A New Dilemma: Capital Controls and Monetary Policy in Sudden Stop Economies

Michael B. Devereux
University of British Columbia

and

Eric R. Young
University of Virginia

and

Changhua Yu
Peking University

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Summary

The dangers of high capital flow volatility and sudden stops have led economists to promote the use of capital controls as an addition to monetary policy in emerging market economies. This paper studies the benefits of capital controls and monetary policy in an open economy with financial frictions, nominal rigidities, and sudden stops. We focus on a time-consistent policy equilibrium. We find that during a crisis, an optimal monetary policy should sharply diverge from price stability. Without commitment, policymakers will also tax capital inflows in a crisis. But this is not optimal from an ex-ante social welfare perspective. An outcome without capital inflow taxes, using optimal monetary policy alone to respond to crises, is superior in welfare terms, but not time-consistent. If policy commitment were in place, capital inflows would be subsidized during crises. We also show that an optimal policy will never involve macro-prudential capital inflow taxes as a precaution against the risk of future crises (whether or not commitment is available).