

Are Capital Controls Prudential? An Empirical Investigation

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Motivation

- A growing theoretical literature - and since also recently the IMF - advocates the use of prudential capital controls as a tool:
 - ▶ For crisis prevention.
 - ▶ For promoting financial stability.
 - ▶ For improving macroeconomic adjustment in economies with nominal rigidities and suboptimal monetary policy.
- The basic idea is that governments should:
 - ▶ Tighten restrictions on capital inflows during booms.
 - ▶ Relax capital restrictions on inflows and tightend restrictions on outflows during recessions.

Summary

- Aim of this paper: To investigate whether capital controls have been used in a macroprudential/counter-cyclical manner.
- Data: Panel consisting of 78 (developed, emerging and low-income) countries between 1995 to 2011.
- Main results:
 - ▶ Unconditional standard deviation of the cyclical components of capital controls is very small.
 - ▶ Cyclical components of controls on capital inflows and outflows are positively correlated.
 - ▶ Controls on capital inflows or outflows are virtually unchanged during booms or busts.

⇒ Countries seem not to apply capital controls in a prudential fashion.

- Very well written paper, gives an excellent overview about the underlying topic.
- Comments on:
 - 1 Data set.
 - 2 Empirical analysis.
 - 3 Relevance of research question.

Real-time vs. ex-post data:

- When analysing the cyclical nature of policy decisions, one should always differentiate between real-time and ex-post information (Orphanides, 2001).
- Especially information on the cyclical stance of the economy (i.e. GDP) is usually subject to substantial data revisions.

- When this paper finds that capital controls are a-cyclical, it might be that:
 - ① Policymakers indeed do not make use of the instrument of macroprudential capital controls.
 - ② Policymakers might have the right intention to change capital controls in a counter-cyclical fashion, but they have wrong information at hand on the current business cycle position.
- **Recommendation:** To disentangle, which of these two explanations explain the a-cyclicity of capital controls, one should accomplish the empirical analysis with macro variables measured in real-time.
- This result will be important for giving the correct policy recommendation.

Treatment of countries without any capital controls:

- Descriptive statistics would help to understand, how many countries have imposed restrictions and how this has changed over time:
 - ▶ Eichengreen and Rose (2014) show that capital controls are very persistent: Once they are removed, they are rarely restored.
 - ▶ Further, countries with no recent history have only little incentive to introduce controls since this would send negative signals that first-best policies are unavailable.

→ There is very likely a substantial share of countries without capital controls in the data set.

- Keeping countries in the sample with no capital regulation will bias downwards the cyclicity of controls.
- Moreover, the focus of the paper should be more on the cyclicity of the intensity of regulation and not the cyclicity of the participation rate, the latter being rather time persistent.
- **Recommendation:** One should better delete all observations, for which the Schindler index is 0.

Estimation vs. graphical inspection:

- Several potential determinants are discussed in the paper that could influence the decision/ability to use capital controls as a macroprudential tool:
 - ▶ Development stage of a country.
 - ▶ Level of external debt.
 - ▶ Currency regime, etc.

⇒ Graphical inspection is not sufficient to control for all these potential factors jointly.

⇒ **Recommendation:** Why not using regression analysis, e.g. fixed effects panel estimation?

Empirical analysis

- Moreover, applying regression analysis allows to control for a potential endogeneity problem:
 - One can assume that not only macroeconomic outcome affects the intensity of capital control, but that it also holds vice versa: capital regulation affects macroeconomic outcome.
- ⇒ Thus, we have a classic simultaneity problem:

capital control \longleftrightarrow **macroeconomic outcome**

- **Recommendation:** Apply instrumental variable estimation approaches to address the endogeneity problem.

Choice of detrending methodology:

- The choice of detrending methods used for the different time series used seems to be quite arbitrary.
- **Recommendation:** Show in the paper, how robust the empirical results are to the choice of the detrending methodology (e.g. linear, quadratic, Hodrick-Prescott, Baxter-King, etc.).

Relevance of research question

- General question: How relevant are capital controls in reality to foster financial stability?
- Several papers have analysed, whether capital controls have the ability to affect macroeconomic outcomes. The results are rather inconclusive:
 - ▶ Most papers find no significant impact of capital controls on macroeconomic outcomes (e.g. Montiel and Reinhart (1999), IMF (2008)).
 - ▶ Only few papers find small and asymmetric effects: Countries do not seem able to effectively stem inflows by restrictions, but in contrast, governments seem to be able to discourage outflows (i.e. Binici at al. (2009)).

Relevance of research question

- Given these uncertainties, a provocative question to kick-off general discussion:
 - ⇒ How relevant is it to analyse, whether governments make use of counter-cyclical capital controls?
 - ⇒ Should one not better conclude that it is recommendable for governments to rely on alternative macroprudential instruments to achieve financial stability, like e.g.:
 - ▶ Cyclical loan-to-value regulation.
 - ▶ Cyclical liquidity standards.
 - ▶ Limitations on banks' balance-sheet expansion.