

# Commentary: Monetary Policy Implications of Increased Capital Flows

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I'm pleased to deal with the issue that we are discussing from a more academic point of view. Having left the central bank a few months ago, I find that I now have a great deal more freedom, and that, I think, is a lot more fun. This is, of course, because not being part of the decisionmaking process, investors and market participants don't care the least bit anymore about what I say. Therefore, I can say what I want.

Now let me turn to Andrew Crockett's paper, which I read with pleasure and interest. I think it's a good paper that surveys most of the issues related to the topic. I think the paper is quite representative of the best thinking among policymakers, particularly European policymakers, on these issues.

You may have found that the paper is often inconclusive, especially in its recommendations, or that it defends compromises or compromise solutions. This may be a reflection to a certain extent of the recent turmoil in Europe, which has shaken confidence and has left people, if I might say so, anchorless. It also reflects more positively a recognition that these issues of monetary policy are complex and difficult. And this after a long period of perhaps excessive optimism about the feasibility of some rosy dreams.

The paper is on monetary policy but refers all the time to exchange rates and exchange rate regimes. And this is indeed the key point. The

fact is that capital flows influence monetary policy essentially because of their impact on exchange rates. This is the point on which I will try to focus my remarks.

Let me begin by saying that I agree with almost everything that Andrew states in his paper. But because he covers so many points, I'll just focus on some key ideas and try to elaborate a little more on some of these key points.

Perhaps the most important point of the paper is that strong capital flows or significant financial integration force a clarification of the exchange rate regime. It is not possible in those conditions to have hybrid solutions attempting to reconcile too many objectives. One has to opt for fairly free floating exchange rates or very credibly fixed ones. Fixed rates, we all agree, require a complete subordination of monetary policy. I'll come back to this point later on. Any autonomy of monetary policy will thus require floating rates.

The point I want to make, however, is that the autonomy of monetary policy under floating rates is largely illusory. I would not go as far as stating as **McKinnon** did that monetary policy does not influence interest rates at all—that it only has an impact on exchange rates. But certainly it is true, and recent experience I think shows, that with strong financial integration most of the impact of monetary policy is actually felt on exchange rates. In fact, with strong capital flows monetary policy influences the real economy essentially through the exchange rates, which means that the impact of monetary policy will fall essentially on the tradable goods sector, on imports and exports, which are affected to a certain extent disproportionately relative to other sectors of the economy. This is in strong contrast with more traditional analysis of monetary policy, which attribute the impact to such interest-sensitive sectors as fixed investment, inventories, and so forth.

Matters are greatly complicated by the fact that exchange rates are frequently unstable. There is always the reality of overshooting, as well as the possibility of speculative bubbles, and other kinds of behavior that are seemingly irrational—as mentioned by Andrew in his paper. One may, therefore, conclude that changes in monetary

policy that yield relatively small changes in interest rates may in fact cause very large swings in exchange rates. We only need to look at recent depreciations—in the United Kingdom of about 20 percent and in Italy of about 30 percent—with relatively small declines in interest rates to illustrate what I am trying to say. I don't think that anybody can argue that this magnitude of devaluation is a movement in the direction of equilibrium. It is rather clear that things have gone way too far in response to a relatively minor change in interest rates.

Perhaps U.S. economists and policymakers will dismiss the importance of large swings in exchange rates. But for open economies, and in particular for very open economies that have 40 to 50 percent of GNP in foreign trade, these large and sudden moves in relative prices may have very detrimental effects on the economy. The exchange rate is a very key price in those cases. Perhaps short-term trade flows will not be affected because there are sufficient instruments to cover against uncertainty in the short term, as Andrew points out. But in the long term, resource allocation is very much affected by this type of instability. And furthermore—as Jacob Frenkel pointed out yesterday—in small, very open economies the exchange rate is a very useful and important instrument of stability, and it is very hard to accept that the exchange rate has to move very substantially in order to gain a little bit of autonomy on monetary policy.

I would like to remind everybody that the same thing happens in the opposite direction—not only in the case of depreciation, but also in the case of appreciation of currencies. A strong positive demand shock countered by monetary policy will probably always have, with strong capital flows, excessive and **undesirable** effects on the exchange rates. We often mention the U.S. case of the early 1980s, but more recently we can talk about German unification or we can talk about the effects of accession to the European Community on the economies of Spain and Portugal. We can also talk about what has happened in Mexico—a case which I know less well but which I believe has quite a few parallels with what happened in Spain and Portugal two or three years ago.

Tighter policies attract strong capital inflows and lead inevitably to an appreciation of the currency. If the appreciation is resisted, infla-

tion accelerates and the real appreciation takes place. Of course, as I think Andrew also pointed out, the alternative option of **accommodating** the shock would produce far more destructive consequences.

So in fact, monetary policy is likely to lead to very large swings in exchange rates. And if such swings are to be avoided, the scope for activist policy is very limited.

One may always defend a better policy mix as the solution; that is the theoretical answer. But I think that in all the cases I mentioned—the German case, the Portuguese and Spanish cases, and perhaps even the Mexican case—the change in fiscal policy that would have been required to stabilize the situation would be too large to be realistic given our experience with fiscal policy decisions. That of course is why stable exchange rates have proven to be so difficult to achieve.

It is possible to solve this dilemma—how to have an effective monetary policy without big exchange rate swings—through better policy coordination. This is more relevant for optimum currency areas, to the extent that they exist, than for the world as a whole. But it is not to be excluded. This requires, however, that the effects of shocks be spread more uniformly and that the cost of fighting them be accepted by all. For example, this would have required that France be prepared to pay the price of high interest rates to help fight inflation in Germany, Spain, Italy, and Portugal. I believe that this acceptance was actually implicit in the decision not to revalue the deutsche mark at the time of German unification—by far the easiest way of dealing with that problem. By choosing to keep the exchange rate constant, every country in the European exchange rate mechanism (ERM) was, in fact, accepting the need to share the burden of fighting inflation in Germany and elsewhere. But I am convinced now that the implications of that option were underestimated at the time.

Let me turn to the other extreme in Andrew's option, the credibly fixed exchange rate system. I certainly agree that free capital flows do not prevent fixed exchange rates, even with very powerful speculators in the markets. But they do impose a very tough discipline. Speculative capital flows can become very large. But even the most successful speculators, and I can mention even Mr. Soros in this

context, have admitted frequently that central banks have all the instruments necessary to defend parities. The question is whether the authorities are willing and able to use those instruments. Sometimes the use of certain instruments is excluded because of situations of extreme financial vulnerability or fragility. Other times, the instruments *can* be used but are not used because of other conflicting objectives of policy.

The reason that central banks are potentially all-powerful is that currency speculation can only proceed if it is financed by central banks. Massive sales of a currency drain massive amounts of liquidity from the market in a matter of days, sometimes hours. If exchange market intervention is not sterilized, the funds available for speculation dry up. Certainly, interest rates will shoot up. There is no doubt about that. But as the Dutch say, I believe that the appropriate source is the Dutch, "If you want low interest rates, you have to be prepared to let them go up when necessary." Furthermore, with some margin of fluctuation as in the original ERM rules, punitive interest rates combined with significant potential exchange rate losses for speculators can be a very powerful deterrent and produce quick results. But this implies that fluctuation bands should not be interpreted as providing scope for monetary policy autonomy, but rather as a tactical weapon to be used in the case of an attack on the currency. In fact, in my view, the properly used margins of fluctuation provide sufficient sand in the wheels to maintain some control over speculative movements, much better than other alternatives that have been floating around recently.

However, to make these strategies successful, it is necessary that (1) every other objective of monetary policy be sacrificed, and (2) conditions must exist to make possible the use of all instruments. The Maastricht Treaty, which apparently is still alive, has some convergence criteria in it. I would argue that they are now insufficient to achieve stable fixed exchange rates. We also need low levels of public and private debt. The reason is not just the free-riding **problem**—which was the original reason for putting limits on public debt in the Maastricht Treaty—but also to reduce the vulnerability of the financial system to speculative attacks on the currency. Beyond this, we also need very limited or no indexation in financial markets to reduce

the possibility of quick transmission of limited short-term swings in interest rates to the rest of the financial system. And perhaps even more important, we would need very, very flexible operating procedures on the part of central banks.

As Andrew emphasizes, much of this would depend on credibility. Without credibility, this process of stabilizing exchange rates does not have much of a chance. Credibility requires not only the ability and willingness to use the appropriate weapons but also that central banks avoid some clear pitfalls. Protracted battles are not sustainable and therefore not credible. Results must be achieved very swiftly. Any mention or even a resemblance of a multiplicity of objectives for monetary policy is immediately interpreted by the markets with all of its implications. And any impression that authorities are trying to test the limits of the autonomy of the system is again a signal that things are going to go wrong.

So let me conclude by saying that free capital flows mean that fixed rates require in fact quasi-perfect convergence. Any divergence in the near or distant future is brought to the present immediately and puts intolerable pressures on the exchange rate. Perhaps this is only now a matter of historical interest, but since European politicians keep sticking to the project of European Monetary Union, I would agree with Andrew that in Europe monetary union might not be feasible with a long, smooth, and gradual transition. Instead, achieving monetary union in Europe may require that tough convergence criteria be met well before any further move can be envisioned.