Formulating a policy response: Reply to Snowden

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The central point of Professor Snowden's note is that, in general, the capital inflows problem should be tackled by a combination of different policies. We fully agree with his assessment and, in fact, made it explicit in our *IMF Staff Papers* article: " ... there are grounds to support a mix of policy intervention based on the imposition of a tax on short-term capital imports, on enhancing the flexibility of exchange rates, and on raising marginal reserve requirements on short-term bank deposits" (Calvo, Leiderman, and Reinhart, p. 149).[1] However, Professor Snowden's objection to our paper is perhaps that we discuss the pros and cons of each separate policy without taking into account their mutual interaction.

We think this is a valid criticism although, to keep the record straight, it should be said that the paper did not intend to provide a complete discussion of the optimal policy response to capital inflows. In this reply we will offer some thoughts on this latter issue with the caveat that they represent just a first step into largely unexplored territory.
As emphasized in our paper, no policy option is free of potential costs. Therefore, it is to be expected that an optimal policy package will involve more than one measure. The nature of such a policy package is,

[1] In effect, the advisabi!ity of relying on a *mix* of complementary policy measures is also stressed in the concluding remarks to Calvo, Leiderman and Reinhart (1993b).

however, much more difficult to determine. Laissez faire is not optimal because, as a general rule, countries exhibit static or dynamic distortions. Therefore, optimal policy should take explicit account of the relevant distortions characterizing a given economy. The statement above from our paper is, for instance, strongly conditioned by our feeling that government intervention should aim at preventing financial crises and overvaluation of the real exchange rate.

The desirability of a policy mix does not imply that the policymaker should feel totally free to vary the mix. Ideally, policies should be designed to be responsive to exogenous factors-like terms of trade changes, earthquakes, and even wars-but the type and size of response should be well understood in advance. Otherwise, policy, by becoming "discretionary," constitutes an independent source of uncertainty, which only in rare circumstances could be expected to raise social welfare. Actually, if policymakers attempt to utilize their freedom to choose the policy mix to their (or even social) advantage on a regular basis, the public will learn to anticipate such behavior, and the resulting solution will be decidedly inferior to a (flexible but well understood and credible) rule set in advance.

In practice, policy transparency is much harder to achieve. This is so for several reasons. Policy feasibility depends on political considerations that are hard to predict-if not, hard to verbalize. Flexible policies could be complex-and, hence, expensive to articulate and difficult to understand by the general public-and such policies may induce a loss of credibility. This last point is important and deserves further elaboration. There exists a subtle line between flexible rules (set in advance) and "discretion." In both cases, the policymaker changes the policy mix in view of circumstances. Thus, the public may find it hard to distinguish between the two. In particular, when rules are mistaken for "discretion," it would be incorrect to apply the policy rule that would be optimal if the public believed that the policy maker will never resort to discretion. This is the reason why the choice of optimal rules should take into account the credibility of the rules themselves.

For example, we suggest that it may be desirable, among other things, to increase exchange rate flexibility. However, this policy may not be optimal if the public interprets greater flexibility as a signal that policymakers have loosened their monetary discipline and are likely to resort to surprise exchange rate devaluations or appreciations. Actually, the more important are credibility-type considerations, the less flexible the policy mix is likely to be. Similarly, the levying of a tax on short-term capital inflows (a form of capital control) may not be advisable if a relatively young stabilization plan, which stresses liberalization and openness, is in effect. Such a measure could endanger the plan's credibility. Consequently, while fully agreeing with Professor Snowden that optimal policy will likely entail a combination of complementary measures, we believe that the characteristics of optimal policy will be heavily deter mined by country-specific considerations. Approximating such an optimum-especially when a country has experienced an episode of high inflation or high indebtedness-requires the cool mind of an analyst, combined with the refined nose, keen eye, and sharp ears of a champion policymaker.

References

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