Managing Financial Flows: Issues and Challenges in Conducting Monetary Policy

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The Trilemma

A country can only achieve two of the following three good things:

- Freely mobile capital
- A fixed (or, in general, managed) exchange rate
- Monetary autonomy

Although intermediate solutions (giving up some of more than one thing) are always possible

Origins

- Hume’s model of the Gold Standard said that in the long run a country’s exchange rate implies a particular value of the money supply
- Mundell’s work in the 1960s showed that a similar proposition holds in the short run with perfect capital mobility
- Because capital flows in/out until the money supply is at its equilibrium level.

Perfect Capital Mobility

Definition: even a microscopic difference in the rate of return brings/repels an indefinitely large volume of funds

So it is compelled to have the same real rate of interest

If it has a separate currency, the same real rate implies that nominal interest plus the expected rate of depreciation equals “the” foreign interest rate

Why capital mobility may not be perfect:

- Exchange rate bands
- Need for someone to take an open position
- If the behavioural model of the exchange rate (De Grauwe and Grimaldi) is right, not all actors in the FX market are fundamentalists.

Empirical Results on the Trilemma

Regression of interest rate changes on changes in the base country's interest rate

- With exchange-rate regime, capital controls, as independent variables
- Consistent results:
  - All types of countries have positive coefficients on the base interest rate (common shocks?)
  - Countries with currency pegs have higher coefficients
  - Countries with capital controls have lower coefficients
  - But even pegged countries without capital controls have coefficients only in the range of 0.4 to 0.6.

Obstfeld, Shambaugh, and Taylor

Weak Form of Trilemma

Thus the results say the trilemma is directionally correct but does not pin down the interest rate/monetary policy

Central banks can still pursue monetary policy directed at domestic objectives, but a given divergence from the international norm will require larger reserve changes

And it follows that there is still some scope for sterilized intervention (as the empirical evidence seems to say).

Monetary Target

- The established principle (since Keynes) is that monetary policy should be directed at domestic stabilization
  - Described as "internal balance" in Keynesian heyday
  - Now inflation targeting, but practical impact usually similar
- Mundell's fiscal-monetary mix of the 1960s assigned monetary policy to external balance, but floating permits a reversion to the traditional objective.

External Balance

- Important in early postwar years
- Mundell’s mix suggested it could be achieved on the cheap
- Importance of target has dwindled with floating (although some of us attempted to define it as the current balance that would match the average capital flow over the cycle)
- Nowadays the most that is commonly regarded as significant is limitation of a *cumulative* net wealth position vis-à-vis the rest of the world
- Which may demand fiscal adjustment.

The Dilemma of a Trilemma EM

- Consider the problem of a typical EM with:
  - The non-extreme form of the trilemma
  - An inflation-targeting central bank
  - No flow target for the balance of payments
  - A desire to keep net foreign assets within bounds
- Healthy world growth provokes both the desire for high interest rates at home and a capital inflow
- High interest rates maintained by sterilizing the inflow invites a further inflow and more reserve accumulation
- Alternative is a real appreciation (inflation if it eases intervention, inflation if it eases sterilization)
- I.e. a danger of Dutch disease
- Problem is more acute if the behavioural theory is right.

Ways of Mitigating the Conflict

- Fiscal policy—but political economy may limit its use
- Ease import restrictions--if they still exist
- Liberalize capital outflows—if it won’t make the problem worse
- Declare a reference rate for the exchange rate—if it’s effective
- But a country may not have an alternative to capital controls.

Capital Controls

- Standard objections:
  - Creation of distortions
  - Opportunities for corruption
- So seek a mechanism that changes the cost calculus but leaves the ultimate decision with the investor
- Examples:
  - Prudential bank regulations—but not a good anti-cyclical instrument
  - Increased reserve ratio of banks
  - Switch public sector deposits from commercial banks to central bank
  - Impose a compulsory deposit on capital inflows (like Chile did)
  - Tax inflows
  - Tax more highly interest income earned by foreigners.

Why So Much Resistance to Capital Controls in Any Form?

- Given a fear of Dutch disease, given the desire to stabilize, case for is strong
- Case against cannot rely on growth
  - Prasad, Rogoff, Wei, and Kose 2003
- Essentially ideological
- Note that the desire to avoid Dutch disease is not the same as running a massive surplus which is not essential to export-led growth
- Classic East Asian model of export-led growth was prior to 1997 when most E. Asian countries had c/a deficits, thus high investment, therefore high growth.

Mrs Machlup’s Wardrobe

- In 1966 Fritz Machlup argued that central bankers’ desires for reserves were paralleled by his wife’s desire for new clothes: both liked a bit more than last year, rather than having rational demands
- At the time we thought he had correctly diagnosed the typical central banker as mildly irrational
- But there is another possible explanation: that even if they like more reserves than last year this is to safeguard themselves against speculative attack because speculators get nervous if they see a decrease
- Implication: a capital inflow cannot be stored for future use, if the recipient wants to use capital inflows to finance investment, then he needs to run a simultaneous c/a deficit.

A Note on High Reserve Accumulation

- Generally believed that countries paid a high price for large reserves
- Cost in terms of:
  - High price in terms of interest foregone
  - And difficulty in combating inflation
  - Though some people argue this was mitigated by gain in stimulating export-led growth
- If in fact reserves have bought little protection, reserve-accumulation has been carried altogether too far.

Conclusions

- There is an inherent trilemma
- But only of the “weak” form
- Which makes life more difficult but does not preclude the possibility of managing the economy and resisting Dutch disease
- Given the importance of these two objectives, it is surprising that the opposition to all forms of capital control is so intense.