The Case for Regulating Finance Capital

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The art of modern banking is at an impasse. The sanctimonious days of *inflation targeting* (IT) with a *primary objective-single instrumen*t under the *bi-polar view* of a free-floating, flexible exchange rate administration are gone.

The idea of equilibrium:
The Savings – Investment Balance

$$Max \int_0^\infty U(c_t)dt$$

Subject to:

$$PC + a_t = wL + ra_{t-1}$$

$Q=f(K,L)$

The producer maximizes profits (the difference between revenues PQ and costs of labour and capital, wL ve rK).

Thus, for producers the problem is to:

$$Max \;\; Pf(K,L) - wL - rK$$

$$a =?= K$$

In fact, what actually was experienced…

Deterioration of the Macro Balances In the Aftermath of Capital account Liberalizations: The Diaz Alejandro-Taylor Cycle:

Increase in the domestic rate of interest:

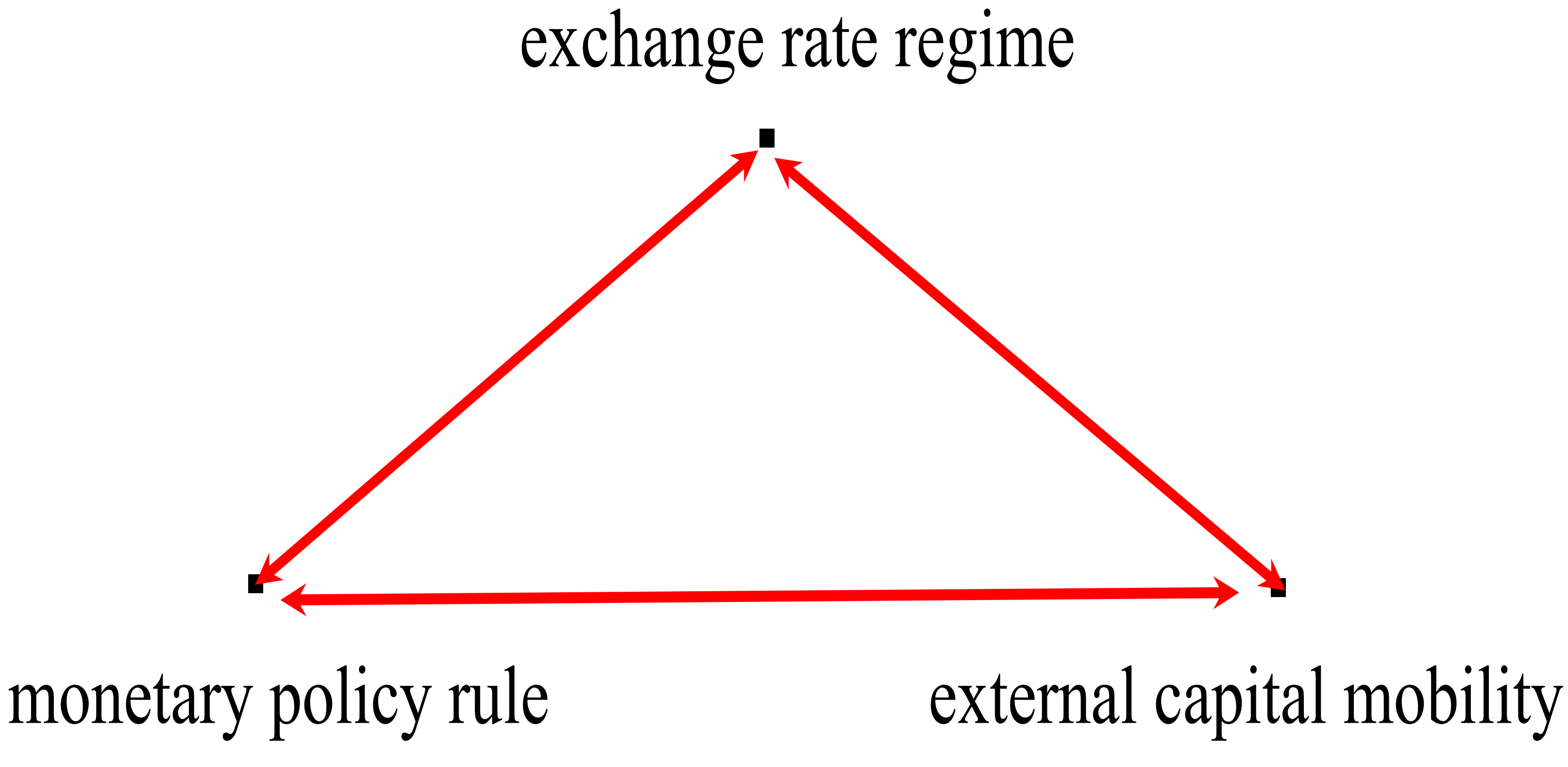
- **Stimulation of capital Inflows**
- **Appreciation of Domestic Currency**
- **Increase in Imports; Widening of CA deficit**
- **Increase of domestic interest rate to invite further inflows to finance CA deficit**

The Un-Holy Trilemma

A Central Bank can choose only two of the following policy regimes:

- exchange rate regime
- monetary policy rule
- external capital mobility

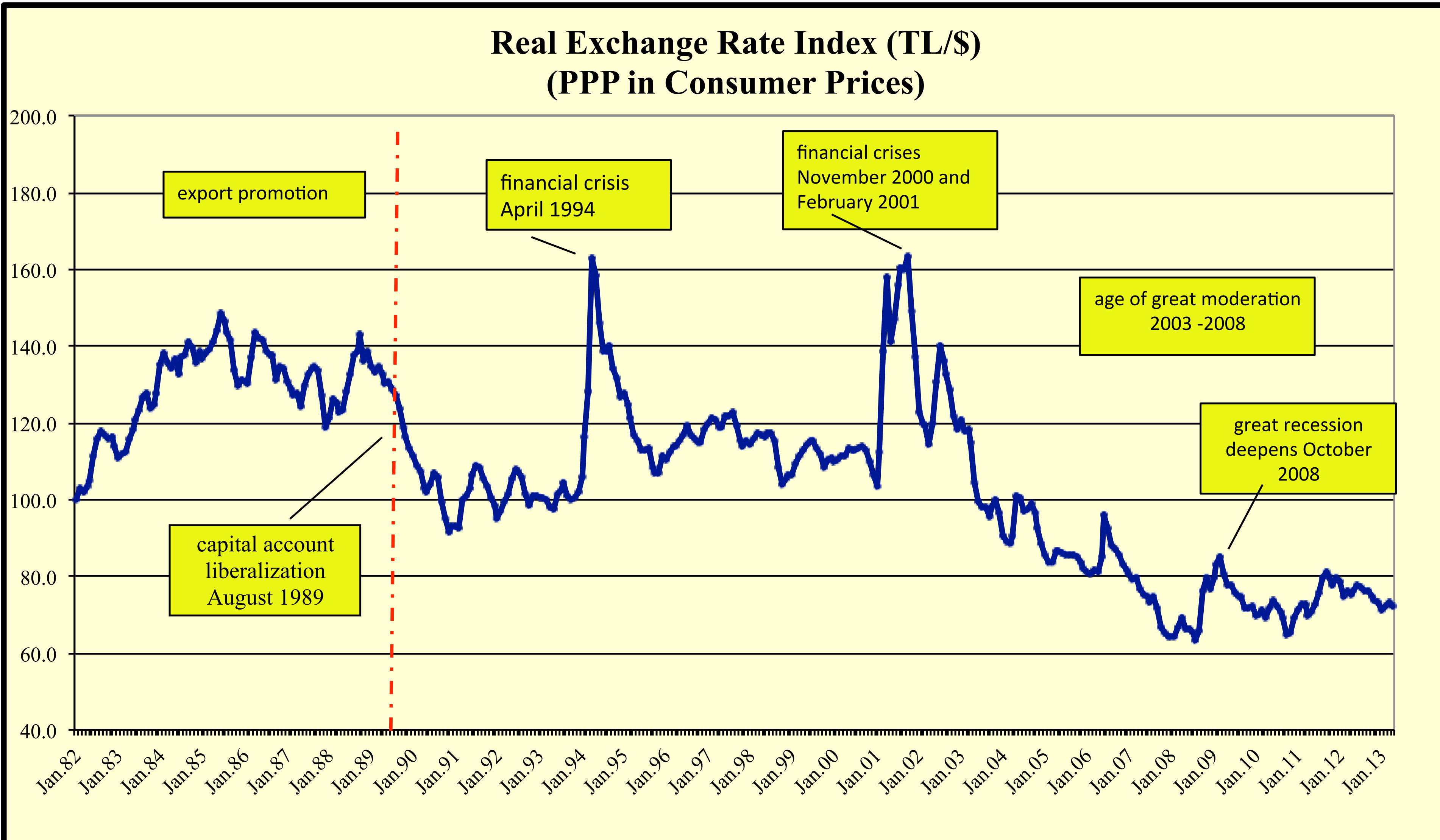
Regard the trilemma in a continuous fashion:

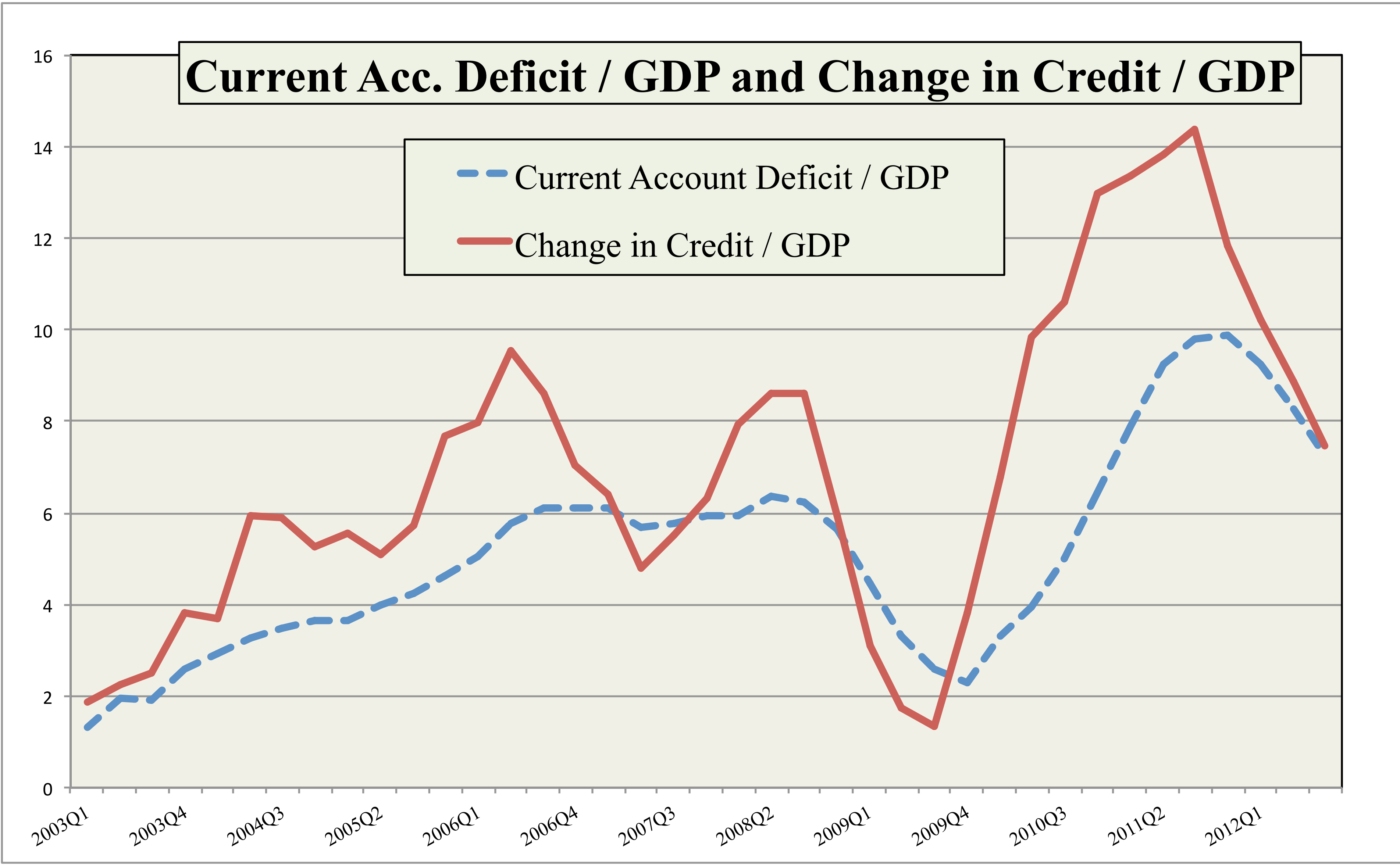


the real problem is that proper functioning of the financial system necessitates an *anchor* to determine the *value of money* the currency crises of the 1990s have underscored the need for *avoiding overvalued* exchange rates.

even under flexible exchange rate regimes, the exchange rate may become misaligned, if its actual value exhibits a sustained departure from that rate which is compatible with the *internal and external equilibrium*.

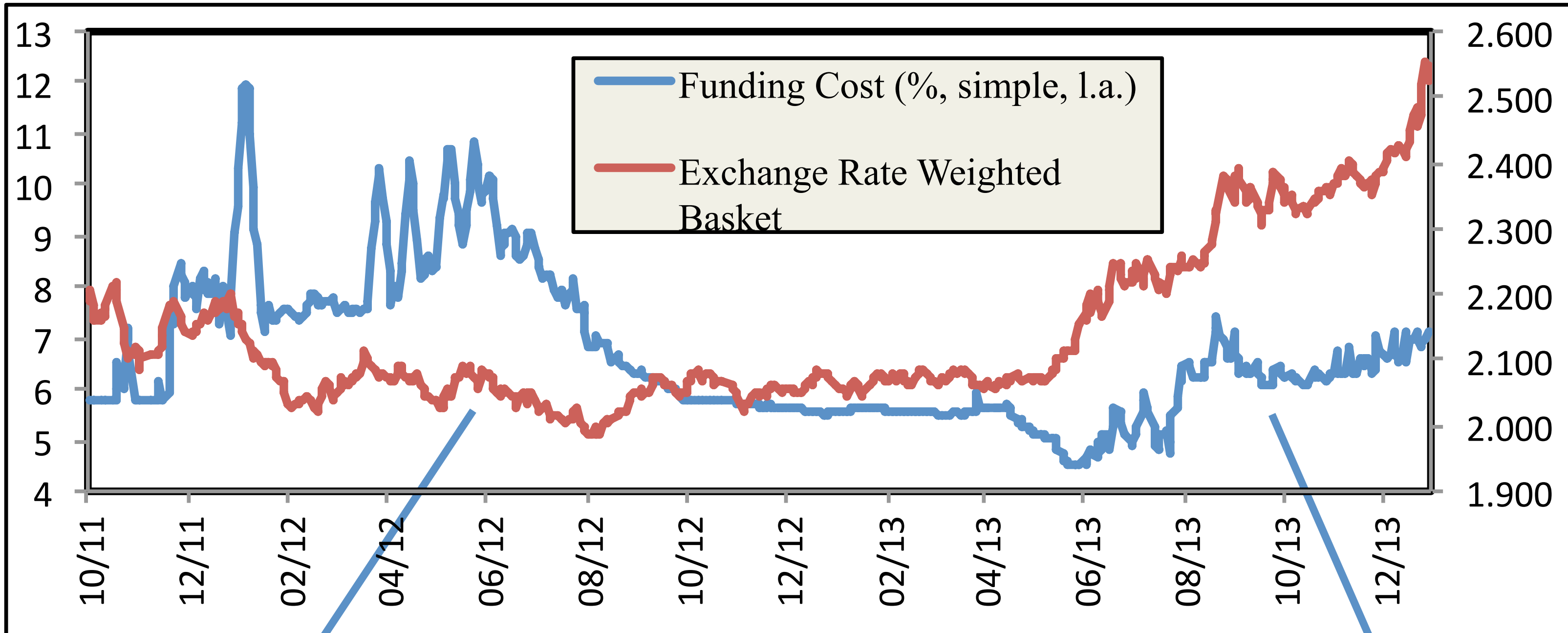
Data from Turkish Foreign Exchange Market (Monthly Averages)




Current Acc. Deficit / GDP and Change in Credit / GDP
Current Account Deficit / GDP
Change in Credit / GDP
0
2
4
6
8
10
12
14
16
2003Q1
2003Q4
2004Q3
2005Q2
2006Q1
2006Q4
2007Q3
2008Q2
2009Q1
2009Q4
2010Q3
2011Q2
2012Q1

But new instruments came with another dilemma…

WHAT TO SMOOTH:
RATE OF INTEREST OR THE FOREIGN EXCHANGE?



Currency stability at the expense of interest rate volatility

Interest rate stability at the expense of currency volatility

Further Lessons:

(1) The link between the classical monetary aggregates and inflation are weaker due to introduction of new financial assets, financial deepening, and a free-er capital account.

(2) Be aware of the risks in the banking sector and money markets:

- open currency positions of the banks as well as the non-financial enterprises

- maturity mismatches in the banks' balance sheets

- sources of the current account deficit –public or private

(3) Be aware of the possible presence of *multiple equilibria*

- a "*good*" equilibrium with low inflation, low real interest rate, and stable currency

- a "*bad*" equilibrium with high inflation, high real interest rate and a sharp depreciation

(4) At times conventional portfolio models may lead to wrong conclusions

A CB may find it improper to increase the interest rate as a disinflationary tool if there is the fear of jeopardizing fiscal fragility and debt sustainability

(5) The impact of capital flows is different when the focus is on the *gross* magnitudes rather than *net* values

(6) over-obsession with fiscal sustainability while neglecting *balance of payments sustainability* is a dangerous game