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# Monetary Policy Options for Small Open Economies Discussion

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**The views expressed in this presentation are those of the presenter and do not necessarily represent those of the IMF or IMF policy.**

# Small Open Economies

- Significant exposure to external shocks through trade or finance or both
- Limited and/or insecure access to international capital markets
- Imperfect capital mobility
- Less developed domestic financial sector than in large AEs
- Exchange rate may matter for domestic objectives (growth, inflation, financial stability) far more than in large AEs

# Policy Instruments to Deal with External Shocks

- Monetary policy
- FX intervention (both inflows and outflows)
- Macro-prudential
- Capital controls
- Fiscal policy

# Klein's Paper: Summary

- Survey on the effectiveness of capital controls distinguishing between episodic or temporary controls (Gates), and long standing controls (Walls)
- Groups countries into three categories (Open, Gates, and Walls) using cluster analysis
- Finds that countries with long standing controls (Walls) have lower per capita income, greater trade openness and less flexible exchange rate regimes
- Also finds a “pecking order” of the use of capital controls, especially in high income countries

# Klein's Paper: Comments (1 / 4)

- Relevant and topical issue as capital controls are back on the radar screen after GFC and their effectiveness highly debated
- Discussion on *episodic* controls seems one-sided
  - Econometric difficulties: (1) possible downward **endogeneity bias**, (2) **unknown objectives of the controls** against which to measure effectiveness, and (3) absence of a **counterfactual**
  - Nevertheless, a large body of literature finds a strong effect of episodic controls on the composition of flows albeit with mixed evidence on FX rate and volume of flows (Magud and Reinhart, 2007; Ostry, Ghosh and Qureshi, 2015)
  - Discussion on Brazilian controls are contradicted by the findings of Chamon and Garcia (2016) that they had a significant impact on FX rate (cumulative effect of about 10% depreciation of BRL)

## Klein's Paper: Comments (2/4)

- The data used for the analysis may miss many *de facto* switches or gates such as changes in the “intensity” of existing controls
  - Partially liberalized country with existing controls that may tighten or relax its controls will not be captured
  - For an open economy, only the first switch to controls would be captured and not any further tightening
- Switches (or episodic controls) may be better captured by the data on “changes” in controls (Ahmed and Zlate, 2014; Ahmed et al., 2015)

## Klein's Paper: Comments (3/4)

- Merging inflow and outflow controls could be problematic
  - The analysis needs to be separated as motivations or determinants of inflow and outflow controls are different
  - Pecking order of controls as conventionally discussed is more pertinent to *inflow* controls (Ostry et al. 2010)
  - Recent debate on the use of controls to mitigate financial and macroeconomic vulnerabilities is also mostly related to inflows
  - On outflow controls, there is broad consensus that they should generally be used in crisis circumstances (IMF 2012)

# Klein's Paper: Comments (4/4)

- Policy implications and suggestions
  - The pecking order suggests that countries may indeed adopt controls to mitigate financial and macroeconomic vulnerabilities—which should alleviate concerns about their potential misuse
  - Since debt flows tend to be the riskiest, countries would begin by targeting such flows and then widen the net if capital flows continue unabated
  - Useful to correlate the imposition of different types of controls with different types of flows to see what motivates countries to target different asset classes
  - Useful and interesting to complement the “aggregate” descriptive analysis on pecking order of capital controls with case studies of incidences of capital

# Gagnon's Paper: Comments (1 / 3)

- The paper is related to the global financial cycle literature of Helene Rey that argues that the traditional trilemma has morphed into a dilemma
- I broadly agree with the paper's proposition that the exchange rate regime still matters
- Countries with floating rates are better able to insulate themselves from external shocks but also macroeconomic and financial vulnerabilities (Ghosh, Ostry and Qureshi, 2015).
- To the extent that excessive FX rate volatility under pure floats poses problems, managed floats (FXI) may present a viable solution (Ostry, Ghosh and Chamon, 2012; Ghosh, Ostry and Qureshi, 2015)

## Gagnon's Paper: Comments (2/3)

- But the paper does not dwell on the option of using capital controls and instead discusses only the option of FX intervention
- Yet both tools are useful in different circumstances as noted in recent literature
  - FXI for currency misalignment, capital controls for financial stability risks but also as a backstop for concerns such as economic overheating and currency overvaluation in the face of persistent inflows (Ostry et al., 2010, 2011; IMF, 2012)
- Perhaps the issue is to **de-stigmatize** capital inflow controls
  - Ghosh and Qureshi (2016) offers historical perspective on why inflow controls have become a bad name

# Gagnon's Paper: Comments (3/3)

- Comparison of post-GFC performance (relative to pre-GFC periods) between hard peg and IT seems to be too narrow a focus
  - In addition, findings on inflation performance (Table 1) indicate that IT regimes are more *deflationary* during post-GFC period than hard pegs
- Comparison can be done separately for a more *normal* pre-GFC period (2000-06) between hard pegs and IT
- It would also be useful to analyze the performance separately for AEs and EMs as central banks in the former enjoy greater policy credibility

## Lee's Paper: Comments (1 / 2)

- An interesting follow-up on Choi (2014) based on *conditional* forecasts
- Qual-VAR (Figures 3 to 5): IR results seem reasonable but several questions remain:
  - Were leverage caps binding (or at least near binding) when first imposed and further tightened? If not, what can be inferred?
  - Unclear if announcement effects and implementation effects are sufficiently distinct in Korea where policy credibility is high
  - Unable to distinguish between effects of leverage cap and macro-prudential stability levy—they need to be analyzed separately as their underlying motivation differs (Figure 4)
  - Why confidence interval of IRs narrows as the horizon increases?

## Lee's Paper: Comments (2/2)

- More detailed discussion on specifics of leverage caps and financial stability levy as well as descriptive analysis on capital flows would be useful
- Counterfactual analysis: Estimated effects of leverage cap and stability levy on ST and LT foreign borrowing by banks appear economically meaningful
  - However, statistical significance needs to be reported to be complete
  - Persistent effects lasting for 30 months or more seem at odd with short-lived IRs from Qual VAR
  - Clarification is needed regarding the unit of foreign borrowing—in US dollar or in percent of GDP?

# Kang's Presentation: Comments (1 / 2)

- Broadly in line with the findings of the existing literature on capital flows but greater focus on global risk appetite as a driver
  - Evidence suggests that global (push) factors matter for surge incidence while domestic (pull) factors affect the magnitude of surges at the country level (Ghosh et al., 2014)
- Cross-border spillovers and international policy cooperation: regulating capital flows at both ends (source and recipient countries) may lead to a better outcome
  - Theory suggests spillovers could be Pareto efficient in which case there is no further scope for policy cooperation (Korinek, 2016)
  - But the same theory is silent on the distribution of losses and gains across countries which is at the heart of policy debate

## Kang's Presentation: Comments (2/2)

- Reminiscent of “Lean vs. Clean” argument applied to vagaries of volatile capital flows
  - Macro-prudential measures for “Lean”?
- Clearer distinction would be necessary between *currency-based* macro-prudential measures and *residency-based* capital controls
- Remaining policy questions for small open EMs:
  - Macro-prudential measures/capital controls: last or first resort?
  - When and how to use FXI for capital “outflow” shock?
  - How to avoid misuse of macro-prudential measures?

# Takeaways

- Exchange rate regime matters, and trilemma rather than dilemma seems to hold for small open economies
- Exchange rate flexibility is desirable to the extent that it does not hamper macro-financial stability
- Multiple instruments are available to deal with capital flows
  - Policy rate adjustments, FXI (for both inflow and outflow shocks), macro-prudential measures and capital controls for large and persistent shocks
- When and what tools to use depends on policy objectives and drivers and types of capital flows (no one-size-fits-all)
- De-stigmatize capital controls while avoiding misuse (that would delay needed macroeconomic/financial adjustment)

**Thank You!**

