

*Economic development in East Germany is not uniform. The building and construction industry is booming but manufacturing industry is stagnating. The paper argues that severe distortions in relative factor prices are the cause of the dichotomous development. These distortions result from excessive.*

Price distortions arise from inefficient flows and prevail as long as a sizable share of market participants is either unwilling or unable to respond to obvious dislocations. There are many causes of such inefficiencies, including risk management rules, liquidity disruptions, mechanical rebalancing rules and government interventions. The basics What are price distortions? Like information inefficiency, price distortions lead to a mispricing of financial contracts relative to their fundamental value. These are transactions in financial markets that are motivated by objectives other than return optimization. Sometimes, trading speed view post here and financial leverage can be of the essence. In order to detect price distortions systematically one can take three different angles: Diagnosing price distortions this way is not the same as estimating price-value gaps, as the latter would require superior information efficiency. Also, temporary mild explosiveness in asset prices or exchange rates in conjunction with relative stability in underlying fundamentals is usually indicative of short-term distortions view post here. Generally, a self-reinforcing price dynamics that is not a reflection or cause of underlying value changes is prone to producing price distortions. Price distortions prevail because most investors are either unable or unwilling to exploit them. This is very realistic. The vast majority of investors is unable to exploit relative price distortions because their access to arbitrage capital and leverage is restricted. These restrictions can hamper even to sophisticated investors, particularly in times of financial turmoil. They are the very cause of persistent relative value opportunities, particularly in the fixed income space view post here. Meanwhile, many investment strategies explicitly disregard price distortions, and their flows may for some time overpower more subtle relative value flows. Herding can, however, lead to price distortions, particularly if its motivated by non-fundamental shocks in markets with limited liquidity and a homogeneous investor community, such as in corporate credit markets view post here. Such distortions can occur when scarce funding or limited balance sheet capacity prevents investors from taking advantage of the resulting trading opportunities. Even risk measures that rely on longer historical simulations have only limited data on actual crises and hence are very vulnerable to changes in assumptions and new crisis experiences view post here. If the estimate of the risk metric-surges, VaR-sensitive institutions automatically recalibrate the risk of their existing positions and subsequently have to reduce their holdings of assets view post here. Put simply, if an institution has a fixed risk budget a doubling of the estimated value-at-risk or expected loss requires it to liquidate half of its nominal positions. Indeed, explicit and implicit short-volatility strategies seem to have expanded strongly in the wake of declining fixed-income yields. They pay steady positive risk premia in normal times at the peril occasional outsized losses. Short-volatility strategies give rise to feedback loops in two ways. From a macro perspective, there is a positive reinforcement between actual volatility and the scale of short-volatility strategies view post here. From a micro or trading perspective, managers attempt to contain losses through dynamic hedging. These are transactions in underlying assets that reinforce initial market moves. CDS are assumed to represent a measure of default risk. In practice this less liquid market can gap in large moves, simply as a consequence of one-sided institutional order flows, which themselves could be motivated by risk management or regulatory considerations view post here. As CDS spreads themselves are used as a measure of credit risk, institutional flows and spreads can reinforce each other to form escalatory dynamics. If public fear of crisis is rising, financial risk managers experience pressure from investors, shareholders and even governments to position more defensively. This is supported theoretically and empirically for equity, bond and credit markets view post here. This creates incentives for fire sales and causes of price distortions view post here. Risk-reduction in banks and other financial intermediaries does not only constrain their own asset holdings but, indirectly, those of other market participants, particularly leveraged investors such as hedge funds. This creates both relative price distortions and high directional risk premia. Most obviously, limitations of arbitrage capital give rise to price differentials between contracts with similar

risk profiles view post here. When credit supply is ample, risk premia and future excess returns are low. When credit supply is scarce, risk premia and future excess returns are high. Market liquidity risk denotes the risk that trading costs surge when the need for trading becomes more urgent view post here. Both liquidity and liquidity risk influence prices. Most institutional and private investors are willing to pay a premium on securities with high and reliable liquidity and require a discount on securities with low and uncertain liquidity view post here. This means that changes in liquidity or liquidity risk of a contract lead to a change in its price, irrespective of its expected discounted present value. Therefore, uncertain and unstable liquidity conditions lend themselves to price distortions. Small shocks can produce large price moves and apparent dislocations. There is evidence that liquidity as a price factor and source of price distortions has increased since the s: For example, in the U. Market making has become more onerous as restrictions and ambiguities of the rule make it harder for dealers to manage inventory and to absorb large volumes of client orders in times of distress view post here. Investment funds often buy and sell with the market, chasing return trends view post here , due to redemptions and reliance on collateralized funding. Also, asset managers often engage in in cash hoarding, which means that they sell more underlying assets in market downturns than is necessary to meet redemptions view post here. This holds true particularly in markets with more precarious liquidity. The sell-off in the U. More generally, empirical research has shown that sudden large drawdowns in government bond markets are aggravated by poor liquidity view post here. Trading flows are highly correlated due to a the usage of benchmarks, and EM asset prices and final investor flows tend to be pro-cyclical and mutually reinforcing view post here. The discretionary decisions of fund managers seem to aggravate this pro-cyclical: This means that they are under legal or reputational obligation to change portfolios in accordance with the conventions of their investment mandate. Benchmark effects arise from changes in global securities indices that are commonly tracked by investment managers. Moreover, benchmark companies revise indices regularly, causing re-weighting of sectors or countries that is not in proportion to market capitalization. Strategic rebalancing can sometimes be caused by regulatory changes. As leveraged ETFs have become a significant factor in U. There is empirical evidence that this will trigger hedging flows. High-frequency trading strategies respond at high speed to changes in prices using relatively simple strategies. Speed, rather than reflection, is of the essence. Moreover, trading speeds have increased across market participants, probably increasing the risk of short-term liquidity events view post here. Resulting legislation, regulations, and interventions can have both intended and unintended consequences. The pervasive influence of government policies over yields at all maturities arises not only from their direct influence on demand and supply but also from it their repercussions on the functioning of markets. This makes the valuation of many assets highly dependent on the underlying policy agenda. A more subtle example for secondary unintended consequences are the effects of cheap financing and capital controls in China on demand for physical metals view post here. Moreover, price distortions arise from the fear of announcement or execution of the intervention. Value generation along the fundamental trend can resume after the intervention has been implemented view post here. Macro trading strategies are defined as alternative investment management styles predicated on macroeconomic and public policy events or trends. If the right principles and ethics are applied, social and economic benefits arise from an improved information value of market prices, increased efficiency of global capital allocation and reduced risk of financial markets crises.

### Chapter 2 : Factor Price Distortions and Public Subsidies in East Germany - CORE

*Price distortions can be detected by conventional valuation metrics but with a focus on extreme price value gaps that associated with obstacles to arbitrage or trading. The third approach is to investigate the time series pattern of asset prices.*

### Chapter 3 : Price Distortions | Systemic Risk and Systematic Value

*The present paper estimates the welfare cost of both labor and capital market distortions in South Korea using a*

*computable general equilibrium model and expands on earlier studies by distinguishing autonomous differentials from distortions in accounting for differences in sectoral wages and returns.*

## Chapter 4 : Factor Price Distortions and Public Subsidies in East Germany

*Tao et al. () studied the industrial sector's energy price distortions and factor substitutions through the shadow price model, finding that the labor price distortion was the most serious, followed by energy price.*

## Chapter 5 : Factor price equalization - Wikipedia

*Market distortion is an economic scenario that occurs when there is an intervention in a given market by a governing body. The intervention may take the form of price ceilings, price floors or tax.*

## Chapter 6 : EconPapers: Factor Price Distortions and Public Subsidies in East Germany

*The present paper estimates the welfare cost of both labor and capital market distortions in South Korea using a computable general equilibrium model and expands on.*

## Chapter 7 : Factor price - Wikipedia

*b) Production technology This implies that production technology is independent of price distortions i.e. there is no substitution between traded and non-traded inputs due to price distortions. c) Factor subsidies tend to be highly socially discriminatory.*

## Chapter 8 : Market Distortion

*Trade Liberalization on Real Factor Prices, by Country and Region<sup>17</sup> The World Bank. 2 3. Agricultural Price Distortions, Inequality, and Poverty.*