Optimal Capital Controls and Real Exchange Rate Policies: A Pecuniary Externality Perspective

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In response to the global financial crisis a new policy paradigm emerged in which capital controls and other quantitative restrictions on credit flows have become part of the standard crisis prevention policy toolkit. A new strand of theoretical literature, studies the use of capital controls in a context in which pecuniary externality justifies policy interventions. Within the same theoretical framework adopted in this literature, we show that the optimal design of crisis prevention (ex-ante) policies depends on the effectiveness of crisis management (ex-post) policies. This interaction between ex-ante and ex-post policies gives rise to a new rationale for the use of capital controls. Specially, we show that when ex-post policies are effective in containing crises, there is no need to intervene ex-ante with capital controls. On the other hand, if crises management policies entail efficiency costs and hence lose effectiveness, then the optimal policy mix consists of both ex-ante and ex-post interventions so that crises prevention policies become desirable. In our model, the optimal policy mix combines capital controls in tranquil times with real exchange rate support to limit its depreciation during crises times and yields welfare gains of more than 1% in consumption equivalence terms.