

Accepted Manuscript

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PII: S0022-0531(18)30092-9
DOI: <https://doi.org/10.1016/j.jet.2018.03.009>
Reference: YJETH 4764

To appear in: *Journal of Economic Theory*

Received date: 18 October 2016
Revised date: 16 February 2018
Accepted date: 20 March 2018

Please cite this article in press as: Kikuchi, T., et al. Volatile capital flows and financial integration: The role of moral hazard. *J. Econ. Theory* (2018), <https://doi.org/10.1016/j.jet.2018.03.009>

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Volatile Capital Flows and Financial Integration: The Role of Moral Hazard¹

Tomoo Kikuchi^a, John Stachurski^b and George Vachadze^c

^aS. Rajaratnam School of International Studies, Nanyang Technological University

^bResearch School of Economics, Australian National University

^cDepartment of Economics, City University of New York

March 28, 2018

ABSTRACT. We study a model in which income and capital flows between countries are jointly determined in a world economy with integrated financial markets. In a setting that combines risky entrepreneurial activity with moral hazard, we find that a shift from autarky to financial integration leads to boom-bust cycles in capital flows, output and consumption. Moral hazard causes cycles because financial intermediaries incentivize effort by insisting entrepreneurs take an equity share in their own projects. The size of this stake rises with wealth, discouraging entrepreneurship and inhibiting capital formation. The reverse is true when wealth falls, generating cycles.

JEL Classifications: E2, E3, E4, F4

Keywords: capital flows, moral hazard, cycles, financial integration

¹The financial support of Singapore Ministry of Education Academic Research Fund Tier 1 R122000140112, Lee Kuan Yew School of Public Policy Academic Research Fund R603000165720, College of Staten Island Provost's Research Scholarship Award and Australian Research Council Discovery Grant DP120100321 is gratefully acknowledged. We thank Joydeep Bhattacharya, Takashi Kamiigashi, Danny Quah, Kiminori Matsuyama and Masaya Sakuragawa for their helpful comments, as well as Chenghan Hou and Mrijan Rimal for excellent research assistance.

Email: istomoo@ntu.edu.sg, john.stachurski@anu.edu.au, george.vachadze@csi.cuny.edu

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