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Questions: How Should the Crisis Affect Our Views of Capital-Account Management?

The economic crisis that began in 2008 revealed the tight links that financial globalization has created across countries. Large capital outflows at the height of the crisis created serious funding problems. Balance-sheet effects, affecting either ultimate borrowers or financial intermediaries, often led to perverse effects of depreciation.

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

How should countries deal with financial openness—specifically, capital flows? What combination of macropolicy and macroprudential responses should they use, and when should capital controls come into play? What should be the rules of the game?

Macroeconomic Response

What is the right macroeconomic response to high capital inflows? The basic principles laid down by the International Monetary 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, and try to maintain output close to potential 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

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reserves depends on the flows themselves. So what is the appropriate level of reserves in this context?

The Macroprudential Response and the Role of Capital Controls

What is the right macroprudential response to high capital flows? Tentative principles might be that macroprudential tools—including balance-sheet restrictions, loan-to-value ratios, and foreign exposure limits—can be used to limit the adverse effects of high inflows on either macro or financial fragility. If these measures are still insufficient (for example, if capital flows are not intermediated and thus not easily subject to macroprudential tools), then (and only then) capital controls should be considered. Are these the right principles? Why should capital controls come last in the list? If ruling out discrimination against foreign residents justifies the ordering, then what should be done about macroprudential measures, such as foreign exposure limits, which often discriminate against nonresidents in practice and have a clear effect on capital flows?

Multilateral Rules of the Game?

More generally, what should be the rules of the game (if any) 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 shouldn't that be left up to the country to decide? Or should it be banned on multilateral grounds? Should countries be left to choose whether to use capital controls? Or should there be multilateral rules as well, and 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 the Federal Reserve's second round of quantitative easing is to encourage carry-trade-type flows. Should the Federal Reserve be restrained? If so, does the argument extend to monetary policy more generally?

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In the Wake of the Crisis

Leading Economists Reassess Economic Policy

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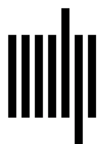

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