Capital Flows and the International Dimension of Monetary Policy

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*Views are my own and do not represent those of the Bank of England or Monetary Policy Committee

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Rethinking Capital Controls and Capital Flows
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Today

• How do capital flows help or hinder adjustments to monetary policy?
  – **Hindrance**: Capital flows can generate domestic adjustments that make it more difficult to increase interest rates
  – **Help**: Capital flows can facilitate international adjustments to allow monetary policy to focus on supporting domestic economy

• Two concrete examples from UK
2014: “Liftoff” Soon

UK Liftoff Expected (Before US)

Chart 1.1 Market expectations for UK, US and euro-area rates diverged further
International forward interest rates\(^{(a)}\)

Sources: Bank of England and Bloomberg.

\(^{(a)}\) The May 2014 and August 2014 curves are estimated using instantaneous forward overnight index swap rates in the fifteen working days to 7 May 2014 and 6 August 2014 respectively.

Supports Sterling Appreciation

Effects?

- Effects of appreciation:
  - Tighter financial conditions
  - Lower net exports
  - Sharp falls in import prices

- All leading to:
  - LOWER CPI INFLATION

Effects of Appreciation Magnified

- Exchange rate pass-through magnified when appreciation linked to monetary policy shocks

The Result

• Harder to raise interest rates from very low level

• Less attractive starting point to respond to the next shock....
UK current account balance as % of GDP
Exchange Rate Facilitates Risk Sharing

Recent deprecation after Brexit estimated to improve UK NFA position by > 20% of GDP

<table>
<thead>
<tr>
<th>Variables</th>
<th>Risk sharing is higher if…</th>
<th>Does this apply to the United Kingdom?</th>
<th>Average of 10 OECD countries with floating ERs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quantity of liabilities</td>
<td>… the higher is the stock of foreign liabilities</td>
<td>Liabilities/GDP: 558%</td>
<td>221%</td>
</tr>
<tr>
<td><strong>Currency denomination of assets</strong></td>
<td>… the higher the proportion of assets denominated in foreign currency</td>
<td>&gt;90% of assets denominated in foreign currency</td>
<td>90%</td>
</tr>
<tr>
<td><strong>Currency denomination of liabilities</strong></td>
<td>… the lower the proportion of liabilities denominated in foreign currency</td>
<td>58% of liabilities denominated in foreign currency</td>
<td>43%</td>
</tr>
<tr>
<td><strong>Hedging ability of ER with respect to capital gains on liabilities</strong></td>
<td>…the less does the ER associated with liabilities co-move with their capital gains</td>
<td>52% Correlation between ER &amp; foreign currency gains on liabilities</td>
<td>26%</td>
</tr>
<tr>
<td><strong>Hedging ability of ER with respect to returns on liabilities</strong></td>
<td>…the less does the ER associated with liabilities co-move with their rate of return</td>
<td>-14% Correlation between ER &amp; foreign currency return on liabilities</td>
<td>10%</td>
</tr>
</tbody>
</table>
The Result

• Capital flows and exchange rate adjustments can mitigate risks related to large current account deficits IF a country meets certain criteria
  – Most major OECD economies with flexible exchange rates (that are not reserve currencies) meet many of these criteria

• Therefore monetary policy can respond to weaker domestic economy and worry less about supporting capital flows to finance the current account deficit
International capital flows can be a help and a hindrance to monetary policy