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Optimal crisis interventions in an open economy with credit constraint

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In an open-economy model with financial constraint, Schmitt-Grohé and Uribe (2017) propose an expression for a capital control policy. From this expression, they argue that the optimal tax, i.e. the one that solves the overborrowing problem, is indeterminate when crises occur (i.e. when the constraint binds) and positive during normal times. In contrast, we show that their capital tax (i) is indeterminate during normal times and, in standard cases, positive during crises, and (ii) does not solve the overborrowing problem, and therefore it is not an optimal capital control policy, as opposed to the capital tax proposed by previous literature (positive during normal times and nil during crisis). We also show that the overborrowing problem can be solved as well by a subsidy on consumption (positive during crises and zero during normal times).

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Update: 15/02/2018, 9:50 a. m. This is an updated version of a paper that circulated under the title "Countercyclicality of financial crisis interventions in an open economy with credit constraint" (March, 2017). With respect to the earlier version there are three important changes: (i) we focus on the ability of some crisis interventions to solve the overborrowing problem rather than their cyclicality, (ii) for ease of comparison we use very similar notation to that in Schmitt-Grohé and Uribe (2017), and (iii) Proof of Proposition 2 has changed.

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