

NOTES ON CAPITAL ACCOUNT MANAGEMENT

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I want to talk about two sets of capital account issues: Country-specific dilemmas in dealing with large capital inflows and global equilibrium issues.

Country Specific Issues

What are the conditions under which a *real appreciation* caused by large inflows is a problem? There are many specific channels through which a problem can arise, but the generic concern is that somehow the medium and long-run health of the economy will be compromised by a sustained appreciation.

In order to justify policy intervention, these concerns must be about *externalities*, either pecuniary or technological. I will focus on the former.

A prominent example of a pecuniary externality arises when there is limited domestic financial development, so the export sector can't ride a temporary capital inflow spike despite its positive net present value. Or even if capital flows are permanent following, for example, a major oil reserve discovery, the speed of the appreciation may be too much for the non-commodity export sector to fund the required retooling.

To understand the mechanism, think about a temporary capital inflow that expands domestic expenditure and hence appreciates the *real* exchange rate. It turns out that there is a potential for a negative externality in this context, even if we completely disregard the welfare of export producers. To see this, ask the question: What happens once the temporary capital inflow goes away? If the export sector is financially damaged, then it will take a much larger real depreciation (and hence expenditure contraction) for it to absorb the labor force released from non-tradables. If consumers collectively could internalize this effect, then they would contain the initial surge in expenditure in order to reduce the real appreciation and its damage on a financially constrained exports sector.

In this context, economic policy is a substitute for the lack of coordinated foresight of domestic consumers.

A second branch of externality arises from a domestic financial system that has its own agency problems, which are exacerbated by cheap external funding. Here the main direct problem is not the real exchange rate but the kind of risks undertaken by the domestic financial system.

Either way, taxing capital flows is a very suboptimal and indirect policy for dealing with these issues:

- If the problem is mostly from excessive expenditure during the boom phase, then the right policies are expenditure stabilization ones, possibly coupled with the development of foreign exchange hedging strategies for the non-commodity export sector.

If the problem is one of imprudence of the domestic financial system, then the issue is more one of domestic financial regulation and supervision than of capital flows control.

In practice—when I think, for example, about the appreciation problems of Brazil— the first policy that comes to mind is fiscal policy, not taxes on capital flows. The genesis of the appreciation problem in Brazil is at best 10 percent due to the second round of U.S. quantitative easing (QE2) and 90 percent due to domestic fiscal policy and exorbitant local market interest rates. Hence, attacking capital inflows *per se* is really an avoidance strategy.

Similarly, when I think of the problems of the United States that led to the crisis, I don't think they had much to do with the level of capital inflows (and hence with the current account deficits) *per se*. Instead, I think the problem was the extreme bias of these flows toward AAA fixed-income assets, which interacted very poorly with incentives in the domestic financial system to create and hold assets that may have been AAA from the point of view of microeconomic shocks but not for macroeconomic ones. Here again, the problem is one of inadequate capital charges for AAA collateralized debt obligation (CDO) tranches and related assets, not capital inflows *per se*.

Of course, one can look at things the other way around and argue that these structural problems can't be fixed at the right speed, and hence we can't afford to let capital flows exacerbate their cost. I am more sympathetic to this argument, but it is important that the complete argument be made. Countries must be explicit and say: "I have a serious problem here and hence I have to slow down capital inflows while I fix the real problem."

Absent this complete statement, I fear policymakers may end up chasing symptoms rather than the illness.

Global Equilibrium Issues

To close the analysis, we need to think about the supply side as well. What is the responsibility of the countries that trigger the capital flows, either due to large saving rates or by feeding carry trade by keeping funding costs very low?

I find this case even harder to make than the domestic justification for taxes on capital flows. What business is it of the United States, France, or Brazil to decide what is the optimal *relative* saving rate for China? Or for Greece and Portugal to do the same for Germany? And I highlight the word *relative*. Thank God they have chosen to do things a little differently; this has been a source of stability, not instability, for the world economy.

It is funny, in Industrial Organization we worry about low prices (in this case low interest rates) when these are part of a deliberate strategy to destroy competition and hike prices later. Are we really worried that the Chinese are keeping rates low to then punish the debtor countries by raising rates quickly? Tea Party claims aside, I doubt many people in this room take this argument seriously—especially since they are the debt holders so they would be punishing themselves! So the advice must be of the paternalistic kind. But we don't know enough about optimal saving rates to do this with any real *intellectual* authority.

The same applies to the concern with the impact of QE2 around the world. I frankly do not see why the United States should risk a repeat of the Japanese lost decade because some overheating emerging market feels uneasy about it. Besides, by stabilizing U.S. equity markets, QE2 ended up doing just the opposite that was feared, and reversed capital flows to emerging markets. We shouldn't be imposing our own preferences about macroeconomic policy frameworks on others, especially when we don't even understand the mechanisms!

Conclusion

Don't attack the thermometer. Deal with the real issues.

For emerging markets, the main concern at this time is a combination of fiscal adjustment and/or fostering the development of domestic financial markets and fx derivatives. Low interest rates are a fact of modern economic life, so we better get used to it.

For developed economies, especially the United States, make sure that AAA assets created and held by banks have the appropriate capital charge if they are built on the basis of the law of large numbers and hence are exposed to systemic risk. The heavy demand for safe assets from the rest of the world will not abate, so we need to get used to that as well.

Thank you.