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ABSTRACT

For the original version of the Kiyotaki-Wright model [1989] with three goods, I construct in this paper new equilibria that converge to stationary cycles. Even assuming small transaction costs, trade is higher and, consequently, social welfare is greater than in the standard equilibria exhibited in the literature. The nontechnical intuition is that when market conditions change, economic agents may find profitable to restructure their portfolios. So, when market conditions are restored, agents may recompose their portfolios by reselling or buying back. Consequently, this “trading” may lead to greater market “liquidity” whose benefits overcome the costs of trade. In the model, the market conditions change cyclically because of self-fulfilling prophecies believed by rational agents.

To show the existence of dynamic equilibria in the model, Kehoe-Kiyotaki-Wright [1993] exhibit also stationary cycles driven by self-fulfilling prophecies. However, the endogenous transaction pattern of their cycles does not allow a great deal of trading. In particular, the least costly to-store good is universally accepted and, consequently, agents exchange it only for their respective consumption good regardless of market conditions. In fact, only on third of agents do “trading.” Of course, one could expect intuitively that if intrinsically

attractive objects have great acceptance, agents would be very reluctant to trade them away even if market conditions change.

In contrast, the endogenous transaction pattern along my cycles is at least roughly analog to what we would expect in financial markets; namely, that the acceptability of an asset varies inversely with the rate of return if other conditions are equal. In fact, all agents in my examples do “trading.” The intuition is that if intrinsically unattractive objects are those that are widely accepted, people would be less reluctant to trade them away and more trade may occur when market conditions change.

To have this “trading-enhancing” transaction pattern in the model, I make agents to play mixed trading strategies at least in one point of the cycle. This seems to be the simplest and surest way because agents have to be indifferent to trading to randomize trading strategies. Hence, I show by example that if transaction costs (or exchange costs) are small enough, there may exist a class of mixed-strategy equilibria that have good welfare properties because more trade occurs than in other equilibria. Therefore, this result may contradict possible cautiously skeptical views about this point (for instance, see Wallace, 1996, p. 252, fn. 6). Also notice that my results may give a basis to question the popular analysis that arbitrarily focuses on the simplest steady states.

My results may also have far reaching implications from a practical point of view. They may rationalize buy-back programs of shares and they may shed some light on benefic market fluctuations (e.g., some rallies followed by “profit taking” periods). Even though we seem to observe at least some times benefic fluctuations, economists traditionally might have insisted too much in macroeconomic stability. Perhaps, a recent example is the advocacy of (low and) **stable** inflation as the central banks’ ultimate goal.

[497 words]