



ELSEVIER

Contents lists available at ScienceDirect

Journal of International Money and Finance

journal homepage: www.elsevier.com/locate/jimf



Capital controls, competitive depreciation, and the technological frontier



Collin Rabe *

University of Richmond

ARTICLE INFO

Article history:

Available online 28 June 2016

JEL Classification:

F34
F38
F43
H23
O040

Keywords:

International reserves
Capital controls
Mercantilism
Economic growth
Real exchange rates
Externalities

ABSTRACT

This paper considers the internal and external welfare effects of international capital controls and real exchange rate undervaluation in a multi-country setting. I present a dynamic open-economy macro model with an endogenously determined rate of interest on internationally traded assets. All countries produce tradable and nontradable goods using technology that converges over time to a global frontier. The model quantifies the welfare effects of the unilateral implementation of capital controls that depreciate the real exchange rate in economies both already at and converging to the technological frontier. For developing economies, I demonstrate that such government interventions may constitute “beggar-thy-neighbor” policies.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

Financial flows following the recent 2007–2009 financial crises have led to renewed interest in the exercise of capital controls in emerging market economies. Furthermore, the rapid ascent of the Chinese economy while utilizing some of the world’s most restrictive controls on capital flows has contributed to a resurgent interest in the so-called “mercantilist” policies that promote exports as a means of achieving economic growth (see Dooley et al., 2004, for an overview). Even following many years of promoting liberalized financial accounts, the IMF has recently expressed official support for the use of capital controls in certain settings. However, much of the research on capital controls has focused on the domestic impact of their use by a single small open economy. As stated by Ostry et al. (2010),

* E-mail address: crabe@richmond.edu.

an important consideration in the evaluation of capital control policies is the potential for multilateral spillover effects. Therefore, a key point of research continues to be the extent to which capital controls may constitute “beggar-thy-neighbor”-type policies, in which one country’s gains come at the expense of another’s. This paper attempts to address such considerations by introducing a model of unilateral capital control implementation in a multi-country framework to quantify the effects on external welfare and the evolution of the global economy.

Generally, capital controls have been used in emerging market economies for two purposes. First, controls may be used to limit the disruptive effects of “hot money” inflows from carry trade. For example, [Jeanne and Korinek \(2010\)](#) discuss the benefits of using capital controls as a way of dealing with the negative externalities of asset price bubbles and general financial instability stemming from transitory foreign financial flows. This paper instead focuses on a second objective of capital controls, namely the enabling of greater governmental influence over the evolution of the domestic real economy. In this case, capital controls are portrayed as a means of pursuing export-promoting or mercantilist objectives by allocating additional resources to tradable-goods sectors of production and/or artificially undervaluing the exchange rate¹ so as to make domestically produced goods more attractive to foreign buyers. Often such pursuits are accompanied by an implicit assumption about the relative superiority of the tradable-goods sector in contributing to a country’s overall economic growth. Many recent studies, including [Rabe \(2016\)](#), [Michaud and Rothert \(2014\)](#), [Benigno and Fornaro \(2012\)](#), [Korinek and Servén \(2010\)](#), and [Aizenman and Lee \(2010\)](#), have demonstrated welfare gains resulting from the use of capital controls/exchange rate management policies to promote the production of tradable-sector goods. However, all of these examples have done so within the context of a single small open economy.

Increasingly, the implementation of capital controls as a means of pursuing a mercantilist agenda has been used to try to explain the massive accumulation of foreign assets by China over recent years. Ideally, a full accounting of reserve accumulation should include multiple motivating factors in addition to mercantilistic export promotion, especially precautionary savings motives.² But despite its increasingly frequent invocation, those studies focusing predominately on the role of mercantilism have had limited success in matching theory to the Chinese empirics, in part because a country with the world’s largest population and second largest nominal GDP strains the common characterization of being “small” for modeling purposes. More realistically, policies that induce large capital inflows or outflows should affect a country’s ability to borrow or lend at a given rate of interest. In other words, if this line of literature hopes to reflect the experience of China, it must consider its position as a *large* economy with external effects on other countries in a global setting. Clearly, government policies that affect the size of a country’s current account balance, regardless of intended purpose, must have rippling effects on that country’s trading partners as well. This paper attempts to quantify these international effects by introducing a model with multiple countries with differing motivations.

In regard to cross-country heterogeneity, I assume the existence of a developed economy that operates at the “global technological frontier,” such that it is the most productive economy in the world on a per-worker basis. The frontier-defining level of technology continually progresses over time due to innovations unique to the developed country’s economy. The developed country trades internationally with other countries that “catch-up” and eventually converge over time to its frontier-defining level of productivity at a rate that is endogenous to the domestic allocation of labor. That is, the greater the share of “human capital” devoted to the production of tradable goods, the more quickly a developing country can adopt the newest technologies and best practices via exposure to the advanced international market. Furthermore, I assume this technological adaptation creates positive cross-sector spillovers for the rest of the economy that are not recognized by individual firms.

Due to the existence of these positive technological externalities, the government can play a welfare-increasing role through implementation of appropriate policy to achieve a more optimal allocation of labor across sectors in the economy. Since individual firms in the tradable sector don’t internalize the impact of their employment decisions on aggregate productivity, they “under-hire” relative to the

¹ See [Jeanne \(2012\)](#), for example.

² See [Aizenman and Lee \(2007\)](#) for an empirical evaluation of the relative roles of mercantilist versus precautionary motives, as well as [Rabe \(2016\)](#) and [Carroll and Jeanne \(2009\)](#) for further theoretical discussion.

Download English Version:

<https://daneshyari.com/en/article/964511>

Download Persian Version:

<https://daneshyari.com/article/964511>

[Daneshyari.com](https://daneshyari.com)