# The optimal domain for financial liberalization

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**Views expressed are my own**

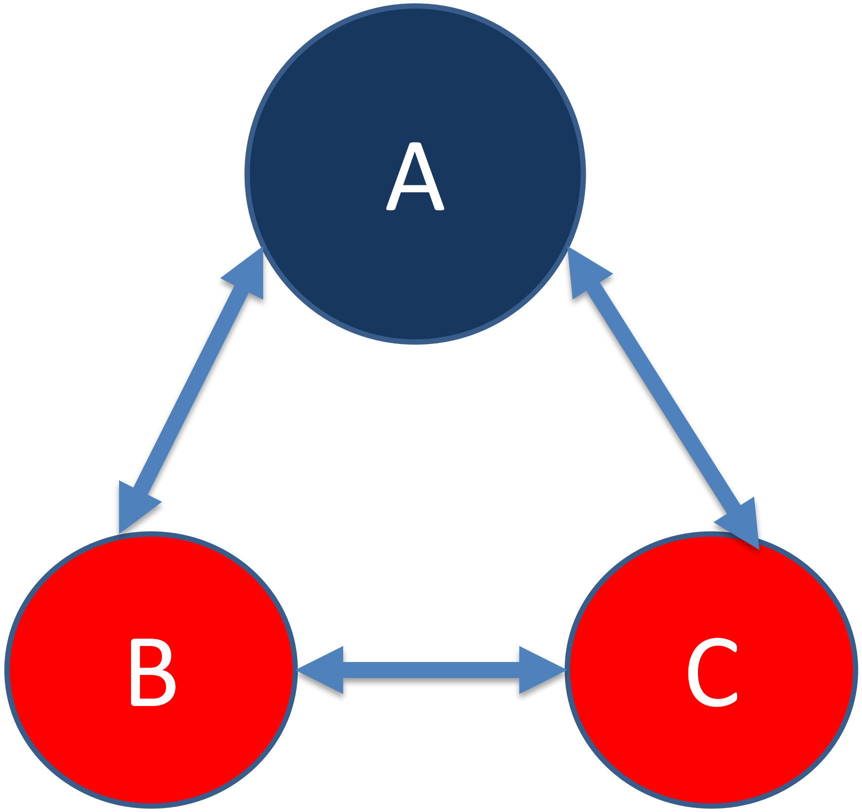
# Capital account management vs. financial repression

- "Capital account management" (aka controls on cross-border capital account transactions) has been gaining respectability.
  - Difficulty in finding empirical evidence for the benefits of free capital mobility
  - Disruptive effects of volatile capital flows on exchange rates (competitiveness) and domestic asset markets
- "Financial repression" (aka limits to domestic financial development) is typically thought of as undesirable
  - Misallocation of capital
  - Transfers from savers to borrowers

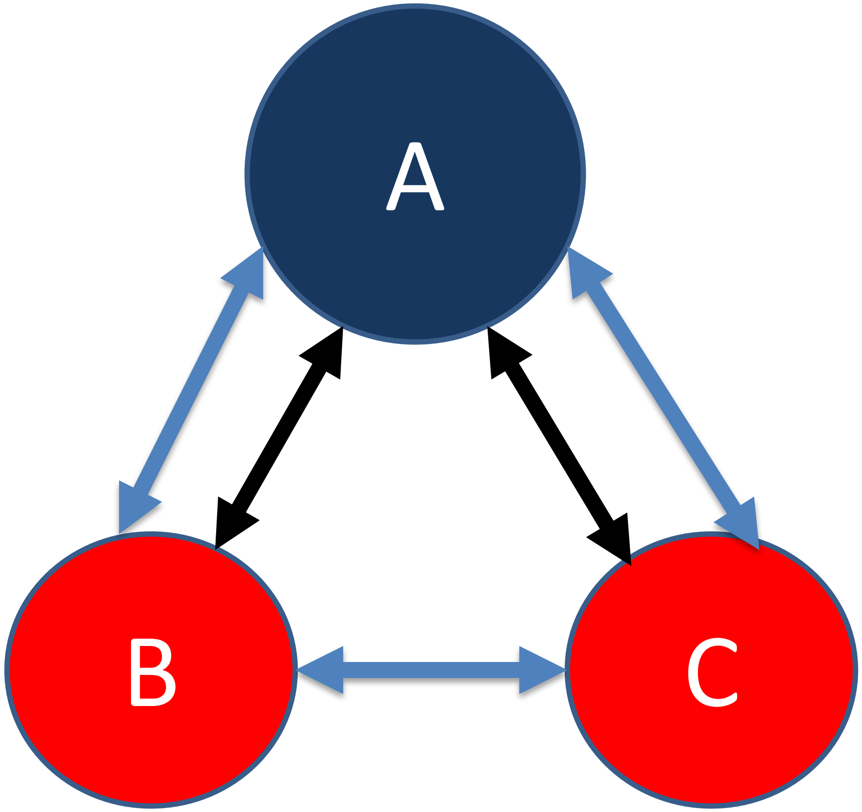
# What’s so special about the national border?

- Should “capital account management” within a national jurisdiction be contemplated?
  - Would it have been useful if some restrictions on FDI into the Nevada real estate sector had been restricted?
- Should controls of cross-border capital flows be ‘discriminatory’ as to the provenance (or destination) of the flows?
  - Do ‘free-flow’ areas (analogous to free-trade areas) make sense? If so, how should they be defined?

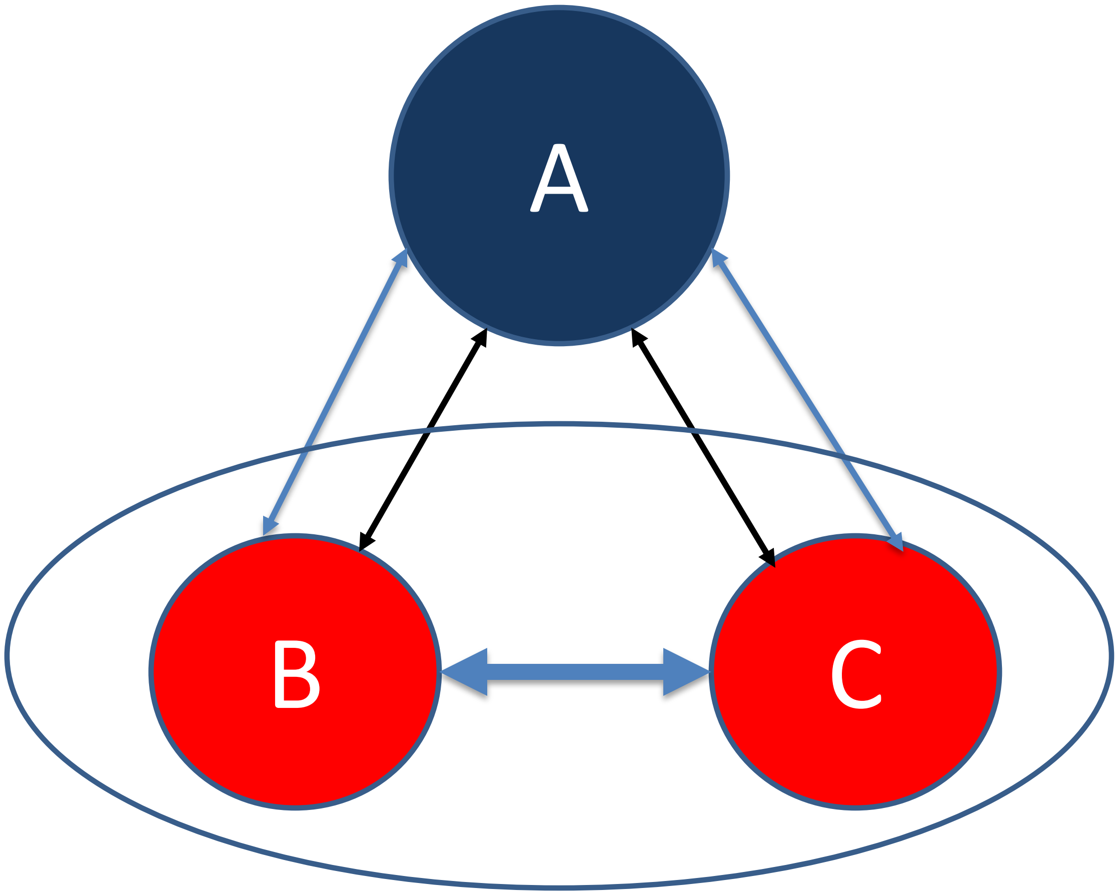
# A stylized example: risk sharing



# A stylized example: risk sharing plus volatile capital flows



# A stylized example: foregoing some risk sharing for reduced capital flow volatility



# Conjecture

- Countries which face symmetrical financial shocks are candidates for an **optimal financial integration area**

- Is this not a criterion for an **optimal currency area**? No, the discussion of optimal currency areas centered around real vs. monetary shocks.

# Speculating further: targeting instruments to shocks

| **Monetary and real shocks** | **Exchange rate management** |
|---|---|
| Financial shocks | Capital account management/financial repression |

# Capital account management in a currency area

- Would it have been useful to limit capital flows to Spain, and in particular to its real estate sector, in the early days of the Euro area?
- How could it have been done? Capital provisioning for banks?
- How do these issues apply to China as it implements reforms of its domestic financial system and moves towards a more open regime for cross-border capital flows?

# Implementation and institutional issues

- So far, no discussion of implementation issues
  - Cost of enforcing capital account measures
  - Coordination and institutional aspects of creating a ‘free-flow’ area
- These have parallels in discussions of common currency areas where the creation of such an area require agreements on common monetary institution and a common monetary policy

# Why the national border still matters

- These institutional and implementation issues may ultimately be the reason why a national border is probably the best predictor of actual domains of currencies

and

- Why  a national border seems to be a good predictor of the domain of financial integration