Inflation and Capital Flows: Discussion

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Special Thanks to FLAR and BCRP...

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...where I have tried to learn about inflation, K flows, and monetary policy (and remembering Renzo Rossini)

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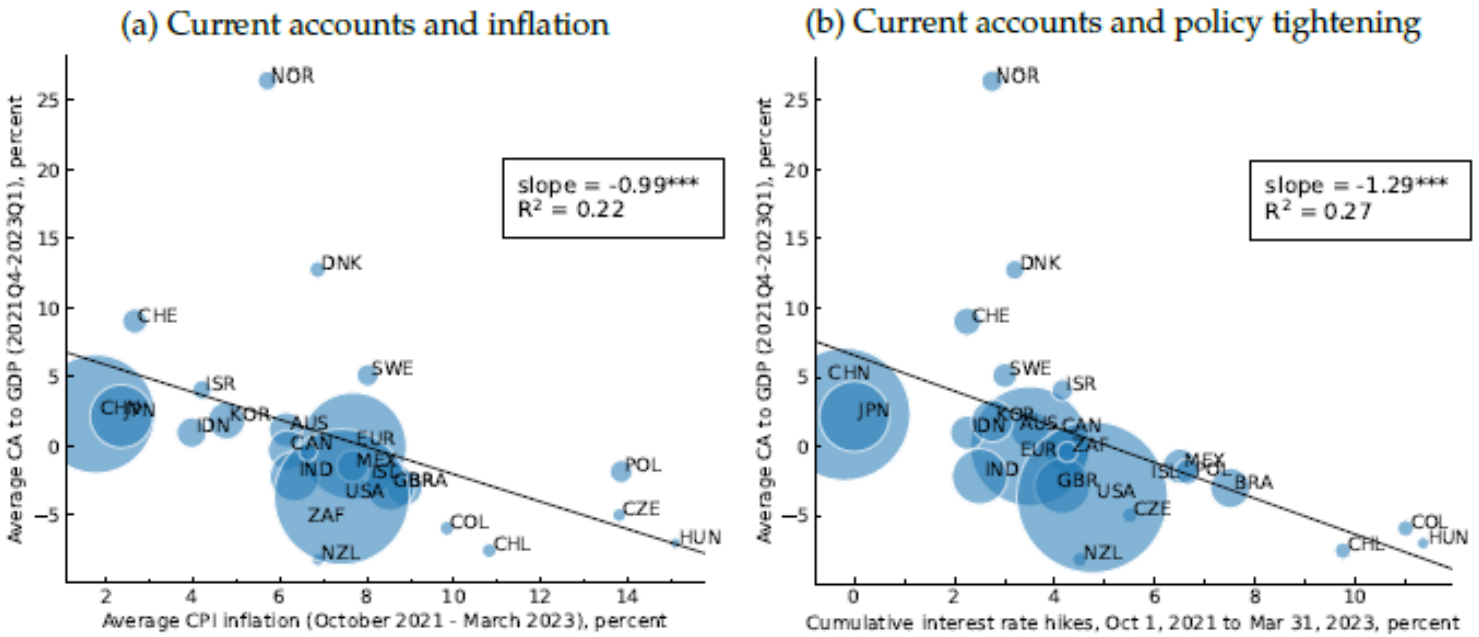
==> The paper's answers: **yes** and **yes**

Some Evidence



- Presumably, countries that had stronger inflationary pressures needed to tighten more
- (A suggestion: graph CA vs **output gaps**)

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- **Supply shock** hits Home country
- Analysis of "**optimal**" monetary policy with and without **capital controls (free K mobility vs managed K flows)**
- "Optimal": world welfare = **sum** of countries' welfare, full cooperation and commitment

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    - Capital inflows increase marginal production costs (because of labor supply effects or real appreciation)
    - In so doing, it worsens the inflation-unemployment tradeoff for the affected country
    - From a **world** viewpoint, it would be welfare improving for capital flows to move in the opposite direction

Basic Framework for the Analysis

Mostly standard two country open economy model leading to

$$\dot{\pi}_t^W = \rho\pi_t^W - \kappa(1+\phi)y_t^W - \kappa u_t^W,$$
$$\dot{\pi}_t^D = \rho\pi_t^D - \kappa\left[\left(\frac{1}{\eta}+\phi\right)y_t^D + \frac{1}{2}\theta_t\right] - \kappa u_t^D.$$

where the W and D denote **world sums and differences** (as in Aoki 1981), e.g.

$$\begin{aligned} y_t^W &= y_t + y_t^* \\ y_t^D &= y_t - y_t^* \end{aligned}$$

u_t, u_t^* are supply shocks, and θ_t is the **consumption differential**:

$$\theta_t = c_t - c_t^*$$

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Special assumptions so that the **world** welfare function can be expressed as

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- **Not really necessary**: Sutherland, Benigno-Benigno

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- This relation could be checked against the data, as noted earlier

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- Policy: the Home country, hit by adverse supply shock, should give its citizens an incentive to reduce consumption (even more, presumably) and invest abroad

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Consider small variations $d\theta_t = x$ and $dy_t^D = z$ that keep other variables the same. Then (x, z) must satisfy:

$$\left(\frac{1}{\eta}+\phi\right)z + \frac{1}{2}x = 0$$

Recalling the world objective:

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Setting to zero and combining with previous slide, we obtain the crucial condition

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- (This is possible if the policy, at the same time, makes the foreign country better off and the improvement in the Foreign country is quantitatively larger than the damage to Home)
- Need to examine the welfare consequences **for each country in isolation**, not only the overall welfare effect

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- The paper illustrates this idea in a simple, attractive framework

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- Most fundamentally: I am skeptical about the maintained assumptions about the world planning problem

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- As a consequence, **the "optimal" policy with managed K may be not Pareto superior to free K mobility**
- Hard to "sell" (e.g. would you tell Home agents that they need to curtail consumption, even if they lose, if their loss is smaller than the gain to Foreigners?)

- Symmetry may be defensible, but analysis is not robust to simple monotonic transformations of utility

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- If the outside option is the free K mobility outcome, the solution would most probably differ from the paper's solution

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- **Thank you!!**