Comments on O. Blanchard, "Currency Wars, Coordination, and Capital Controls"

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Outline of the Blanchard paper

- Spillover from AE to EM
  - Trade channel
  - Financial channel (forex and financial markets)
- Scope for coordination
  - Was, and is, limited
  - Given little coordination, “capital controls” are the best macroeconomic instrument
- Effects of capital flows on the financial systems in EM
  - Capital controls as a financial stability tool

Currency Wars

- [As mentioned by Blanchard]
  - Mantega, in Sept. 2010, complained about QE in US and Europe, that depreciated AE currencies and appreciated EM currencies
  - At the time of Taper Tantrum and subsequent phase, EM complained about US monetary tightening
  - More recently, Rajan warned that QE among AE is doing harm to EM and called for policy coordination
- [Question] So, do EM complain both inflows and outflows?

Spillovers

- [Blanchard] Three channels
  - Trade
  - Exchange Rate
  - Financial Markets
- [Q] Is the crisis contagion literature helpful in understanding the inflow stage too? Several hypotheses to explain contagion
  - Trade channel
  - Direct financial channel (asset exposure; liability exposure)
  - Regional liquidity dry-up
  - Investors' "wake-up" hypothesis
  - Common lenders hypothesis
  - A same asset class hypothesis

Spillovers

- Spillovers were there even under <u>conventional</u> monetary easing/tightening in AE.
- [Q] Why do EMs complain spillovers under <u>unconventional</u> monetary policy of AE more than under <u>conventional</u> monetary policy?
  - [Blanchard] Inflows and outflows, even if they match and an impact on the exchange rate is minimal, the gross inflows may go to the financial sectors and products that increase the vulnerability in the future
  - [Comments] In addition, in ZIRP/QE, transmission channels are more limited than otherwise and the exchange rate channel may be more important

Policy Coordination

- [Blanchard definition] All countries become better off.
- [Comments] Good definition. Naturally, a cooperative solution is better than a Nash equilibrium

- [Q] Classics
- Koichi Hamada, "A Strategic Analysis of Monetary Interdependence," Journal of Political Economy 1976, vol. 84, no. 4: August: 677-700.
  - Although the paper deals with monetary expansion/contraction under the fixed exchange rate, it is a seminal work on the possibility of welfare enhancing policy coordination in a game theoretic framework

Policy coordination [Blanchard's] Mundell-Fleming model

- [Q] Can this model handles a monetary policy (easing) spillover to another country?
- How can gross capital flows be treated?
  - Exchange rate would overshoot (depreciation followed by gradual appreciation that is UIP), but it may not have to be associated with volume (capital flows)
  - So, the foreign country would face the exchange rate appreciation of the own currency. That can be countered by the same size of monetary policy easing. Is this wrong?

Policy Coordination

- [Blanchard] Little welfare gains.
- [Q] Agreed. Additional skepticism to "coordination." Any penalty for deviation? A repeated game? To enforce coordination

Policy coordination – difficulty

- Ralph Bryant study in 1988 shows the difficulty
  - Model uncertainty
  - Disagreement among models
  - Enforcement mechanism?
  - Bryant, Ralph C., and others, eds. 1988. Empirical Macroeconomics for Interdependent Economies. Washington: Brookings
- I thought the literature on policy coordination became dead with this book.
- In practice second thoughts on the Plaza Accord by 1988. Initial enthusiasm had waned by 1988

- What is different this time with regard to “policy coordination” in the 21st century?

Capital Flows

- EM long complained that
  - A small open economy is like a small boat in the ocean. Only a small re-balancing of portfolio of institutional investors in AE has a sizable effects
  - There is a limit to macroeconomic response or interventions
  - So, they have used capital controls (mainly on inflows)

What a small open economy can do, when massive capital flows come?

- [Textbook answer]
  - Lower the interest rate
    - Narrow the interest rate spread;
    - But it may cause overheating and an asset bubble
  - Appreciate the exchange rate
    - That mitigate overheating from monetary easing
    - But it may cause the loss of export competitiveness
  - Intervention
    - If not sterilized, it leads to an asset bubble (same of monetary easing)
    - If sterilized, the interest rate differential remains and invites more capital inflows
    - Intervention may change the composition of inflows from FDI to short-term securities (this is bad)
  - Tighten fiscal policy
    - That mitigate overheating from monetary easing
    - But tax hike/expenditure cut or what?
  - Capital controls
    - That mitigates the problems above
    - But a bad reputation
  - Macro-prudential policy
    - Bubble burst tends to damage the financial system
    - Prevent/reduce risk of a bubble (mentioned above), like LTV

What's new? Compared to recent IMF positions

- Jonathan D. Ostry, Atish R. Ghosh, Karl Habermeier, Luc Laeven, Marcos Chamon, Mahvash S. Qureshi, and Annamaria Kokenyne (2011), "Managing Capital Inflows: What Tools to Use?" IMF Staff Discussion Note 11/06, available at: http://www.imf.org/external/pubs/ft/sdn/2011/sdn1106.pdf
- "First, capital controls may be useful in addressing both macroeconomic and financialstability concerns in the face of inflow surges, but regardless of the purpose, countries should first exhaust their macro policy options before implementing capital controls (or prudential measures that act as controls). The macro policy response needs to have primacy both because of its importance in helping to abate the inflow surge, and because it ensures that countries act in a multilaterally-consistent manner and do not resort to controls as a substitute for needed policy adjustments."
- [Q. Does Blanchard advocate capital controls differently?] Capital controls first? Or at least in parallel with macro?

Capital Controls

- [Blanchard] Capital controls may be preferred to Fx interventions
  - Capital controls: tax revenue (+)
  - Fx Interventions: quasi-fiscal costs (-)
  - Capital controls: no buffer for sudden outflows (-)
  - Fx intervention: contributes to self-insurance (+)
  - Capital controls: foreigners' portfolio shift (+ or -)
  - Fx intervention: foreigners' portfolio shift (+ or -)
- [Blanchard] "Thus, if the purpose is to limit the effects of AE monetary policy on the EM financial system, capital controls dominates FX intervention."
- [Q] Really? Why did Asian countries accumulate Fx reserves so much? Should they have adopted capital controls, instead?
- It seems that Asian countries are comfortable with large reserves as "self-insurance," and deeply skeptical of IMF as a lender of last resort. See Ito, Takatoshi, (2012) "Can Asia Overcome the IMF Stigma?" American Economic Review, vol. 102, no.3: 198-202.

Historical Note: First (?) approving mention of "capital controls" in an IMF document (Quiz, which year?)

- "In light of the recent experiences of countries that adopted measures designed to curb short-term capital inflows, it appears that, at least in the short run, the policies were effective in either reducing the volume of capital inflows or affecting their composition, or both. A conclusion, therefore, is that, if the capital inflows are perceived as being temporary, these types of policies may be effective, not least because they reduce potential future outflows and the economic costs of such turbulence."
- " … market-based controls may be more effective than quantity constraints."
- " … controls on capital outflows offer only limited relief from market pressure."

Answer to the Quiz: Citation of the preceding slide

- International Monetary Fund, *International Capital Markets: Developments, Prospects, and Policy Issues*, Washington D.C., August 1995: p.108

- The ICM is a predecessor of IMF, Global Financial Stability Report (GFSR), written in the Research Department
- The document, published in 1995, was in response to the Mexican crisis; but unfortunately, largely forgotten and the orthodoxy returned until the efforts by Blanchard and Ostry