

# **Capital Inflow: The Role of Controls**



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# Outline



- **INTRODUCTION AND OVERVIEW**
- **RESPONDING TO CAPITAL INFLOWS**
- **INFLOW, FRAGILITIES, AND CONTROLS**
- **CONCLUSION**

# Introduction and Overview



# Introduction and Overview



- The Financial Crisis – huge capital flow to EMEs
- Surge in Capital Inflow – perceived to be short-term
  - Exchange Rate Overshooting – reduce trade competitiveness
  - Inflate Asset Price Bubbles or Collateral Damage – sudden reversal
- The sudden surge can complicate macroeconomics management and create financial risk
- The surge may not be a result from rational investing decision.
  - Excessive foreign borrowing and foreign currency exposure – fueling domestic credit boom and asset bubbles
- So free capital flow might bring:
  - Financial Fragility and Crisis Risk

# Introduction and Overview



- **The possible tool to handle the surge:**
  - Fiscal and Monetary Policy
  - Exchange Rate Policy
  - Foreign Market Intervention
  - Domestic Prudential Regulation
  - Lastly, Capital Control
- **The appropriate mix of policy is likely to depend on:**
  - The State of Economy
  - The Level of Reserves
  - The Quality of the Existing Prudential Regulation
  - The Scope to Allow the Currency to Strengthen
  - The Persistence of the Inflow

# Introduction and Overview



- **A key conclusion in using the capital control:**
  - The economy is operating close to potential level
  - The level of reserve is adequate
  - The exchange rate is not undervalued
  - The flow is short-term
  - Then, the capital control is justified as part of policy to handle with surge.
- **A key issue of course is whether the capital control work in practice: (the data subject to simultaneity bias)**
  - Quite effective in the extensive closed capital account
  - Effect on some composition of the inflow but not the total volume

# Introduction and Overview



- **An Interesting Finding:**
  - Foreign direct investment (FDI) – Financial Sector FDI is less safe, especially in the form of debt.
- **A Significant Caveat:**
  - Potential for Adverse Multilateral Consequences
    - ✦ Global recovery depend on macroeconomic policy adjustment which could be undercut by capital control, notably in cases where currencies are undervalued
    - ✦ Widespread Adoption of Control:
      - Worse global imbalance and deter the rebalancing of global demand and the sources of growth in individual countries
      - Reducing long-term impact on financial integration and globalization, with significant output and welfare losses

# Responding to Capital Inflows

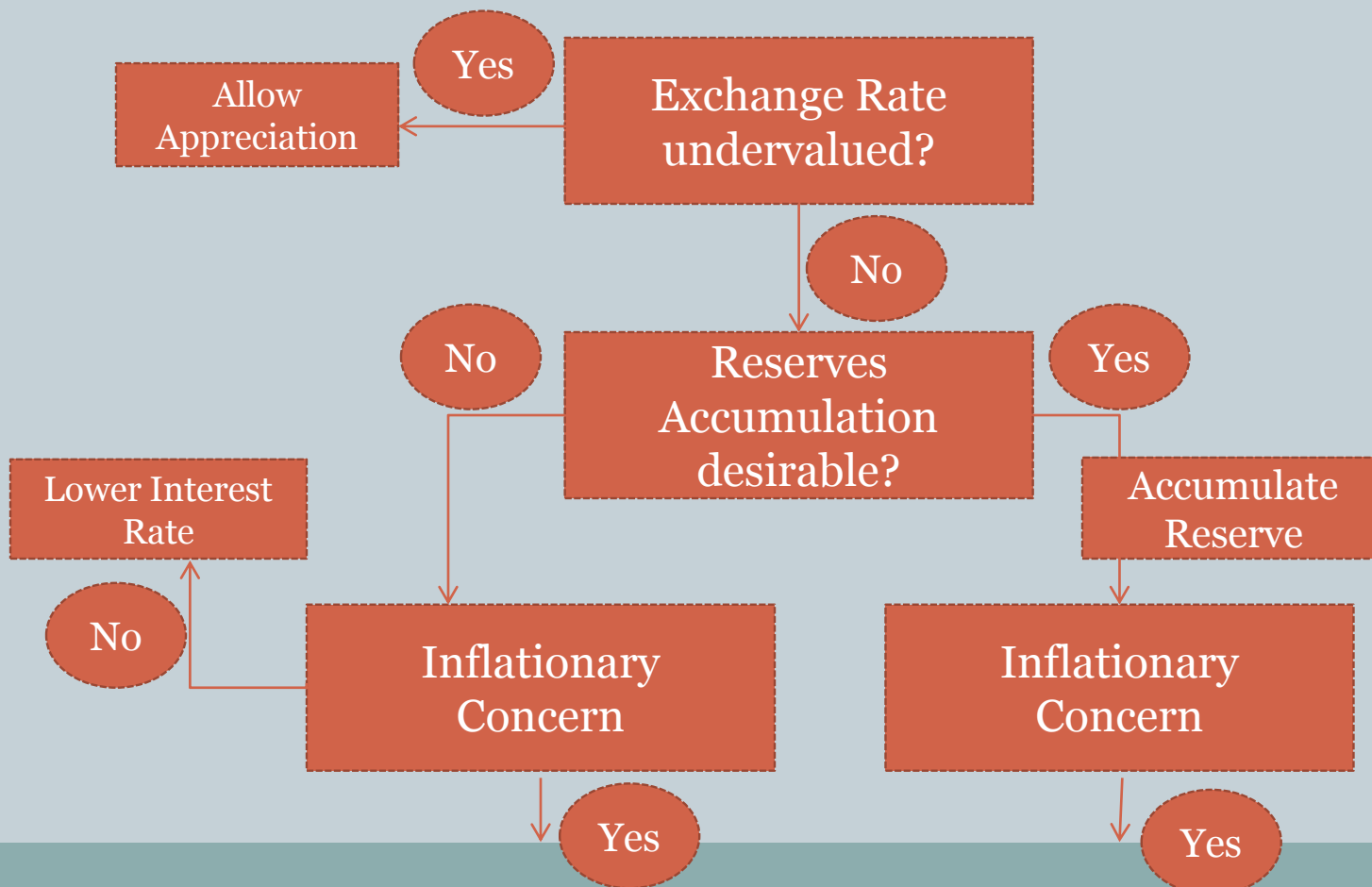


**MACROECONOMICS CONSIDERATION  
AND PRUDENTIAL CONCERNS**

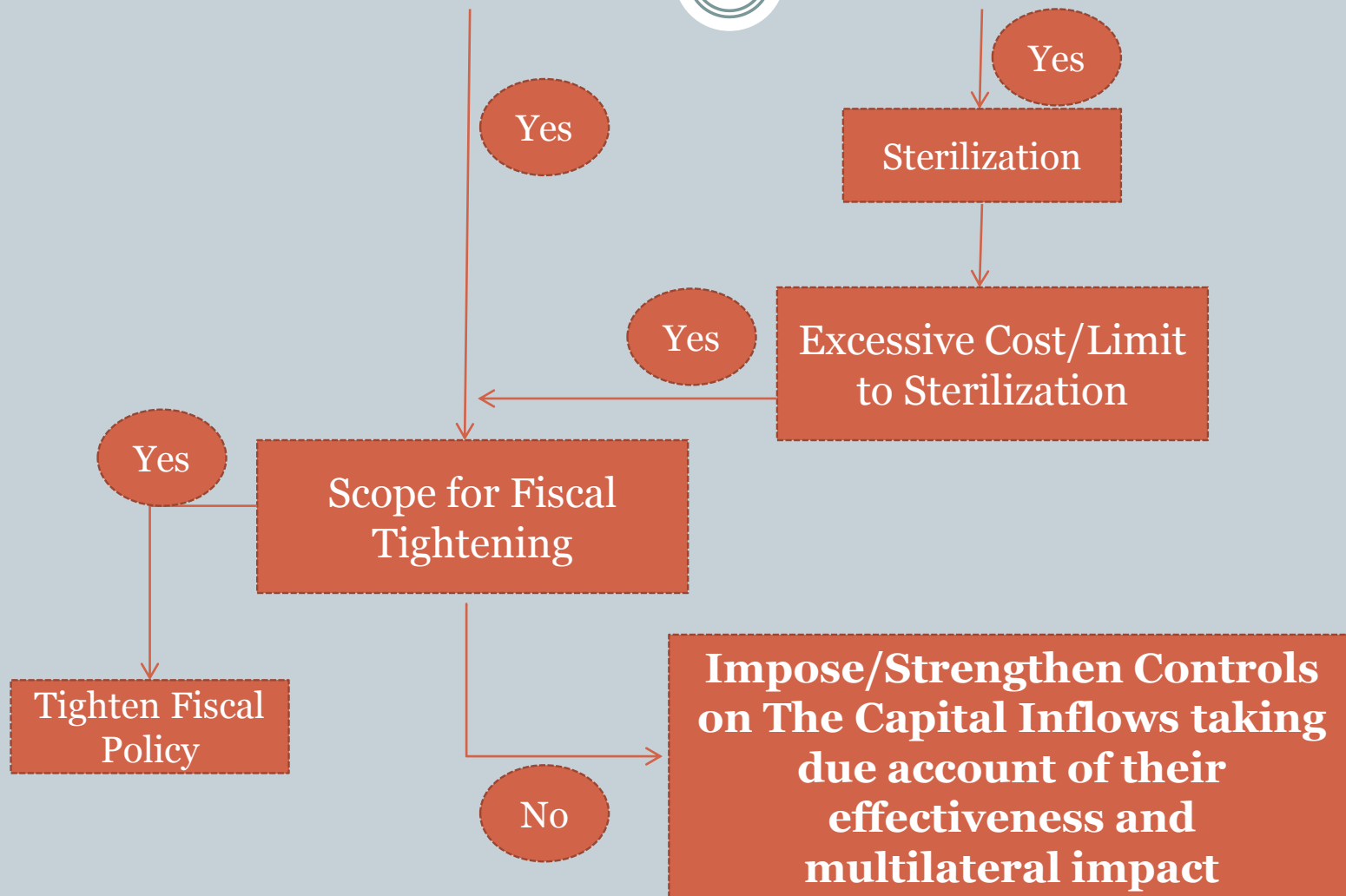
# Responding to Capital Inflows



- Macroeconomics Consideration with multilateral context:



# Responding to Capital Inflows



# Responding to Capital Inflows



- Prudential Concerns:
  - Can we manage the riskiness inflow?
- Order of capital inflow by riskiness (with short-term riskier than long-term):
  - Foreign-currency Debt – highest-risk
  - Consumer-price-indexed Local Currency Debt
  - Local-currency Debt
  - Portfolio Equity Investment
  - Foreign Direct Investment

# Responding to Capital Inflows



- Prudential Regulation:
  - During the Surge - reduce the risky inflow and increase the safer inflow
    - ✦ Minimum-stay Requirement
    - ✦ Unremunerated Reserve Requirements - foreign exchange debt
    - ✦ Financial Transaction Tax – short-term carry trade
- But if this is not sufficient – Capital Control might be necessary

# Responding to Capital Inflows



- If Macroeconomics and Regulation Consideration suggest to impose Capital Control, but with cautions:
- Other Consideration:
  - Effectiveness
    - ✦ Those countries with closed capital account will be easier.
    - ✦ Those with open capital account – excessive distortion
  - Controls on Outflows
    - ✦ Lower the New Inflow - but might also attract more inflow, due to greater assurance that capital can be repatriated
  - Multilateral Consideration:
    - ✦ Greatest concerns is the widespread use of capital controls, especially by EMEs could deter the rebalancing of global imbalance.
      - The risk of a bandwagon response and contagion effect
      - The beggar-thy-neighbor policy
    - ✦ It hurts global economy and slows the crisis recovery

# Inflows, Fragilities, and Controls



**SOME STYLIZED FACTS**

# Inflows, Fragilities, and Controls - Some Stylized Facts

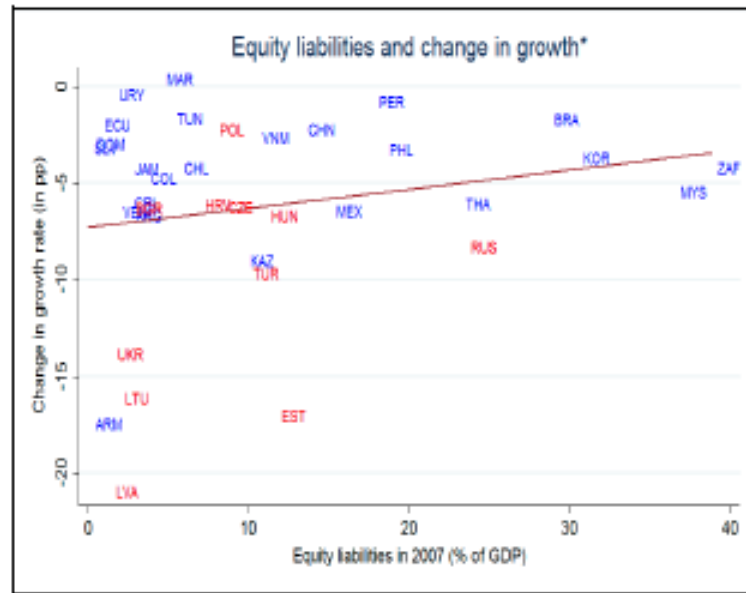
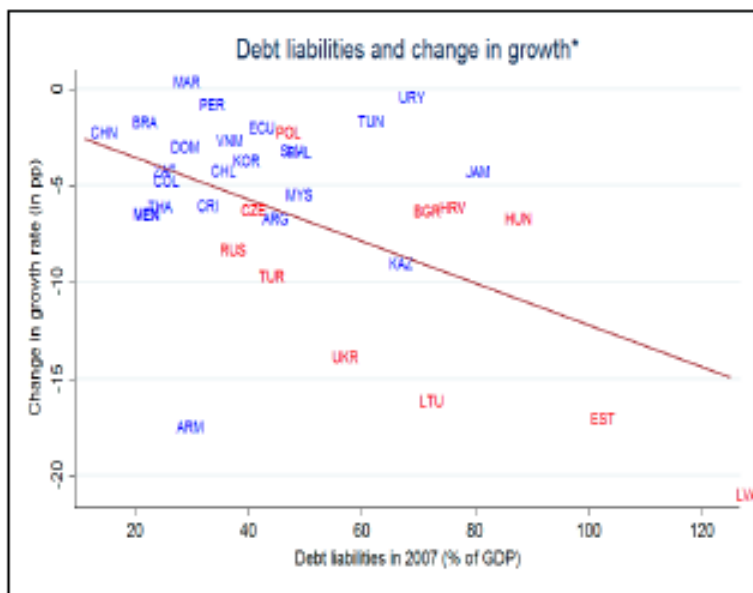


- Existing Empirical Evidence
  - The individual study often find little or no impact of capital controls on the total volume of inflows.
    - ✦ But at least, those with controls had smaller surge
  - But corresponding to above finding, they usually do not find much effect on exchange rate appreciation either

# Inflows, Fragilities, and Controls - Some Stylized Facts

- Evidence from Current Global Financial Crisis
  - Certain types of pose greater risk of financial fragility

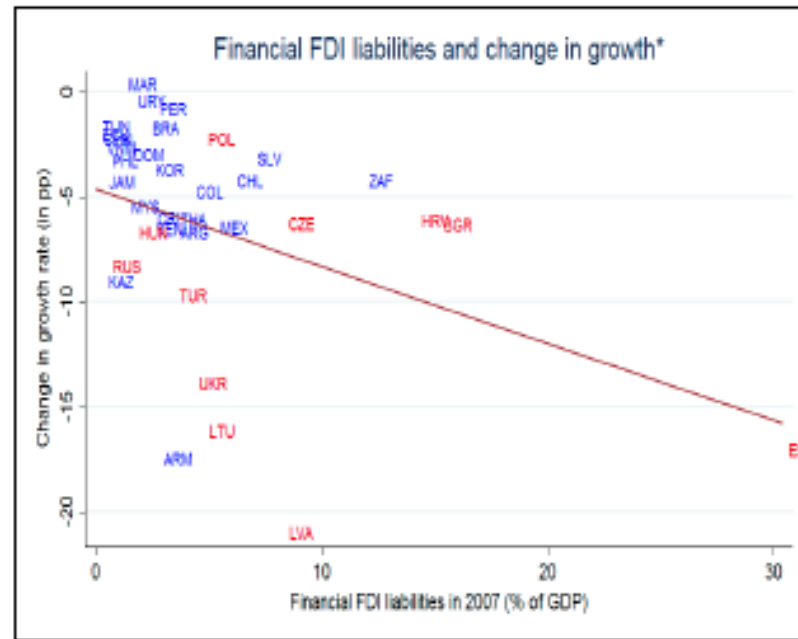
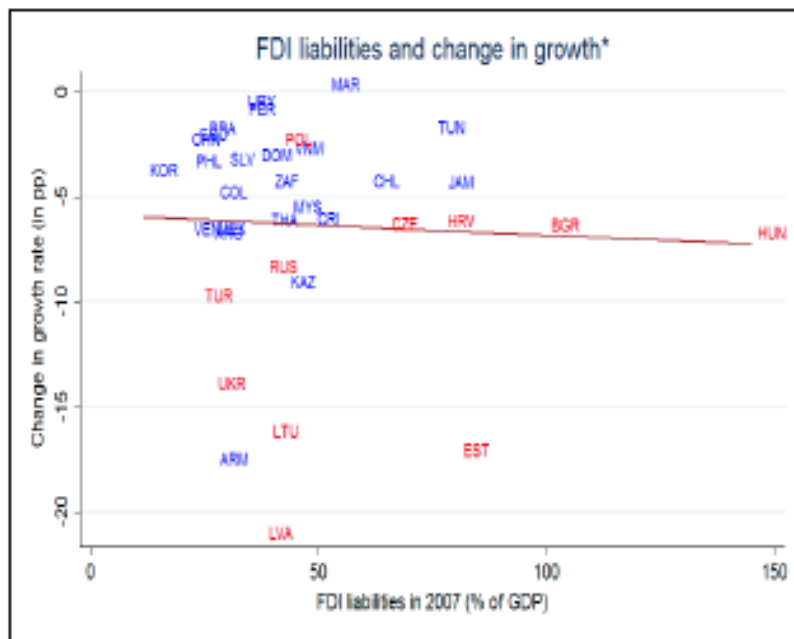
Figure A1. Foreign Liabilities and Growth Decline (in percentage points)



# Inflows, Fragilities, and Controls - Some Stylized Facts



- Evidence from Current Global Financial Crisis
  - Certain types of pose greater risk of financial fragility
    - ✦ Some composition of FDI also associated with negative growth during 2007



# Inflows, Fragilities, and Controls - Some Stylized Facts



- Evidence from Current Global Financial Crisis
  - Why debt and some components of financial FDI added greater risk to country?
    - ✦ Both strongly associated with credit booms and foreign-exchange-denominated lending by domestic banking system which in turn is associated with greater vulnerability of the economy.
  - For the effectiveness of the capital control
    - ✦ There does appear to be a negative relation between capital controls that were in place prior to the global financial crisis and output declines suffered during the crisis
    - ✦ Capital controls was associated with avoiding the worst growth outcomes associated with financial fragility
  - Debt flows should be controlled

# Conclusion



# Conclusions



- There is no absolute tools to deal with the impact of potential destabilizing of short-term capital inflow
- For both macroeconomics and prudential reason, there may be circumstances where the capital control is the legitimate policy to handle the surge
- Certain types of flow, especially debt, should be focused

# Conclusions



- Multilateral Dimension should be considered along when using capital control policy. Capital control can be helpful to individual countries under certain condition, but their widespread use could have deleterious the effects on the efficient allocation of investment across countries, and harm prospect for global recovery and growth.
- When imposing the capital control, balancing the various consideration, internally and externally, could be helpful in managing possible cross-country spillovers.
- And it should be reassessment overtime to maintain the optimum level

# Q&A

