Capital flows: Stabilizing or Destabilizing

Have capital flows been stabilizing or destabilizing?

Yeganeh Forouheshfar

Problèmes contemporains en macro-économie internationale
15 Fev. 2012

Outline

1. Introduction
   - In the past
   - Types of capital control
2. Capital mobility and exchange rate regime
   - Monetary union
   - Capital controls
3. Sudden stops

History of capital mobility

- Since 1944 liberalization of capital movements has been encouraged by IMF to allow for an optimal allocation of world savings (from rich countries to poor countries)
- Throughout the 1990s, capital movement liberalization was part of the “Washington consensus” and was imposed by the G7,OECD and IMF on many emerging nations
- 1990s twin banking and currency crisis in Asia and Mexique
- Most capital flows were “north-north” rather than “north-south”
- Welfare gains were much lower than previously thought
- IMF took a more benign approach : *“High openness to international capital flows can be dangerous for countries with weak or inconsistent macro-economic policies or inadequately capitalized and regulated financial systems ”*

DAUPHINE UNIVERSITÉ PARIS

Types of captal control

- Administrative control of foreign exchange operations
  almost all counties have some control on capital transactions (sometime for security reasons)
- Actions based on incentives rather than control
  - Leave a min reserves at the central bank as an interest free deposit (90s in Chili)
  - Tobin tax : Tax on foreign exchange transactions

The control is not advisable in the long run!

Has capital mobility increased?

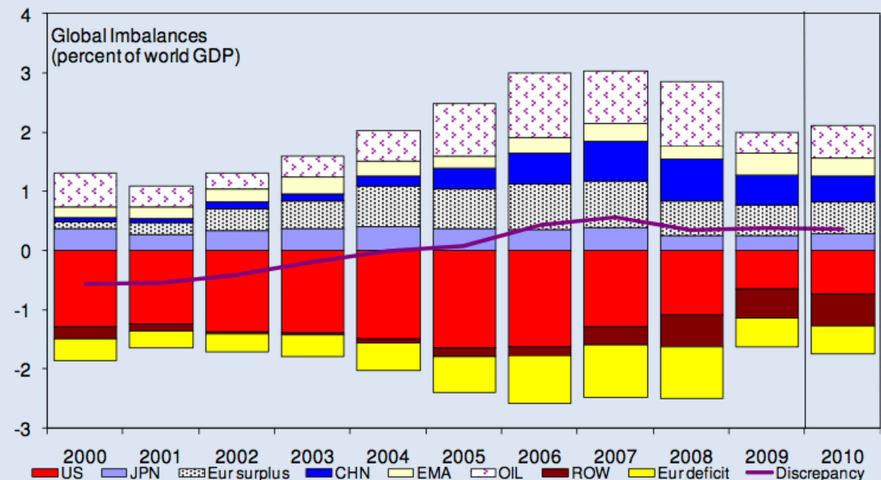
In the late nineteenth century capital markets were relatively well integrated under the classic gold standard centered on London
The interwar period was the time of disintegration and imperfect capital mobility, specially after 1929.
The postwar period has been characterized by gradually increasing capital market integration. (Tylor 1996)

- We have same order of magnitude of capital mobility as the international gold standard (a century ago)
- The degree of financial integration in the world has been increasing in the last few decades

Capital mobility: pros and cons

- Models of perfect markets suggest that international capital movements benefit both borrowers and lenders
- $\uparrow$ capital mobility $\Rightarrow$ $\uparrow$ exchange rate volatility
- $\uparrow$ capital mobility $\Rightarrow$ greater credibility of low inflation policies
- perfect capital mobility $\Rightarrow$ better allocation of investment (is it always true?)

Net flows 1996-2010



Impact of the capital mobility on the exchange rate regime

- Increase in capital mobility:
  - $\uparrow$ fragile fixed exchange rate regime (speculative attacks)
  - $\uparrow$ contagious effects of crises (second generation models)
- The number of countries pegging their currencies dropped by half during 1975-1998

Consensus

Intermediate regime of pegging is not sustainable for long in a world of high capital mobility

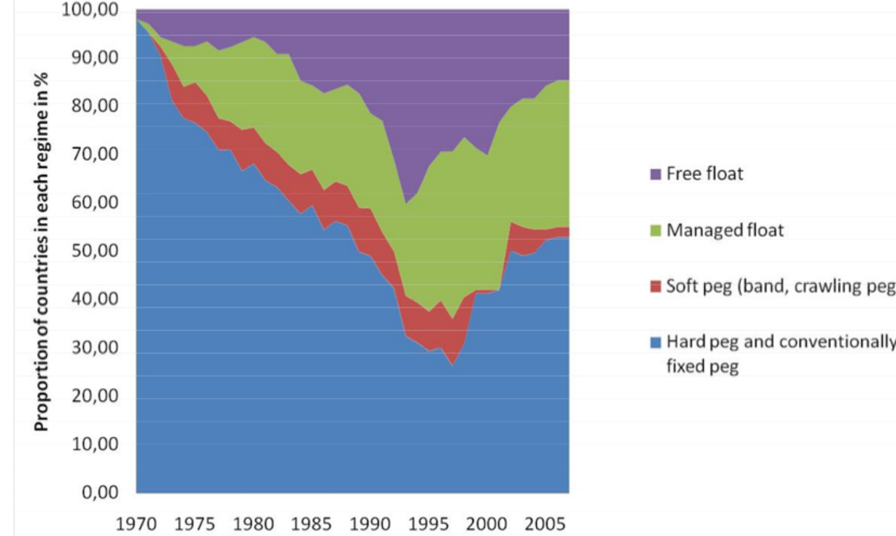
- The increasing degree of capital mobility puts countries in to the uncomfortable situation of having to choose for more flexibility or much tighter arrangements

DAUPHINE
UNIVERSITÉ PARIS

Different exchange rate regime choices and their flexibility level

Currency board
'Dollarization', 'euroization'
Fixed exchange rate
Crawling peg
High flexibility
Low flexibility
Monetary union
Soft peg with fluctuation band
Managed float
Free float
Hard pegs
Intermediate regimes

A tendency toward extreme regimes!?



Which exchange rate regime?

Extreme exchange regimes :

More flexibility:

- **Float:**
  - Volatile
  - Need to anchor nominal variables (domestic price levels)
  - Inflation targeting
  - Tend to stabilize exchange rates

More rigidity:

- **Currency board**:
  - Performed well
    - inflation
    - out put
  - weak points:
    - speculative attack
    - fragile
    - difficult transition
- **Monetary union**

Under a monetary union:

- Countries with tighter exchange rate arrangements $\rightarrow$ increase monetary cooperation (because the interest rates of the member countries should equalized)
- EMU affect spillover effects of fiscal policies
  - Intense trade links : price transparency and competition
  - Intense financial integration (through the interest rate chanel)

Stability pact

The fear that excessive budget deficits and debt levels in one country would affect other countries through the interest rate channel : control fiscal policies

- *Problem:* spillovers $\uparrow$, but the sign of the impact on economic activities are different $\Rightarrow$ total spillover may or may not increase the output level of EMU

DAUPHINE
UNIVERSITÉ PARIS

Financial integration

- Financial integration $\rightarrow$income convergence within the integrating area (convergence club)$\rightarrow$ faster growth in the more backward countries (through domestic saving and also by resources generated in the more advanced economies). capital flows from developed economies to developing ones
- In the standard neoclassical framework, internationally open capital markets generate capital flows from capital-abundant developed countries, where the return to capital is low, to capital-scarce developing countries, where it is high. The latter should therefore experience a foreign-financed increase in investment and growth. But skeptics argue that the opening of capital markets triggers speculation and the recurrence of market crises

A need for coordination

- It is unclear wether a more intense coordination of fiscal policies in EMU will increase welfare:
  - The use of fiscal policies creates public good effects ⇒ an incentive to spend too little
  - Shift part of the financing costs of the expanding country to other members ⇒ incentive to spend too much
- Asymmetric shocks are likely to occur in a monetary union ⇒ an insurance mechanism:
  - Unified budget (not set for EMU)
  - Individual nations should use their fiscal policies to absorb asymmetric shocks (difficult cooperation)
  - Financial integration (equally powerful as a unified budget)

Tobin Tax

A penalty on short-term financial round-trip excursions into another currency.(0.05 or 1%)

- **Making exchange rate less volatile:**
  - Only 5% of exchange transactions is due to imports and exports
  - 80% of daily transactions are for purposes of hedging and not speculation!!!
  - The existence of many dealers : efficient risk spreading mechanism
  - Taxing all transactions in the foreign market $\Rightarrow$ (?) less volatility
- **Making fixed exchange rate less fragile:**
  - Speculative attacks on a pegged currency are driven by expectations of relatively high devaluations (20% or more)
  - Tobint tax of 1% will do little to discourage panic flows
  - $\Rightarrow$ Tobin tax will do little to reduce exchange rate volatility

Perfect capital mobility and sudden stops

Empirical analysis : looking for large and unexpected fall in capital flows:

Figure 3. The Bunching of Sudden Stops Events: Emerging Markets vs. Developed Economies

Emerging Markets
Developed Economies

0 1 2 3 4 5 6 7

1992 1993 1994 1995 1996 1997 1998 1999 2000 2001

Results

- **EM**: 63% of the depreciation episodes is associated with a sudden stop
- **Developed**: 17% of the depreciation episodes is associated with a sudden stop
- Large RER fluctuations accompanied by sudden stops are basically an EM phenomenon
- Developed countries can sustain large depreciations while keeping their capital account open
- Sudden stops $\Rightarrow$ interest rate $\uparrow$, reserves $\downarrow$, current account adjustment
- Key determinants of the probability of a sudden stop :
  - Openness
  - Domestic liability dolarization

Bibliography

Agnès Bénassy-Quéré, Benoît Coeuré, Pierre Jacquet and Jean Pisani-Ferry
Economic policy theory and practice
Oxford University Press, 2010

John Driffill and Daniel Gros
The stability and sustainability of the Euro- pean Monetary System with perfect capital markets
pages 211–231 Cambridge University Press, 1988.

Paul De Grauwe Magdalena Polan
Increased Capital Mobility: A Challenge for National Macroeconomic Policies
University of Leuven 2000

Guillermo A Calvo and Carmen Reinhart
When Capital Inflows Come to a Sudden Stop: Consequences and Policy Options
University of Maryland 2000

DAUPHINE UNIVERSITÉ PARIS

Bibliography

Guillermo A. Calvo , Alejandro Izquierdo and Luis-Fernando Mejía
On the Empirics of Sudden Stops: The Relevance of Balance-Sheet Effects
July 2004

Barry Eichengreen
Capital Account-Liberalization: What Do Cross-Country Studies Tell Us?
The world bank economic review, volume15 , 2001, Number 3

PETER BLAIR HENRY
Capital Account Liberalization: Theory, Evidence, and Speculation
Journal of Economic Literature Vol. XLV (December 2007), pp. 887–935

DAUPHINE
UNIVERSITÉ PARIS