Discussion of
“Liquidity Traps, Capital Flows”
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Policy discussion

- **Debate about the desirability of capital flows**
- **Policy discussion:**
  - **Until the 1960s: Capital flows are destabilising; Need for coordination and capital controls**
  - **After the collapse of Bretton-Woods (1971): move towards the Washington consensus of flexible exchange rate, free flow of goods and capital**
  - **Following GFC (2008): Under certain circumstances capital flow management is desirable (IMF, 2010).**

Academic discussion

- Theoretical discussion: Under which circumstance are capital flows management techniques desirable?
- Two reasons pointed out in the literature
  - Terms of trade response excessive (de Paoli and Lipinska, 2012 ; Costinot, Lorenzoni and Werning, 2014)
  - Financial stability considerations (Caballero and Krishnamurthy, 2001; Korinek, 2007, 2010)

Terms of trade hedge

- **Cole and Obstfeld (1991)**
  - **Incomplete markets can, under specific assumptions, mimic the complete markets allocation due to ToT adjusment.**
- **Corsetti, Dedola and Leduc (2007):**
  - **Models that generate strong wealth effects implying that large swings in ToT magnify the consumption risk of fundamental supply shocks**
- **Brunnemeier and Sannikov (2014)**
  - **Undercapitalized country borrows too much**
    - **Individual firm does not internalise that increase in production worsens ToT.**
    - **Terms of trade hedge undermined due to pecuniary externalities.**

This paper

- **Optimal monetary policy under commitment for arbitrary capital flow regimes**
  - **Demand driven recession (discount rate shock).**
  - **Cole and Obstfeld (1991) parametarization: unitary intra – and intertemporal elasticity of substitution.**
  - **Mon pol at the ZLB: prolong the period at which the policy rate is kept at zero. (Eggertson and Woodford, 2003).**
  - **Stimulate current output by promising future boom.**
- **World equilibrium under Nash**
  - **Free capital flows: North hits the ZLB, but exits earlier than in a closed economy. South: output stabilized with more moderate interest rate cuts.**
  - **Terms-of-trade movement alleviate demand-driven recession in the North.**

This paper

- **Planning problem**
  - **Constrained efficient capital flow regime implies coordination of**

of capital control policies.

  - **Why? ZLB translates into a constraint on the path of the exchange rate -> we need new instruments.**
  - **Capital controls allow for a relaxation of this constraint by letting FX rate dynamics to decouple from interest rate dynamics.**

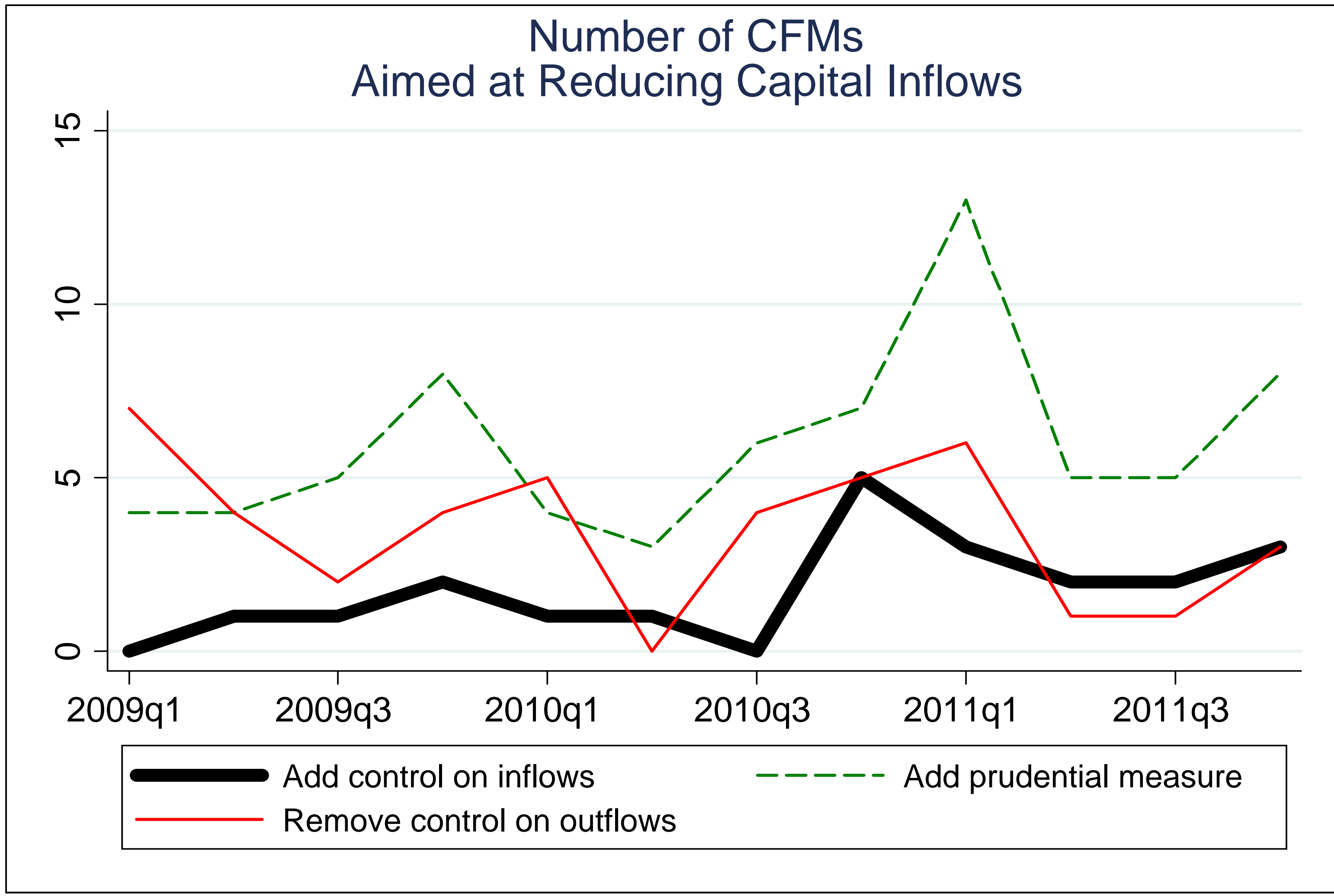
Empirical evidence from 2009-11

- **More changes in macroprudential measures (121 events) than capital controls (99 events).**
- **Mainly affecting bonds (67) and equities (47) than FDI (18), and more focus on foreign exchange (130) and banks (107) than loans (46).**

Controls on Inflows		Controls on Outflows		Macro-Prudential Measures		Related to Pressures From Capital:		
–	+	–	+	–	+	Outflows	Inflows	Total
29	21	42	7	49	72	85	135	220

Source: Forbes, Fratzscher and Straub (2014, JIE)

Reducing Capital Inflow Pressure



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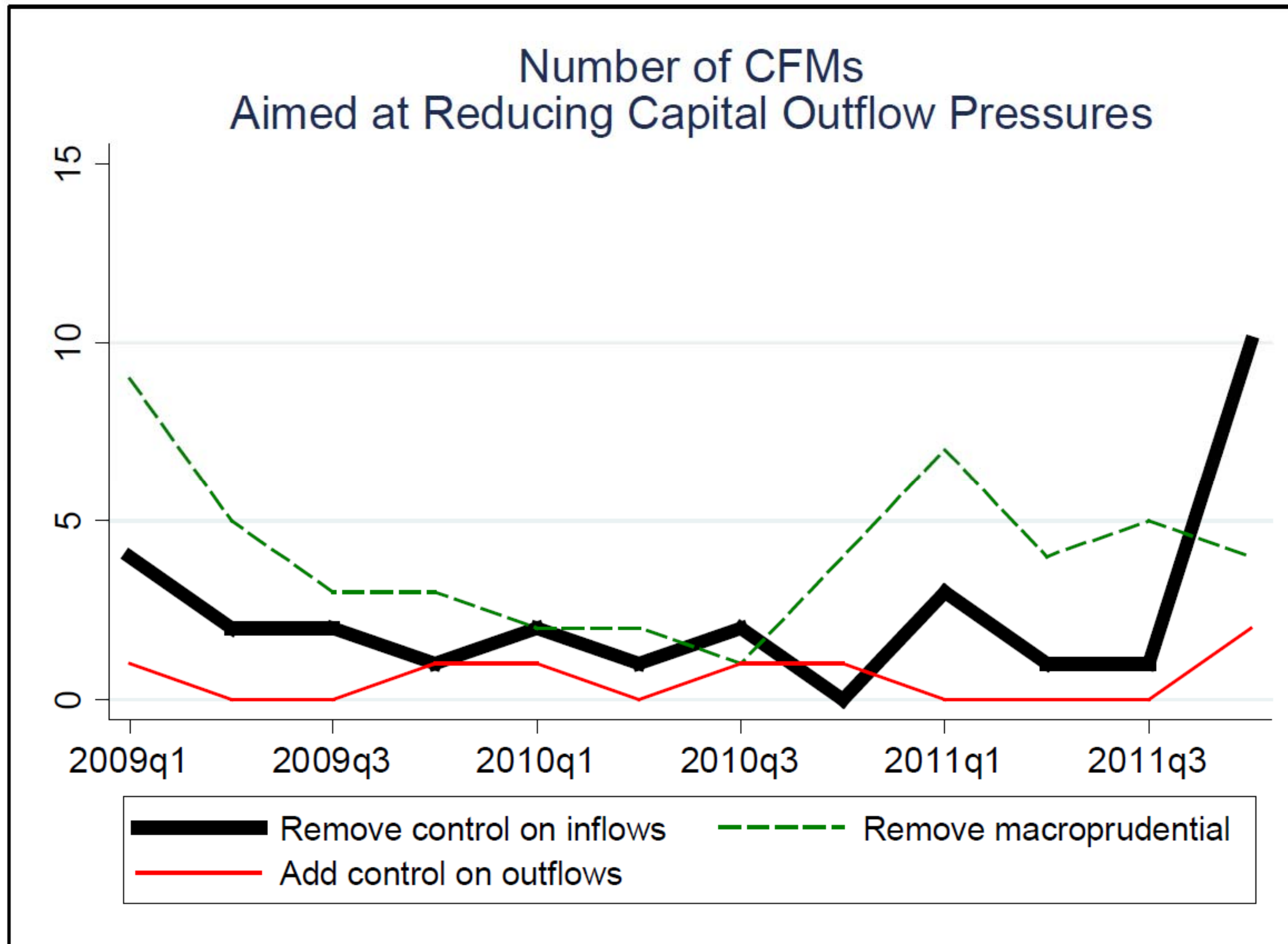


Source: Forbes, Fratzscher and Straub (2014, JIE)

Policy implications of the paper

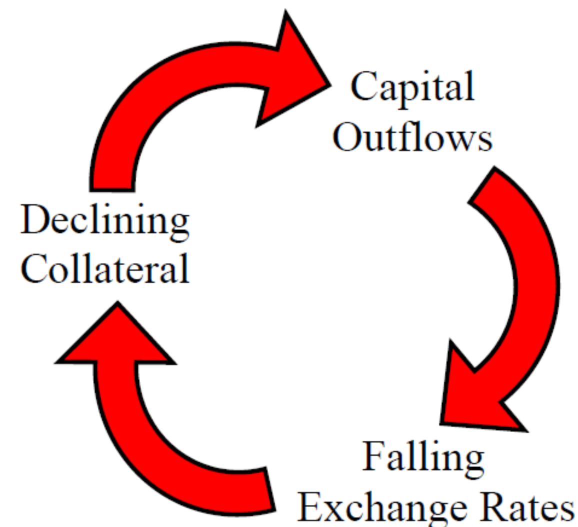
- Capital flow management measures in the South might hamper and delay macroeconomic stabilization in countries with deficient aggregate demand during a liquidity trap.
- Need for global policy coordination.
- Subsidies to downstream flows (or taxes on upstream flows) during the liquidity trap; subsidies to upstream flows between the end of the trap and North’s exit.

Spillbacks?

- What about the financial fragility implications in the South?
- Can higher capital inflows into the South result into negative spillbacks to the North?
- The latter might imply further deterioration of economic conditions in the North.

Financial stability considerations

- **Risky forms of capital inflows can create externalities.**
- **Small shocks can lead to relatively large declines FX rates, borrowing capacity and economic activity**
- **Negative feedback loops between collateral, capital outflows and depreciating FX rates occur when the country is subject to a negative shock.**



Source: Korinek (2010)

Put your own house in order

- This paper: ex-post perspective.
- Leverage has been a key contributing factor.
- Deleveraging represents a reduction in aggregate demand as constrained HHs/ firms cut back spending.
- Fall in interest rates induce unconstrained HHs to make up for aggregate demand. But the effective lower bound is a constraint.
- Korinek and Simsek (2016): Ex-ante macroprudential policies in debt markets, such as debt limits and insurance subsidies, are ex-ante efficient.

Externalities from capital controls

- International coordination is important despite domestic policy mandates.
- Forbes et al. (JIE, 2016): Testing for direct portfolio effects and externalities from capital controls on investor portfolios.
  - Brazil's tax on foreign investment reduced portfolio allocations.
  - It also leads to increase in allocations in countries that have substantial exposure to China and decrease allocations to countries viewed as more likely to adjust their capital controls.
- “Bubble they neighbour” effect : Capital control in many countries simultaneously can create distortions effect which may lead to retaliation across countries and reduce global welfare.