Capital Controls and Free Trade Agreements

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Comments

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What Does Paper Do?

- Unified framework for the analysis of capital controls and trade tariffs
  - Framework: Pecuniary Externalities TOT (Demand)/ Large Country
  - Compares **Capital Control** Policies
    - With and without **Free Trade**
    - With and Without **Retaliation**
  - Additional cases (a proxy for small open economy)

- Main Findings
  - *Proposition 5 (Globally Cooperative Allocation):* In the cooperative allocation, **no intervention is optimal**
  - *Corollary (Negative Spillovers):* **Any policy intervention which improves Home welfare necessarily reduces global welfare**.

Capital Controls and Free Trade Agreements Mechanism

- Interaction between optimal capital controls and trade taxes
  - **Two-country model** of trade within and across time;
  - Two-good endowment model (**no production,** no uncertainty);
  - **Simple financial markets (non-contingent bonds): no equities, no hedging**
  - Home bias

- Pecuniary externalities from TOT (large economies)
  - Large economy planner internalizes its size in markets, monopoly
  - Restrict quantities, change prices: 2 targets, 2 instruments
    - Aggregate consumption over time: interest rate (tax: capital control)
    - Across goods varieties: relative price of goods (tax: tariff)

$$\ln(1-\theta_t) \approx -\theta_t = \underbrace{-\sigma\left(\hat{C}_t - \hat{C}_{t+1} + \hat{C}^*_{t+1} - \hat{C}^*_t\right)}_{\text{Consumption Wedge}} + \underbrace{\left(\hat{Q}_t - \hat{Q}_{t+1}\right)}_{\text{RER Wedge}}$$

- **Many** cases: Capital flows and trade good restrictions--complement or substitute
  - Shock (home goods, foreign goods); relation to home bias (trade surplus or deficit)
  - Whether other country retaliates or not

Paper: Overview

- Very clear, comprehensive paper, important contribution.
- Adds to the set of theory papers questioning the robustness of some models used to justify the use of capital controls: multiple equilibria, timing collateral constraints, limited choice of policy variables
  - Schmitt-Grohe and Uribe (2020). Multiple equilibria in open economies with collateral constraints”
  - Perez, Ottonello, Varraso (2021) “Are Collateral-Constraint Models Ready for Macroprudential Policy Design?
  - Benigno, Chen, Otrok, and Rebuccit and Young (2020) “Optimal Policy for Macro-Financial Stability” :
    - Other policy choices can achieve first best
- This paper extends the concerns to the choice of **policy variables available, negative spillovers to other countries, and their retaliation.**

Comments

- Paper is very polished
- Comments:
  1. Suggestions for extension (future work)
  2. Take to Data
     - Additional Extension (future work)

1. Cases to Further Explore

- **Role of Investment**
  - What if "over-borrowing" is to invest in **K** and finance new technologies (**A**)?
  - Not easy; but perhaps simulation can provide intuition

- **Role of Financial Sector**: models tend to only have non-contingent bonds
  - Contingent instruments (allow risk sharing)

- Not convinced **small economy** case is covered with particular case substitutions=1

- However: robustness likely to strengthen the results of the paper (as likely to weaken the welfare effects of restrictions),
  - Except perhaps **A and technology theft** (complex case of IP protection; Alfaro, Bao, Chen, Hong, Steinwender, 2021).

2. Empirics
Capital Controls and Free Trade Agreements

- For the Most Part: Rich/Large Countries: Very low tariffs

- How about capital controls? Acosta, Alfaro, Fernandez (2020)
  - Dataset on priced-based capital controls complemented with extensive measures (restrictions, prohibitions, and authorizations)

✓ Rich/large countries tend not to restrict capital mobility

✓ Capital Controls are **Sticky** (not contingent on the different outlined cases)
  - Some cases would require subsidizing borrowing (pay capital to come)
  - Reality: protectionism/interest groups (Alfaro, Chari, Kanczuk, 2017).

➢ Macroprudential implemented not clear all map to changes intertemporal r (many are related to housing/nontradable – home bias (effect-parameters)
  - If anything, more substitutes than complements with capital controls.
  - But also don't move as much with the different cases/scenarios

What about China?

- Capital controls + exchange rate management in general
  - Contingent (?)
- But how about the trade war US-China:
  - Related to the model?

Tariffs and Retaliation
Negative Effects: Consistent with the Model

- **Tariffs: Higher prices; reduce jobs, investment, exports, financials, and welfare**
  - Trump Tariffs: Flaaen and Pierce (2020), Amiti, Redding and Weinstein (2019), Fajgelbaum et al. (2020); Cavallo et al. (2019); Huang et al. (2019) and Amiti, Kong and Weinstein (2020); Caldara et al. (2019); Washing machines, Flaaen, Hortacsu and Tintelnot (2020);
  - Tariffs: Since the 80s, Bown et al. (2020);
  - Benefits Inputs Liberalization: Amiti and Konings (2007) and Goldberg et al. (2010), Halpern et al. (2015); Exchange Rate Devaluations: Negative effects via imported inputs: Alfaro, Cuñat, Fadinger, Liu (2019)
  - **Older Literature:** on Intermediate inputs & rising input cost:
    - Balassa (1965) and Corden (1966); European Integration Project; Failed Import Substitution in LA; Development literature on Effective Protection: Krueger, Harberger, ….
- **Retaliation: Higher Prices; lower employment, consumption**
  - Trump tariffs, Flaaen and Pierce (2020), Goswami (2020), Blanchard, Bown and Chor . 2019);
  - Spillovers to Other Countries: Reyes-Heroles, et al. (2019).
  - **Older Literature:** Kaldor (1940) and Johnson (1953). Cordell Hull (1922).
- **But…Fajgelbaum and Khandelwal (2021): "neither country seemed able to manipulate the terms of the trend in its favor"**

Trade War US- China

- Trade war US-China: related to model?
  - Evidence negative effects **and retaliation (<u>relevant case</u>)**
- But motivation: TOT pecuniary demand (?)
- Alfaro, Chor, Chen (2022): Randomized information treatments across annual surveys from 2018-2022, to a representative sample of the US general population,
  - <u>Finding</u>: information on the price benefits of trade or the cost of tariff reduces protectionist policy choices.
  - <u>Mechanisms</u>: **concerns over trade with China.**
    - People are willing to endure the negative effects of tariffs due to overall concerns trade with China.
    - Individuals' preferences over trade policies are shaped by priorities on jobs and great power competition;
- If these concerns--- are capital controls an additional instrument?
  - Fears next step in the Trade Wars (listing of firms, bonds, etc.).

    → Extension to the paper.

Conclusion

- Paper: leads us to think in the right directions

  1. Policymakers have **many instruments** at their disposal

  2. The effects of tariffs and capital controls are more complicated when allowing for **retaliation**

  3. **Next step: policymakers** (voters) care about other **policy objectives**

- Implications complex: **first order of importance**

Great Interesting Paper