ECO 407
Competing Views in Macroeconomic Theory and Policy

Lecture 11
Should Financial Flows Be Regulated?

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The Breaking-Up of Macroeconomic Consensuses

- Subbarao (2014) reminds us that important macroeconomic ***consensuses*** were broken as a result of the Great Recession
  - The movement towards a fully open ***capital account*** came to a stop
  - Intervention in ***foreign exchange*** markets came to be seen as desirable
  - It became acceptable the use of ***capital controls*** as a short-run stabilization tool

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Traditional Arguments in Favour of Unrestricted Capital Flows

- Advocates of financial liberalization have ***faith*** in the ***efficiency*** of markets
  - They believe government regulations would introduce ***inefficiencie***s
- Regarding capital movements, orthodox economists make a ***leap*** from the ***national*** to the ***international*** economy
  - But there are differences between purely ***domestic*** financial transactions and ***international*** ones
  - Arguments are based on ***microeconomic*** logic and do not take into account ***macroeconomic*** concerns
- Advocates associate ***free*** capital mobility with
  - Greater economic ***growth***
  - Better ***allocation*** of financial resources

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Benefits and Costs of Financial Liberalization (*Santor & Schembri*)

- There appears to be a weak relationship between capital account liberalization and ***economic growth***
- Investment should increase in countries where savings are too low through ***capital inflows***
  - But savings are high in emerging market economies
- Opening the capital account too early can result in ***negative*** economic outcomes
- Evidence suggests that capital account liberalization can be beneficial when conducted in the ***proper sequence***
- Nonetheless, the authors conclude that financial liberalization is a ***key determinant*** of ***long-run*** economic growth

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Orthodox View of Domestic and Foreign Savings

- Orthodox economists see ***investment*** as an almost ***automatic outcome*** of the social decision to ***save***

- Therefore, they believe ***foreign savings*** would also contribute to increasing ***investment***
  - They implicitly assume that ***foreign savings*** complement ***domestic savings***

- They associate ***free*** capital mobility with a better ***allocation*** of financial resources and greater economic ***growth***

- This view justifies the adoption of ***growth*** cum ***foreign savings*** policy
  - Rich countries should transfer ***capital*** to capital-poor developing countries

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Orthodox View of Foreign Savings and Investment

- Consider an economy with no government sector:

$$\mathbf{Y = C + I + NX}$$

$$\boxed{\mathbf{NX = -\,S_f}}$$

where $\mathbf{Y}$ is GDP, $\mathbf{C}$ is consumption, $\mathbf{I}$ is investment, $\mathbf{NX}$ is net exports, and $\mathbf{S_f}$ is the balance in the ***capital account*** (i.e., the so-called ***foreign savings***)

- Since $\mathbf{Y = C + S_d}$ where $\mathbf{S_d}$ is domestic savings, then

$$\mathbf{C + S_d = C + I - S_f}$$

$$\boxed{\mathbf{S_d + S_f = I}}$$

- But these are ***ex-post*** concepts, expressing mere ***accounting identities*** and not ***economic relationships***

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Arguments for Capital Account Regulations: The "Trilemma"

- It is difficult for a country to maintain the following three goals simultaneously:
  - Free capital mobility
  - Fixed exchange rates
  - An autonomous monetary policy
- The ***"Trilemma"*** or ***"Impossible Trinity"***: Countries can achieve at most only two of these three goals simultaneously
- If a country wants to keep a ***stable*** and ***competitive exchange rate*** and have an ***independent monetary policy***, then it must ***control capital mobility***

Arguments for Capital Account Regulations (*Ocampo*)

- ***Pro-cyclical*** capital flows are one of the major determinants of business cycles in emerging economies
  - Capital inflows are entirely delinked from their ***need for capital***
  - They have strong effects on major ***macroeconomic variables***
- Developing countries also have the disadvantage of having more ***"incomplete"*** domestic financial markets
  - Their capital markets are small relative to magnitude of the speculative pressure they face
- Capital flows exacerbate major macroeconomic trade-offs, reducing the space for ***counter-cyclical macroeconomic policies***

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Arguments for Capital Account Regulations (cont'd)

- Capital account regulations can be ***justified*** during ***boom*** periods
  - To avoid ***currency appreciation***, risk of rising ***current account deficits***, and useless accumulation of ***foreign exchange reserve***
- Capital account regulations can also be ***justified*** during ***crises*** to avoid the opposite macroeconomic impacts
- Opponents argue that capital market regulations ***segment*** domestic market from international markets
  - But this only recognizes the fact that markets are already segmented

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Objectives and Types of Capital Account Regulations

- The ***objectives*** of capital account regulations include:
  - To promote financial stability
  - To encourage desirable investment and financing arrangements
  - To enhance policy autonomy, including the maintenance of a stable and competitive exchange rate
- ***Quantity-based*** capital account regulations:
  - Prohibition of certain capital flows
  - Minimum stay periods
  - Restrictions on foreign investors
- ***Price-based*** capital account regulations:
  - Unremunerated reserve requirements on capital inflows
  - Taxes on flows
  - Larger reserve requirements for external liabilities

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The Empirical Evidence

- Regulation on both ***inflows*** and ***outflows*** can work, but most particularly on the former
  - But authorities must have ***administrative capacity*** to manage them

- Regulations help generate a mix of greater monetary autonomy, lower exchange rate pressure, lower magnitudes of flows, better composition of flows
  - Some of these effects may be ***temporary*** due to greater circumvention of regulations as time passes by

- There is not one capital account regulation that works ***best for all*** countries

- Countries with capital account regulations fared better during the ***2008 financial crisis***

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IFM's New View on Capital Controls

- Significant ***ideological*** shift → No longer telling developing countries to ***liberalize*** their capital accounts

- Recognizes that capital flows carry ***risks***, particularly when financial markets and institutions are not sufficiently developed

- Acknowledges that capital flows should be ***regulated*** to avoid effects of flow surges and sudden stops

- Points out that nations that are the source of excessive capital flows should pay attention to their ***negative spillover effects***

- Notes that its new view on capital flow management may be ***at odds*** with other international commitments (e.g., FTAs)

- Liberalization should be ***sequenced***, ***gradual***, and ***not the same*** for all countries at all times

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Shortcomings of the IFM View

- Continues to insist on long-run benefits of ***capital market liberalization*** despite the lack of evidence supporting it
  - No strong correlation between ***capital account liberalization*** and ***economic growth***
- Wrong to call for the use of regulations only once all other ***macroeconomic policy-options*** have been exhausted
- On the contrary, regulations should be used to avoid:
  - Excessive ***exchange rate*** appreciation
  - Excessive ***foreign exchange*** accumulation
  - ***Fiscal policy*** becoming hostage of private capital flows
- Wrong to stress that capital account regulations should be ***temporary*** and ***not discriminatory***

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