Capital Controls and Free-Trade Agreements

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Simon Lloyd[1,2] and Emile Marin[3]

[1]Bank of England, [2]Centre For Macroeconomics, [3]University of California, Davis

We study how the conduct of optimal cross-border financial policy changes with prevailing trade agreements. To do this, we use a canonical two-country, two-good endowment economy model, absent nominal and financial frictions. Households make an inter-temporal consumption-savings decision and choose their optimal consumption bundle intra-temporally. In the laissez-faire or decentralised allocation, relative consumption growth across countries is proportional to the relative decrease in price levels—i.e., the rate of real exchange rate depreciation. However, households do not internalise the effect of their actions on relative prices. These pecuniary externalities imply that a country planner maximising domestic welfare has an incentive to manipulate the inter- and intra-temporal terms of trade—i.e., world interest rates and relative goods prices, respectively—even though the laissez-faire allocation is optimal from a global perspective.

Within this setup, when domestic households borrow between two periods, the planner tends to levy capital-inflow taxes to delay consumption relative to the decentralised allocation, but must trade off the incentive to drive down the world interest rate with second-best effects on relative goods prices. In this paper, we ask: what more can a country planner achieve by deviating from a free-trade agreement (FTA), and what might this imply for the conduct of optimal capital controls and world welfare?

Our key contribution is to relax the constraint imposed on the planner by a FTA and assess the interactions between optimal capital-flow management and trade policy within a tractable environment. We show that introducing tariffs (or trade disruptions more generally) distorts the cost of borrowing. In turn, this reduces efficiency and gives rise to a novel motive for managing capital flows. When tariffs are optimally chosen, we show that whether the optimal capital controls are larger or smaller in the absence of a FTA depends on whether the inter- and intra-temporal incentive to manipulate the terms of trade are aligned. Our results generalise to environments with production, nominal rigidities, small-open economies, market segmentation and exogenous trade disruptions and sanctions.

While employing tariffs in addition to capital controls can improve welfare domestically when a planner faces no retaliation, this comes at a disproportionate cost to foreign welfare. In a Nash equilibrium with retaliation, capital controls tend to be larger absent a FTA in all states of the economy because of the effect of tariff wars on the real exchange rate. As a consequence, the welfare costs from capital-control wars are disproportionately larger at both a country-level and globally when there is no FTA in place—giving rise to tariff wars too.

Finally, we conduct a policy experiment and show that commitment to a FTA can reduce incentives to depart from a FFFA and use capital controls. Since capital-control wars are costly for global welfare, our analysis highlights a novel argument in favour of FTAs: namely that retaining openness in trade can help to sustain financial openness.