

International capital mobility in the wake of the Great Recession

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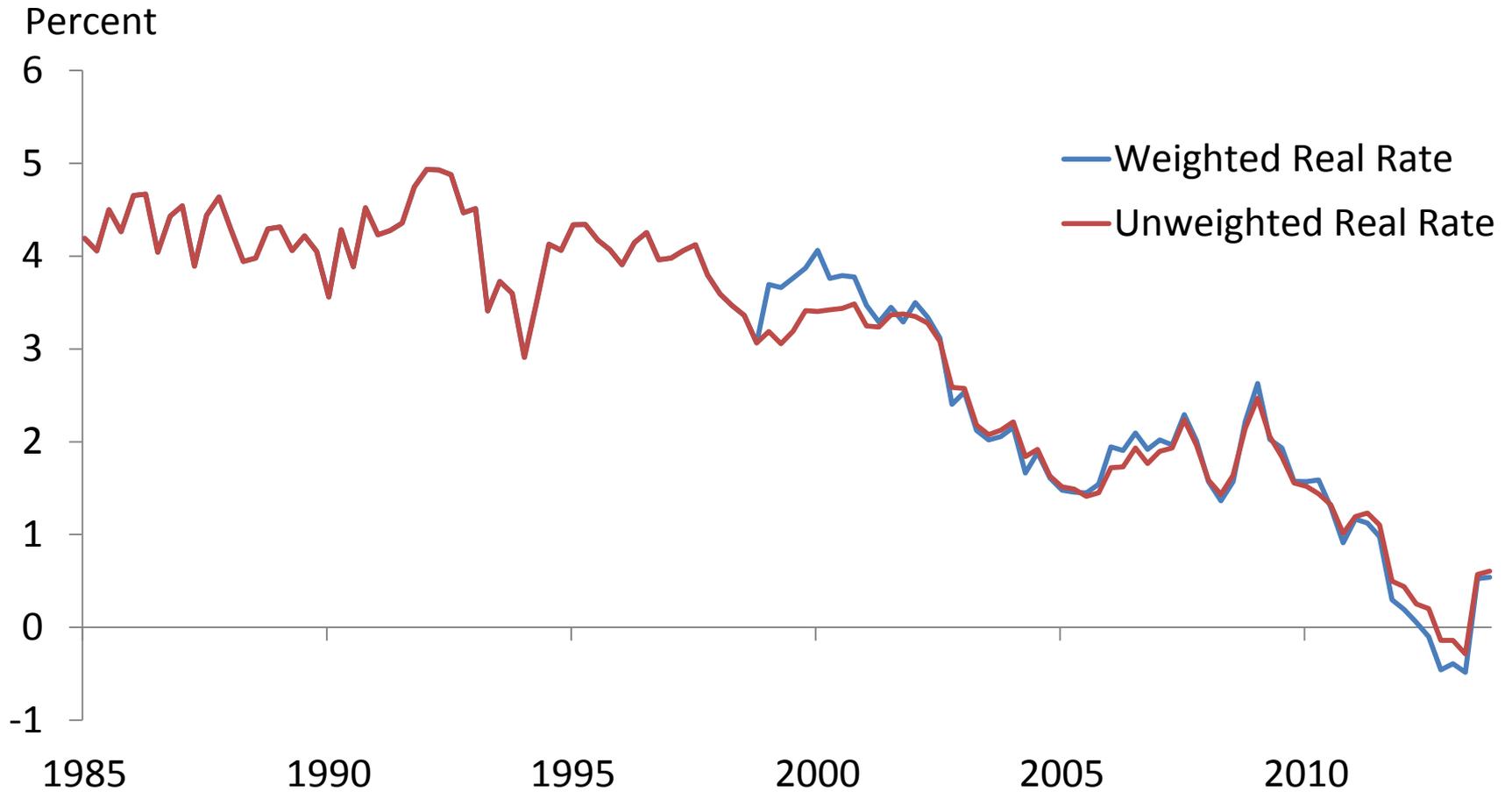
Outline

- International capital flows were central to the recent housing boom and bust in the US
- There seems to be something different about external finance
- Do we need tighter regulation of capital flows?
- Implications for how monetary policy should be conducted?

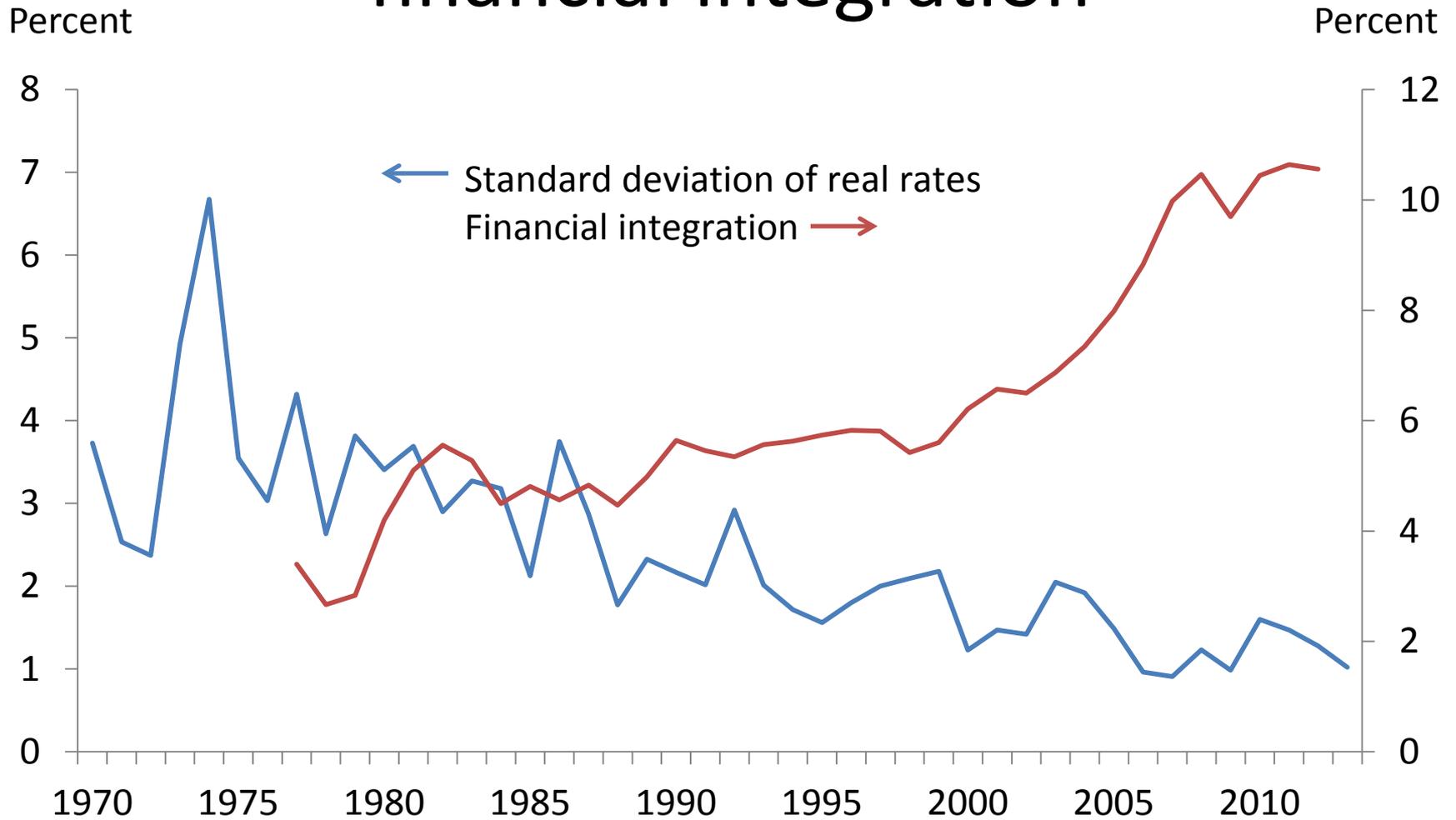
Global [.]

- Global output gaps
 - Tootell *New England Economic Review* (1998)
 - Martínez-García & Wynne *FRB Dallas Staff Papers* (2010)
- Global liquidity
 - D'Agostino & Surico *JMCB* (2009)
 - Eickmeier, Gambacorta & Hofman *EER* (2014)
- Global interest rates
 - King & Low *NBER WP* (2014)

The “World” Real Interest Rate

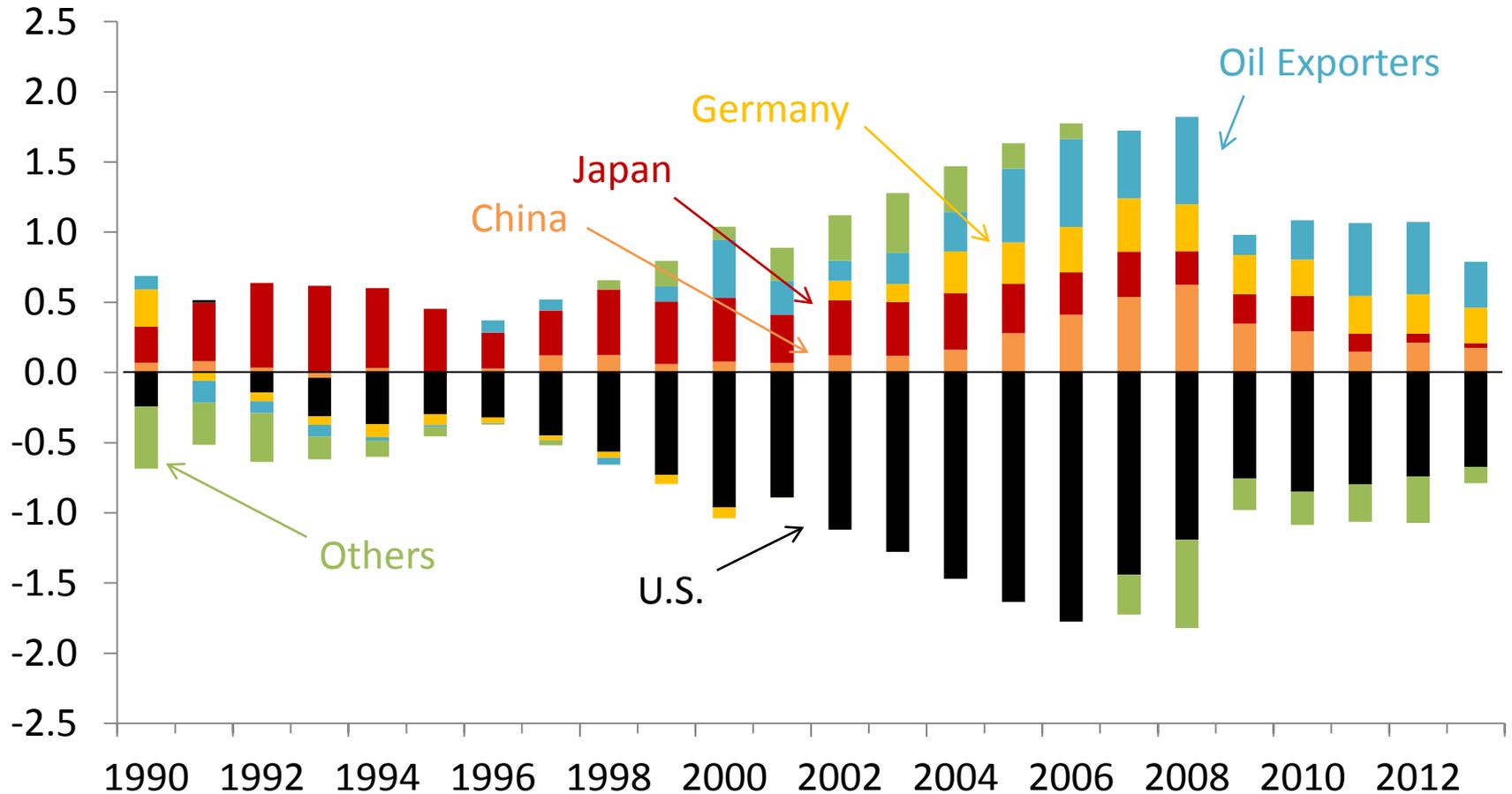


Convergence of real interest rates and financial integration

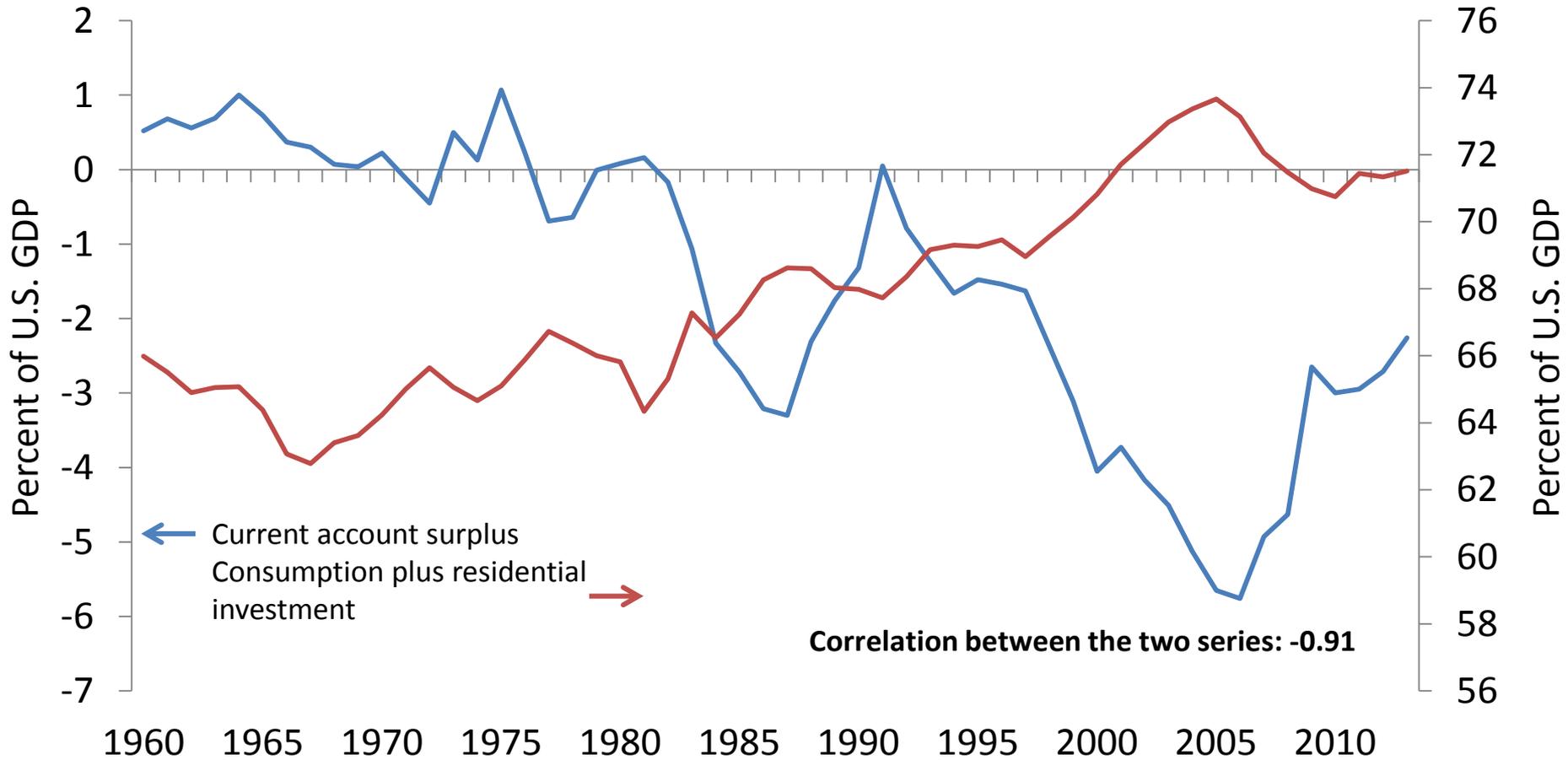


Current account balances

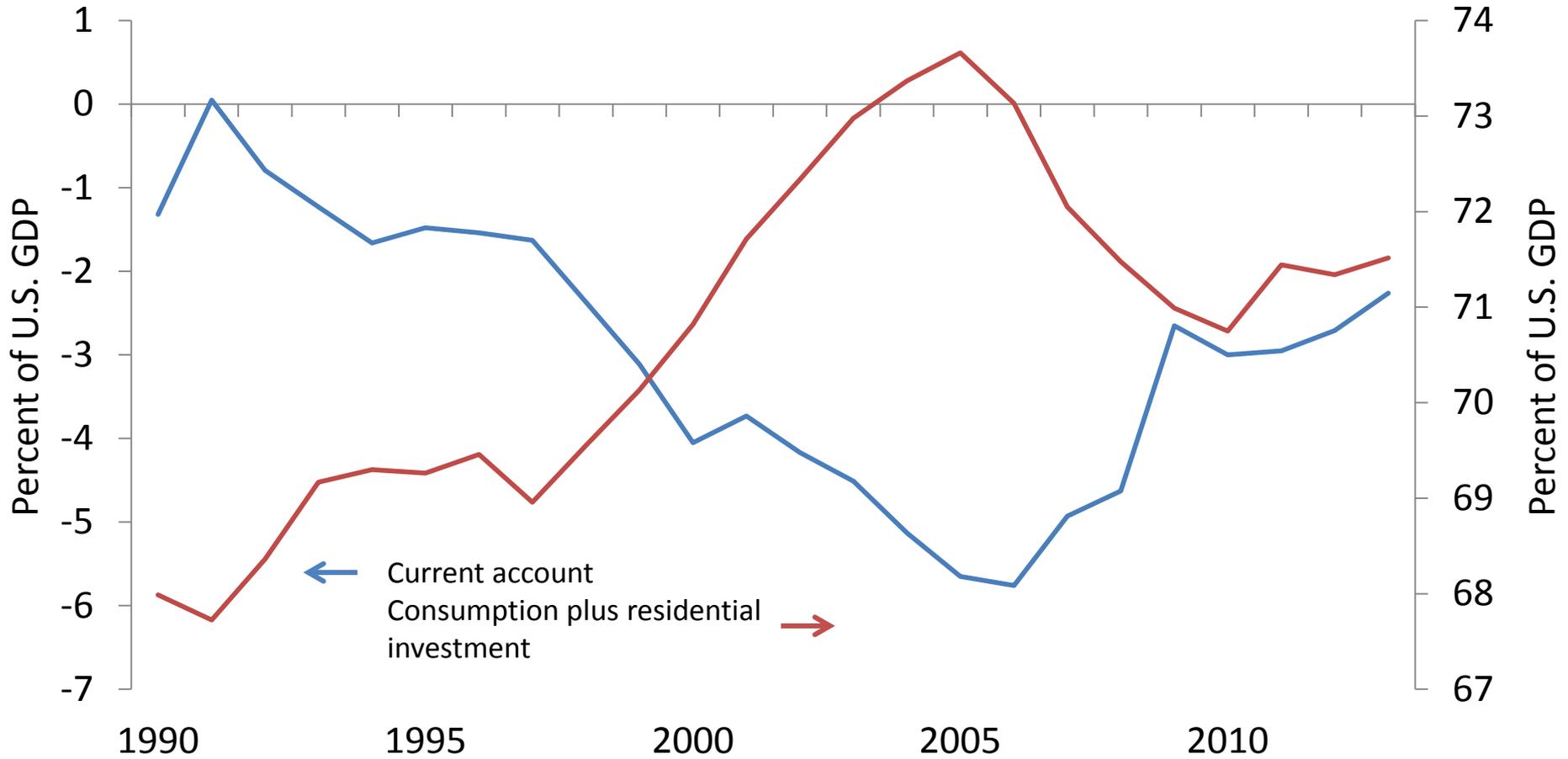
Percent of world GDP



U.S. borrowing from the rest of the world



Party time!



Its not just correlations

- Warnock & Warnock JIMF (2009)
 - Absent the substantial foreign inflows into U.S. government bonds the 10-year Treasury rate would be 80 basis points higher
- Tomura JEDC (2010)
 - Openness to international capital flows crucial to driving expectational boom-bust cycles in house prices
- Bertaut, DeMarco, Kamin & Tryon (2012)
 - Global Savings Glut (GSG) inflows into Treasuries and Agencies and European bank acquisitions of ABS both played a key role in putting downward pressure on U.S. interest rates
- Sá, Towbin & Wieladek JEEA (2013)
 - Capital flow shocks have a significant effect on real house prices, real credit available to the private sector and real residential investment
- Justiniano, Primiceri & Tambalotti JIE (2014)
 - Foreign capital inflows account for between $\frac{1}{4}$ and $\frac{1}{3}$ of the increase in U.S. house prices and household debt that preceded the financial crisis

External finance is different

- “Credit booms, banking crises and the current account”
 - Davis, Mack, Phoa & Vandenabeele (2014) FRB Dallas Globalization & Monetary Policy Institute Working Paper number 178
- Marginal effect of higher private debt levels on the probability of a crisis depends on how it is financed
 - When a country has a current account deficit of 10 percent, a 10 percentage point increase the private sector debt ratio leads to a 10 percentage point increase in the probability of a crisis

Return to capital controls?

- “The inhabitant of London ...adventure his wealth in the natural resources and new enterprises of any quarter of the world, and share, without exertion or even trouble, in their prospective fruits and advantages; or he could decide to couple the security of his fortunes with the good faith of the townspeople of any substantial municipality in any continent that fancy or information might recommend.”
 - Keynes, 1919, *The Economic Consequences of the Peace*

Return to capital controls?

- “I sympathize ... with those who would minimize rather than those who would maximize economic entanglements among nations ... let goods be home-spun whenever it is reasonable and conveniently possible and, above all, let finance be national.”
 - Keynes, 1933, *National Self-Sufficiency*, inaugural Finlay Lecture at University College Dublin

Return to capital controls?

- Arguments for prudential capital controls usually made with reference to emerging market economies
 - Korinek IMFER (2011)
- But do capital controls work?
 - Block & Forbes (2004): Myths and realities of open capital accounts
 - Klein BPEA 2012: “Gates versus walls”

Implications for monetary policy?

- Inflation targeting as best practice central banking
- Focus on consumer price inflation led central bankers to take their eye off the ball of broader inflation developments?
 - Return to a Fisherian definition of inflation?
- Looking for keys under the lamppost

Concluding observations

- Financial globalization has fundamentally altered the macro policy environment
- Recent North Atlantic financial crisis – and ongoing (?) euro area crisis – highlight the challenges posed by internationally mobile capital
- Policy debate is still trying to catch up
- Key challenge: maintaining open capital markets while keeping policy mandates domestically focused

