

# **International Capital Flows: Preferences, Pathologies, and a Patchwork of Policy Responses**

**David Vines**

Economics Department, Balliol College, St Antony's College and  
Oxford Martin School, Oxford University;

Centre for Economic Policy Research, London

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# 1 Preliminaries

## 1.1 The possibility of an independent monetary policy

### *The Impossible Trinity*

- It is not possible to have all three of fixed exchange rates, open international markets and an independent monetary policy
  - Analysis using Mundell Fleming model

### *The Conventional Wisdom on what is possible*

- It *is* possible to have independent monetary policy, in a world of open international markets, providing exchange rates are floating
  - Analysis using Mundell Fleming model
- “It is difficult to think of plausible economic mechanisms through which globalization should impair in any substantial way the ability of central banks to control domestic inflation through national monetary policy.” *Michael Woodford, 2007*

### *The Conventional Wisdom on the virtues of opening international capital markets*

- The implication was that it was in the interests of emerging market economies to fully open international capital markets

## 2 Preferences

### 2.1 The Global Credit Cycle a la Helene Rey

*Helene Rey's empirical attack*

- “There is a global financial cycle in capital flows, asset prices and in credit growth... The global financial cycle is not aligned with countries’ specific macroeconomic conditions. In a number of countries, this can lead to excess credit growth (or alternatively to monetary conditions which are too tight) ... Our VAR analysis suggests that one important determinant of the global financial cycle is monetary policy in the center country, which affects leverage of global banks, credit flows and credit growth in the international financial system. This channel invalidates the “trilemma”, which postulates that in a world of free capital mobility, independent monetary policies are feasible if .... exchange rates are floating.” *Helene Rey, 2015*

- This wake up call was given prominence in the 2014 Mundell Fleming Lecture

- Hyun Shin has produced closely related work

## **2.2 The analytical implications of Helene's empirical attack**

-Woodford's ideas based on "uncovered interest parity" (UIP)

- An unjustified application of the "efficient markets hypothesis" to the global economy

-We no longer believe that the exchange rate will necessarily smoothly move so that expected changes exactly compensate for differences between home foreign interest rates.

- As a result independent monetary policies may cease to be easily obtainable

-UIP must be replaced with a careful analysis, using modern portfolio theory based on investor preferences, of the international allocation of investment portfolios in the face of differing risks and return across countries

- Sometimes independent and effective monetary policy is possible – the recent case of Australia is a spectacular example – but sometimes it is not.

## **2.3 Towards a model of investor preferences and portfolio allocation**

-A number of us are beginning to produce a new modelling framework, including my Oxford student Dylan Smith

# 3 Pathologies

The new modelling framework can be used to study:

- The international transmission of the effects of monetary policies in the US economy (the global credit cycle)
  - The very large inflows of capital which may occur in emerging market economies and which may be very difficult to manage
  - The very large outflows of capital which may occur in emerging market economies and which may be similarly difficult to manage
- The sudden stops which may occur in emerging market economies as a result of the revaluation of risk attached to such economies

# 4 Patchwork of Policy Responses

This new modelling framework suggests three important policy responses

## 4.1 The (non)-implications for the international coordination of macroeconomics policies

- A number of distinguished economists from emerging market economies have called for international macroeconomic cooperation, to protect them from their vulnerabilities.
- For example, Raghuram Rajan, Governor of the Reserve Bank of India, has complained that the tapering of quantitative easing has been carried out without sufficient regard for international spillovers and has called for the US Federal Reserve to ‘be aware’ of the interests of other countries (Wessel, D. (2014)).
- But this is difficult. In the words of the Australian Treasurer, Joe Hockey:
  - “There is no doubt that the Fed needs to be aware of these international implications in detail, and be mindful of them. ... [However] ultimately, the Fed has to operate in a manner that is consistent with its domestic mandate.”
- Instead there have been calls for capital controls to protect emerging market economies from shocks. These have come both from the IMF and from Olivier Blanchard (former chief economist of the IMF)

## 4.2 A need for Capital Controls within in Emerging Market Economies

- The IMF's 2012 note *The Liberalization and Management of Capital Flows*, sets out the Fund's new "Institutional View" on the question of capital controls.
- The paper discusses management of large or sudden inflows and outflows separately, and makes similar sets of recommendations in both cases:
  - The use of capital controls should follow only after exhausting macroeconomic policy options (such as monetary policy and exchange-rate stabilisation interventions), but it does have a role.
  - Capital controls should be *targeted, temporary, transparent*, and part of a broader package of stabilising interventions.
- There are implications for macroeconomic policy in emerging market economies
  - Implications for both the appropriate form of nominal anchor and exchange rate policy
  - Implications for the appropriate form of defence from shocks

### **4.3 Implications for the Global Financial System: a need for the provision of international financial liquidity for emerging market economies**

- In a world of (some limited) capital controls there is a need for international cooperation to support emerging market economies, by providing foreign exchange liquidity to them.
- There are two ways in which this can happen
  - The first form of cooperation would involve strengthening and expanding facilities at the IMF, such as the Flexible Credit Line (FCL) and the Precautionary Credit Line (PCL).
  - The second form of cooperation is through currency swaps between central banks.
- There are difficulties in the face of both of these options
  - The first brings reputation risk
  - The second has severe governance problems
- Two necessary sets of policy developments
  - Improve provision of the safety net, through the IMF, and through regional facilities, for non G7 countries
    - Regional provision requires strong binding into IMF provision
      - See discussion in session 3
  - Regularise the provision of swaps for all G7 countries, particularly China

