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Olivier Jeanne

Johns Hopkins University and Peterson Institute for International Economics

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Capital controls to deal with booms and busts in capital flows: should they be part of the **"new normal"**?

1. The case for capital controls

2. Common objections

My remarks draw on Jeanne, Subramanian and Williamson (2011).

1. <u>The case for capital controls</u>

- Emerging market economies are subject to fluctuations in their access to foreign capital.

- We have a better theoretical understanding of the kind of stabilizing policies that are called for:

    - the "new welfare economics" of capital controls

An analogy:

- Abundance and droughts in a common water pool.

- Textbook solution: Pigouvian tax on water in periods of abundance.

Application to capital flows:

- Unrestrained reliance on foreign capital in good times can lead to “congestion externalities” and economic disruption in bad times.

- Over-reliance on foreign capital in good times must be curbed by a Pigouvian tax.

Other versions of the same basic argument:

- Buildup of financial fragility during booms (Korinek, 2010; Bianchi, 2011).

- Currency appreciation leading to excessive erosion of export capacity (Caballero and Lorenzoni, 2009).

- Each externality calls for a particular form of taxation: but a tax on inflows has nice properties as a general-purpose instrument.

2. **Common objections**

- Capital controls are ineffective or have significant unintended costs.

- One can use other policy instruments.

Capital controls are circumvented:

- Taxing the rich is harder work than taxing the poor:
    - a general problem in financial regulation;
    - suggests broad tax base and moderate tax rate;
    - "spread-the-weight": use all the policy levers in moderation.

- Evidence suggests that capital controls are effective at least in affecting the composition of capital inflows.

- Capital controls have costs for the economies that impose them:

  - negative impact on credit, investment and growth;

- But isn’t this what the controls are supposed to do (to some extent)?

- Capital controls have costs for the rest of the world.

- They reduce global demand, and may hinder global rebalancing.

- But a tax of a few percentage points can affect the real exchange rate by a few percentage points, no more (Jeanne, 2011).
    - Chinese-style controls are another matter.

- Capital controls are a collective concern: this may warrant international oversight.

- <u>Other instruments can be used:</u>

- ➢ fiscal policy;
- ➢ accumulation of international reserves;
- ➢ macroprudential regulation.

- On balance, I agree with Ostry et al. (2010) that capital controls have a distinct role to play.

- But why should they be used only as a tool of last resort?

Conclusion

- Why can't we relax about (the right kind) of capital controls?

- Two reasons to have some form of international oversight:

  - reduce stigma;
  - international spillovers.