Capital Controls and Monetary Policy in Sudden Stop Economies

Devereux, Young and Yu

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This is a Very Nice Paper!

The paper is related to the Bianchi-Mendoza (2017) paper, but makes two important changes:

1. The Kiyotaki-Moore borrowing constraints depend on expected future value of capital rather than current value.
2. Nominal prices are sticky, so monetary policy matters

Some important findings:

1. Optimal monetary policy can relax the borrowing constraint in some circumstances
2. If capital controls are available, they can improve outcomes, and monetary policy devotes to inflation targeting
2. There is never a circumstance where macroprudential capital controls are optimal.

Don’t Follow This Policy Advice!!

- I’m not saying the model is bad or the derivations are incorrect.
- Most of the advice is under “discretion”. We don’t want to tell policymakers the optimal discretionary policy. Optimal discretionary policy can be very bad.
- Indeed, the paper shows that the “optimal” capital inflow taxes tend to reduce capital prices and increase the likelihood of a crisis – even though they are intended to do the opposite.
- It would even be better to tell the policymaker some rule of thumb to follow rather than the optimal policy under discretion (as, indeed, the paper shows.)
- Calculating optimal discretionary policy is useful in positive analysis – to account for something we have seen happen.

Comments on the Right-Hand-Side of Collateral Constraint

In K-M, debt must be less than $\kappa q_{t+1} k_{t+1}$. Lender can recover $\kappa q_{t+1} k_{t+1}$ if debtor runs away.

1. Does this make sense for an open economy? Can a foreign lender recover collateral?

2. The key difference between this paper and B-M is the latter put the constraint as $\kappa q_t k_{t+1}$. In the real world, how would you explain the difference to a borrower? $q_{t+1} = q_t \left(1 + r\right) - r_k$

3. K-M have perfect foresight. This paper has uncertainty and writes the rhs as $\kappa E_t \left(q_{t+1}\right) k_{t+1}$. Is that the right way to move to uncertainty? Shouldn't it be $\kappa \min\left(q_{t+1}\right) k_{t+1}$?

4. In any case, is the threat of absconding with the loan the real reason for credit constraints? Maybe it is default that matters.

Comments on the Left-Hand-Side of Collateral Constraint

The LHS of the collateral constraint has:

Working Capital Debt + Household Debt

1. WCD must be repaid within the period. Only HD is carried over, so only HD affects future constraints. Some policies involve manipulating WCD relative to HD to affect future constraints. Odd

2. If WCD is repaid this period, shouldn't it be constrained by the value of capital today, not tomorrow?

3. In general, maybe households and firms face separate constraints. Also, households probably don't borrow directly internationally. Instead they borrow from domestic lenders that borrow from abroad. (Devereux, Banerjee, Lombardo, 2016)

Some Other Considerations

Extensions of the model might consider:

1. While the paper considers currency mismatch, maturity mismatch is also an important issue.

2. Capital flows in both directions, and during crises there is retrenchment. Capital controls might suffocate “good” retrenchment (Caballero and Simsek, 2016).

3. Borrowing constraints are affected also by regulations. Regulatory “leakages” are an important consideration in open economies.

4. ZLB and capital controls (Farhi and Werning, 2014)

Conclusions

In the end, this paper is an important step in understanding monetary and capital account policies.

The particular results are model-specific, but it is important to read the paper to get insights on:

- How monetary policy and capital account policies interact
- The different policy implications for forward-looking constraints versus non-forward-looking
- Time-consistency problems with discretionary policy, and how policy commitment might differ

Thanks for giving me the opportunity to read and discuss this thought-provoking paper!