A Case for An Integrated Policy Framework

Jackson Hole Economic Policy Symposium
August 24th, 2019

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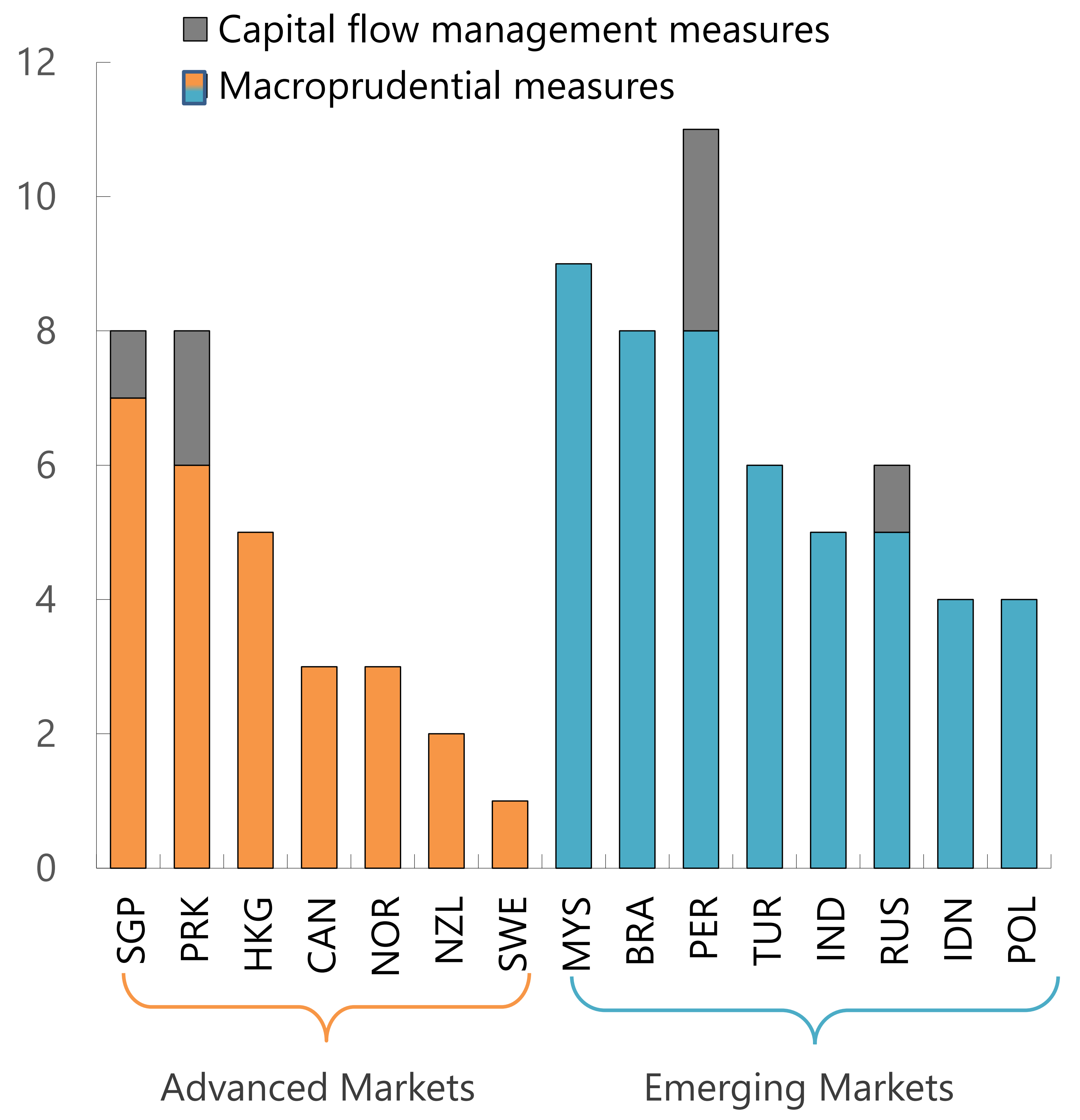
Countries have used various policy tools for macro management

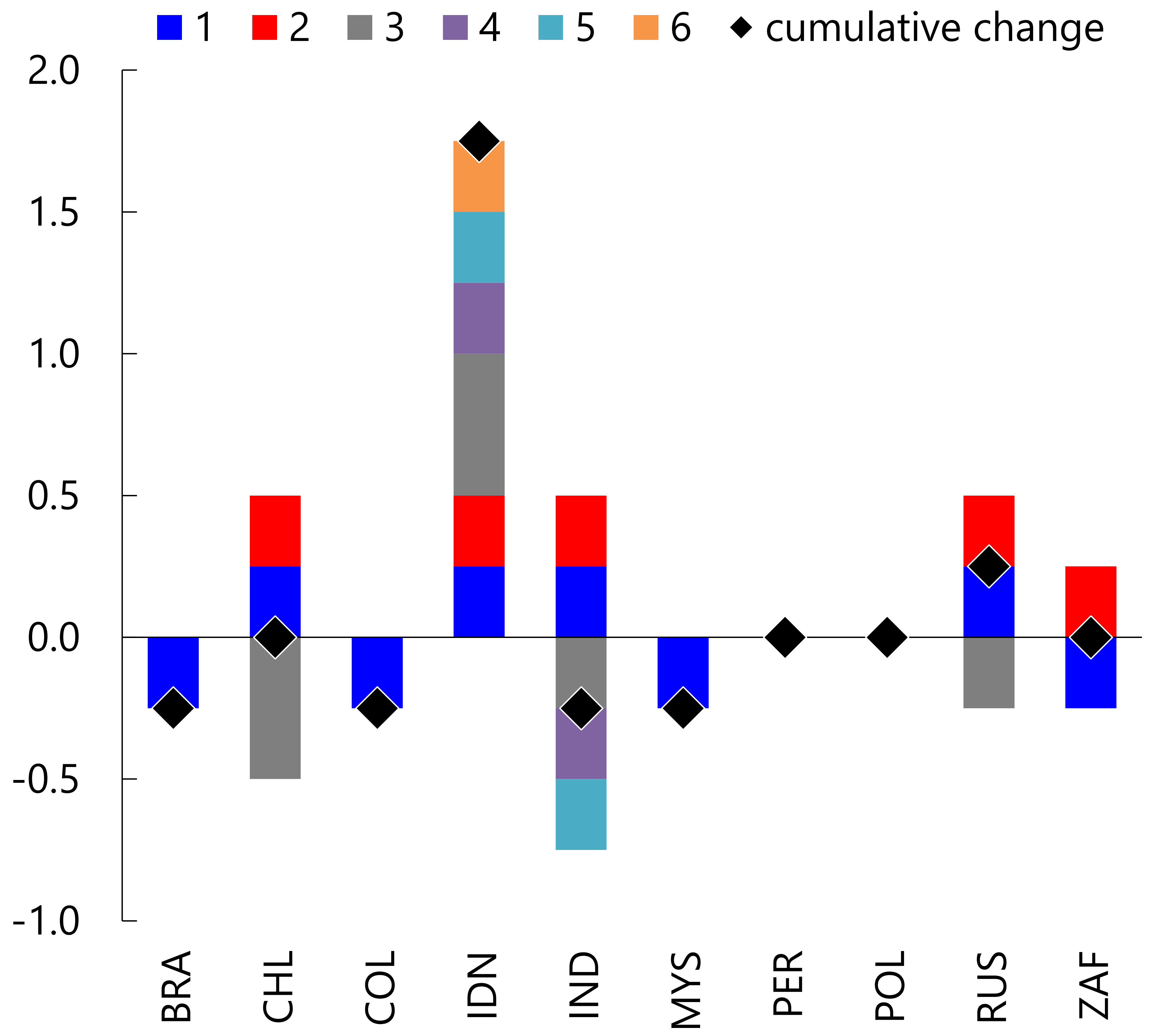
Inflow Episode

Number of macroprudential and capital flow management measures, 2010-11
(number of measures)

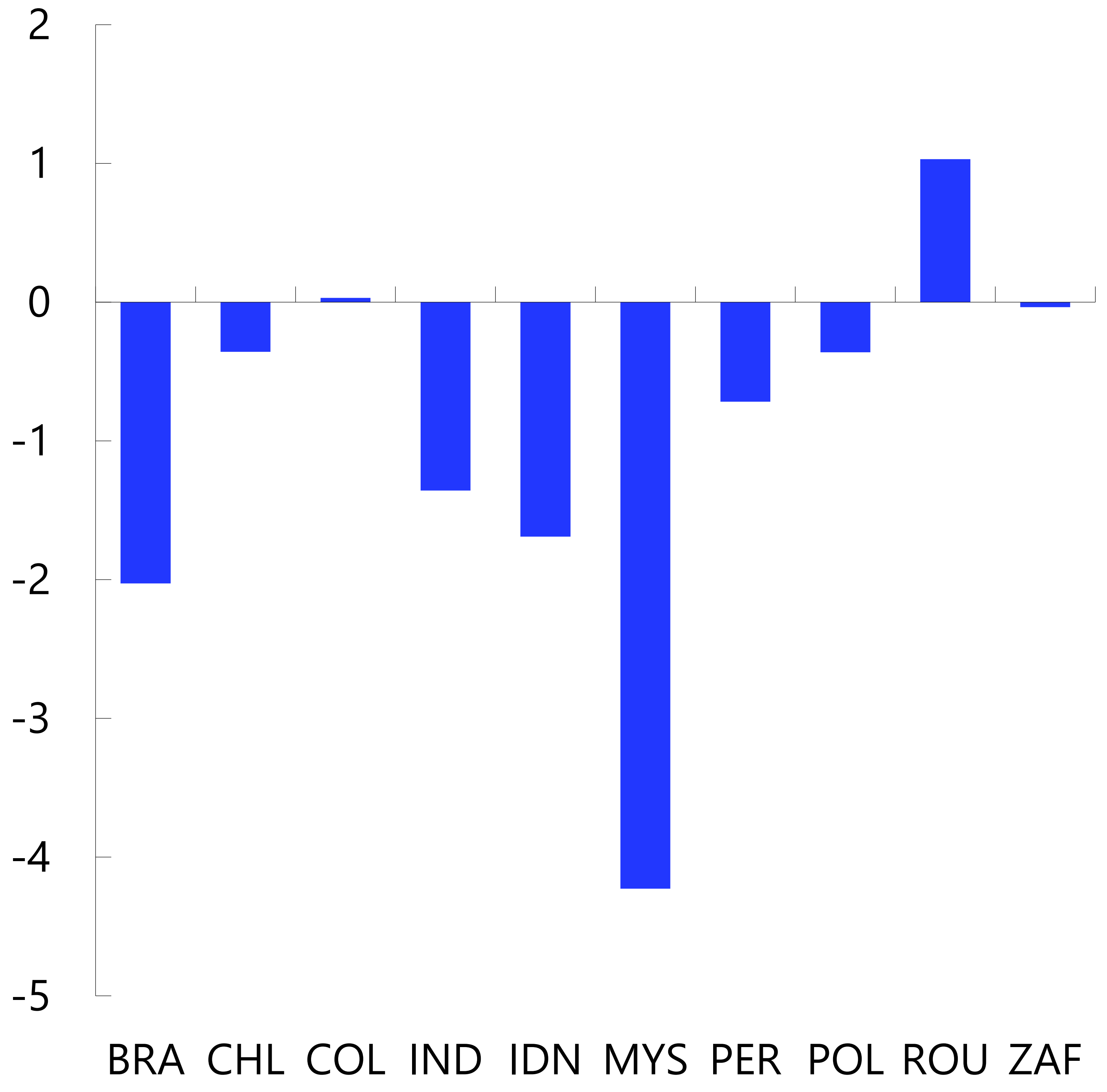


Outflow Episode

Policy rates changes since March 2018
(percentage points)



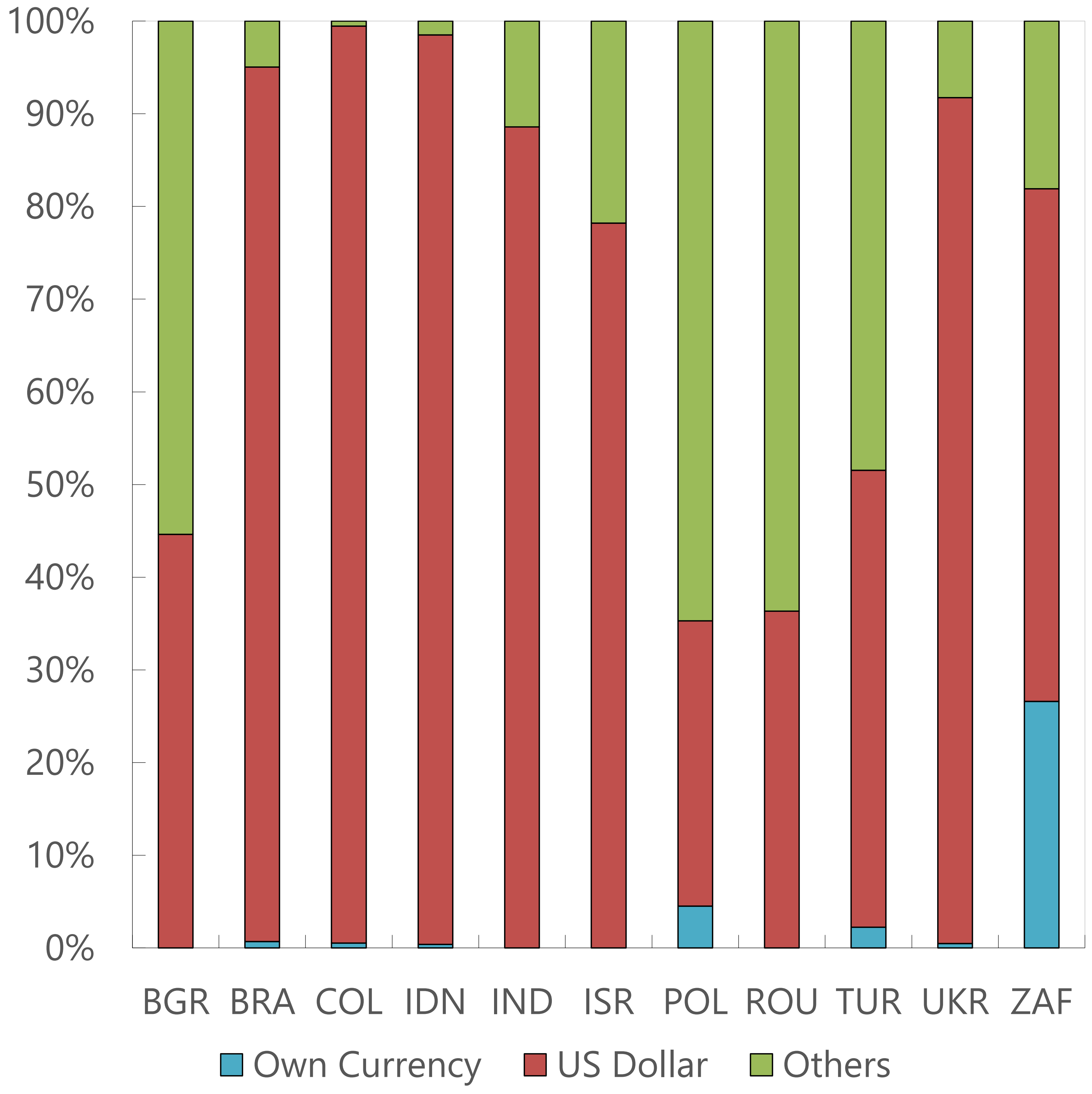
Change of Reserves, March-October 2018
(cumulative, percent of GDP)



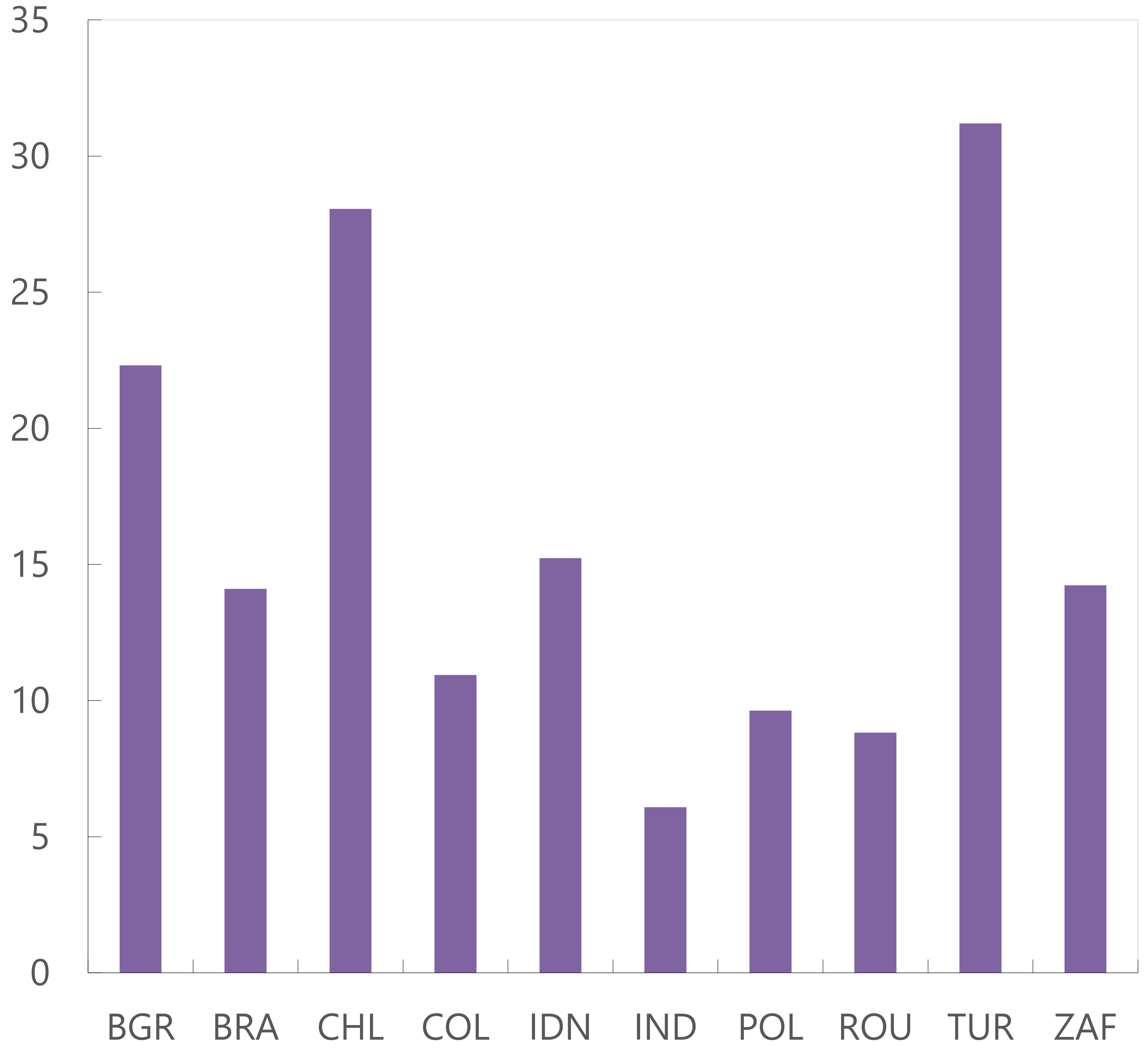
Sources: Alam and Others (2019), Haver Analytics; and Bloomberg, L.P., IMF BOP, and IMF staff estimates.

Country characteristics vary along several dimensions

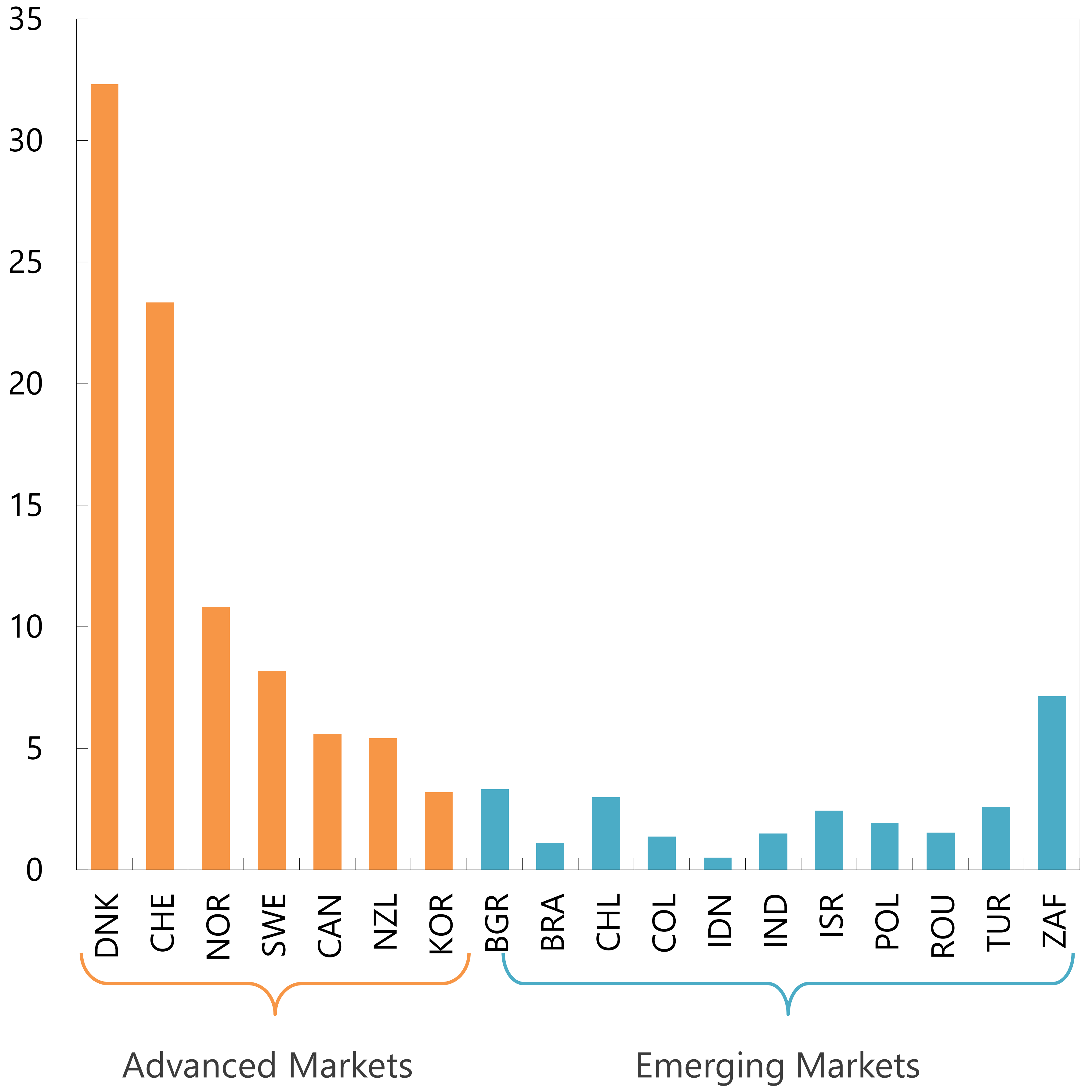
Currency of export invoicing
(percent of total)



Non-financial corporate foreign currency debt
(in percent of GDP, 2018)



FX market turnover
(in percent of GDP, 2016)



Sources: Gopinath (2016), IMF, and BIS.

Modeling an integrated policy framework

Shocks

- Real: productivity, commodity price
- Financial: world interest rate, debt limit, capital flows

Country Characteristics

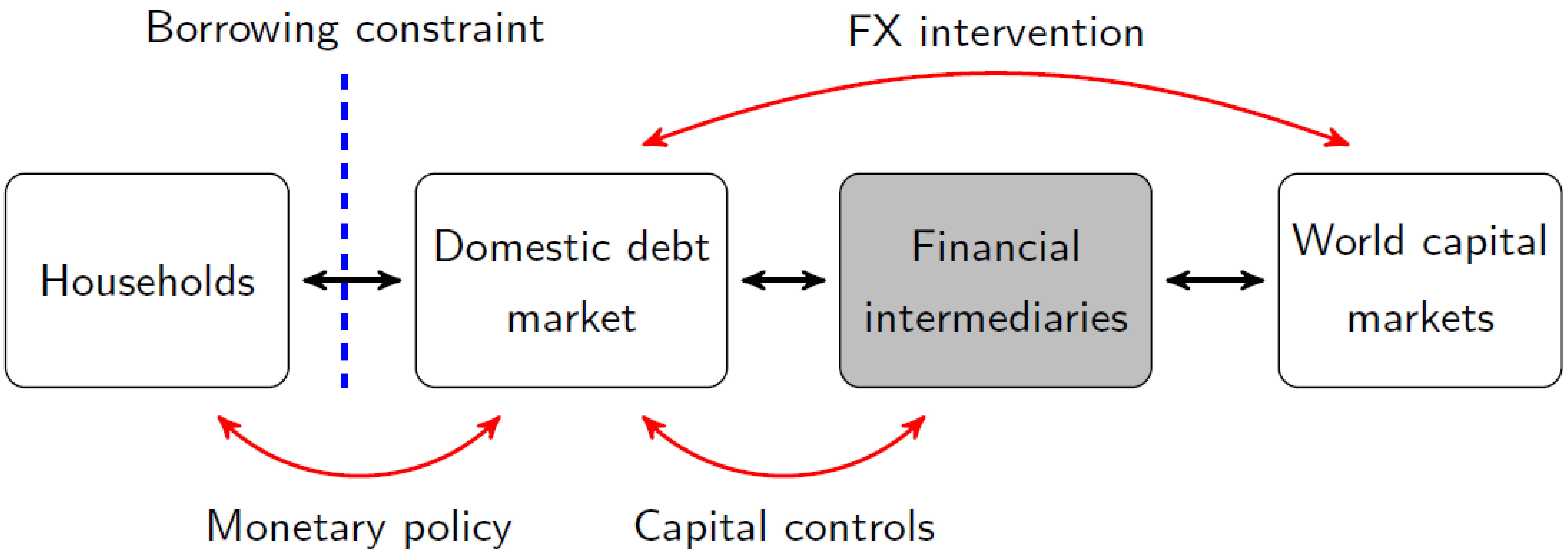
- Currency of trade invoicing
- Commodity export share
- Currency mismatch
- Debt limit
- Stock of debt
- Depth of FX market
- Imperfect domestic credit markets

Policy Options

- Monetary policy/Exchange rate flexibility
- Capital controls
- FX Intervention
- Macroprudential policy

Model ingredients

- A micro-founded small open economy: tradable goods, sticky prices, producer currency pricing (PCP) or dominant currency pricing (DCP)
- Policy tools: integrate monetary policy, capital controls and FXI



Policy trade-offs

Policy		
Flexible exchange rates	Benefits	Expenditure switching but weaker under DCP
	Costs	Negative balance sheet effect and risk of binding borrowing constraint in case of depreciation
Capital controls	Benefits	Prevent overborrowing and alter debt/consumption profiles
	Costs	Distort capital flows
FX intervention	Benefits	Can free up monetary policy by affecting the exchange rate separately
	Costs	Carry cost

Remark 1: Not all instruments affect all imperfections

Shock: Real (productivity) shock
Country characteristics: Dominant currency pricing, deep FX markets

Shock hits

t = 0

t = 1

Monetary policy: stimulate the economy → **Output gap remains**

Despite output gap, there is no case for capital controls or FX intervention:

- Imperfect stabilization arises from stickiness of price in dominant currency, not from overborrowing

Remark 2: Instruments typically affect multiple imperfections

Shock: Financial (debt-limit) shock
Country characteristics: Dominant currency pricing, deep FX market

Shock hits

t = 0

t = 1

Monetary policy: stimulate the economy and defend the ER

Prudential policy (t = 0):

- Impose capital controls, which may lead to higher post-shock policy rate

Prudential CC > 0

Shock hits

t = 0

t = 1

Monetary policy: less need to stimulate, less need to defend the ER

Country characteristics matter

Country Characteristics	Shocks	Policies (preliminary)
PCP/DCP Commodity exporter Deep FX markets	Productivity Commodity price World interest rate	Mundell-Fleming prescription
FX mismatch Shallow FX markets	Debt limit Capital flows	Role for capital controls/FXI

Five broad principles

1. Not just the number but the workings of instruments matter.
   - **Not all instruments affect all imperfections.**
   - **Instruments typically affect multiple imperfections.**

2. PCP countries receive greater benefits from exchange rate flexibility. Since exchange rate adjustment is a weaker tool, DCP countries achieve less macro stabilization and may need larger exchange rate movements.

3. DCP alone does not change the M-F prescription.

4. Prudential capital controls can help when there is a possibility of not being able to borrow. DCP countries impose higher capital controls because of the larger exchange rate movements desired based on trade considerations.

5. FX intervention can increase monetary autonomy when foreign exchange markets are shallow and monetary transmission channel is at least partially functional.

In practice incorporating multiple objectives and tools into monetary policy frameworks is likely to be challenging. Clear communication is key in safeguarding efficacy and credibility of monetary policy.