare — thus confirming the view that *enhancing the credibility of reform should be one of government's first priorities.* The paper's main objective, however, is to examine the role of state-contingent markets, which is the realm of modern financial engineering. In this respect, the central result is that implications are radically different depending on the type of reform. The paper shows that if the government utilizes domestic resident's probabilities to evaluate social expected utility, then there is no room for welfare-improving intervention in the context of output-enhancing reform. However, the paper also shows that, if trade liberalization is not fully credible, even the absence of state-contingent markets welfare-dominates complete markets in a wide set of relevant situations — thus providing a rationale for government intervention. Moreover, if the government is "paternalistic" and utilizes its own probabilities of reform's failure in evaluating social expected utility, there is room for welfare-improving intervention even in the output-enhancing reform case.

[2] In reality there seems to be no contract directly linked to the maintenance or discontinuation of reform. However, there are options and future contracts on exchange rates and other variables that are themselves linked to reform. Thus, these contingent contracts are proxies for the contracts examined in this paper.

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