

Introduction

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Currency flows have always been a leading policy concern, especially in emerging markets. The long Japanese slump, the ensuing very low interest rates in Japan that have lasted 20 years, and the carry trades this fostered made currency flows a hot topic again, even before the global financial crisis increased liquidity in all developed economies and led to a new wave of currency flows to emerging market economies.

Emerging market economies – and developed economies, for that matter – have a love-hate relationship with capital flows. On the one hand, in principal, capital flows can help intertemporal smoothing by allowing increased current consumption and investment against future income, which these countries welcome. On the other hand, these are often short-term flows – so-called hot money – which may be reversed at any time and pose repayment difficulties. Moreover, in practice, such capital flows are often pro-cyclical, rather than countercyclical, leading to greater volatility in consumption and investment. Further, there may be externalities from foreign borrowing-led exchange rate exposure and domestic credit growth.

Policymakers take these issues seriously and devote considerable time and energy to thinking about policies related to currency flows and implementing them. This duty almost always falls to central banks, which are asked to lean against the wind and set policy tools to control, or at least stabilize, currency flows. Accordingly, this volume on currency flows leads off with two essays from central bankers on the experiences of Peru and Turkey with these flows and their attempts to manage them. The discussion then turns to current trends in capital flows, particularly with analyses of the Chilean, Brazilian and Chinese cases, and concludes with discussions of policy effectiveness, spillovers and coordination.

The chapters in this volume were presented as papers in their draft forms at the International Economic Association roundtable, hosted by the Central Bank of Turkey in Izmir in 2012. There was a very lively debate, on both policy issues and theoretical considerations. The papers were revised based on feedback received, and their final forms are presented here.

The narratives of the Peruvian and Turkish experiences with capital flows set the tone of the volume. Both countries had similar periods of booms and busts, fueled by capital flows, and both have seen the nature of these flows change over time. Importantly, capital flows that were once driven by government borrowing are now driven by private borrowing.

This post-twin deficits era poses its own problems. Peru, which had moved away from large budget deficits and the associated capital flows before Turkey did, experienced a period of large capital inflows with low budget deficits. The capital flows were not seen as problems because the policy reflex was that so long as the budget deficit was controlled, the economy was on a sound footing. Tellingly, it later turned out that large capital inflows can be reversed and cause major problems quickly, regardless of who the domestic borrower is. Of course, this is a lesson that should have been learned from the East Asia crisis: those countries had long had sound budgetary finance, but the region experienced a severe crisis nonetheless.

Both Peru and Turkey had heterodox policy responses to capital flows to control the capital account. These ranged from explicit capital controls in the form of taxes on short-term capital inflows to deliberately increasing the variance of the overnight interest rate to increase the risk of capital flows.

In “Peru’s Recent Experience in Managing Capital Flows,” Paul Castillo explains the Peruvian experience and stresses the importance of jointly prudential monetary and fiscal policies. Fiscal discipline helped limit capital flows, and credible monetary policy prevented high dollarization and excessive exchange rate risks. Hence, even the sudden capital flow reversal associated with the global financial crisis did not lead to a crisis in Peru.

Turning to the Turkish experience, in “The Turkish Approach to Capital Flow Volatility,” Yasin Akçelik, Erdem Başçı, Ergun Ermişoğlu and Arif Oduncu present the Turkish response to the financial crisis-induced capital flow reversal. The Turkish case was marked by the use of unconventional monetary policy tools for macroprudential purposes. Reserve requirements, active liquidity management tools and a wide interest rate corridor were employed at different times or in tandem.

The Chinese experience is fundamentally different, as China has yet to liberalize its capital account and allow unhindered capital flows. It is slowly opening up its capital account and distinguishing between different types of capital flows in placing or removing barriers to flows.

Ming Zhang focuses on the Chinese case in “The Liberalization of Capital Account in China: Retrospect and Prospect.” This paper is different from the rest of the volume in that, while all other countries are looking for ways to control existing capital flows, China is looking for

ways to open up and increase capital flows in a controlled way, without causing macroeconomic fluctuations.

The question of cross-border policy spillovers appears in the work of Brittany Baumann and Kevin Gallagher, who study the effectiveness of Brazilian capital controls and their spillover to Chile. In “Navigating Capital Flows in Brazil and Chile,” Baumann and Gallagher show that Brazilian policies effectively lengthened the maturity of capital flows but also led to increased flows to Chile.

Controlling capital flows requires policy coordination, be it in the form of coordination between policymaking institutions within a country, or coordination across countries. An important question for each country is who shall be responsible for capital account management. In many countries, this duty is shouldered by the central bank, but it is not clear that this is the optimal allocation of responsibility. In particular, if the capital flows are driven by fiscal policy, either because of budget deficits or due to balanced-budget expansionary policies, the central bank taking the responsibility for currency flows may actually make it easier for fiscal policymakers to pursue policies that foster an unsustainable volume of capital inflow, with the monetary authorities taking the blame from any untoward effects of the capital market interventions. Hence, intra-country policy coordination becomes important in thinking about optimal controls on capital accounts. The current regime of central banks taking responsibility for all cyclical policies may not be the best one (even more so as we have come to understand the limitations of monetary policies in the aftermath of the crisis).

Refet Gürkaynak highlights this issue in “Appropriate Policy Tools to Manage Capital Flow Externalities.” Gürkaynak argues that central banks shouldering the duty of managing capital flows has led to them also shouldering the blame for the effects of these flows. This, especially in the Turkish case, gave the government wrong incentives to pursue unsustainable expansionary policies, which increased foreign borrowing and made the central bank’s job even harder.

Inter-country policy coordination has traditionally been studied in much deeper detail. In particular, policies directly targeting the capital account and foreign exchange interventions may help in dealing with currency flows but may also have spillover effects to other countries. In this case, international policy coordination will likely enhance welfare by making it less likely that such measures are not merely diverting flows to other countries.

An important case in this regard is the US quantitative easing, which has had worldwide effects. The United States is not a small open economy; hence studying it requires modeling a world with at least two large countries. In such a world, each of the actions of a large country (both conventional monetary actions as well as those associated with capital account management) has consequences for the macroeconomic equilibrium in other countries, and the rules governing a large country’s responses to shocks of various sorts have implications for the consequences of alternative rules adopted by other countries. Moreover, the spillovers from the United States to the rest of the world make the policy less effective in the United States, as part of the stimulus is diverted to other countries in the form of capital flows.

Joseph Stiglitz tackles this issue in “Monetary Policy in a Multi-Polar World.” His findings imply that controls on capital flows may make monetary policy more effective, that including such controls in the toolkits of countries enhances the possibility of a cooperative equilibrium, and that the equilibrium of the coordinated game is welfare superior to that of the uncoordinated Nash equilibrium. Hence, international monetary policy coordination is imperative, especially if the policy action is being taken by large open economies. Further, it was a mistake by the international community to try to proscribe capital account management tools – a mistake which has now been recognized by the IMF, but which trade negotiators, particularly from the United States, seem not to have fully taken on board.

Returning to the issue of capital control spillovers, Jonathan Ostry presents an empirical study of capital controls and foreign exchange interventions in emerging markets, in “Managing Capital Flows – Capital Controls and Foreign Exchange Intervention.” Ostry argues that while these policies may have spillover effects to other countries, their use may still be warranted, but coordinated policy actions would perform better than isolated policies of individual countries, reinforcing Stiglitz’s theoretical analyses. He also notes that the same policies may be used to prevent painful but necessary external adjustment, in which case they would not be welfare-enhancing.

This volume, as a whole, presents the current state of the art in policymaking and academic thinking on currency flows in a non-technical, accessible manner. The editors hope it will spur more research in this critical policy area.