Do Capital Controls Limit Inflow Surges?

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Background: 2-slide primer

Basic questions:

1. Do surges make countries more crisis-prone?
   - Yes or no question
2. Why interventions, including CCs, are warranted?
   - Need to argue inefficient boom-bust, surge-stop cycles

Do surges make countries more crisis prone?

"The probability of … crises conditional on a *capital flow bonanza* is significantly higher than the unconditional probability."

Probability of Crisis (in Percent)	External Default	Currency Crash	Inflation Crisis	Banking Crisis
	All Countries			
Conditional on a bonanza (3-year window)	22.2	25.8	24.2	18.4
Unconditional	15.7	19.1	18.0	13.2
Difference	6.5*	6.7*	6.2*	5.2*

*Significant at the 1% confidence level.

Reinhart and Reinhart (2010)

Pecuniary externalities

- Why are capital controls needed?
- What kind of inefficiency are they fixing?

- “Overborrowing” by e.g., Bianchi (2011),
  - A simple small open economy model subject to occasionally binding borrowing constraints, in which maximum size of their borrowing depends on asset prices, pecuniary externalities (PEs) arise.
- Inefficiently elevated probability of sudden-stops, resulting in inefficient boom-bust (or surge-stop) cycles

- IMF (2012, 2018) discusses the “institutional view” on CFMs

This paper…

..makes a case for capital controls because

1. to prevent crises, curbing capital inflow surges are effective (in line with early studies),

2. to curb capital inflow surges, capital controls are effective,
3. based on their new and recent dataset
4. with a difference-in-difference type Probit model

1. Endogeneity

Causality

A) Capital control ➔ Less surges

B) Surges ➔More capital control

$$\text{Prob}(InflowSurge_{i,t}) = \beta_1 Control_{i,t-1,t-4} + \beta_2 DiffGDPgrowth_{i,t-1} + \beta_3 DiffIR_{i,t-1} + \theta X_{i,t-1} + \gamma_i + \theta_t + \varepsilon_{i,t},$$

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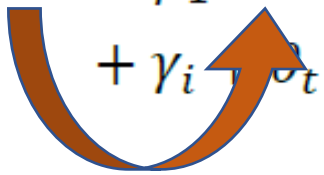

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Identification problem

- Policy reaction function (B)
- Effectiveness of the policy measure (A)

- BBKARS: Introduction timing NOT relevant to surge experiences
- More formal method: Propensity score matching (Imbens and Wooldridge 2009, Shirota 2018)

2. Capital outflow promoting measures

- If measures to *promote capital outflow* ***during booms/surges*** are taken and/or enhanced, could not they affect the results?
  - Likely to reduce sudden-stop probability
  - Somehow included in $Control_i$ in equation (2)?
  - Easing actions are captured – both simultaneously and separately, but "easing" means removal of capital controls on *inflow*?

- The Fund's traditional policy recommendation before 2012 to cope with ongoing inflow surges (e.g., GFSR 2007)

  "..some general guidelines.. aimed at alleviating the pressures arising from large capital inflows:" "Loosening or eliminating restrictions on residents' capital outflows is a tool that can ease pressures from large capital inflows."

3. Strength/intensity of CC tightening measures

- Explanatory variable of the interest: Number of tightening measures ($Control_i$)
- 0-1 binary dummy or integers?
- E.g., 1 percent and 10 percent tax levy increases on foreign borrowing are equally counted as “1’s”?

- Intensity difference b/w tightening and easing measures are handled, but how about within tightening measures?