Discussion of "Integrated Monetary and Financial Policies for Small Open Economies" by Basu, Boz, Gopinath, Roch, and Unsal

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UC Berkeley and NBER

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Exchange-rate systems: More controlled flexibility since the late 1990s

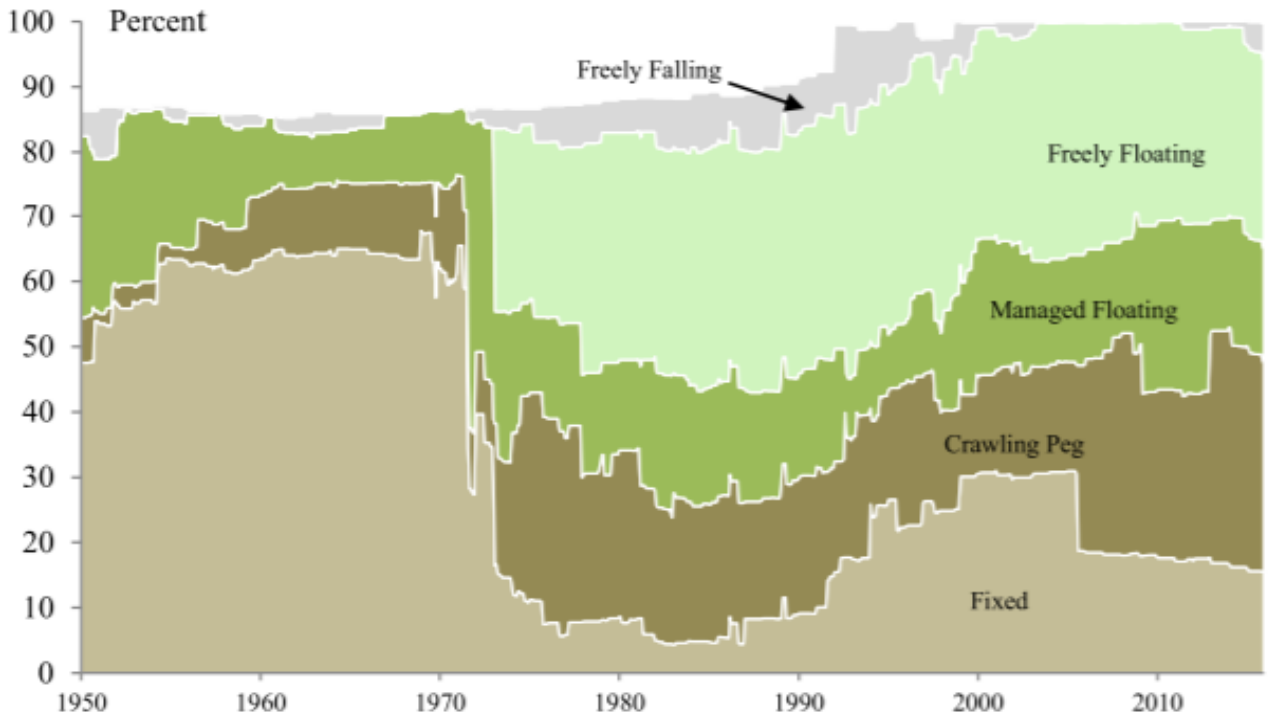


FIGURE IV

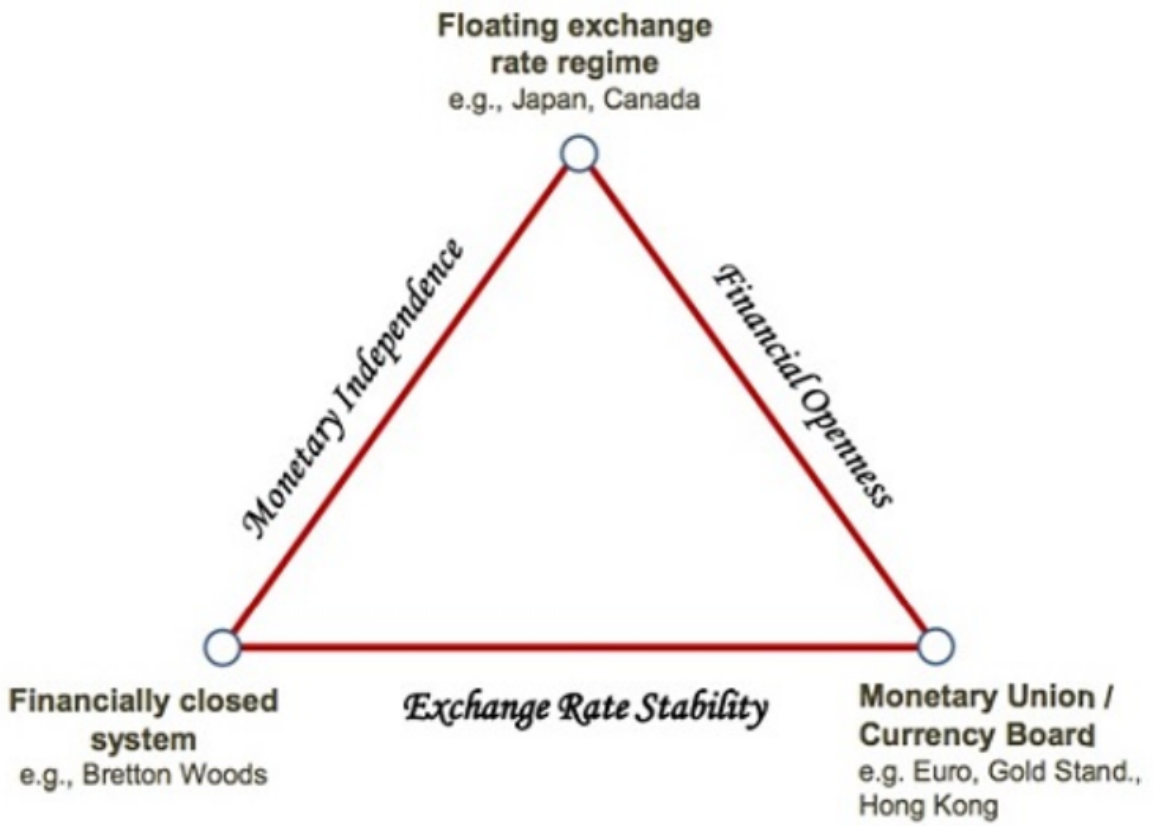
De Facto Exchange Rate Arrangements, Coarse Classification, 1946–2016: Share of World GDP in Each Group

Source: Ilzetzki, Reinhart, Rogoff (2019)

Key concept: The international monetary trilemma

Pick two out of three:

- Exchange-rate stability
- Open financial account
- Monetary policy autonomy



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  1. How to use capital controls?
  2. How does monetary policy change if macroprudential tools are available?
  3. What if financial frictions deliver FX intervention as an additional tool?

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- **This paper** is welcome because it shows how all these tools can be complementary – opening the door to more balanced advice to EMDE members of the Fund

A general point about policy from Stanley Fischer

Not infrequently we hear central bankers say something like: "We have only one instrument – money growth (or the interest rate) – and so we can have only one target, inflation." This view may be based on the targets and instruments approach of Tinbergen, of over 50 years ago, the general result of which was that you need as many instruments as targets. That view is correct if you have to hit the target exactly.

But it is not correct if the problem is set up as is typical in microeconomics, where the goal is to maximize a utility function subject to constraints, in a situation where for whatever reason it is not possible to hit all the targets precisely and all the time. Among the reasons we may not be able to hit our targets precisely and all the time is that there may be more targets than instruments, for instance when the central bank's maximand is a function of output and growth. In that case we have to find marginal conditions for a maximum, and to talk about trade-offs in explaining the optimum.

Source: Israel Economic Review, 2010

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- The necessary optimality conditions are:

$$\frac{\partial L/\partial w_1}{\partial L/\partial w_2} = \frac{\mathrm{d}w_2}{\mathrm{d}w_1} = \frac{\mathrm{d}w_2}{\mathrm{d}\tau}\frac{\mathrm{d}\tau}{\mathrm{d}w_1} = \frac{g'(\tau)}{f'(\tau)}$$

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- When there are $N > 2$ targets and $M < N$ instruments, life becomes more complex–and in dynamic settings there are tradeoffs across time

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2. Interactions among instruments will likely be important
3. You will be forced to trade off different goals – so anything you can do to make the tradeoffs more palatable will be welcome (ex ante measures)

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- Is this rationale for capital (inflow) controls the right one; and is it empirically important?
- One might worry more about appetite shocks fueling excessive lending (a macroprudential issue) or causing an appreciation that squeezes the export sector and thereby weakens external sustainability

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- Define the Lagrange multiplier Ψ_B in the main text, please

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- Under both regimes, doesn't market segmentation open up another welfare-relevant wedge: between home and foreign prices of the same home-produced good?