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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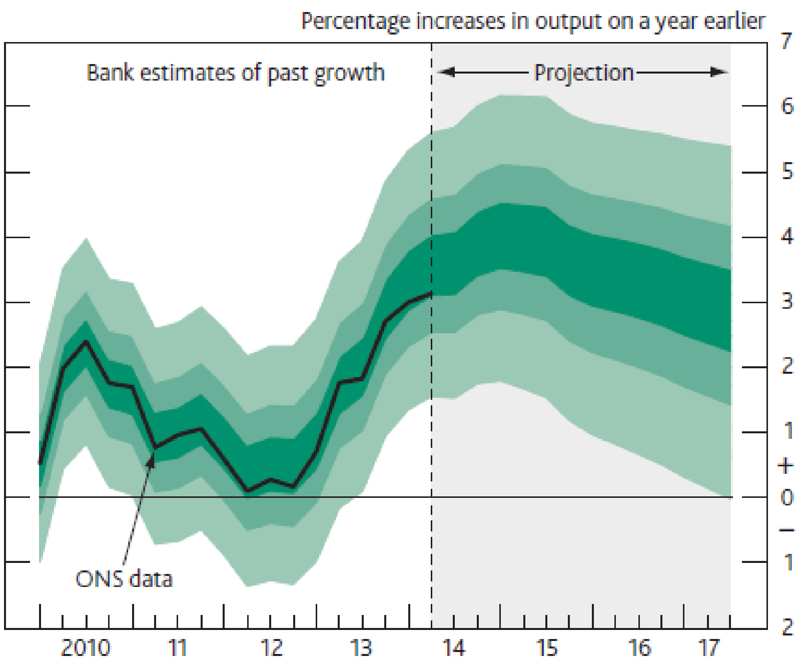
Today

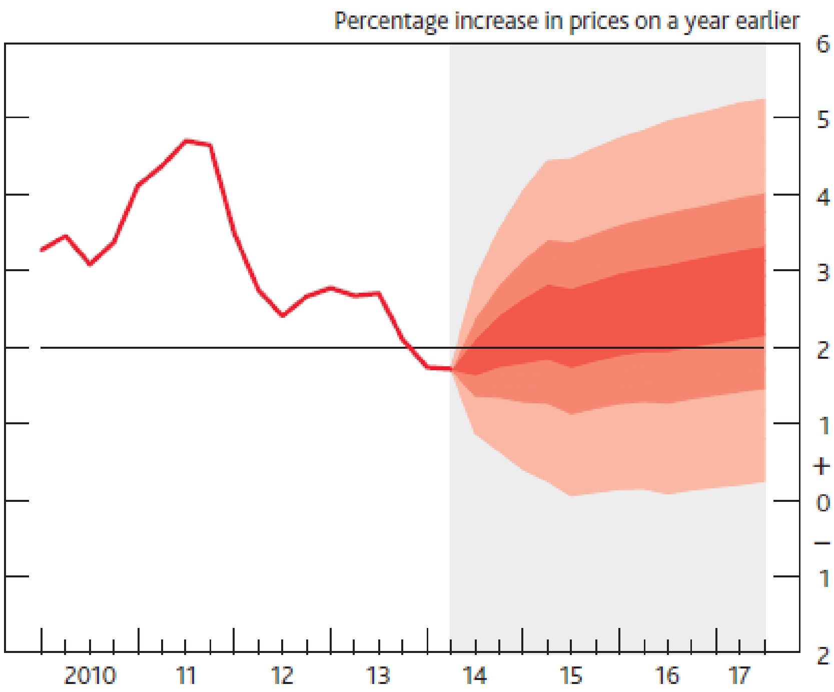
- How do capital flows help or hinder adjustments to monetary policy?
  - ***Hindrance***: Capital flows can generate domestic adjustments that make it more difficult to increase interest rates
  - ***Help***: Capital flows can facilitate international adjustments to allow monetary policy to focus on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

2014: “Liftoff”Soon

GDP projection based on constant nominal interest rates at 0.5% (wide bands)[a][b]



CPI inflation projection based on constant nominal interest rates at 0.5% (wide bands)[a]

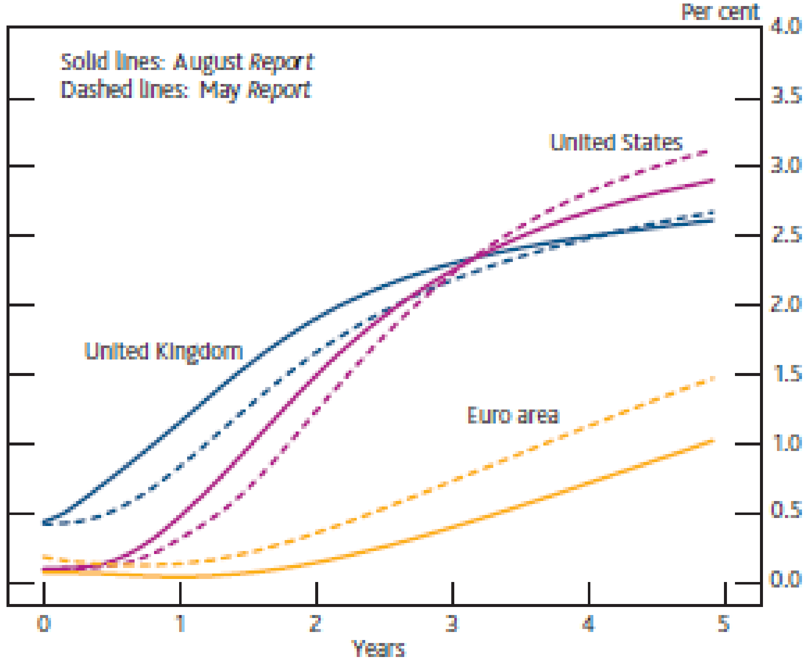


Source: Bank of England, *Inflation Report,* August 2014

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.

Source: Bank of England, *Inflation Report,* August 2014

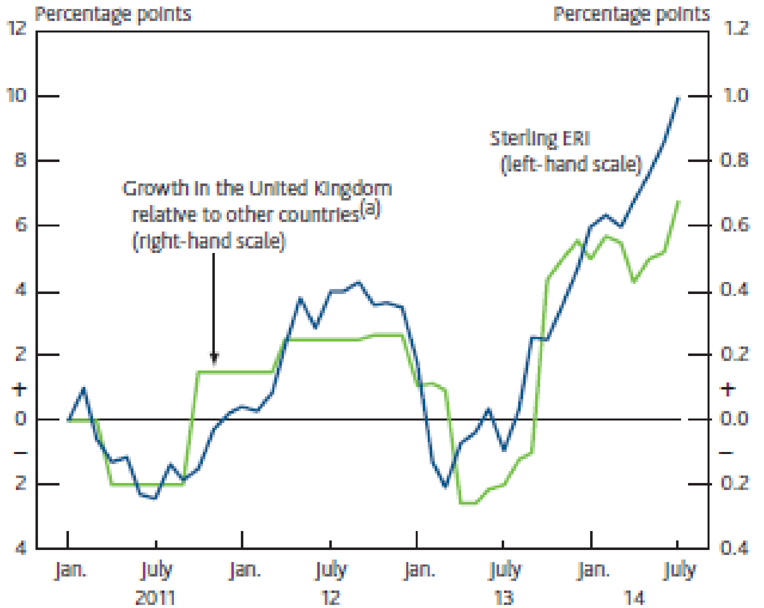
Supports Sterling Appreciation

Chart 1.3 Sterling appreciated further

Sterling exchange rates

Chart 1.4 Sterling supported by improving UK growth prospects

Relative revisions to Consensus domestic demand growth forecasts for 2014–16 and sterling ERI



Sources: Bank of England, Bureau of Economic Analysis, Consensus Economics, Eurostat, ONS and Bank calculations.

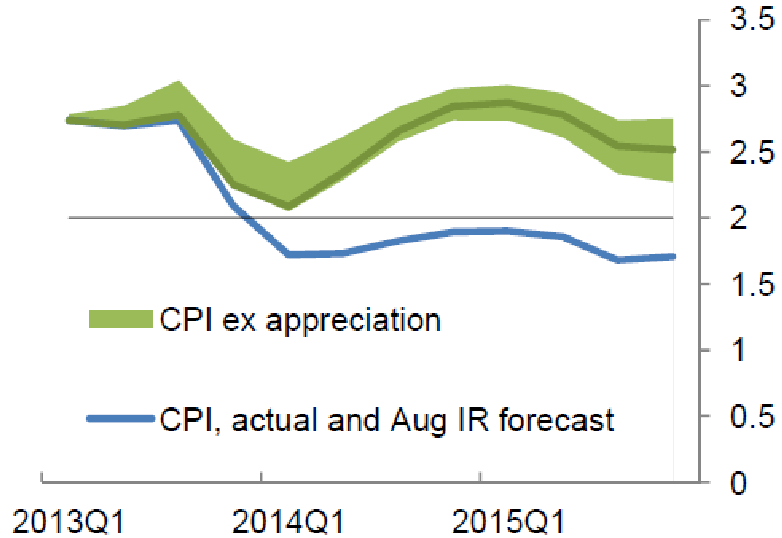
(a) Revisions since January 2011 to Consensus expectations for the weighted sum of investment and private consumption growth in the United Kingdom less that in the United States, euro area and Japan. Average of projections for end-2014, end-2015 and end-2016.

Source: Bank of England, *Inflation Report,* August 2014

Effects?

- Effects of appreciation:
  - Tighter financial conditions
  - Lower net exports
  - Sharp falls in import prices
- All leading to:
  - LOWER CPI INFLATION

Figure 14: Actual and predicted consumer price inflation, with and without drag from exchange rate appreciation



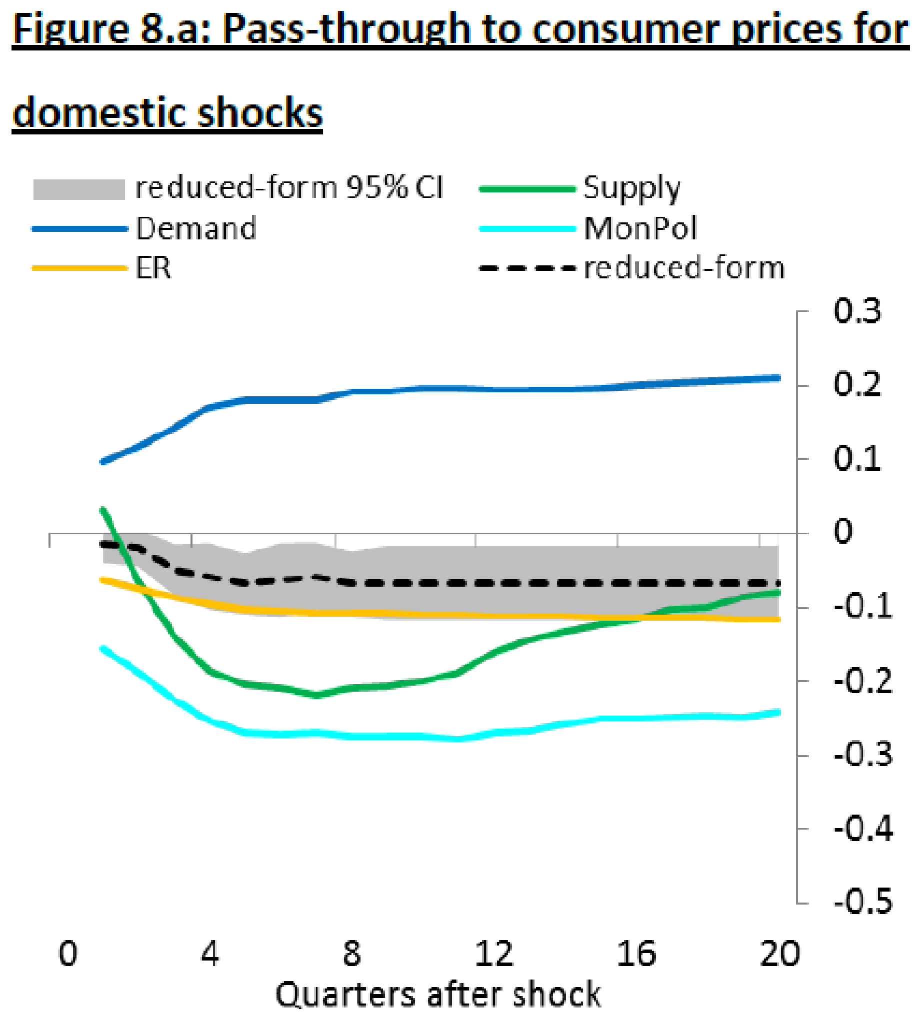
The green swathe shows COMPASS' predictions of CPI inflation had the exchange rate remained at its 2013Q1 level, under different degrees of persistence of the exchange rate appreciation. The appreciation is assumed to be exogenous, no other shocks are assumed to hit, and policies are assumed not to change.

Source: Speech, "The Economic Impact of Sterling's Recent Moves: More than a Midsummer Nights Dream," by Kristin Forbes, 1 October 2014.

Effects of Appreciation Magnified

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

- See: Forbes, Hjortsoe and Nenova (2015), *Bank of England External MPC Unit Discussion Paper #43*, “The Shocks Matter: Improving Our Estimates of Exchange Rate Pass-Through”

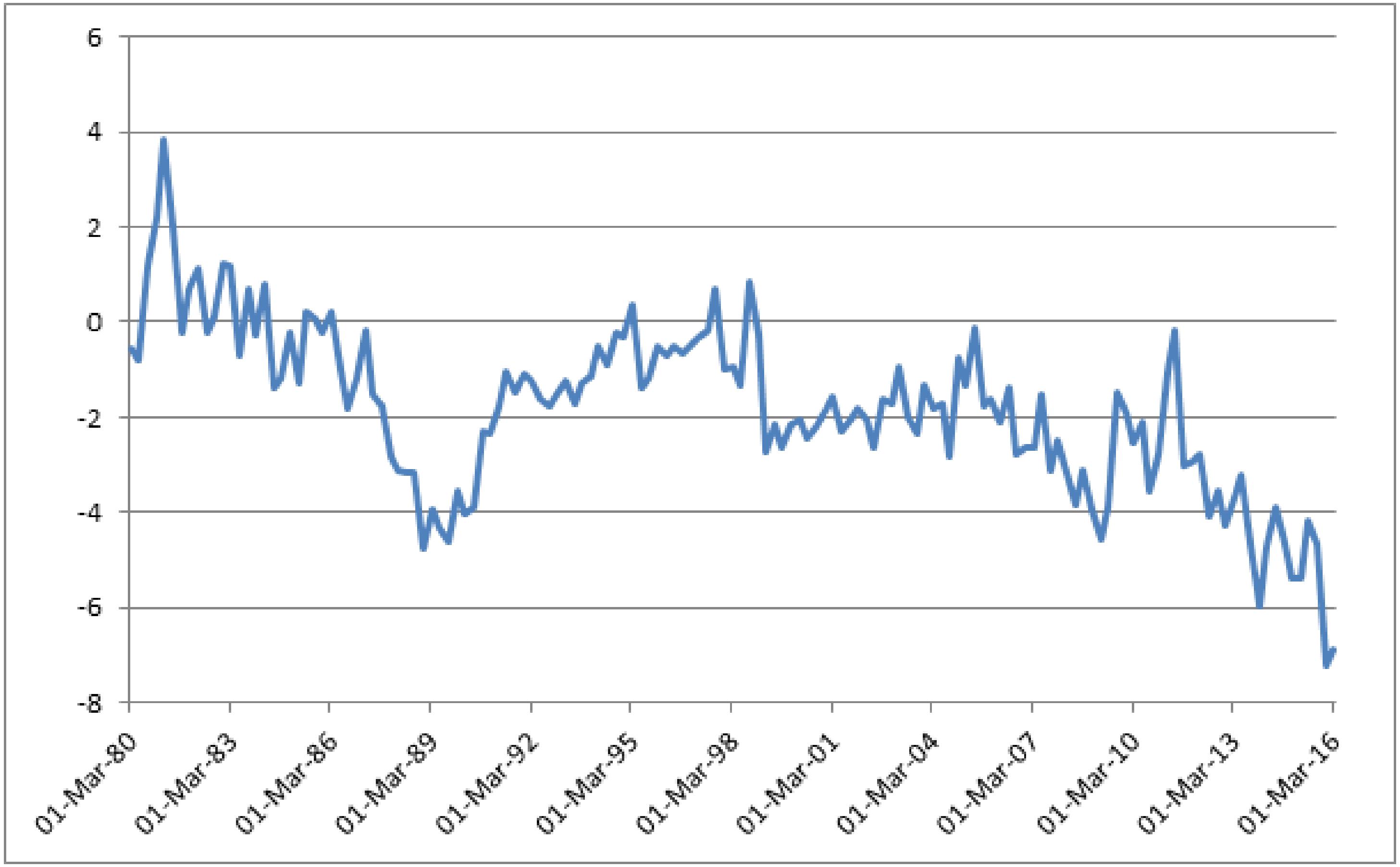


The Result

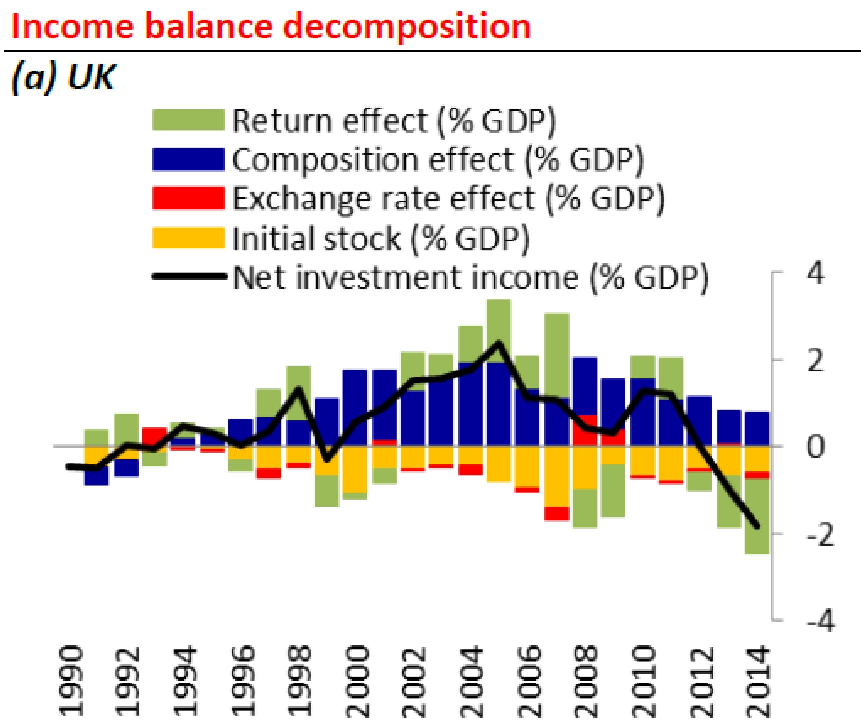
- Harder to raise interest rates from very low level
- Less attractive starting point to respond to the next shock….

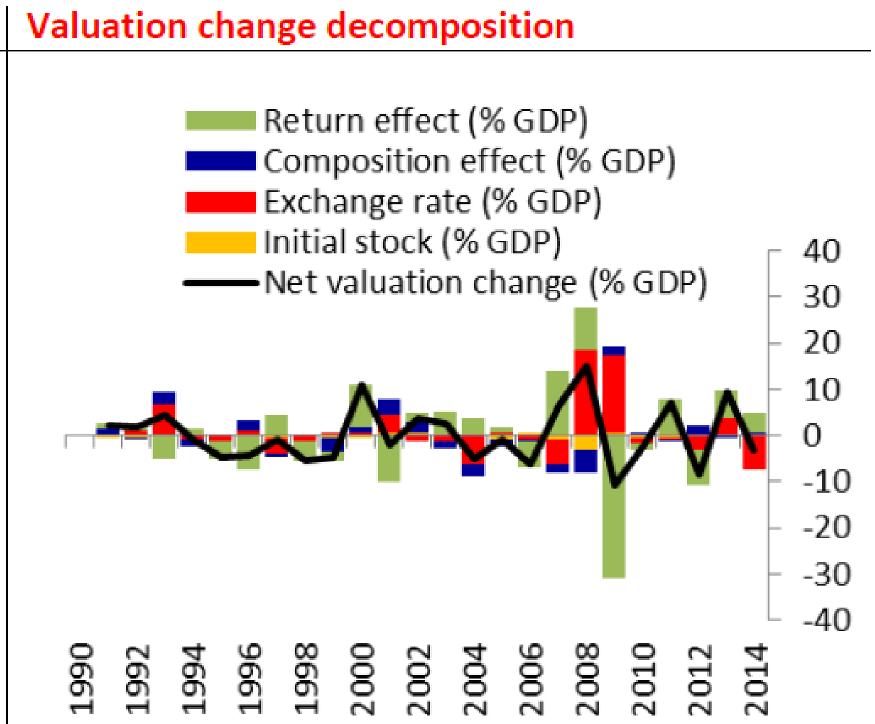
On the Other Hand?

UK current account balance as % of GDP



Exchange Rate Facilitates Risk Sharing





Forbes, Hjortsoe and Nenova (2016), *Bank of England External MPC Unit Discussion Paper #46*, "Current Accounts During Heightened Risk: Menacing or Mitigating?"

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

Scenario: Heightened UK Risk

Variables Determining the NIIP Impact	Risk sharing is higher if…	Does this apply to the United Kingdom?	Average of 10 OECD countries with floating ERs
Quantity of liabilities	…. the higher is the stock of foreign liabilities	Liabilities/GDP: 558%	221%
Currency denomination of assets	… the higher the proportion of assets denominated in foreign currency	>90% of assets denominated in foreign currency	90%
Currency denomination of liabilities	… the lower the proportion of liabilities denominated in foreign currency	58% of liabilities denominated in foreign currency	43%
Hedging ability of ER with respect to capital gains on liabilities	…the less does the ER associated with liabilities co-move with their capital gains	52% Correlation between ER & foreign currency gains on liabilities	26%
Hedging ability of ER with respect to returtns on liabilities	…the less does the ER associated with liabilities co-move with their rate of return	-14% Correlation between ER & foreign currency return on liabilities	10%

The Result

- Capital flows and exchange rate adjustments can mitigate ricks 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

Bottom Line

International capital flows can be a help and a hindrance to monetary policy