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Living in the world of free and turbulent capital flows – consequences for macroeconomic policy making

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Issues for discussion

- Capital mobility and balance-of-payment management
- Capital mobility and monetary policy
- What policy instruments remain in the hands of national governments (in both cases)

BoP analysis: traditional assumptions

- BoP and IIP are concepts based on residency
- capital has its fixed residency (domicile)
- individual country gross national investment must be ultimately financed out of this country gross national saving (even if inter-temporal balance-of-payments imbalances are accepted) - echo of the Feldstein-Horioka (1980) “home country bias”

BoP analysis: policy implications of traditional assumptions

Net capital inflow leads to accumulation of country’s external liabilities, which

- cannot grow indefinitely,
- must be repaid at some point,
- higher they are, more vulnerable country’s external position is

BoP analysis: the alternative set of assumptions

- unrestricted international capital mobility
- major sources of capital do not have country of origin (may change their domicile)
- private investors seek the highest rate of return disregarding country borders
- some countries may offer higher rate of return than others for a long period of time

Can countries influence the size and direction of capital flows?

- Capital controls – unavailable for EU members, doubtful effectiveness in other cases
- Monetary policy (no impact under hard peg, limited impact under flexible exchange rate)
- Fiscal policy (macro): some impact
- Fiscal incentives (micro): some impact (more in respect to structure of capital flows than volume)
- Macro-prudential regulation: depending what does it mean in practice
- Micro-prudential regulation: see fiscal incentives

BoP analysis: consequences of modified assumptions

- Country may become capital exporter or capital importer for a long period of time
- The expected rate of return determines the direction of capital movement
- In the case of capital outflow it also affects residents
- But current account imbalances still matter as long as country has its own currency (exchange rate risk)

Current account vs. capital account

- Traditional approach (in the world of restricted capital mobility): domestic factors of competitiveness + trade policy + exchange rate policy $\Rightarrow$ trade and current account balance $\Rightarrow$ capital flows
- The reverse causality in the world of free capital mobility: net capital flows have exogenous character and current account balance adapts to changes in capital account (through changes in real exchange rates)
- Policy consequences: national macroeconomic policy has limited control over current account balance and real exchange rate (even if it controls nominal exchange rate)
- Criteria of assessment of current account: who is doing well, who is vulnerable (doubts in respect to the EU’s Excessive Imbalance Procedure or idea of current account targeting within the G20)

Capital mobility and monetary policy (national perspective)

- Domestic money supply is largely exogenous as result of capital flows.
- Even under the free floating exchange rate and inflation targeting limited room of maneuver (interest rate decisions must take into account international financial market trends, limits of currency appreciation/ depreciation).
- Consequences of monetary policies of major central banks (especially the US Fed) far beyond their formal jurisdictions $\Rightarrow$ major source of actual volatility in capital flows, export of inflation or deflation
- Others must follow decisions of major players (dealing with ‘external’ shocks produced by their decisions)

Capital mobility and monetary policy (global perspective)

- Call for global monetary policy coordination – how much politically realistic???
- Worse, macroeconomic theory does not provide conceptual and analytical tools for such a coordination
  - How to define and measure a global money supply?
  - What factors and mechanisms determine changes in global money supply? (for example, the role of cross-country money multipliers under various exchange rate regimes)
  - All theoretical models of monetary policy (like the Taylor rule) analyze its determinants, tools and consequences within a single national economy (no global monetary model or even sufficient external spillovers in national models)