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Notes on Capital-Account Management

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In this chapter, I look at two sets of capital-account issues—country-specific dilemmas in dealing with large capital inflows and global equilibrium issues.

Country-Specific Issues

What are the conditions under which a real appreciation caused by large inflows is a problem? There are many specific channels through which a problem can arise, but the generic concern is that somehow the medium- and long-run health of the economy will be compromised by a sustained appreciation. To justify policy intervention, these concerns must be about externalities, either pecuniary or technological. I focus on the former.

A pecuniary externality can arise when there is limited domestic financial development and the export sector is not able to ride a temporary capital inflow spike despite its positive net present value. Even if capital flows are permanent, following, for example, a major oil reserve discovery, the speed of the appreciation may be too much for the noncommodity export sector to fund the required retooling.

To understand the mechanism, think about a temporary capital inflow that expands domestic expenditure and hence appreciates the real exchange rate. There is a potential for a negative externality in this context, even if we completely disregard the welfare of export producers. Consider what happens when the temporary capital inflow goes away. If the export sector is financially damaged, then it will take a much larger real depreciation (and hence expenditure contraction) for it to absorb the labor force released from nontradables. If consumers collectively could internalize this effect, then they would contain the

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initial surge in expenditure to reduce the real appreciation and its damage on a financially constrained exports sector. In this context, economic policy is a substitute for the lack of coordinated foresight of domestic consumers.

A second branch of externality arises from a domestic financial system that has its own agency problems, which are exacerbated by cheap external funding. Here the main direct problem is not the real exchange rate but the kind of risks undertaken by the domestic financial system.

Either way, taxing capital flows is a suboptimal and indirect policy for dealing with these issues. If the problem is mostly from excessive expenditure during the boom phase, then the right policies are expenditure stabilization ones, possibly coupled with the development of foreign-exchange hedging strategies for the noncommodity export sector. If the problem is one of imprudence of the domestic financial system, then the issue is more one of domestic financial regulation and supervision than of capital-flows control.

In practice—as with the appreciation problems of Brazil, for example—the first policy that comes to mind is fiscal policy, not taxes on capital flows. The genesis of the appreciation problem in Brazil is at best 10 percent due to the second round of U.S. quantitative easing and 90 percent due to domestic fiscal policy and exorbitant local market interest rates. Hence, attacking capital inflows is really an avoidance strategy.

Similarly, the problems of the United States that led to the crisis did not have much to do with the level of capital inflows (and hence with the current-account deficits). Instead, the problem was the extreme bias of these flows toward AAA fixed-income assets, which interacted very poorly with incentives in the domestic financial system to create and hold assets that may have been AAA from the point of view of microeconomic shocks but not from the point of view of macroeconomic ones. Here again, the problem is one of inadequate capital charges for AAA collateralized debt obligation tranches and related assets, not capital inflows.

Some have argued that these structural problems cannot be fixed at the right speed and that we therefore cannot afford to let capital flows exacerbate their cost. I am sympathetic to this argument, but the complete argument must be made. Countries must explicitly say: “I have a

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serious problem here, and hence I have to slow down capital inflows while I fix the real problem." Absent this complete statement, policymakers may end up chasing symptoms rather than the illness.

Global Equilibrium Issues

The supply side must be looked at, as well. What is the responsibility of the countries that trigger the capital flows, either by maintaining large saving rates or by feeding carry trade by keeping funding costs very low?

I find this case even harder to make than the domestic justification for taxes on capital flows. What business is it of the United States, France, or Brazil to decide what is the optimal relative saving rate for China or of Greece and Portugal to decide the same for Germany? These high-saving countries have been a source of stability, not instability, for the world economy.

In industrial organization, we worry about low prices (in this case, low interest rates) when these are part of a deliberate strategy to destroy competition and hike prices later. Are we really worried that the Chinese are keeping rates low so that they later can punish the debtor countries by raising rates quickly? I doubt it.

The same applies to concerns about the effects of the second round of qualitative easing around the world. I do not see why the United States should risk a repeat of the Japanese lost decade because an overheating emerging market feels uneasy about it. By stabilizing U.S. equity markets, QE2 ended up doing just the opposite that was feared and reversed capital flows to emerging markets. Imposing our own preferences about macroeconomic policy frameworks on others is not likely to be effective, especially when we do not even understand the mechanisms.

Conclusion

When you run a fever, don't attack the thermometer. Deal with the real issues.

For emerging markets, the main concern at this time is a combination of making fiscal adjustment and fostering the development of domestic

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financial markets and foreign-exchange derivatives. Low interest rates are a fact of modern economic life, so we need to get used to them.

For developed economies, especially the United States, AAA assets that are created and held by banks need to have the appropriate capital charge if they are built on the basis of the law of large numbers and hence are exposed to systemic risk. The heavy demand for safe assets from the rest of the world will not abate, so we need to get used to that as well.

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Leading Economists Reassess Economic Policy

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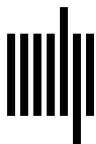

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