Discussion of Goodhart Peiris Tsomocos "Global Imbalances and Taxing Capital Flows"

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The Plan

1. Main Takeaway
2. Big Picture: Is this an important topic?
3. The focus on debt flows. Is it reasonable?
4. Are capital controls the appropriate tool?
5. Bringing it back to the paper

1. Main Takeaway

- Some countries have large current account (CA) surpluses, and their accompanying financial outflows can lead to an unsustainable accumulation of debt in CA deficit countries.

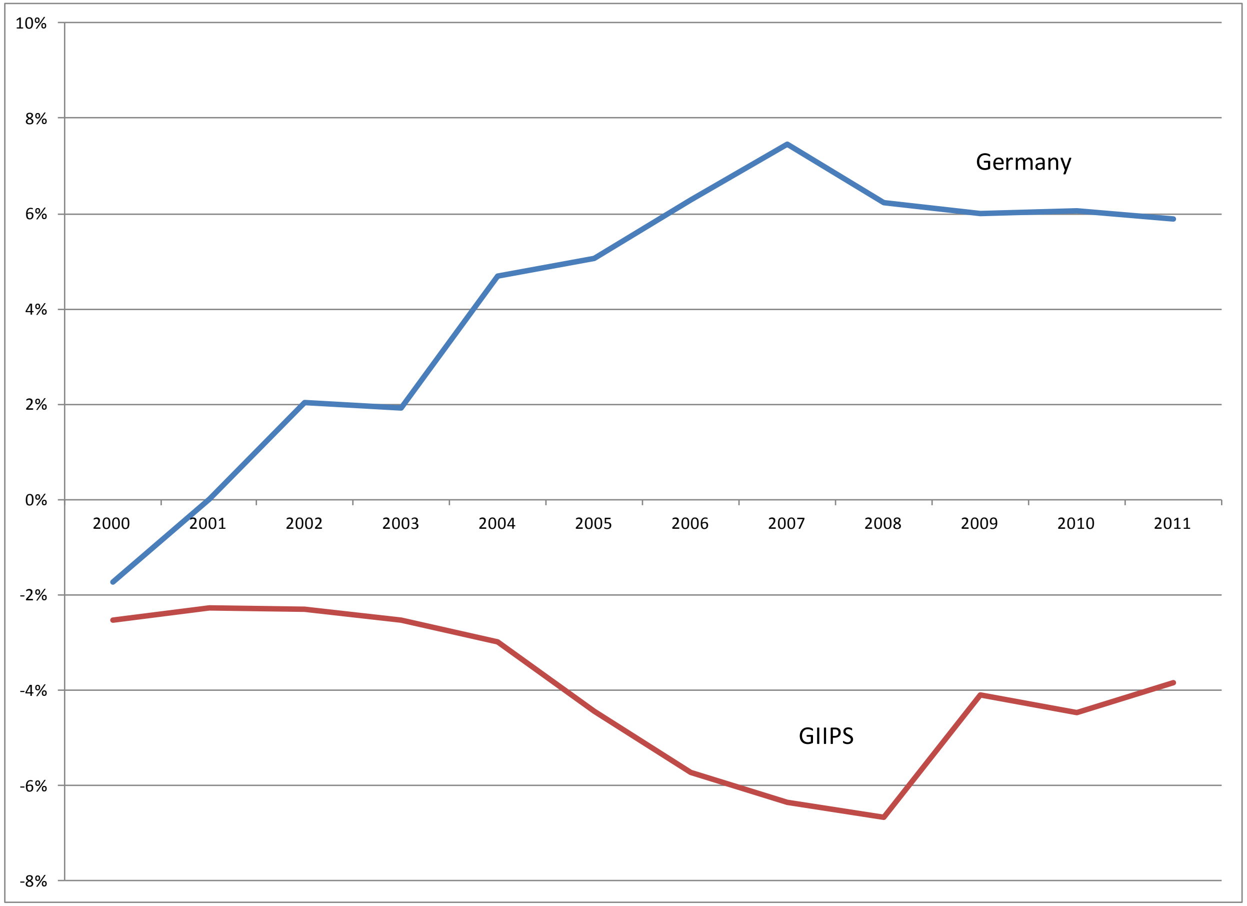
- The somewhat inevitable debt restructuring is costly. Both surplus and deficit countries would be better off had capital controls (i.e., restrictions on financial account transactions) been in place.

2. Big Picture: Is this an important topic?

- Are there large CA imbalances?
- Is capital mobility associated with crises?

Are there large CA imbalances? Sure, within Europe…

Current account balances (% of GDP)



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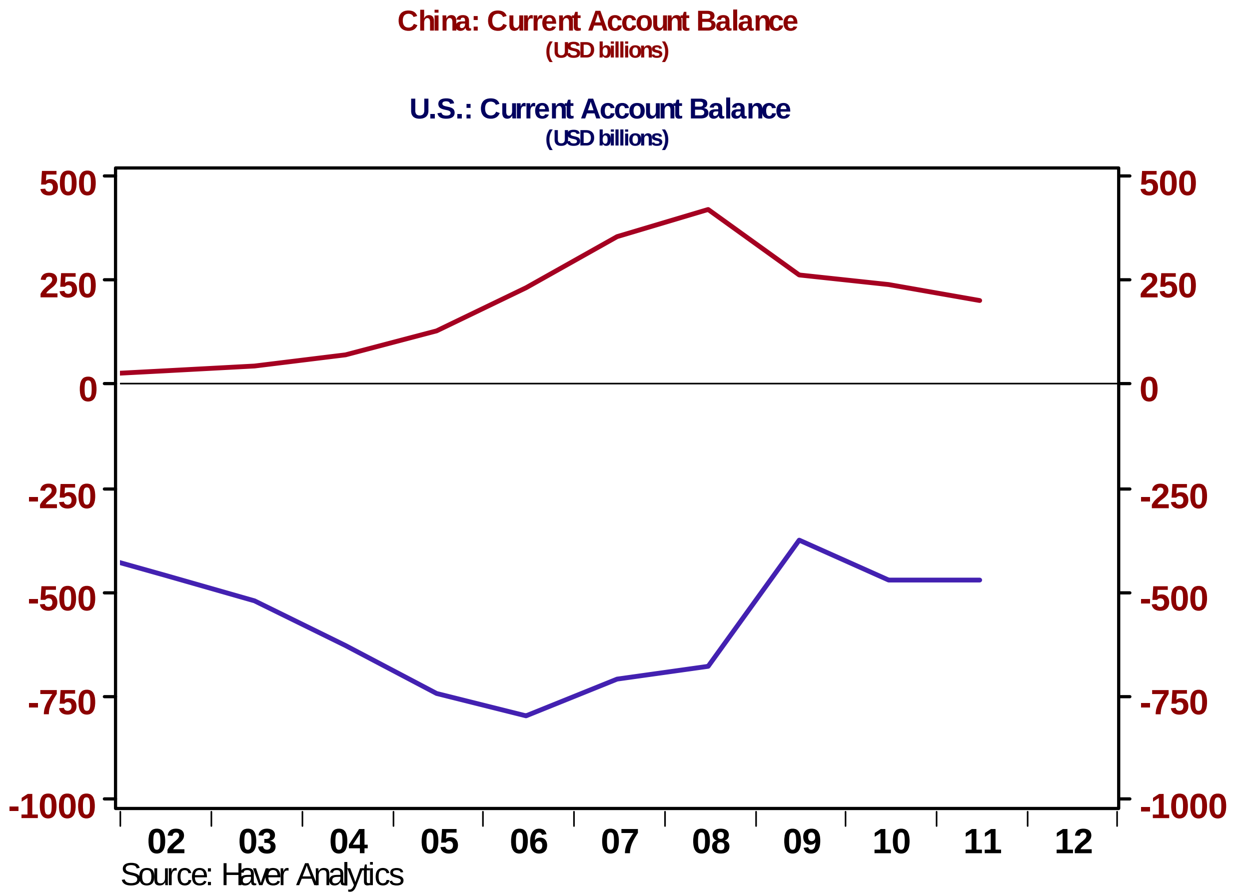
Source: "Eurozone Convergence, Divergence…and Then What?" Warnock and Debaere 2012

…and also among some other large countries.



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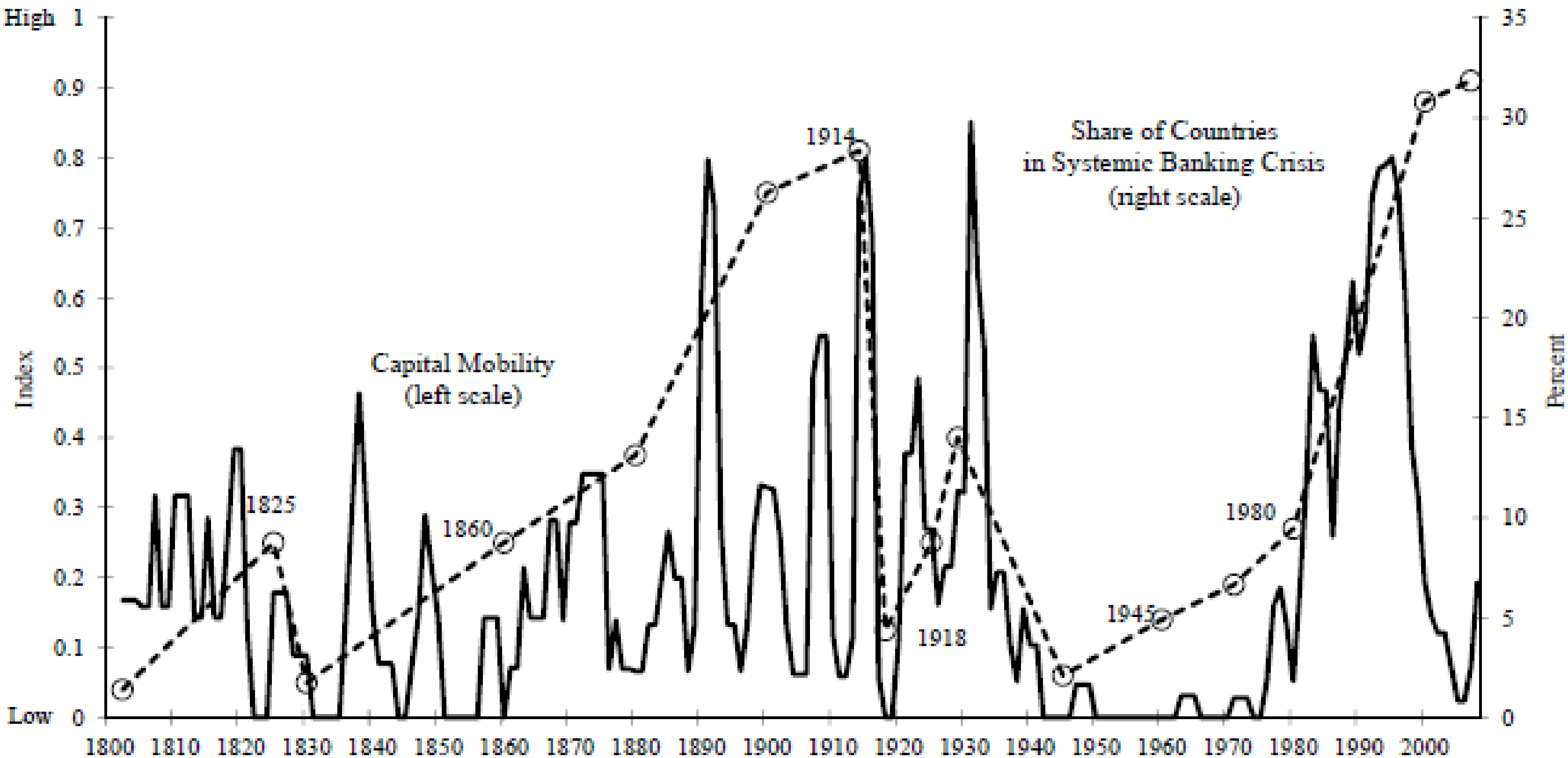
Is capital mobility associated with crises?

It seems. Periods of high international capital mobility have more banking crises.



Source: Reinhart and Rogoff (2009), as presented in Korinek (2011)

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Big Picture: Is this an important topic?

- Are there large CA imbalances? YES

- Is capital mobility associated with crises? IT SEEMS

The underlying phenomena the authors are tackling are relevant, evident, and can be associated with substantial pain.

This is an important topic.

3. The focus on debt flows. Is it reasonable?

- The model has only debt flows, but in reality there are also equity and FDI flows.

- Does this worry us? It might if
  - Extreme capital flow episodes are rarely driven by debt flows.
  - CA adjustments preceded by large debt inflows are less painful.

Are extreme capital flow episodes rarely driven by debt flows?

No…in most extreme capital flow episodes, changes in debt flows exceed dominate changes in FDI/equity flows.

	Surge	Stop	Flight	Retrenchment
	% of episodes that are debt-led			
	82%	80%	71%	72%
High income	81	83	79	75
Med income	81	83	63	76
Lower income	84	68	64	56
North America	67	69	74	72
Western Europe	89	87	81	77
Asia	80	79	67	68
Eastern Europe	88	71	64	82
Latin America	81	85	74	67
Other	33	54	42	29

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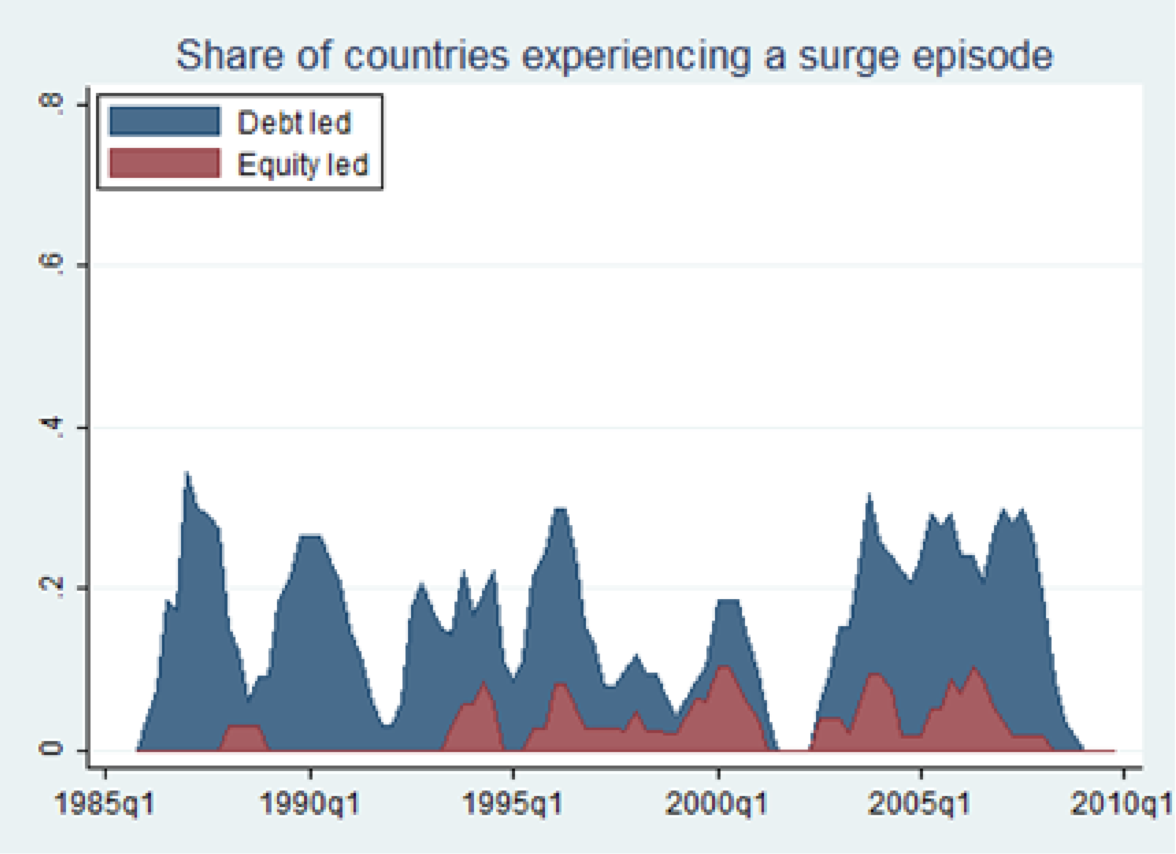
Source: Forbes and Warnock (2012) “Debt- and Equity-Led Capital Flow Episodes”

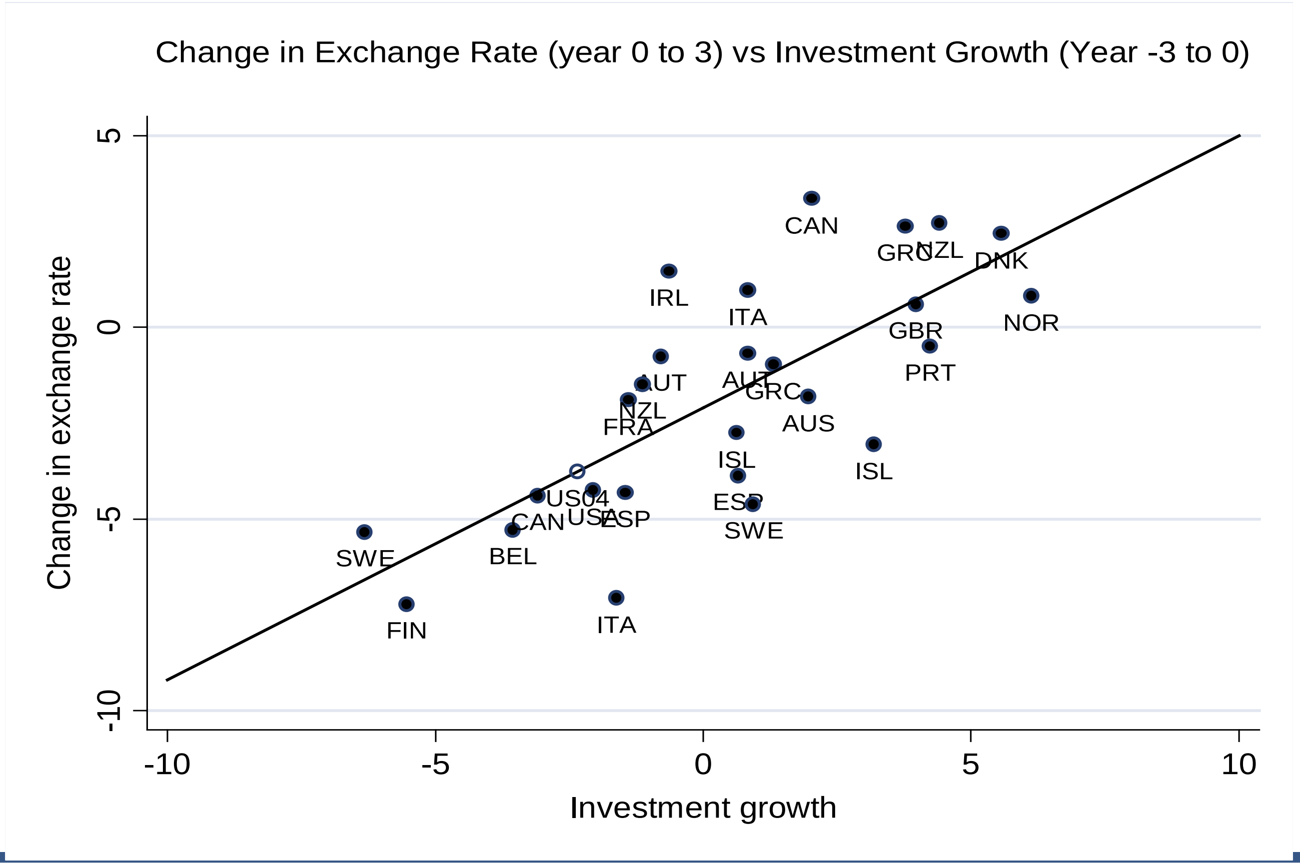
As an aside, in the period that motivates this paper, there were indeed an elevated number of debt-led surge episodes.



Source: Forbes and Warnock (2012) “Debt- and Equity-Led Capital Flow Episodes”

Are CA adjustments preceded by large debt inflows less painful?

I'm not sure. It seems that in AEs after large CA deficits in which investment increased more (consumption increased less), during the subsequent adjustment the exchange rate took a smaller hit. How you use the funds matter. (But no such results on large debt flows pre-adjustment.)



Source: Freund and Warnock (2009) "Current Account Deficits in Industrial Countries: The Bigger They Are, the Harder They Fall? "

The focus on debt flows. Is it reasonable?

- The model has only debt flows, but in reality there are also equity and FDI flows.
- Does this worry us? It might if
  - Extreme capital flow episodes are rarely driven by debt flows. MOST CAPITAL SURGES ARE DRIVEN BY LARGE DEBT FLOWS.
  - CA adjustments preceded by large debt inflows are less painful. NO EVIDENCE THAT THEY ARE LESS OR MORE PAINFUL, but more painful feels right.
- My take: A focus on debt flows, while it ignores surges in equity flows, seems appropriate enough.

4. Are capital controls the appropriate tool?

- Depends on who you ask.
  - IMF and many others…yes.
  - Others…no.

The case for capital controls (1).

- Dani Rodrik has argued eloquently that in a second-best world first-best solutions are not necessarily appropriate.
  - In general, this line of reasoning seems very compelling.
  - Rodrik puts real exchange rate appreciation at the heart of the pain of large capital inflows.

- Anton Korinek has a nice series of papers on prudential capital controls.
  - Basic idea is that flows might be optimal for each individual but negative externalities are not internalized, so there's room for a Pigouvian tax.
  - The pain here tends to come from balance sheet effects.

- Last year the IMF, based on *x*, *y*, and *z* evidence, blessed capital controls.

The case against capital controls (1).*

- Effect on the real exchange rate?
  - A primary reason emerging economies want to implement capital controls is to limit exchange rate appreciation. Some work** for Chile suggests that the capital controls Chile implemented in the 1990s had no persistent effect on the real value of the peso.
  - The controls did alter the *reported* composition of capital inflows, away from the type of flows that were taxed, toward other type of flows, but had no impact on the overall amount of inflows into the country.
  - (Parenthetically, it is never clear if “reported” is equivalent to “actual”; financial engineers are paid to get around controls and, given enough time, they surely will.)

*(1) – (5) are as discussed in Warnock 2011, “Doubts about capital controls” (CFR Capital Flows Comment)

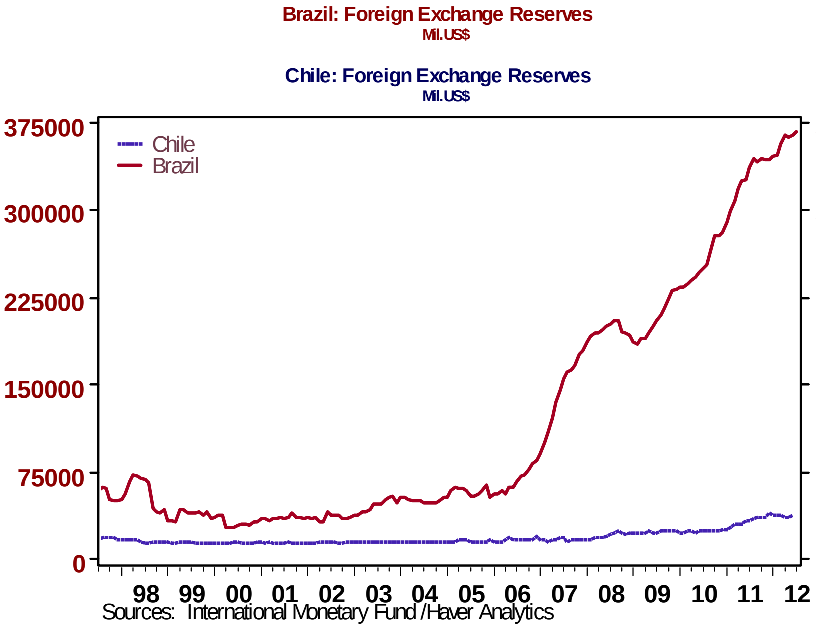
**J. De Gregorio, S. Edwards and R. Valdés, 2000,.“Controls on Capital Inflows: Do They Work?” *Journal of Development Economics* 63(1): 59–83.

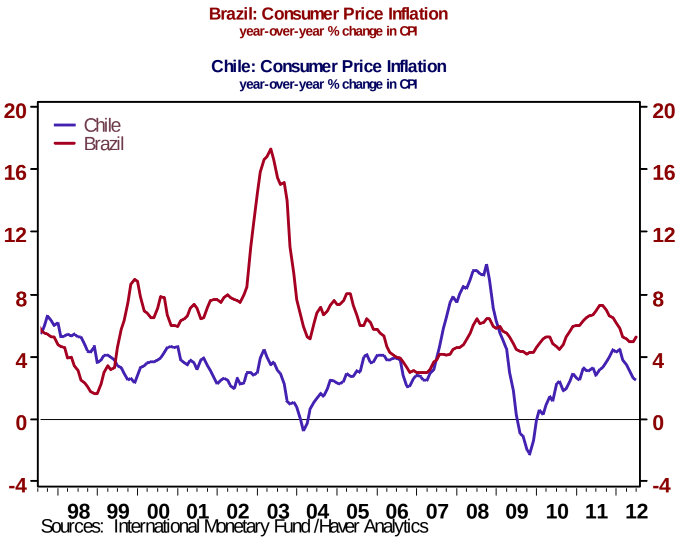
The case against capital controls (1b).

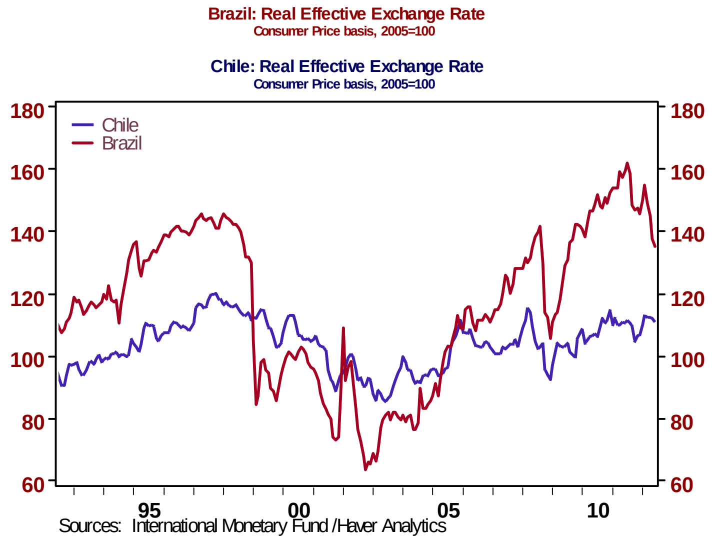
- OK, this isn't capital controls, but…
  - More recently, De Gregorio has criticized EMEs' other favorite response to capital inflows, which is to resist exchange-rate appreciation by accumulating foreign-currency reserves.
  - Reserve accumulation is intended to prevent the nominal appreciation of a currency. But, as he correctly points out, it is not the nominal exchange rate that measures a country's international competiveness, but the real exchange rate (the nominal exchange rate adjusted for inflation differentials).
  - In almost every case, countries that limit nominal exchange rate appreciation through reserve accumulation experience a real appreciation anyway, because the reserve accumulation is inflationary. So they end up in the same place—with a real appreciation—and have only traded off nominal exchange rate appreciation for higher inflation.

J. De Gregorio, "Adjustment in the Global Economy." Presentation at the 2011 IIF Latin American Economic Forum, March 27, 2011.

This isn't proof, but makes one think.







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The case against capital controls (2).

- Another De Gregorio point: Flow diversion…or why aren't we considering third country effects?
  - It's known from international trade in goods that one country's protectionism (through tariffs or quotas, for example) can lead to similar responses by other countries.
  - The same can be true for international capital flows.
    - If B implements effective capital controls, flows will be diverted to other countries.
    - Why, if B does not welcome these flows, should its neighbors feel differently? If diverted flows went to A, why wouldn't A implement controls; and if these diverted flows to U or P, why wouldn't those countries follow suit?

J. De Gregorio, "Adjustment in the Global Economy." Presentation at the 2011 IIF Latin American Economic Forum, March 27, 2011.

The case against capital controls.

- Flow diversion…or why aren’t we considering third country effects?

    - This collective action problem has yet to be properly addressed.
        - The IMF mentions this (briefly, on pages 40–42 of a ninety-five-page report), but one gets the impression that it was an afterthought—a strange stance for a global institution whose distinctive contribution should be to focus on global public goods.
        - Did the IMF’s conclusion that seven of twenty-two countries they studied are good candidates for capital controls take this “flow diversion” into account?
        - Whether it did or did not, the prospect of flow diversion implies that the bar for blessing the implementation of capital controls should be high.

The case against capital controls (3 4 5).

- The empirical evidence in support of capital controls is less than compelling.

  - IMF's October 2010 *Global Financial Stability Report*: "Th(e) self-reinforcing cycle between flows and returns exacerbates market movements on the upside and on the downside, with important implications for financial stability. Higher returns and lower volatilities resulting from elevated foreign inflows can lead to perceptions of higher risk-adjusted returns and an underpricing of risk. By the same token, if flows to emerging markets reverse suddenly, a self-reinforcing cycle of outflows and lower risk-adjusted returns could follow, potentially resulting in a deep market sell-off."
  - The IMF then goes on to suggest that in the face of such potentially destabilizing capital flows, the imposition of capital controls might indeed be a reasonable policy response.
  - This sounds right. Momentum trading can drive asset prices further and further way from anything justified by fundamentals until some bad event leads to a reassessment of risk, at which point the capital flows reverse themselves and emerging economies become cut off from global capital markets. If this is the way the world works, perhaps capital controls should be implemented early in such a cycle.
  - But is it right?

The case against capital controls.

- The empirical evidence in support of capital controls is less than compelling.
  - But is it right? I don't think so.
  - The IMF bases its assessment of the trading behavior of international investors on bilateral flow data, which show that global investors chase past returns.
  - This is in line with seminal research on international capital flows from the 1990s, which found a positive correlation between U.S. flows into a country's equity market and past returns in that market (and also labeled U.S. investors as returns chasers).
  - This positive relationship between bilateral flows and past returns is at the heart of most analysis of returns chasing by international macroeconomists. But can we really say anything about trading behavior by observing bilateral flows?
  - Recent research* suggests evidence on trading behavior that arises from flow data should be reassessed. The results are striking. For one large and important group of global investors (U.S. investors), a flows-based assessment of trading behavior—the type of assessment at the heart of many policymakers' views about global capital flows—is almost entirely incorrect.
    - In fact, at the 1-, 2-, and 3-month horizons, U.S. investors don't chase returns, but rather sell past winners. This is stabilizing.

*Stephanie E. Curcuru, Charles P. Thomas, Jon Wongswan, and Francis E. Warnock, 2011. "U.S. International Equity Investment and Past and Prospective Returns," *American Economic Review*.

The case against capital controls (3 4 5).

- The empirical evidence in support of capital controls is less than compelling.
  - We know that when interest rates in the U.S. are low, we will see a surge in capital inflows that can destabilize EME markets.
  - This is at the heart of references to a “currency war” in response to the Fed’s QE policies. The empirical literature on capital flows backs up this view, as study after study has found that low interest rates in the United States lead to higher flows to emerging markets.
  - But recent research* suggests that this consensus should be reassessed. Episodes of surges of capital inflows are no more likely when U.S. rates are low.
    - If the Fed and other central banks spur global growth, or if global money supply increases sharply (something that, in the aftermath to the global financial crisis, has not yet been witnessed), then yes, one would expect more surge episodes.
    - But low US interest rates aren’t enough. Case to make the point: The darkest days of the GFC…US rates plummeted and there were no surges, just retrenchment.

* Kristin Forbes and Francis E. Warnock, 2012. “Capital Flow Waves: Surges, Stops, Flight, and Retrenchment,” Journal of International Economics.

The case against capital controls (3 4 5).

- The empirical evidence in support of capital controls is less than compelling.

- Net or gross inflows? The focus is almost always on net inflows.
  - The IMF, in its April 2011 *Global Financial Stability Report*, asks whether *net* capital flows are reliable or fickle (and argues that they are fickle).
  - Many researchers and policymakers assess net inflows, but in their minds (and words) they are really focusing on foreigners' flows.

- Problem: Net inflows consist of distinct components: inflows and outflows from foreigners, and inflows and outflows from domestic investors. When focusing on net inflows one never knows who, foreigners or locals, is behind the flows.

The case against capital controls.

- Problem: When focusing on net inflows one never knows who, foreigners or locals, is behind the flows.
- Example: A country experiences <u>increasing net inflows</u> and assumes, naturally, that foreigners are behind the "surge" in inflows. But perhaps locals, knowing that prospects in the local economy are good, are repatriating funds or shipping fewer funds to foreign markets? Looking at net inflows, and assuming any increase owes to increased inflows by foreigners, the policymaker might conclude that a tax on inflows is the right response. But suppose the "surge" owed to locals keeping money home, rather than foreigners wanting to invest in the country. In that case, policy would be addressing something (a surge in foreign inflows) that did not exist.
- Another: Net inflows can plummet either because foreigners rapidly exit the market, as is often presumed, or because knowledgeable locals, perhaps knowing that domestic returns are about to decrease, lead the rush to the exit. If such a "sudden stop" is troublesome, policymakers may well impose capital controls on foreigners to prevent a large buildup of positions that they might later liquidate (en masse). But if the stop owed to locals' decision to leave (capital flight?), are capital controls on foreigners really the right policy? Or should the conditions that prompted locals to flee be addressed?

The case against capital controls.

- Problem: When focusing on net inflows one never knows who, foreigners or locals, is behind the flows.

- How often might this confusion matter?

  - Unknowable to me. It requires peering into the minds of policymakers.

  - But a study* shows that almost half (24 of 55) of previously defined “sudden stops” of net capital inflows are actually episodes if ”sudden flight.”

    - The fall in net inflows reflected the actions of locals, not foreigners..

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* Alexander D. Rothenberg and Francis E. Warnock, 2011. “Sudden flight and true sudden stops,” *Review of International Economics*.

5. Bringing it back to the paper

- Recall the main takeaway
  - Some countries have large current account (CA) surpluses, and their accompanying financial outflows can lead to an unsustainable accumulation of debt in CA deficit countries.
  - The somewhat inevitable debt restructuring is costly. Both surplus and deficit countries would be better off had capital controls (i.e., restrictions on financial account transactions) been in place.

- While I fully agree that capital flows are scary, this puts a lot of faith on capital controls.
- If it's debt flows we're talking about, why not properly regulate and supervise the financial sectors that are very likely intermediating these flows?
  - I acknowledge that I'm not sure how to think about the unregulated, more shadowy corners of our financial sectors. Some discussion on this is warranted.

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- I really like the paper – theory is good for us – but I am uneasy with the focus on capital controls when the existing evidence doesn't seem worthy of the term .
  - (And I'm happy to be proven wrong on this.)

Thanks!