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Financial Integration With and Without International Policy Coordination

by

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Abstract

This paper studies the relationship between international capital mobility and international policy coordination. I show that: (i) a regime with capital mobility results in higher welfare levels than a regime without it provided that governments coordinate their macroeconomic policies, and that (ii) in the absence of policy coordination, capital mobility results in lower welfare levels than portfolio autarky.

These results follow from the fact that financial integration enhances the impact of domestic government financial policies on foreign interest rates, real allocations, and welfare. Therefore, financial integration increases the welfare losses from noncooperative policymaking.

The policy message is that financial integration, of the type attempted by European countries, can be successful if and only if governments agree to coordinate their macroeconomic policies.

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