

# Managing Capital Flows

How to combine capital controls, macro prudential tools, FX intervention, and the policy rate

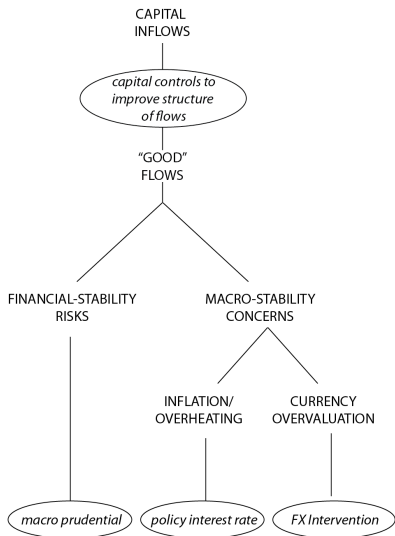
Olivier Blanchard    Jonathan Ostry  
Atish Ghosh        Marcos Chamon

Discussion by Mark Aguiar

# Policy Goals

- ▶ Manage capital flows to emerging markets (EM)
  - ▶ Separate “good” from “bad” flows
  - ▶ Distinguished by maturity
- ▶ Focus on stability
  - ▶ Prevent over-heating
  - ▶ Financial stability
- ▶ Policy Tools:
  - ▶ Policy Rate
  - ▶ Capital Controls
  - ▶ Macro-Prudential Policy

Figure 1. The Simple Mapping



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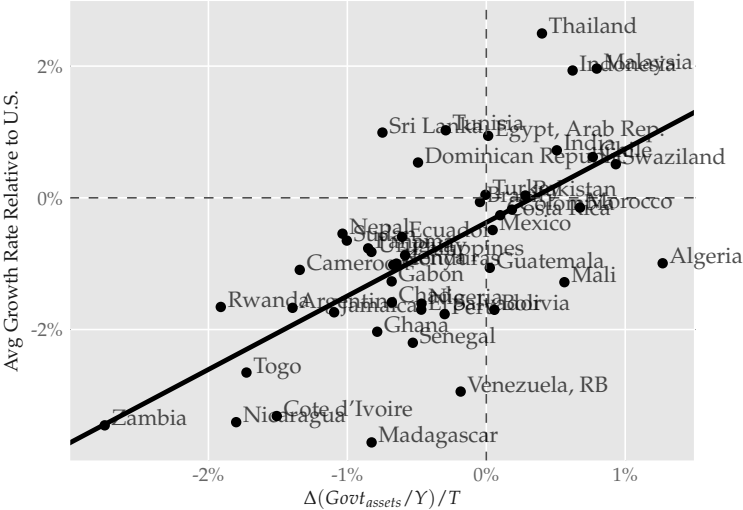
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  - ▶ Their question: Net inflows are useful for EM, but how to manage risks?
  - ▶ Correct question: [Are net inflows useful?](#)

# The Allocation Puzzle and "Growth in the Shadow of Expropriation"

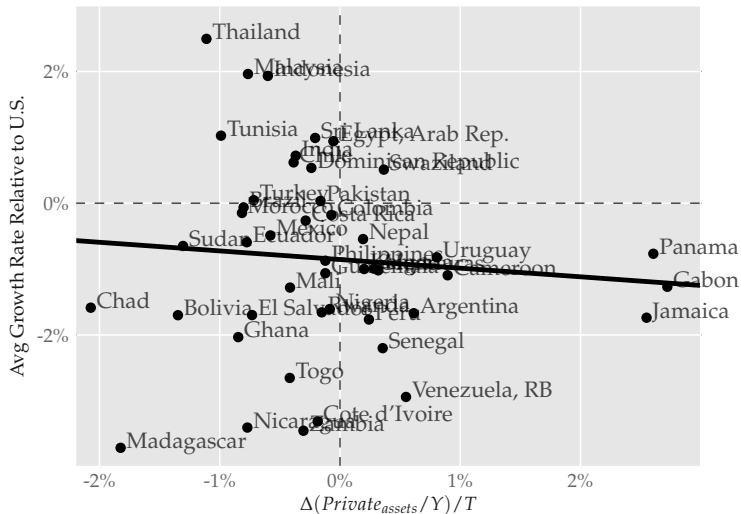
Public Flows





# Allocation Puzzle

## Private Flows



# Good and Bad Capital Flows

- ▶ EM with above-average growth records tend to have governments that accumulate net foreign assets (pay down debt and/or accumulate reserves)
- ▶ Simultaneously have private net inflows
- ▶ Missing from figure: Hidden public inflows via banking system

# Good and Bad Capital Flows

- ▶ EM with above-average growth records tend to have governments that accumulate net foreign assets (pay down debt and/or accumulate reserves)
- ▶ Simultaneously have private net inflows
- ▶ Missing from figure: Hidden public inflows via banking system
- ▶ Works in practice, but does it work in theory?

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- ▶ Reverse sign of private and public flows not a coincidence!
- ▶ Indebted governments are tempted to engage in distortionary policies
- ▶ Holding assets provides insurance as well as commitment not to expropriate
- ▶ Government assets “crowd in” private investment

# Policies

- ▶ Paying down sovereign debt and/or accumulating reserves may require distorting aggregate saving behavior
  - ▶ Tax on borrowing or subsidy to saving
  - ▶ Difficulty is running surpluses in good times – political economy frictions key impediment to growth

# Policies

- ▶ Paying down sovereign debt and/or accumulating reserves may require distorting aggregate saving behavior
  - ▶ Tax on borrowing or subsidy to saving
  - ▶ Difficulty is running surpluses in good times – political economy frictions key impediment to growth
- ▶ Reduced domestic demand may prevent over-valuation of exchange rate
  - ▶ Accumulation of public assets not necessarily driven by exchange rate policy (more than sterilized intervention)
  - ▶ Growth not necessarily due to under-valuation
  - ▶ These are by-products of optimal policy due to lack of commitment and political economy distortions

## More on Over-valuation

- ▶ Goldfajn and Valdes documented quite convincingly that over-valued exchange rates are “unwound” dramatically
- ▶ Downward nominal rigidity makes the alternative very costly
- ▶ Over-valued exchange rate is perhaps best predictor of oncoming crisis
  - ▶ Preventing debt-fueled public and private consumption booms seems to be useful for both long-term growth and short-term stability



# Taking Stock

- ▶ Not clear that aggregate net inflows are important for growth
- ▶ Public-sector outflows associated with private inflows as well as faster growth
  - ▶ “Bad” flows are public (including banks) and “good” flows are private
- ▶ No tough tradeoff between long-run growth and short-run stabilization policy
- ▶ Difficult policy to implement due to political economy frictions

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- ▶ Robust solution to both is lower debt-to-GDP
- ▶ Maturity Management:
  - ▶ Short-term debt provides greater incentive to reduce debt (mitigates commitment problems)
  - ▶ Longer maturity provides safety from roll-over risk
- ▶ Possible approaches:
  - ▶ Long-term debt plus conditionality
  - ▶ Short-term debt plus LOLR (*but* domestic currency debt is no panacea)
  - ▶ Variable-rate long-term debt with a cap