Managing Capital Flows

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Booms-bust-boom in capital flows to emerging markets

Inflows
Outflows

Emerging Markets (ex-China)
gross outflow % GDP
• The return of prudential capital controls on inflows.

• Brazil: Oct. 2009: 2% tax on portfolio on debt and equity inflows.
  o Oct. 2010: tax raised to 6% for debt inflows.

• Indonesia, Korea and Thailand: measures on foreign holding of domestic currency bonds + macroprudential measures.

• But Chile makes a different choice: reserve accumulation rather than controls.
- **Debate 1**: (small open economy perspective) what is the best way of managing capital inflows ("toolkit").

- **Debate 2**: (global perspective) should this be a concern for the international community?

- **Fora**: G20, IMF.

• I will talk about the role of capital controls: Should they be part of the “new normal”?

1. The case for capital controls

2. Common objections

3. The case for international oversight

My remarks draw on Jeanne, Subramanian and Williamson (2011).
1. **The case for capital controls**

- Emerging market economies are subject to fluctuations in their access to foreign capital: “sudden stops”.

- We have a better theoretical understanding of the kind of stabilizing policies that are called for:
  
  ➢  the “new welfare economics” of capital controls.
• Is a tax on capital inflows an optimal tax in the same sense as a carbon tax?

• The volatility of capital flows is not a sufficient reason to tax them.

• One needs to add an externality.

• Two externalities have been studied in the literature
  ○ finance;
  ○ trade.
Finance externality:

- Buildup of financial fragility during booms leading to excessive leverage and fire sale externality in bust (Korinek, 2010; Bianchi, 2011; Jeanne and Korinek, 2010).
• Appropriate instrument: a tax on “systemically dangerous” financial instruments

Externalities in Indonesia, 1998

<table>
<thead>
<tr>
<th>Asset category</th>
<th>Real gross return</th>
<th>Externality in 1998</th>
<th>Optimal tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollar debt</td>
<td>218 %</td>
<td>30.7 %</td>
<td>1.54%</td>
</tr>
<tr>
<td>GDP-indexed dollar debt</td>
<td>190%</td>
<td>26.8%</td>
<td>1.34%</td>
</tr>
<tr>
<td>CPI-indexed rupiah debt</td>
<td>100%</td>
<td>14.1%</td>
<td>0.71%</td>
</tr>
<tr>
<td>Rupiah debt</td>
<td>63%</td>
<td>8.9%</td>
<td>0.44%</td>
</tr>
<tr>
<td>Stock market</td>
<td>44%</td>
<td>6.2%</td>
<td>0.31%</td>
</tr>
</tbody>
</table>

Source: Korinek (2010)
• Optimal tax rate on foreign currency debt

Source: Bianchi (2011), based on calibrated DSGE model
Trade externality

- Currency appreciation leading to excessive erosion of export capacity, which is costly in busts (Caballero and Lorenzoni, 2009).

- Dutch disease (Korinek and Serven, 2010).

- Optimal policy: subsidy on tradable sector.
• Each externality calls for its own kind of taxation: relation with capital controls?

• Financial externality: capital controls or domestic macroprudential regulation?

• I.e., should one treat transactions between residents and nonresidents differently?
  o yes if nonresident investors are more “fickle”.
  o but the evidence on that is mixed (Forbes and Warnock, 2010).
• **Trade externality:** controls on capital inflows address it by resisting appreciation of currency in boom.

• Capital controls may not be the best instrument, but may be (politically) easier to implement than a subsidy on tradable sector.

• General point: a tax on inflows may not be the best instrument for a particular externality…

• … but it has nice properties as a general-purpose, robust instrument.
2. **Common objections**

- Capital controls are ineffective or have significant unintended costs.

- One can use other policy instruments.
Ineffectiveness: capital controls are circumvented:

• Evidence suggests that capital controls are effective at least in affecting the composition of capital inflows (Chilean URR).

• The argument can be turned on its head:
  
  o it is because financial regulation is circumvented that capital controls should be used at the margin.
• Taxing the rich is harder work than taxing the poor:
  ➢ a general problem in financial regulation;
  ➢ suggests broad tax base and moderate tax rate;
  ➢ “spread-the-weight”: use all the policy levers in moderation.

• The instruments of macroprudential regulation are like “buckets with holes”.
• Capital controls have costs for the economies that impose them:

  ➢ negative impact on credit and investment (Forbes, 2007).

• But isn’t this what the controls are supposed to do?

• More generally, link between capital account liberalization and growth is difficult to find
  o some evidence for FDI, stock market liberalization.
Advanced economies are more liberalized

2007: Log GDP per cap vs. quinn index (Adv+EM)

De jure index on CAL - Quinn

- log_y_wdi
- Fitted values
But little evidence of a correlation in changes

1970:2007: Growth GDP per cap vs. Change in quinn (Adv+EM)

Change in quinn 1970

Growth_wdi 1970
Fitted values
• Other instruments can be used:
  ➢ fiscal policy;
  ➢ accumulation of international reserves;
  ➢ macroprudential regulation.

• Fiscal policy:
  o blunt
    o if one is going to increase taxes, why not use corrective ones?
• **International reserves:**
  - complicated instrument,
  - creates moral hazard ex ante, not very useful in crisis,
  - seems effective to limit appreciation.

• **Macroprudential regulation:**
  - bank intermediation can be bypassed,
  - circumvention.

• On balance, I agree with IMF analysis (Ostry et al., 2010) that capital controls have a role to play,
  - but it does not follow that they should be used as a tool of last resort.
3. The case for international oversight

- Status quo: (almost) no rule for capital account policies
  - unlike for trade (WTO),
  - IMF has no jurisdiction on capital account.

- There have been calls to change that
  - e.g. a “code of good practices” developed under the auspices of the IMF,
  - to reduce the stigma associated with the use of good prudential controls.
• Another justification: capital controls reduce global demand, and may hinder global rebalancing.

• But a tax of a few percentage points can affect the real exchange rate by a few percentage points, no more (Jeanne, 2011).

• Chinese-style policies are another matter.
Current account surpluses ($bn)

Source: WEO (2010)
Chinese foreign assets (% of GDP)
Chinese foreign liabilities
• Then the government controls
  ➢ the current account balance = $\Delta NFA$
  ➢ the trade balance
  ➢ the real exchange rate.

• Real (not monetary) mechanism; capital controls are key.
• “Forced saving” through capital account policies.

• Relaxing those policies probably quickest way of reducing Chinese saving rate.

• Link with internationalizing the RMB
  o the Chinese dilemma.
Correlation goes beyond China
• Tension between framework for international trade in goods, and lack of framework for trade in assets.

• A conflict in one area tends to spill over in the other
  o e.g. Gagnon and Hufbauer (2011).
Conclusion

• Why can’t we relax (more) about (the right kind of) capital controls?

• Two reasons to have some form of international oversight:
  ➢ reduce stigma;
  ➢ international spillovers, and link with trade.