Liquidity Traps, Capital Flows Acharya and Bengui

Discussion by Gregory Thwaites

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Plan of discussion

- What the paper does
- What I liked
- Questions and suggestions
  - Small picture
  - Bigger picture

What this paper does - setup

- DGE model of 2 blocs of small open economies in continuous
- International bond traded. Returns are subject to a ‘capital flow tax’
- Fixed producer prices
- Optimal policy is to stabilise output gap

What this paper does - experiment

- ‘Northern’ bloc becomes more patient and hits the ZLB.
- To stabilise output, North must hold rates at zero beyond dissipation of the shock (a la Eggertsson and Woodford)
- This switches expenditure towards Northern good, so South lowers rates too but remains above the zero bound.
- Optimal policy defined as maximising Northern welfare subject to not making South worse off than no-controls case

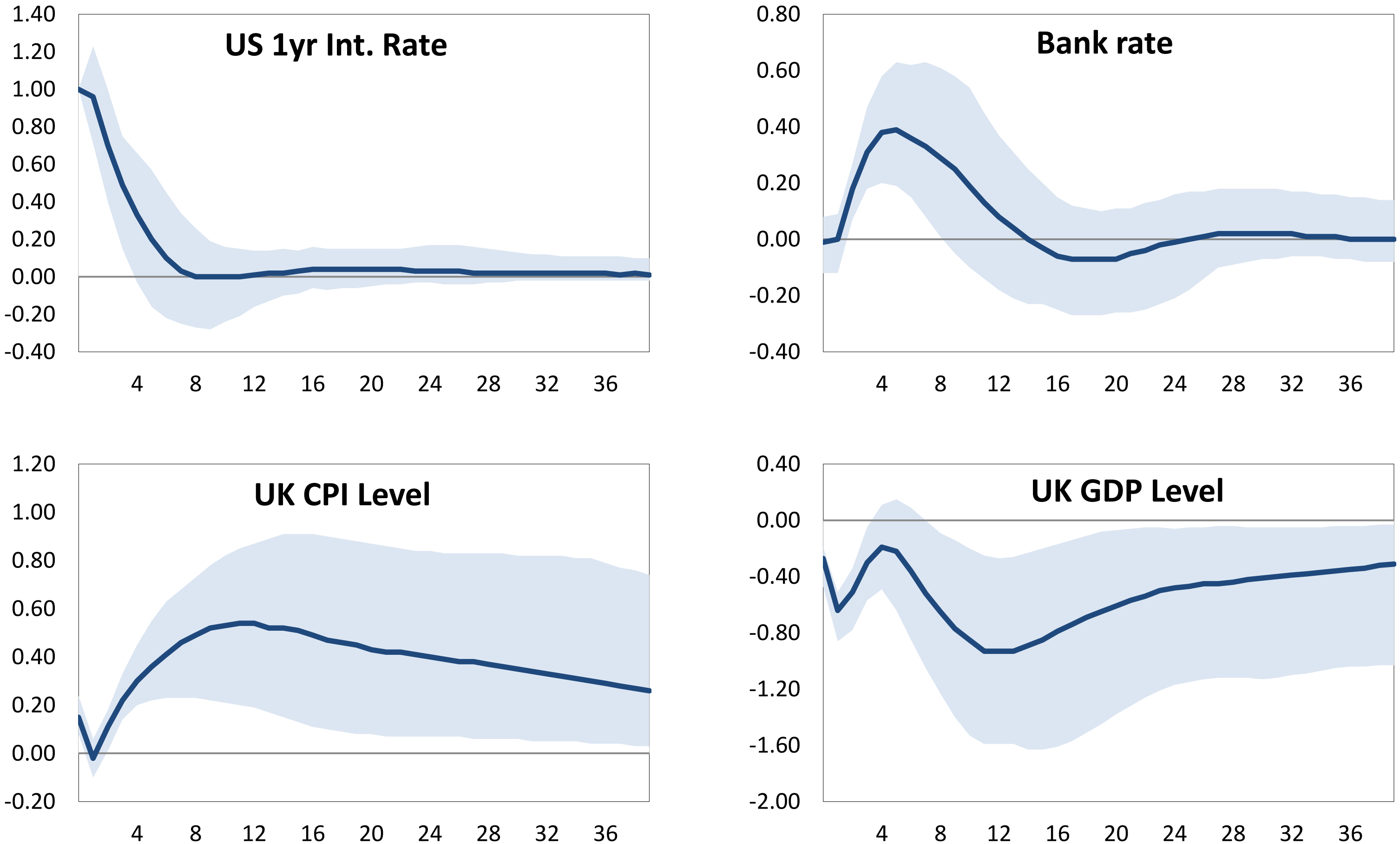
What this paper does - findings

- South should subsidise capital inflows while North has weak demand, then tax them while North has low rates but normal discount factor
- Capital flow subsidy increases expenditure switching relative to demand effects of monetary policy, then switches expenditure back the other way

What I liked

- Highly topical and policy-relevant question
- Provocative and credible answer

Effects of US monetary policy on the UK – empirical estimates



Note: *The charts report the impulse response functions to a monetary policy surprise that raises US 1-year government bond yield by 1pp. The y-axis shows percentage deviations from a long-run trend. Dotted lines represent 95% confidence bands. The x-axis shows quarters after the monetary policy surprise*

Source: Ambrogio Cesa-Bianchi (Bank of England)

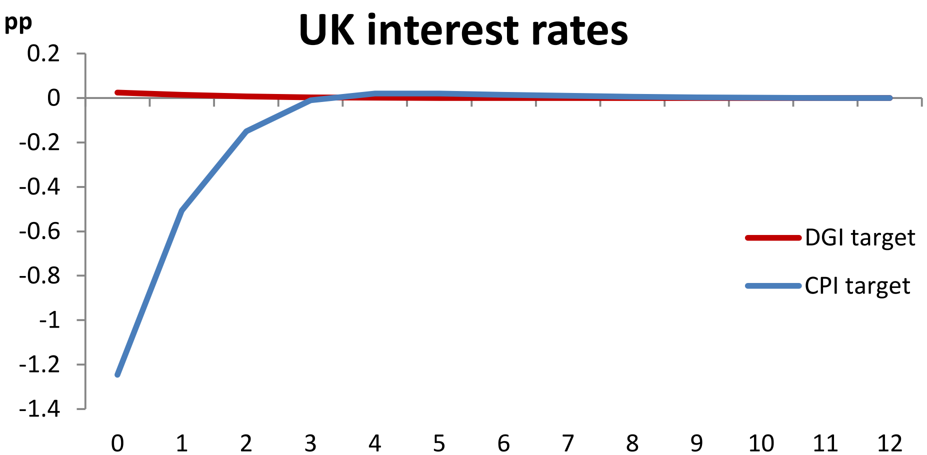
How general are the results?

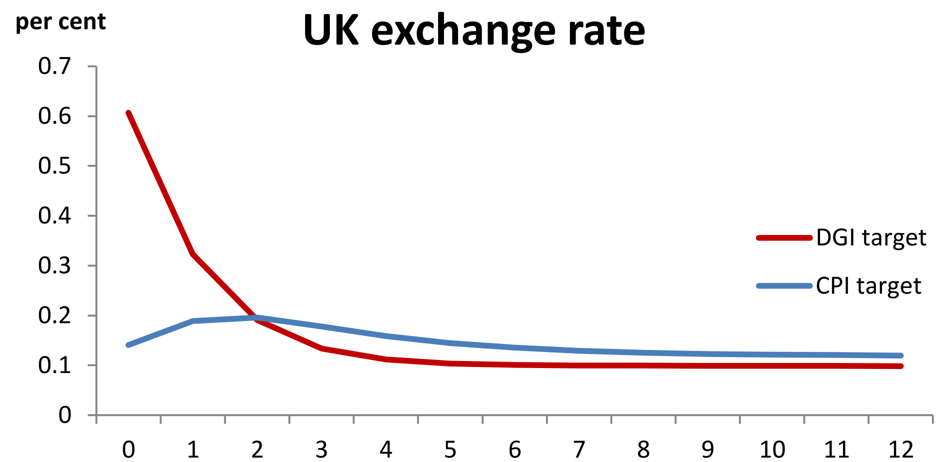
- Parameterisation
  - Capital controls work by breaking link between interest and exchange rates
  - i.e between effects on volume of expenditure and relative price
  - <u>**Home-foreign elasticity of substitution**</u> is key to their effects
  - So desire to skew interest and exchange rates may be sensitive to the choice of this parameter
  - Other studies (e.g. Haberis and Lipinska) find that results very sensitive to this choice
  - Worth exploring sensitivity here

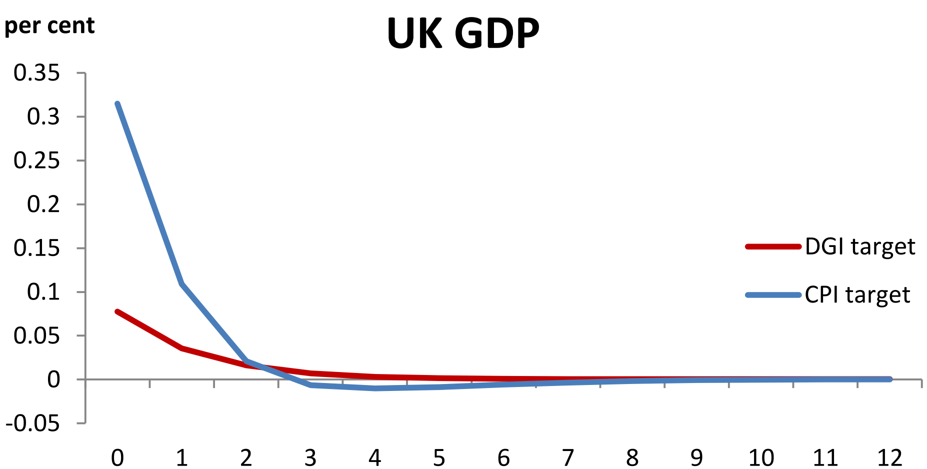
Policy questions

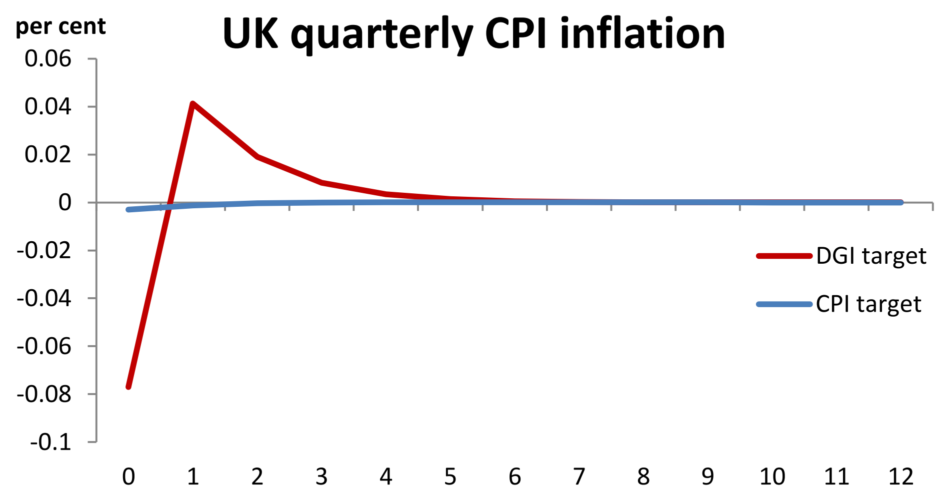
- Post-crisis policy was arguably time-consistent
  - What happens if countries follows time-consistent policy?
  - Are capital controls still optimal?
- Time-varying optimal capital controls add additional dimension of time inconsistency
  - By construction, South does this for no benefit
  - What if we maximise South welfare subject to North being no worse off?
- What happens if central banks care about inflation?
- How large are the welfare gains vs no capital controls?

Policy rules targeting domestic or headline inflation – response to foreign monetary shock









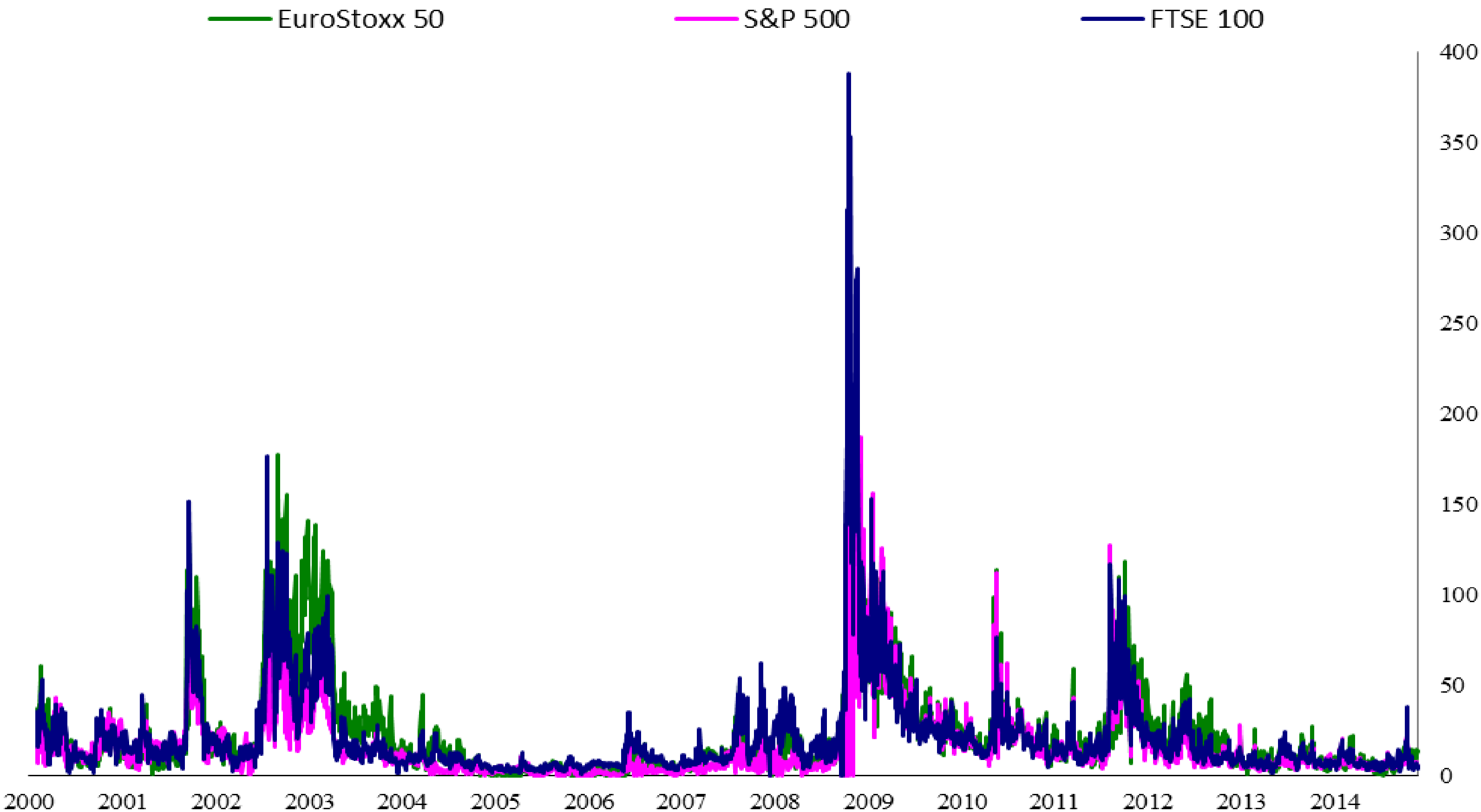
- In the face of a foreign monetary expansion, hold rates to stabilise domestic costs, cut them to stabilise CPI

Source: Ida Hjortsø (Bank of England)

Additional channels of international monetary transmission

- Is foreign monetary policy expansion stimulative for home?
  - Foreign economy bigger
  - Home goods more expensive higher
  - Results can go either way, or nearly offset
- Additional channels are quantatively relevant
  - Gross balance sheets and asset revaluation
  - Risk premia and financial conditions

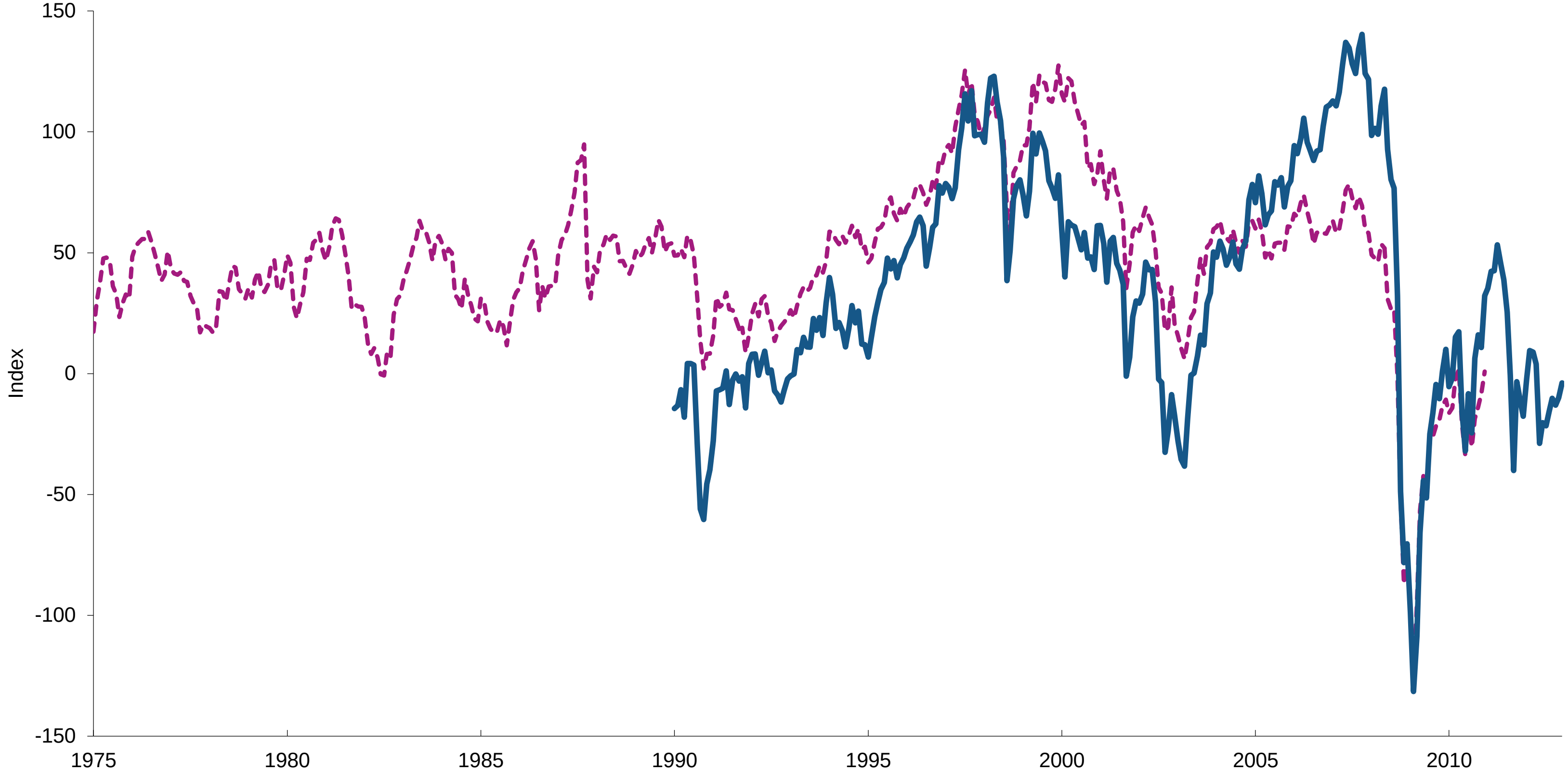
Global variance risk premia



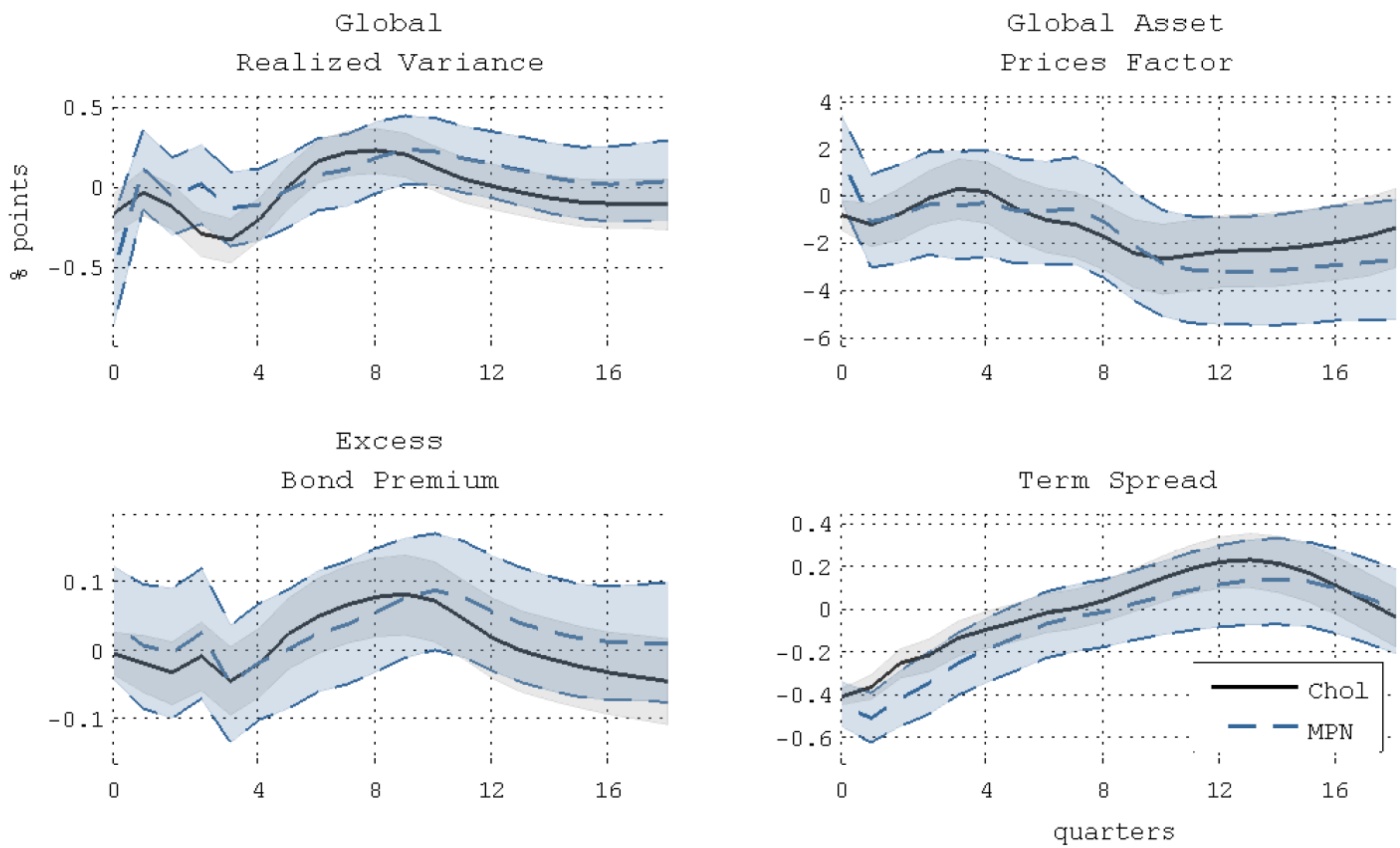
- Risk premia are highly correlated across markets

Source: Kaminska and Roberts-Sklar (forthcoming)

Global financial cycle - common factor

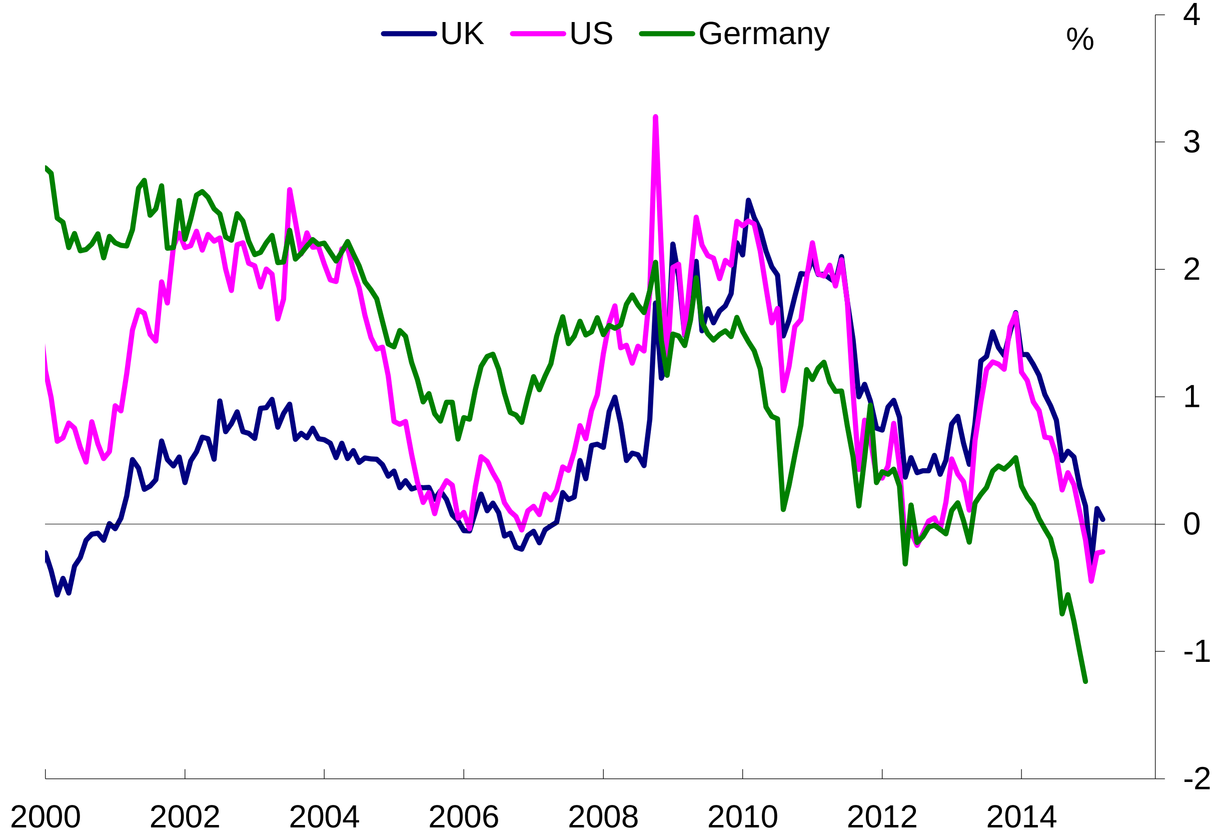


Response of global financial variables to surprise tightening of US monetary



Miranda-Agrippino and Rey (2015)

Estimated 10yr term premium



- Estimated term premia appear to co-move across countries.

Summary

- Nice paper on an important question
- Optimal policy seems a long way off, but we have to start somewhere
- How general are the results?
  - Parameterisation
  - Additional channels of international transmission