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How should the crisis affect our view of capital account management?

Background Note for Session IV– Monetary Policy
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The crisis showed the tight links financial globalization has created across countries. Large capital outflows created serious funding problems. Balance sheet effects, affecting either ultimate borrowers or financial intermediaries often led to perverse effects of depreciation.

The post crisis shows the tensions coming instead from large capital inflows. Many emerging market countries are considering---and some are actually implementing---capital controls. They often blame policies in advanced countries, from low interest rates to quantitative easing policy, for generating excessive and volatile capital flows.

Where do we stand on the issue of financial openness? More specifically, how should countries deal with capital flows? What combination of macro policy and macro prudential responses should they use, and when should capital controls come into play? What should be the rules of the game?

Taking these questions in turn:

I. Macroeconomic response

What is the right macroeconomic response to high capital inflows? The basic principles laid down by the Fund are that the country should use monetary and fiscal policy with three objectives in mind: Let the exchange rate appreciate to the point where it is fairly valued. Do not accumulate reserves beyond precautionary needs. Try to maintain output close to potential, so as to maintain stable inflation.

Are these the right principles? And what do they mean in practice? Suppose a country had a correctly valued exchange rate before capital flows increased. What is the "correct" exchange rate given the increase in capital flows? Just like the exchange rate, the appropriate level of reserves depends on the flows themselves. So what is the appropriate level of reserves in this context?

II. Macroprudential response, and the role of capital controls.

What is the right macroprudential response to high capital flows? Tentative principles might be that macro-prudential tools---from balance sheet restrictions, to loan to value ratios, to

foreign exchange restrictions---can be used to limit the adverse effects of high inflows on either macro or financial fragility. Then and only then, if these measures are still insufficient, for example if capital flows are not intermediated and thus not easily subject to macro prudential tools, should capital controls be considered. Are these the right principles? Why should capital controls come last in the list? If ruling out discrimination against foreign residents is what justifies the ordering, what about macro prudential measures, such as FX restrictions, which often de facto discriminate against non residents, and have a clear effect on capital flows?

III. Multilateral rules of the game?

More generally, what should be the rules of the game (if any) be in terms of reserve accumulation, and in terms of capital controls? Reserve accumulation beyond a reasonable precautionary saving level may or may not be in the interest of a country, but isn't it for the country to decide? Or should it be banned on multilateral grounds? Should countries be left to choose whether or not to use capital controls, or should there be multilateral rules as well? If the answer is yes, can realistic rules be designed? Do the countries of origin also have some responsibility? Suppose for example that the main effect of QE2 is to encourage carry-trade type flows. Should the Fed be restrained? If so, does the argument extend to monetary policy more generally?