

Managing Capital Flows

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

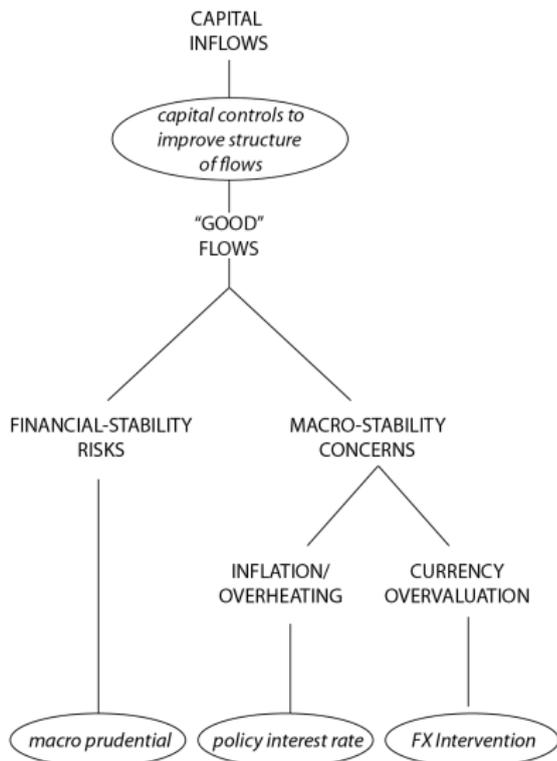
Olivier Blanchard Jonathan Ostry
Atish Ghosh Marcos Chamon

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



Comments

- ▶ Agree with the authors' answers

Comments

- ▶ Agree with the authors' answers
- ▶ Disagree with their question

Comments

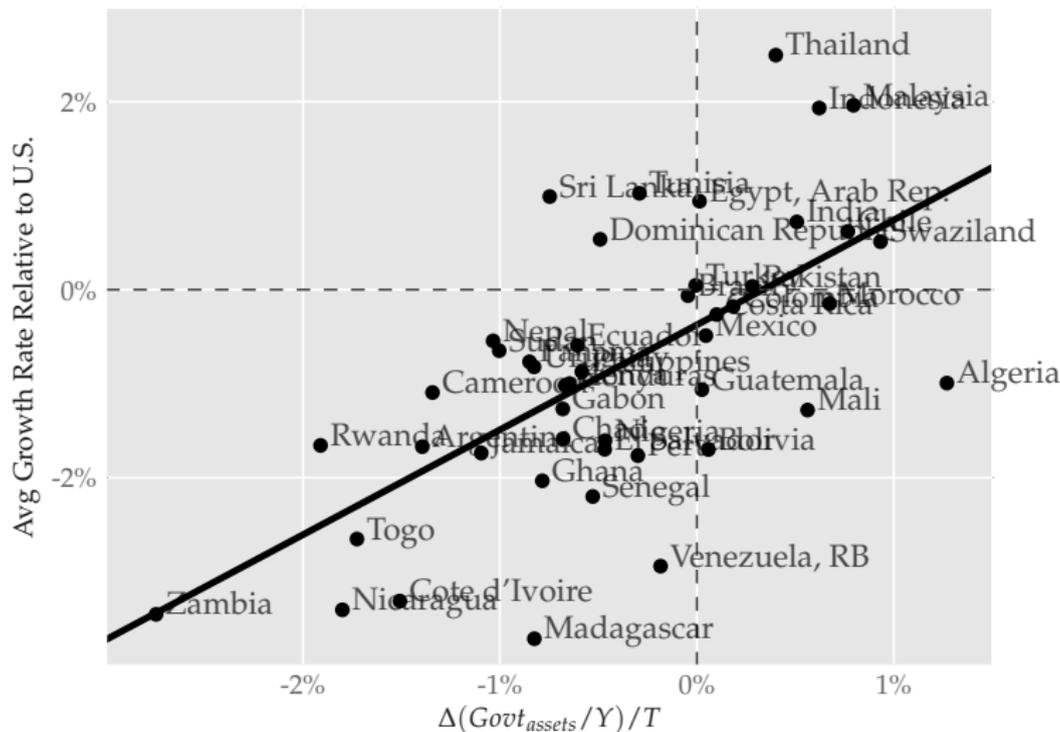
- ▶ Agree with the authors' answers
- ▶ Disagree with their question
 - ▶ Their question: Net inflows are useful for EM, but how to manage risks?

Comments

- ▶ Agree with the authors' answers
- ▶ Disagree with their question
 - ▶ Their question: Net inflows are useful for EM, but how to manage risks?
 - ▶ Correct question: [Are net inflows useful?](#)

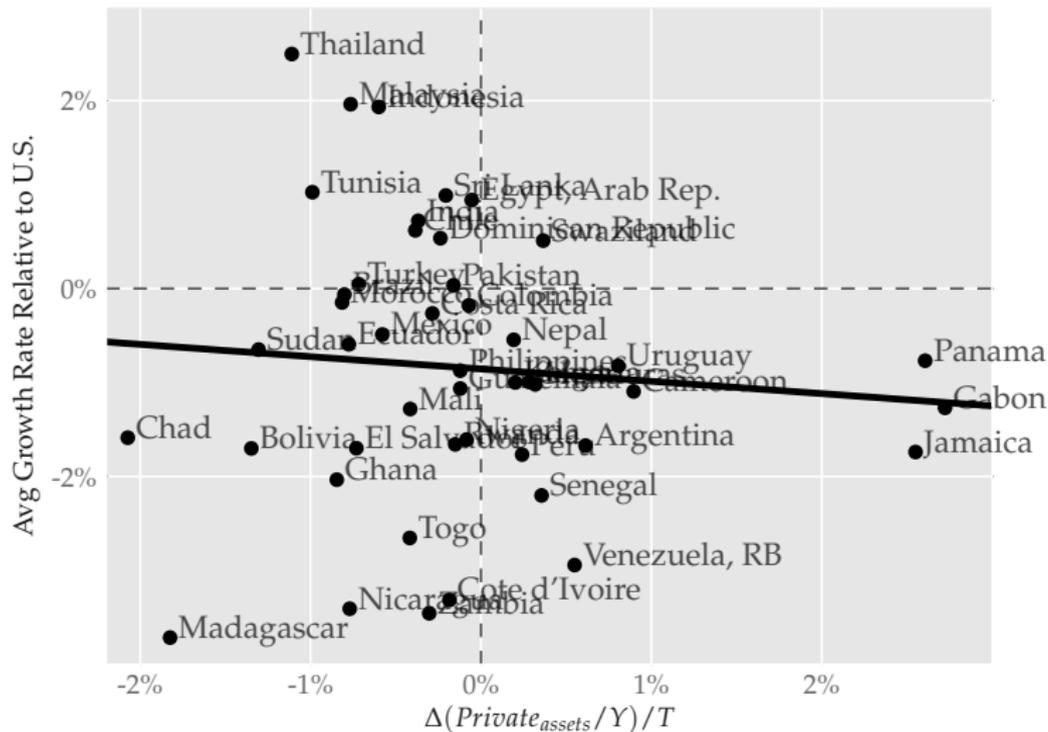
The Allocation Puzzle and “Growth in the Shadow of Expropriation”

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?

Tradeoff between Public and Private Flows

- ▶ Reverse sign of private and public flows not a coincidence!

Tradeoff between Public and Private Flows

- ▶ 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

Maturity

A Real Tradeoff

- ▶ Countries with large debt-to-GDP ratios face default risk from two sources: Fundamental Risk and Rollover Risk

Maturity

A Real Tradeoff

- ▶ Countries with large debt-to-GDP ratios face default risk from two sources: Fundamental Risk and Rollover Risk
- ▶ Robust solution to both is lower debt-to-GDP

Maturity

A Real Tradeoff

- ▶ Countries with large debt-to-GDP ratios face default risk from two sources: Fundamental Risk and Rollover Risk
- ▶ 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

Maturity

A Real Tradeoff

- ▶ Countries with large debt-to-GDP ratios face default risk from two sources: Fundamental Risk and Rollover Risk
- ▶ 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