

Capital Controls and Monetary Policy Autonomy in a Small Open Economy

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Abstract

Is there a link between capital controls and monetary policy autonomy in a country with a *floating* currency? Shocks to capital flows into a small open economy lead to volatility in asset prices and credit supply. To lessen the impact of capital flows on financial instability, a central bank finds it optimal to use the domestic interest rate to "manage" the capital account. Capital account restrictions affect the behavior of optimal monetary policy following shocks to the foreign interest rate. Capital controls allow optimal monetary policy to focus less on the foreign interest rate and more on domestic variables.

Keywords: capital controls; credit constraints; small open economy

JEL classification: F32; F41; E52; E32

1. Introduction

Repeated cycles of capital flows into and out of emerging markets are a fixture of the financially integrated global economy. Surges in capital inflows have led to talk of "currency wars" and the danger of overheating in many emerging markets. Likewise, a sudden reversal of capital flows has been blamed for the recent financial and macroeconomic instability in many emerging markets.

Rey (2015) and Forbes and Warnock (2012) show that capital flows into and out of emerging markets are largely driven by global factors. Reinhart and Reinhart (2009) argue that surges in capital inflows into emerging markets are associated with a higher likelihood of banking, inflation, and currency crises, and contribute to economic and financial instability. Kaminsky et al. (2005) argue that capital inflows are a primary reason for the procyclicality of monetary policy observed in many emerging markets. Rey (2015) argues that this cycle of capital inflows and outflows means that the "trilemma" of international finance is actually more of a "dilemma", and that "independent monetary policies are possible if and only if the capital account is managed." Obstfeld (2015) addresses this same issue and acknowledges that under certain conditions, a central bank with a floating currency has complete monetary autonomy, but he discusses how financial globalization affects the trade-offs faced by monetary policy makers.¹

In this paper we address this issue in a dynamic, general equilibrium model where nominal rigidities and credit frictions give rise to welfare reducing distortions. A policy maker sets policy in order to minimize the effects of these distortions. If there are multiple distortions and only one monetary policy instrument then the policy maker is faced with a trade-off. How are these trade-offs in a small open economy affected by exogenous shocks from the rest of the world that lead to sharp reversals in capital inflows and outflows?

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¹The trilemma has been a feature of the international macroeconomics literature since Mundell (1963). The trilemma states that a country cannot simultaneously maintain a fixed exchange rate, an open capital account, and monetary policy autonomy.

In technical terms, the fact that the combination of a fixed exchange rate and an open capital account lead to the loss of monetary policy autonomy is purely mechanical. When a central bank maintains a fixed exchange rate, monetary policy takes the form of a rule stating that the nominal exchange rate is held constant. So for instance, in response to a fall in net capital inflows, the central bank is forced to raise the interest rate to attract capital flows and prevent depreciation.

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