Managing Capital Flows

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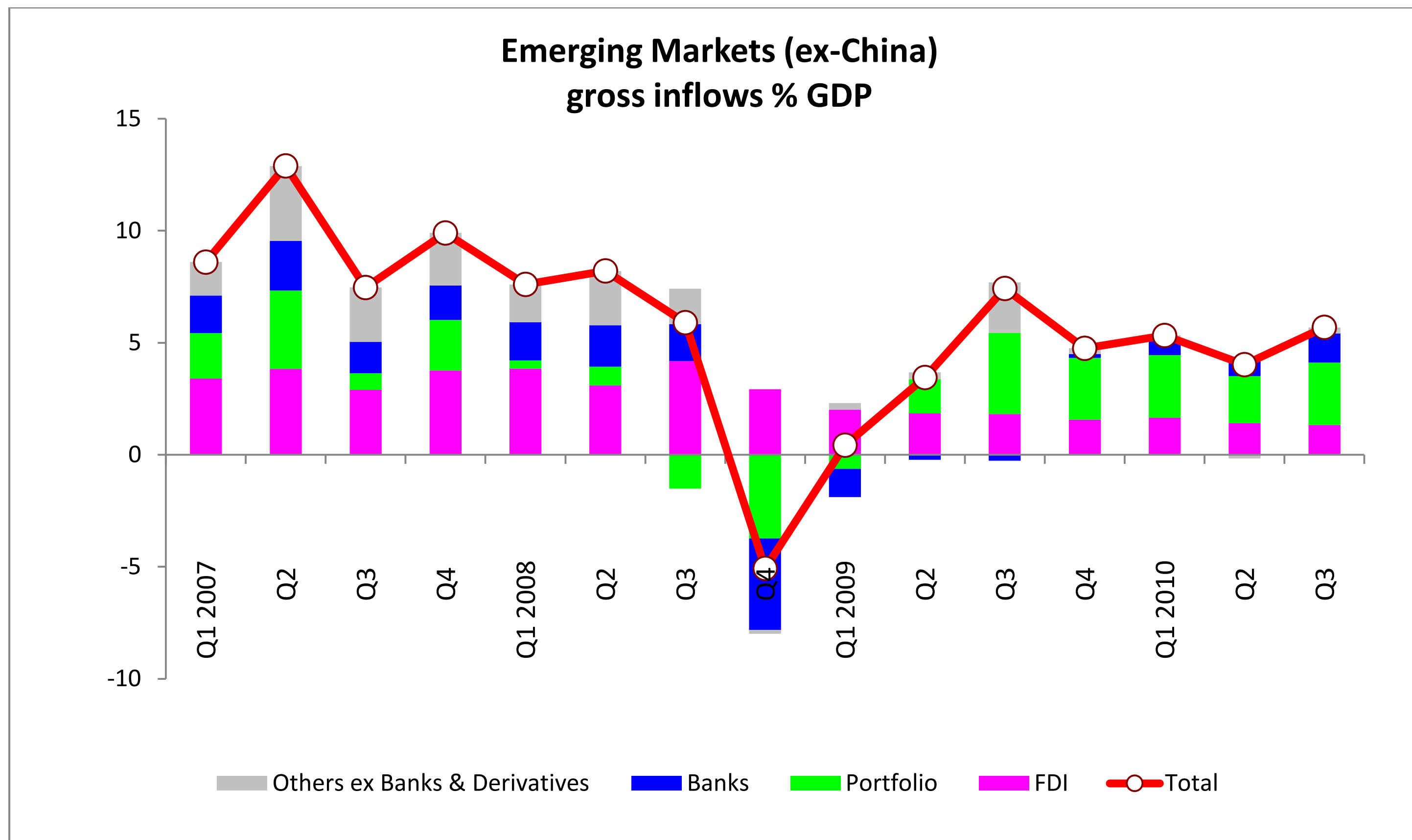
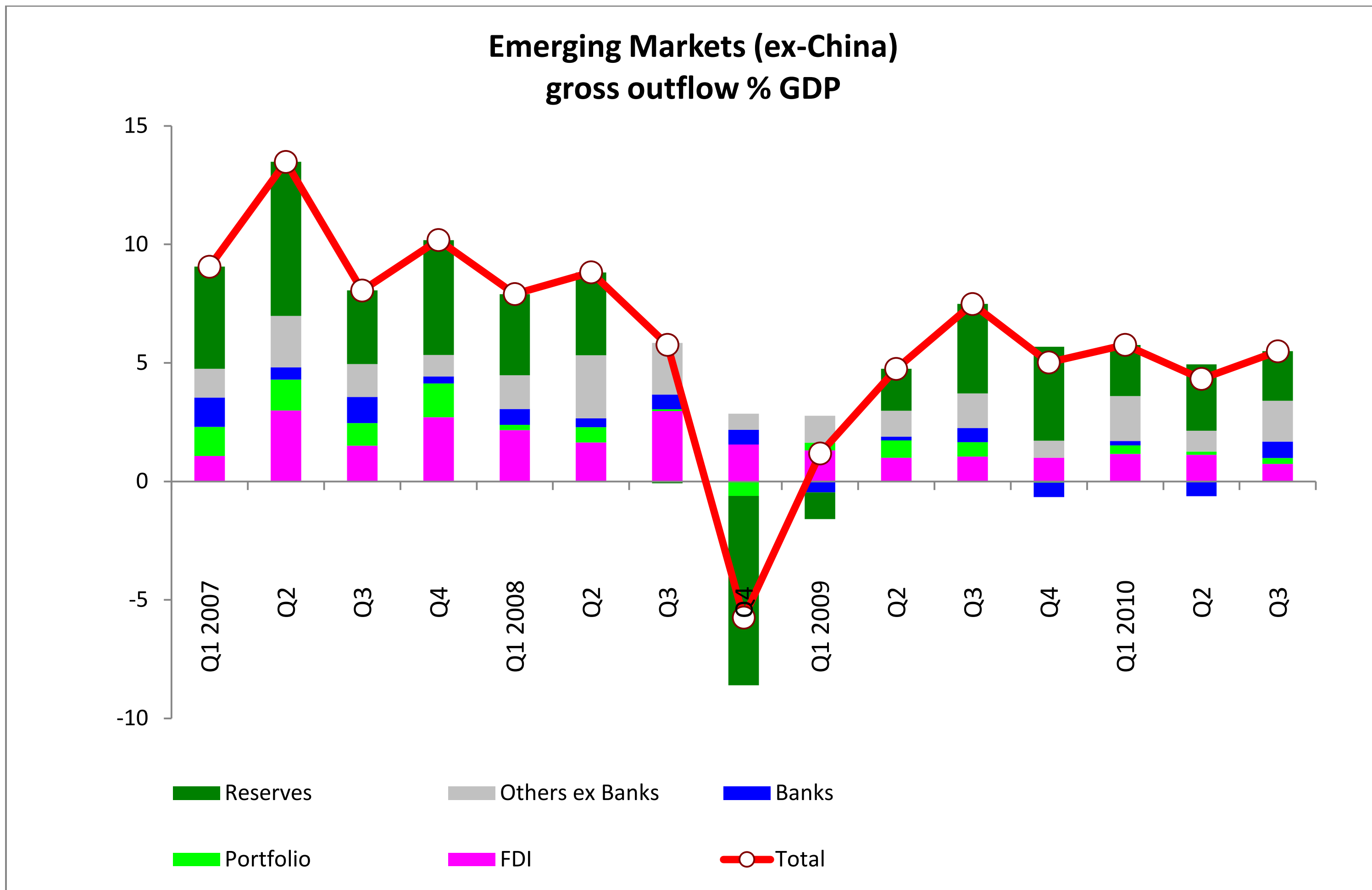
Booms-bust-boom in capital flows to emerging markets

Inflows



Outflows



- The return of prudential capital controls on inflows.

- Brazil: Oct. 2009: 2% tax on portfolio on debt and equity inflows.
    - 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.

- Recent evolutions in the IMF’s position: “Managing Capital Inflows: What Tools to Use?” (Ostry et al, 2011).

- 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?

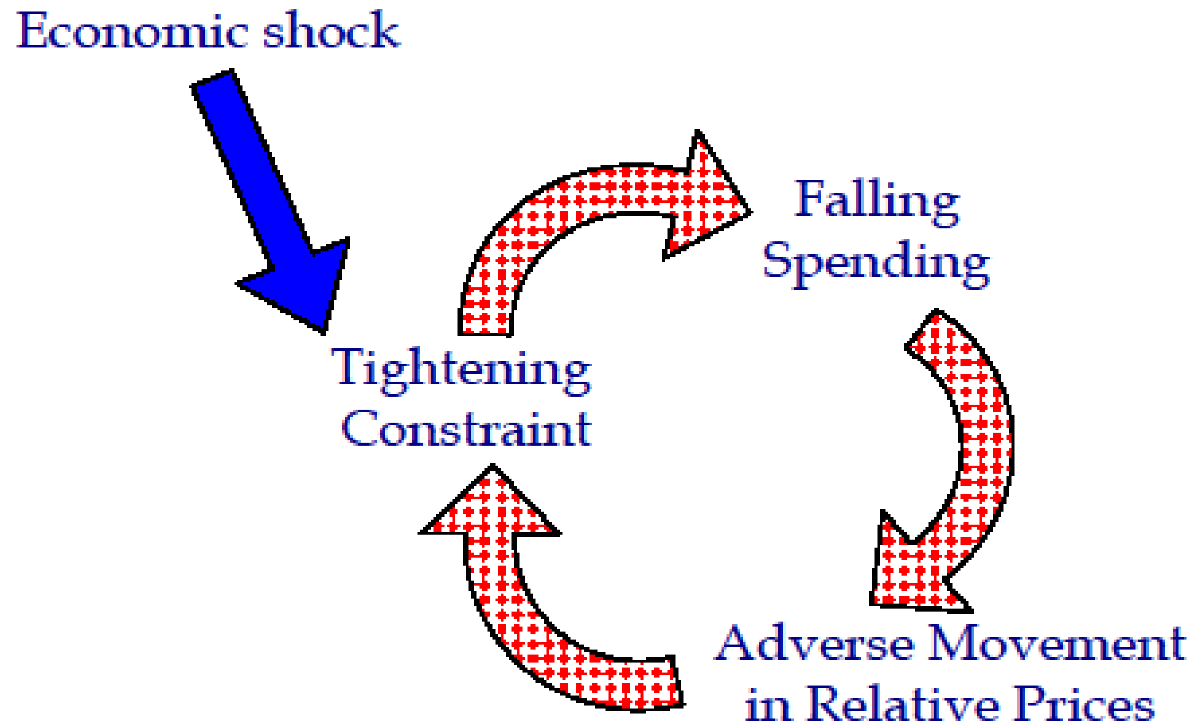
- The volatility of capital flows is *not* a sufficient reason to tax them.

- 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).



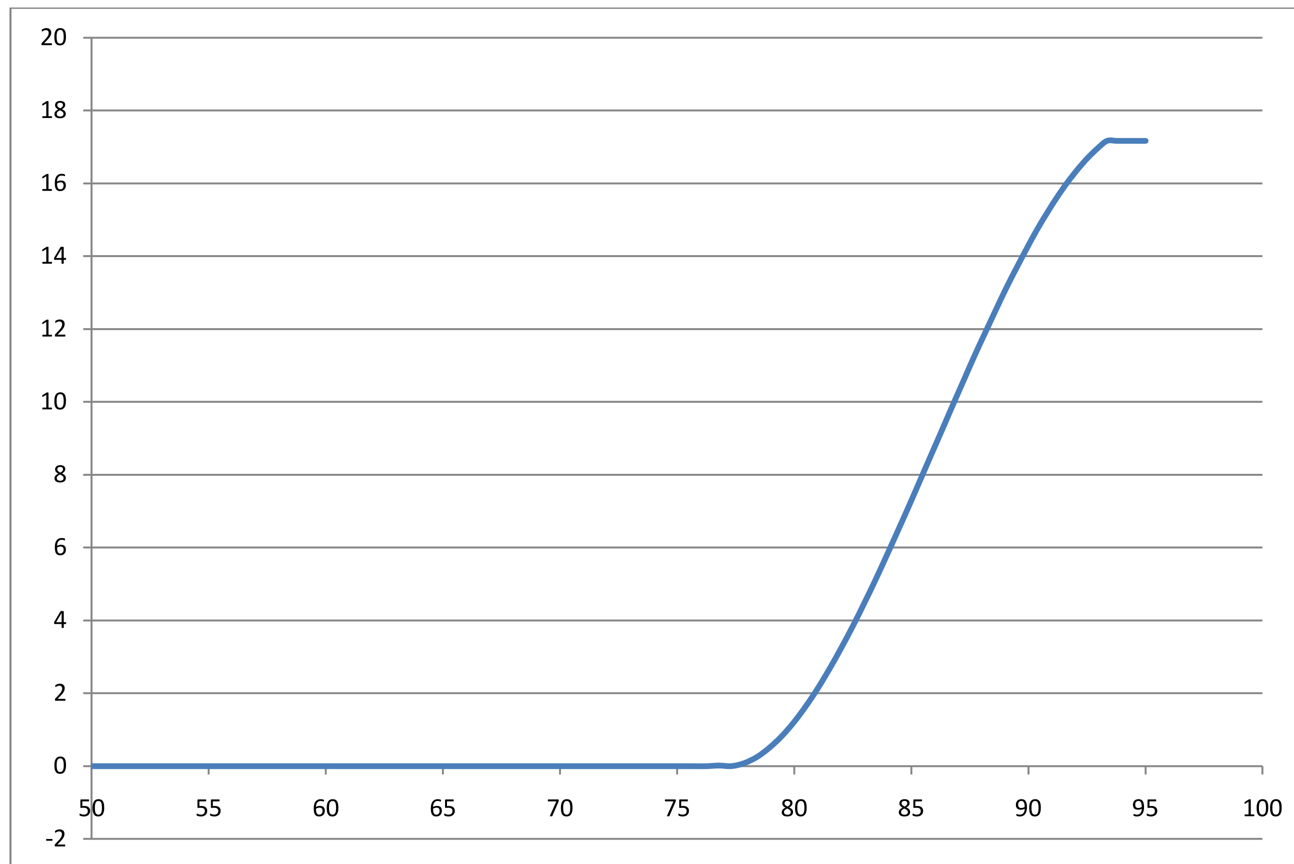
- Appropriate instrument: a tax on “systemically dangerous” financial instruments
  Externalities in Indonesia, 1998

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

Source: Korinek (2010)

• Optimal tax rate on foreign currency debt

Tax rate (%)



Debt/tradable GDP (%)

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?
  - yes if nonresident investors are more “fickle” .
  - 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:

    - 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”.

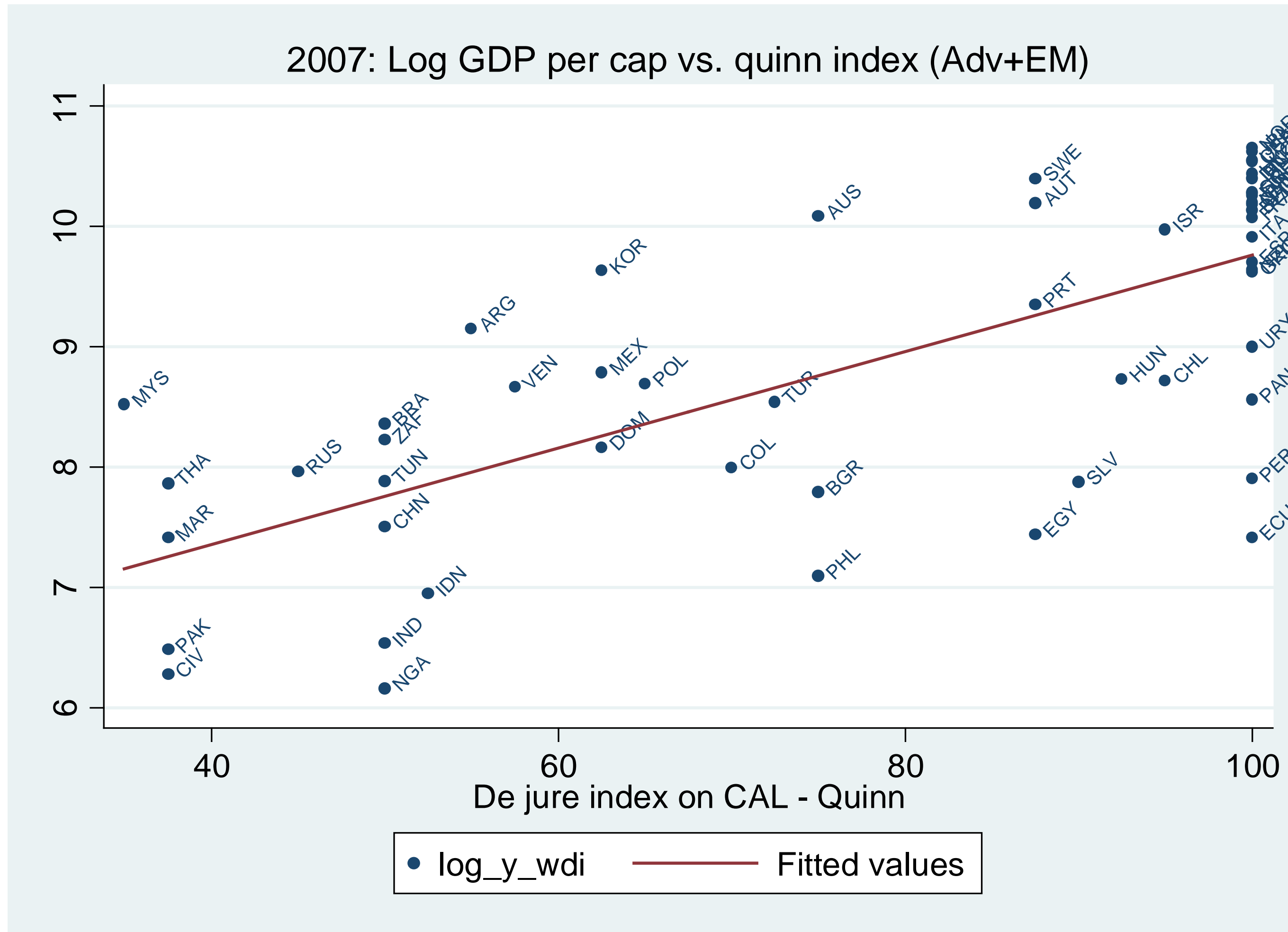
- Capital controls have costs for the economies that impose them:

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

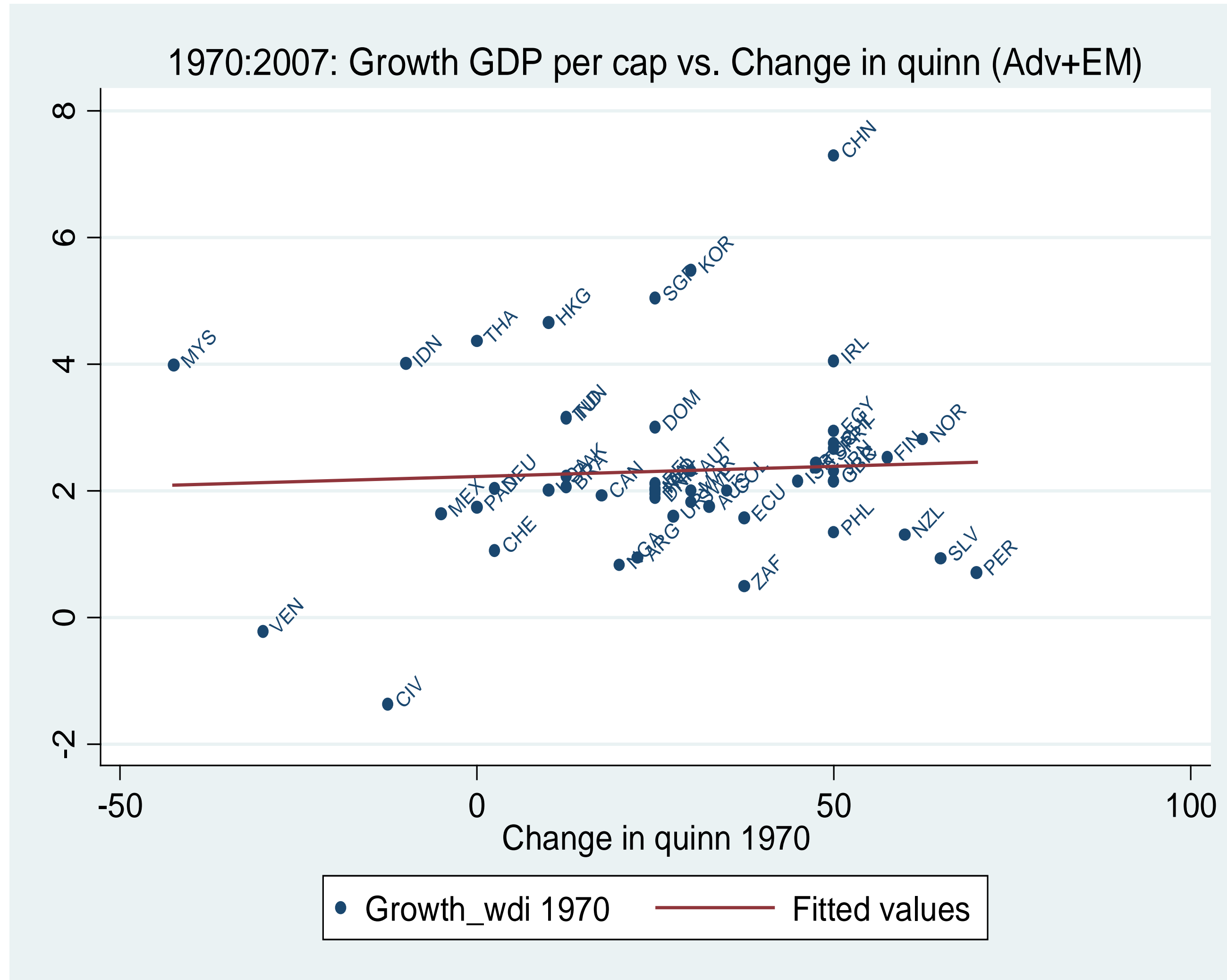
- But isn't this what the controls are supposed to do?

- More generally, link between capital account liberalization and growth is difficult to find
  - some evidence for FDI, stock market liberalization.

Advanced economies are more liberalized



But little evidence of a correlation in changes



- Other instruments can be used:

➢ fiscal policy;
➢ accumulation of international reserves;
➢ macroprudential regulation.

- Fiscal policy:
    - blunt
    - 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.

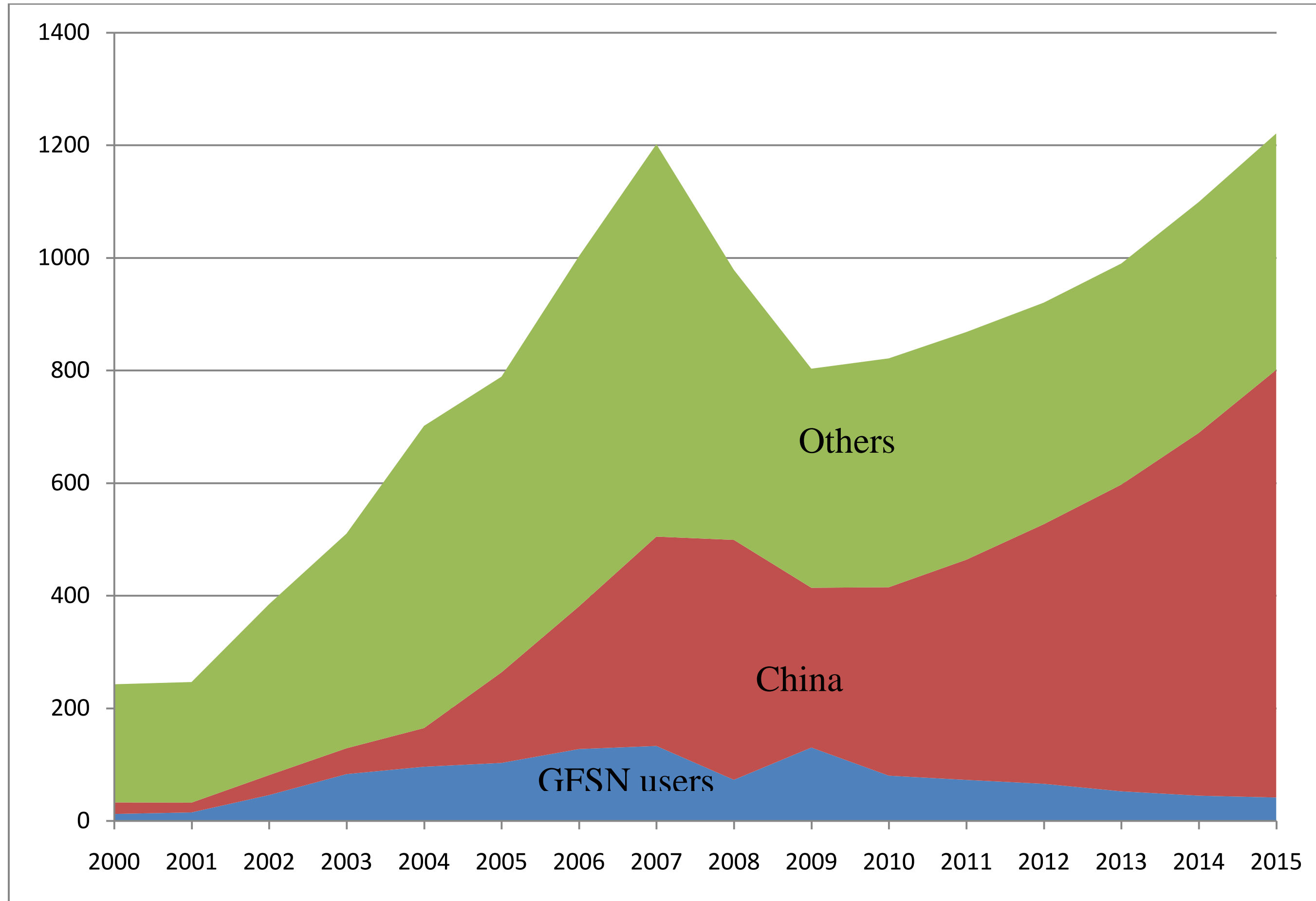
- There have been calls to change that
  - e.g. a "code of good practices" developed under the auspices of the IMF,
  - to reduce the stigma associated with the use of good prudential controls.

- 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).

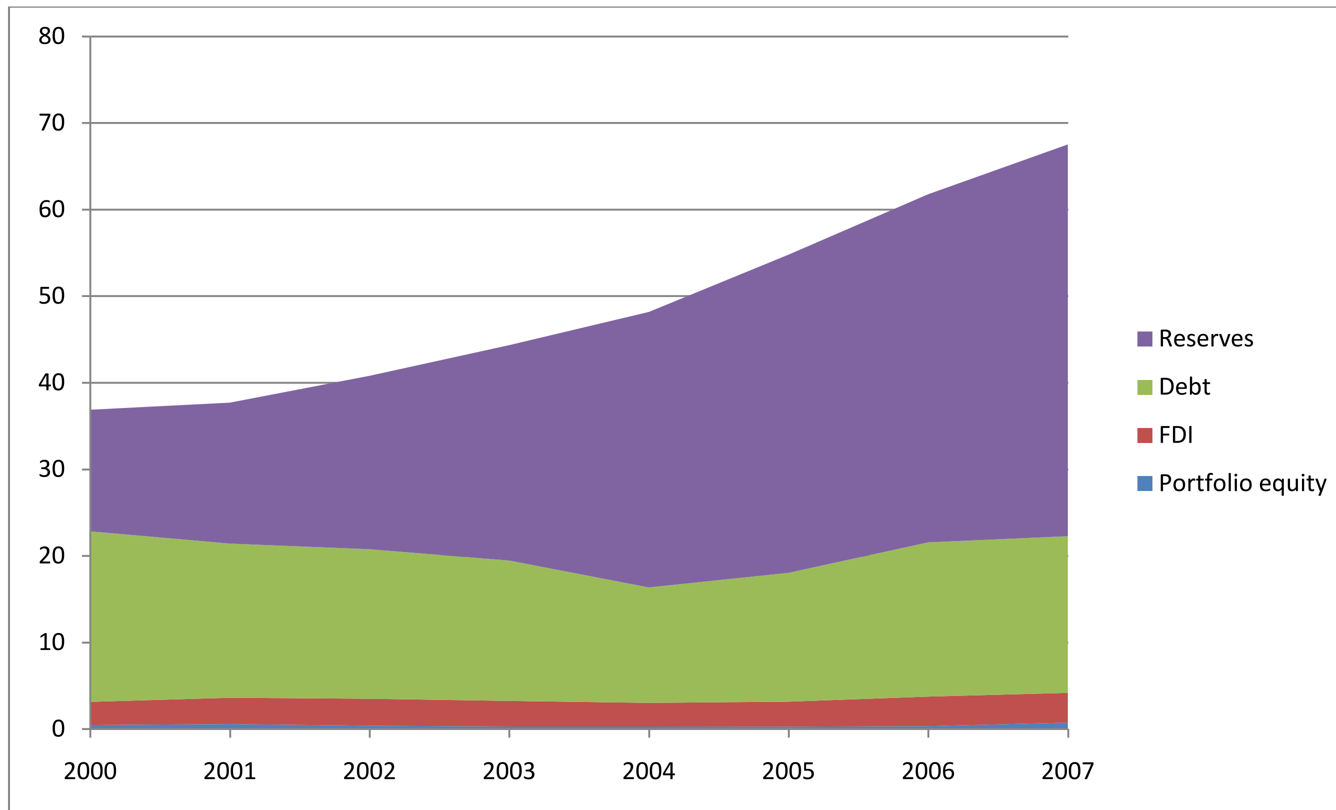
- Chinese-style policies are another matter.

Current account surpluses ($bn)

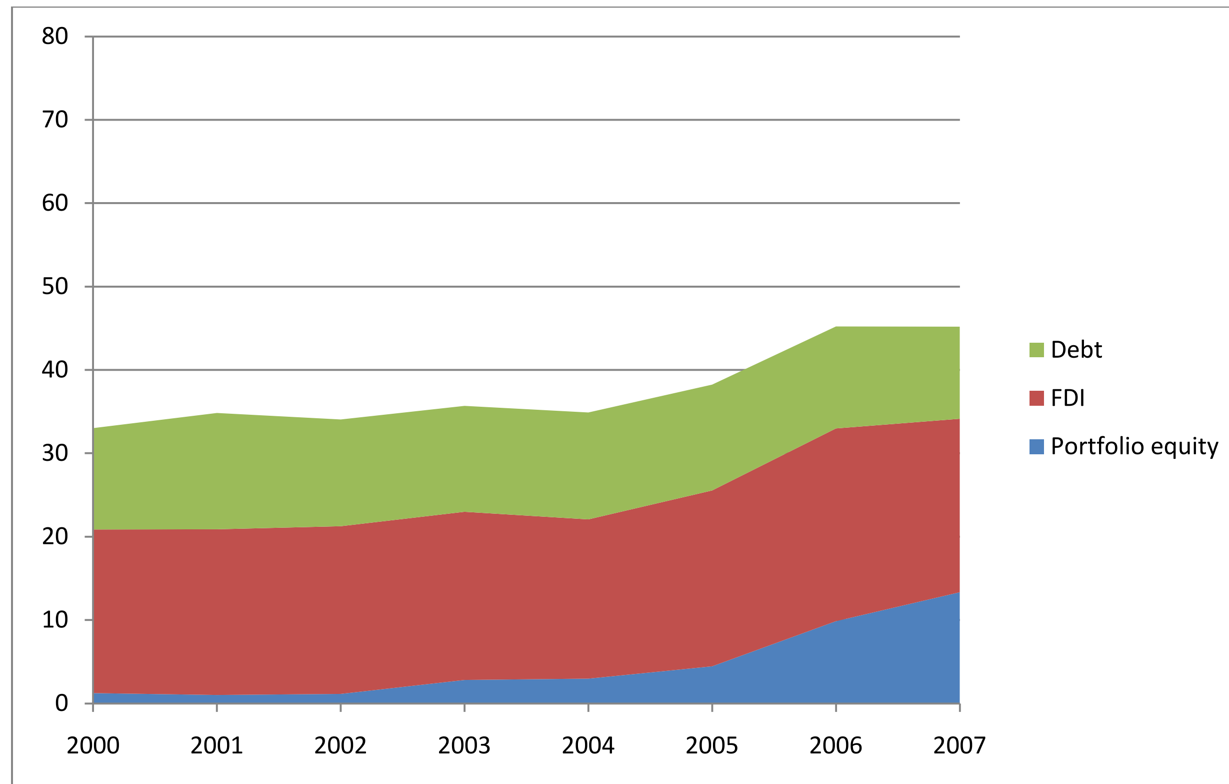


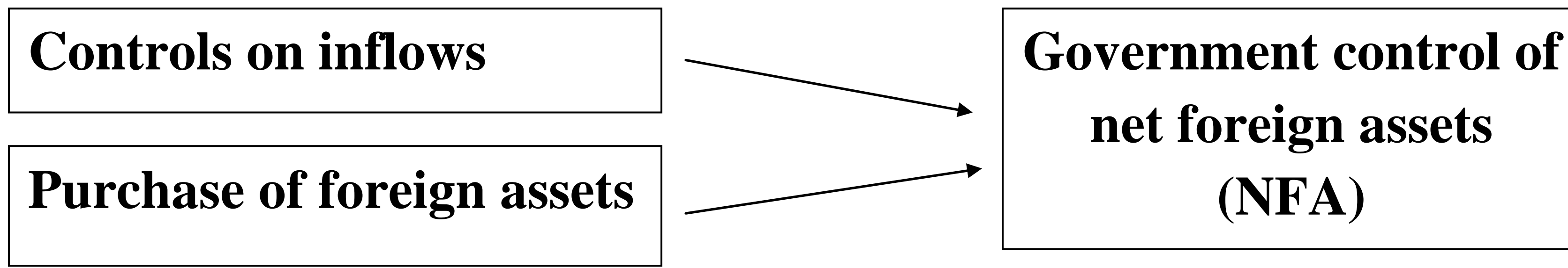
Source: WEO (2010)

Chinese foreign assets (% of GDP)



Chinese foreign liabilities





- Then the government controls
  - the current account balance = ΔNFA
  - the trade balance
  - the real exchange rate.

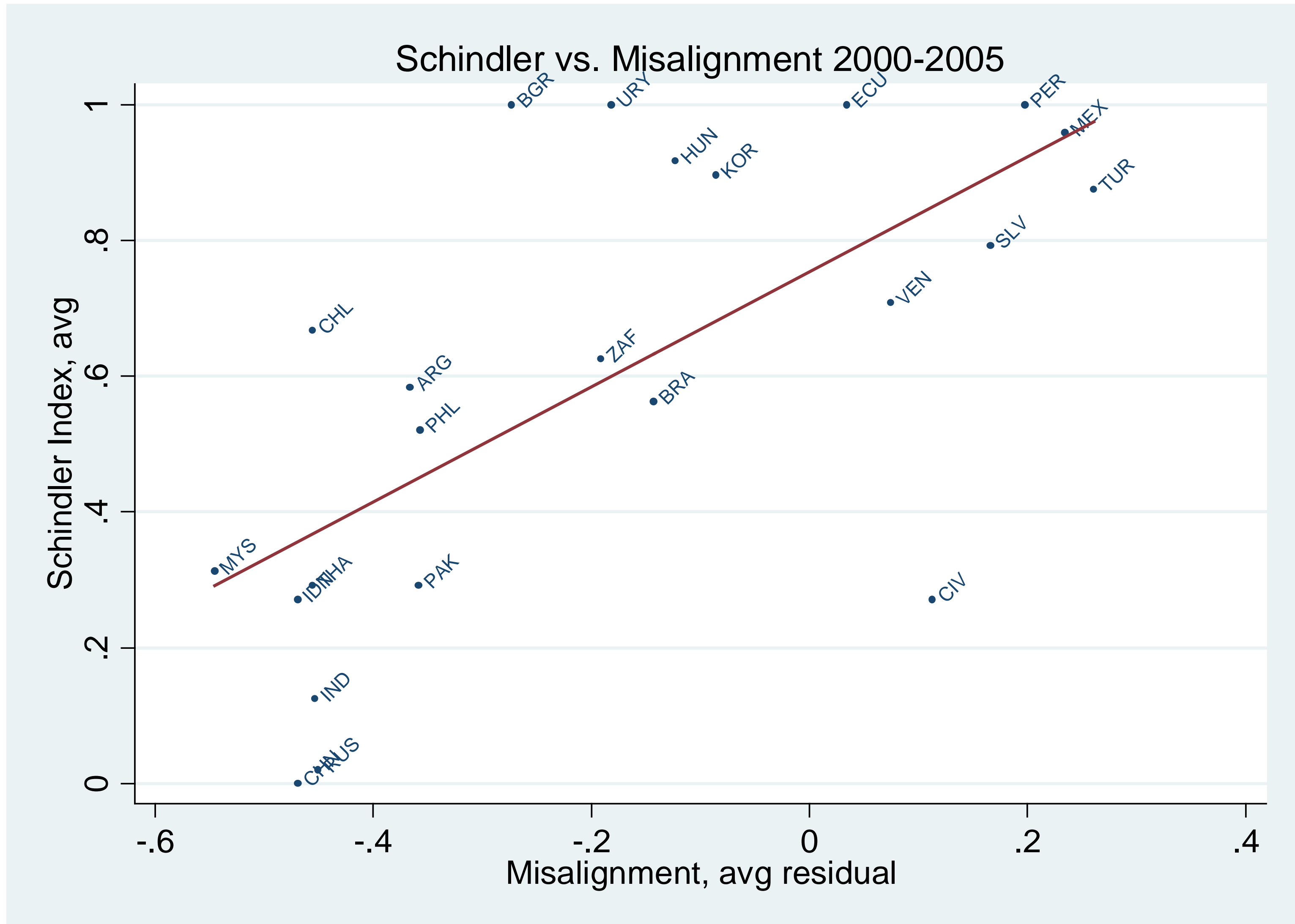
- Real (not monetary) mechanism; capital controls are key.

- “Forced saving” through capital account policies.

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

- Link with internationalizing the RMB
    - 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

    - 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.