

TO TRADE, OR NOT TO TRADE, THAT IS THE QUESTION: NEW ROLES FOR INCOMPLETE CONTRACTS IN DYNAMIC SETTINGS

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Abstract

We reexamine the role of incomplete contracts in a dynamic model of renegotiation that endogenizes the timing of investments and trade. The interaction between bargaining and investment significantly alters the lessons learned from static models. When the opportunity to trade is expected to be long lasting, contracts that exacerbate the parties' absolute vulnerability to hold-up – especially following under-investment – are desirable. For example, joint ownership of complementary assets can be optimal, an exclusivity agreement can protect the investments of its recipient, and trade contracts can facilitate purely cooperative investment. (JEL: C73, C78, L14)

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