Capital controls, macroprudential measures & monetary policy interactions in an emerging economy

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Discussion by
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ABFER conference, Singapore, May 2018

What the paper does

Considers means of mitigating the negative effects of financial and technology shocks in an economy with foreign currency denominated (FC) debt.

Explores the roles of

- a tax on FC debt (capital control) &
- a subsidy on bank capital (macro-prudential policy)

Can they improve welfare?
How do they interact with monetary policy?

Findings

In an economy with foreign currency denominated debt

- In response to foreign interest rate (MP) shocks
  - tax on FC debt aids stabilisation
  - complements MP in addressing tradeoffs between inflation and financial fluctuations
  - allows MP to focus on inflation
  - subsidy on bank capital less effective

- In response to net worth (risk) shocks
  - tax on FC debt aides stabilisation
  - MP independent of FC debt tax
  - optimal FC debt tax increasing in MP agressiveness

- In response to productivity shocks
  - subsidy on bank capital more effective

Fit in literature

Closest paper: Aoki, Benigno and Kiyotaki 2016 (working paper)

- economy with foreign currency debt
- GK-type bank financing constraint
- no entrepreneur financing constraint
  (bank holds risky assets directly)
- tax on risky bank assets, tax on FC debt, subsidy on bank capital
- Foreign interest rate shock: important
  - tax on foreign debt is optimal
  - cyclical tax allows MP to focus on inflation, provides a complementary stabilisation tool (Rey 2015, Obstfeld 2015)
- Technology shock:
  - tax on bank risky assets "similar to capital requirement" improves welfare

Contribution: focus on new worth (risk) shock

... relative to Aoki et al (2016)

- Extend the model to include entrepreneur financing constraint
  Gain from doing so not clear
- Add net worth shocks. Nice. Spread vs benchmark?
  ... that increase funding costs, but reduce inflation
  $>$ MP is independent of capital controls
  $>$ optimal capital control policy increasing in MP aggressiveness
- Technology shock:
  $>$ subsidy on bank net worth is optimal
  Broader literature?

Terminology "macro-prudential policy", "capital control", "financial shock"

Suggestion: Local currency benchmark

These papers consider monetary policy, macro-prudential policy, a capital control.

Foreign currency denominated debt is taken as a given feature of EMEs. Not all of them!

What about structural policy?

How does a shift to LC debt compare in your model environment?

A useful benchmark, at least. Policy agenda. Broader relevance.

Local currency debt markets

For people to buy local currency debt:

- Effective monetary policy
  (commit not to inflate away the debt)
- Commitment to prudent fiscal policy
  (don't burden the banks with fiscal debt)
- Clarity regarding exchange rate policy
  (don't meddle in FX component of returns)
- *Allow non-residents (hedging counterparties) to issue local currency debt*

Synthetic local currency debt

Many advanced country banks/firms issue a large amount in foreign currencies, but don't have currency mismatch because they swap the proceeds into local currency. (eg New Zealand, US-Euro area, increasingly EMEs)

Why? (Munro and Wooldridge 2011)

- obvious answer: its cheaper. Why is it cheaper?
- unbundle correlated risks
- complete markets

Risk of early opening of financial account? Yes, but manageable?

SG example

Brazil:

- international debt securities outstanding about the same as NZ
- Bazil's GDP double NZ GDP

Policy instrument dynamics: show IRFs

Transmission mechanism of policy instruments is not clear.

- Add a shock to the AR(1) process to show IRFs for each policy instrument - especially the net worth shock (they can be in the appendix)
- Then the policy transmission mechanism is clear.
- Policy experiments unchanged (turn off policy shocks for those anyway) ... but easier to explain and understand.

Dilemma vs trilemma

In part, motivated by Rey 2015
... but in your model, the trilemma is alive and well
- model economy has open financial account and control of the local interest rate.
- interest arbitrage ties down the exchange rate
(UIP is the trilemma in an open economy)

Obstfeld 2015: Is it just that MP tradeoffs have become less favorable?
At what stage do tradeoffs look like a Dilemma?
eg. When the main driver of the home policy rate is foreign policy rate?

Summary

A well executed paper that addresses interesting and important policy questions.

Suggestions:

1. Focus on risk shock (benchmark vs spread)

2. LC debt is a useful benchmark. Relevance, policy agenda.

3. Clarity re policy transmission mechanisms.

4. Trilemma (Dilemma) exists in this model - can you inform the debate?.