

COMMENTARY

Macroprudential Policies in a Global Perspective

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Olivier Jeanne's paper is elegant and makes a number of important points regarding the appropriate policies to mitigate financial risk and the possible benefits of policy coordination in the realm of capital controls and macroprudential policies.

Olivier's first result is that when the externality relates to total borrowing rather than external borrowing, the correct intervention is a macroprudential tax. This is surely right. He proves that a capital control, which discriminates against transactions between residents and nonresidents, is distortive rather than purely corrective; this is in contrast to the macroprudential tax, which is purely corrective. A capital control distorts saving, which is not the source of any distortion to begin with, so it is a second-best policy in Olivier's setup.

I worry though that the arguments made in the paper could be used to suggest that there is a general superiority of macroprudential taxes over capital controls. I do not believe there is a general argument for capital controls being second-best and macroprudential policies, which don't discriminate against nonresidents, being first-best. I believe that the model could be recast to consider a situation in which resident–nonresident transactions are the riskier ones, and that in such a model the first-best intervention would be a capital control. Foreign lenders could in principle be flightier than domestic lenders: In such cases, the marginal foreign loan might engender more systemic risk and deserve to be taxed more heavily.

More generally, I believe that macroprudential policies of the type in Olivier's model have their limitations. If the risky flows bypass the regulated financial sector, or if agents move outside the regulated financial sector to bypass the taxes, the macroprudential taxes will be ineffective. If there is direct borrowing between residents and nonresidents that is particularly risky, macroprudential policies geared to the regulated financial sector will lack traction

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to address the problem. Capital controls might be the preferred instrument in such cases. Beyond this, sometimes the risks to the economy are different from the ones highlighted by Olivier's model: They may relate specifically to overvaluation rather than financial stability risks as such. Capital controls may be more appropriate in such circumstances as well. These issues are fleshed out more in Ostry et al. (2011, 2012).¹

Olivier's second result relates to the need for policy coordination. The paper makes the point that a Nash game in which countries independently choose the level of their macroprudential or capital control tax may be globally efficient. I think this is an important point because, in other papers, it is sometimes alleged that the mere existence of spillovers from countries' capital control policies generates a need for coordination. Olivier's point, also made by Korinek (2012), is that capital control wars—in which country A's actions engender higher capital controls in country B—may not indicate any global efficiency cost or need for coordination. The spillovers from each country's policy may not be externalities in the relevant sense, but merely the normal functioning of a market system in which the cross-border effects of policies are intermediated through the relevant prices.

My issue though is that, while the point is valid as far as it goes, it seems quite likely that countries will not be able to costlessly inoculate themselves against the cross-border effects of capital controls or macroprudential policies in other countries. In a world in which using the policy instrument is costly—and I think this is the world in which we live—the cross-border spillovers will have implications for global efficiency. Playing Nash in such circumstances will not be efficient and there will be gains from coordination. The costs from using the capital controls or macroprudential instrument may be bureaucratic or, more importantly, result from the imperfect targeting of the flows. In aiming to limit hot money flows, for example, there will inevitably be some collateral damage in which other, more beneficial flows are also impeded. This is a point my colleagues and I make in some related work (Ostry, Ghosh, and Korinek, 2012).

The third result in the paper concerns the benefits from coordination in a situation of liquidity traps and unemployment. In such a case, the Nash equilibrium is shown to be inefficient because countries do not internalize the spillover effects from their macroprudential policies in reducing global aggregate demand. This is a genuine externality because of the zero lower bound constraint on monetary policy. By coordinating the macroprudential taxes, it is possible to obtain a first-order employment gain at only a second-order cost of additional financial instability. I agree with the argument. However, I worry that there is a potentially serious domestic coordination issue that needs to be

confronted. The macroprudential regulator may not care much about the benefit from additional employment but will be held accountable for the increase in financial instability that a move from Nash to coordination implies. My second comment relates to whether generating additional aggregate demand would not more logically fall to fiscal policy than to macroprudential policy. While the result of course holds with macroprudential policy, thinking in terms of targets and instruments would pull one more toward fiscal policy in my view.

Olivier's final result concerns the nature of the Nash and coordinated equilibrium between a large surplus country with an undervalued currency and a large deficit country in a liquidity trap with deficient demand. The paper shows that a coordinated equilibrium in which the liquidity trap country actually tightens monetary policy and the surplus country reduces its dollar purchases is Pareto improving. The logic is that, while there is a first-order loss to the liquidity trap country from higher interest rates, this can be more than compensated for by the additional demand from a reduction in foreign exchange intervention (or equivalently, more total expenditure, including on foreign goods) in the surplus country. For the surplus country, reduced intervention only engenders a second-order loss. But the tighter monetary policy in the liquidity trap country engenders a welcome reduction in capital inflows, and thus a first-order gain. A Pareto improved outcome is the result. There is logic to this story, and perhaps it mirrors the calls for a faster exit from unconventional monetary policy to reduce financial spillovers to other countries. It would be good if the paper discussed more how the coordinated equilibrium affects the *composition* of aggregate demand in the surplus country, and in particular how it relates to the narratives that call for more internal rebalancing—involving more consumption and less investment in such countries. It would also be good if the paper said more about the implementation, specifically the likely extent of needed monetary tightening in exchange for decreased reserve buildup that the coordinated equilibrium envisages, and the split of the gains between the two countries.

I will conclude my comments with a couple further points. On the case for coordination over capital control-macroprudential policies, one should keep in mind that the purposes of these policies may not always, or even typically, be to reduce financial-stability risks (Jeanne 2012, Ostry et al. 2011, and Jeanne, Subramanian, and Williamson 2012). Such policies may be deployed to prevent warranted external adjustment, to exploit market power (terms-of-trade gains) or as a second-best response to production externalities. In all such cases, the use of capital controls may be problematic from a multilateral point of view. But the scope for coordination may be very small. Instead, rules of the road to limit multilaterally problematic behavior may be called for.

Finally, I believe much of the analysis in Olivier's paper can be usefully understood in terms of an older literature on policy coordination, which highlighted that gains from coordination depend on there being a deficit of instruments relative to policy targets. In Olivier's first coordination example, there is only one target—financial stability—and one instrument gets the job done without a need for coordination. In his examples with liquidity traps, there is a demand management target but no instrument to meet it because of the zero lower bound. Coordination becomes useful because of a dearth of policy instruments.

One important issue we need to confront is why, despite obvious gains from coordination, policymaking is more typically unilateral than multilateral. One salient point in this regard is the role of uncertainty and disagreement about the magnitude, and even the sign, of cross-border spillovers, which may indeed be an impediment to negotiating and sustaining coordinated policies. The international community needs to think harder about how to overcome the impediments to coordination. Would a neutral assessor help bridge the differences about the nature of cross-border spillovers? Are guideposts needed when policies give rise to palpable cross-border spillovers, but coordination is not in the cards?

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NOTE

1 Another issue is the relative cost of prudential and capital control instruments in terms of access to credit. It is possible that, if the goal is to maintain credit access for small and medium enterprises (SMEs) that rely on bank financing rather than direct borrowing abroad, capital controls may be less costly than prudential taxes that may cause banks to curtail lending to SMEs.