Policy Rules for Capital Controls

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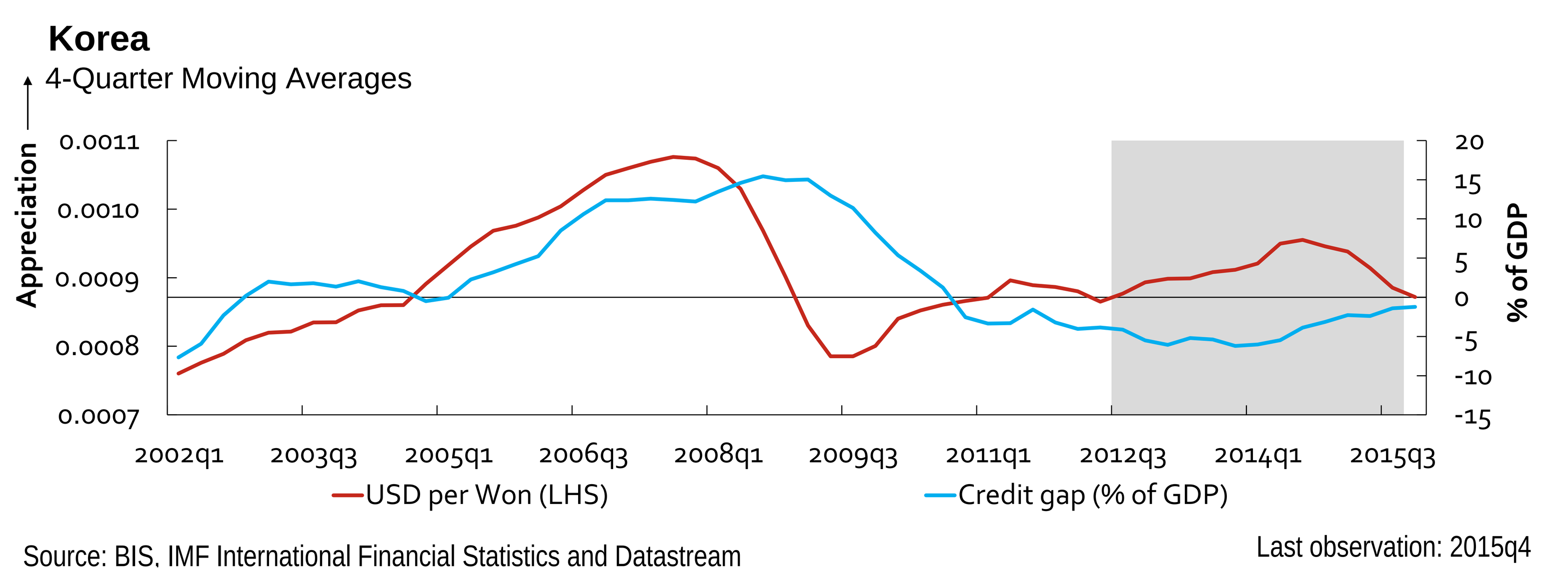
Abstract

- Are capital controls macroprudential or mercantilist?
- The paper uses a policy reaction function approach to examine this question
- Two novel datasets:
  - A novel, weekly dataset on capital controls policy actions in 21 EMEs from 1 January 2001 to 31 December 2015
  - A new proxy for mercantilist motivations: the weighted appreciation of an emerging-market currency against its top five trade competitors

Introduction

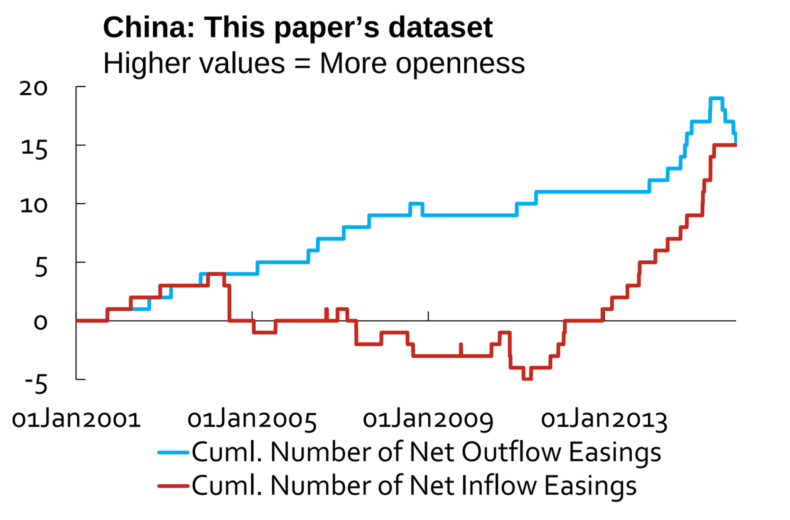
- A policy rule describes the systematic response of policy to competing objectives
- Two main objectives of capital controls policy:
  - **Macroprudential:** Mitigate systemic risk from excessive foreign borrowing
  - **Mercantilist:** Exchange rate management to maintain export competitiveness
- The different objectives of capital controls policy can involve trade-offs:



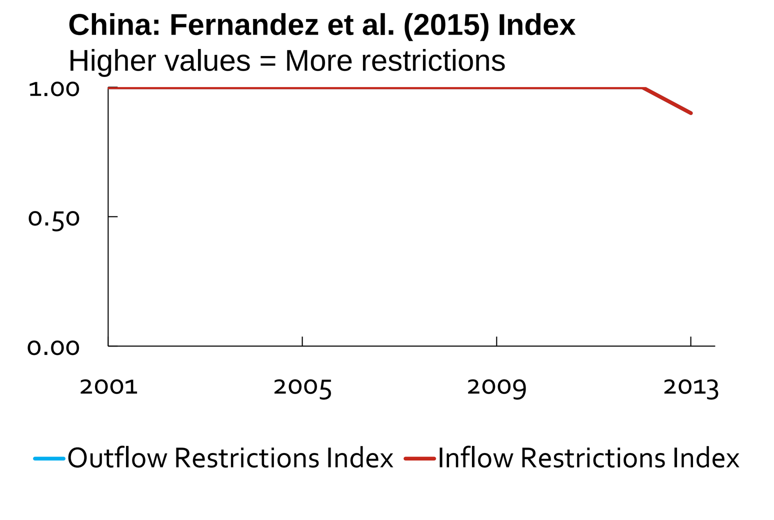
Source: BIS, IMF International Financial Statistics and Datastream
Last observation: 2015q4

Dataset on capital control policy actions

- ~1300 policy actions for 21 EMEs,1 January 2001 - 31 December 2015.
- A policy action: Easing or tightening of capital controls.
- Extension of Pasricha et al (2018 JIE) dataset, available online at: http://www.nber.org/data-appendix/w20822/



Source: Author's calculations
Last observation: 30-Dec-2015



Source: Fernández, Klein, Rebucci, Schindler and Uribe (2015)

New Mercantilism Proxy

- Measures nominal/real appreciation against trade competitors (not USD)
- Identify top 5 trade competitors for each EME: Merchandise Trade Correlation Index (UNCTAD)

Appreciation against competitors makes you uncompetitive but doesn't increase systemic risk

Methodology: Panel Ordered Logit

- Dependent variable: Number of net inflow tightening actions in the week
- Main explanatory variables:
  - Mercantilism proxy
  - Macroprudential concerns, proxied by Domestic Bank Credit-GDP gap
- Other key controls: VIX, Other domestic policies (fiscal, monetary)

Results

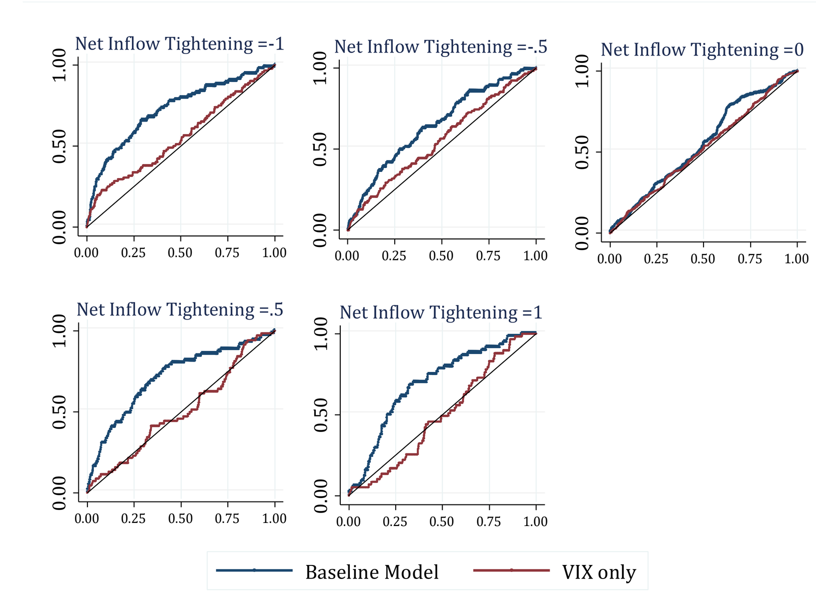
1. **Capital controls are both macroprudential and mercantilist**
   - Mercantilism stronger with higher exchange rate pass-through to export prices
   - Stronger governance arrangements for macroprudential policy lead to more responsiveness to macroprudential motivations
2. **Choice of instruments is also systematic:**
   - Policymakers respond to mercantilist concerns by using both instruments: inflow tightenings and outflow easings
   - Only inflow tightenings in response to macroprudential concerns
3. **However, policy is not well-targeted to foreign debt:**
   - No systematic response to foreign currency debt or external credit

For inflow controls, macroprudential and mercantilist variables both important

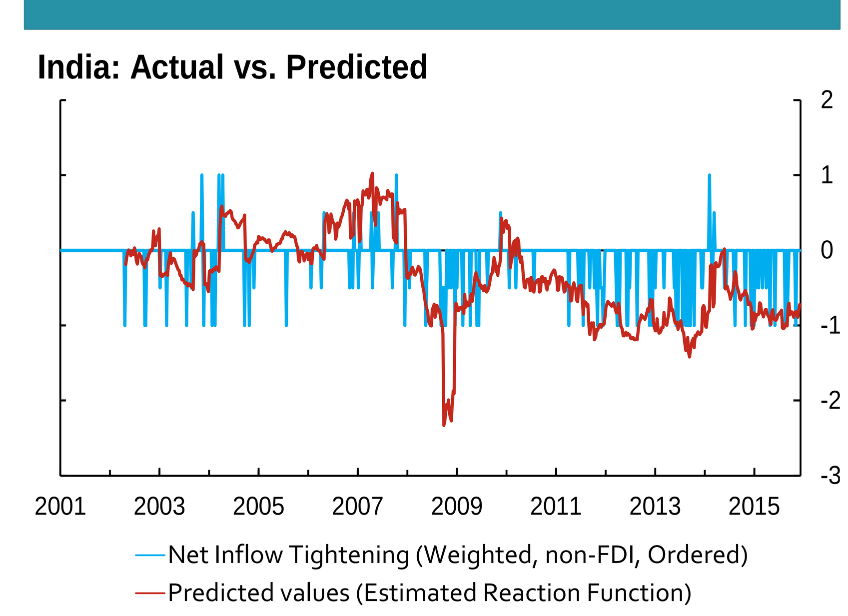
	Dependent Variable: Weighted Net Inflow Tightenings (non-FDI)	
Mercantilism Proxy (Nominal, 13-wk appr, %)	1.27***	
Mercantilism Proxy (Real, 13-wk appr, %)		1.26**
Bank Credit-GDP gap (%)	1.30***	1.31**
Previous policy action (T, E)	1.33***	1.32***
Observations	7,448	7,448
Number of Countries	11	11
Pseudo-Log Likelihood	-1715	-1716
Chi-Squared (All coefficients =0)	68	76.12
P-value (Chi-Squared)	0	0

Note: Table reports the proportional odds ratios.

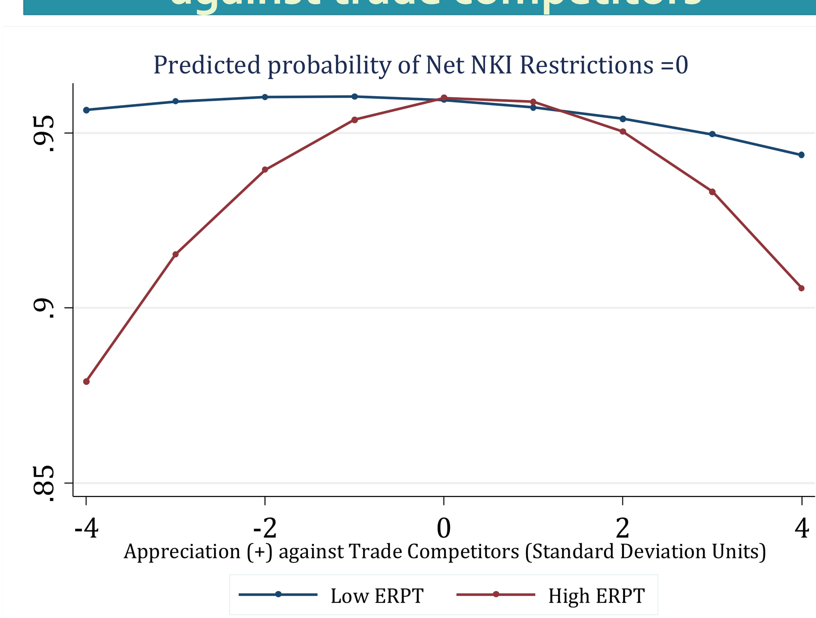
AUROC: Baseline model outperforms VIX-only model



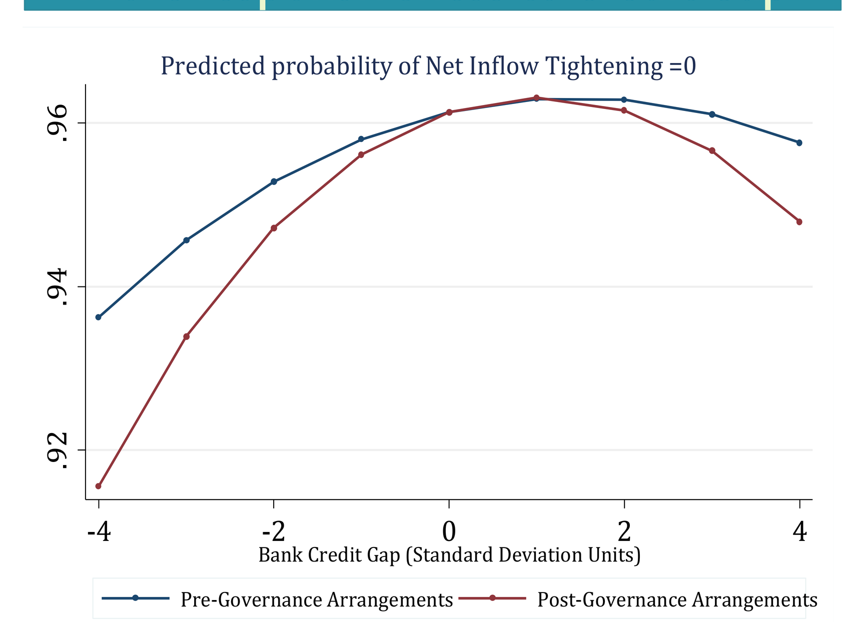
Model predicts actual policy well



Countries with high export price ERPT respond more to currency pressures against trade competitors



Stronger governance arrangements for macroprudential policy meant more responsiveness to Credit Gap



Conclusions

- Capital Controls are both macroprudential and mercantilist
- First paper to provide direct evidence of the existence either motivation in the use of capital controls policy
- More transparency of objectives can improve effectiveness and accountability

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References

1. Fernández, A, M Klein, A Rebucci, M Schindler and M Uribe (2015) "Capital control measures: a new dataset", IMF Working Papers, no. 80, April.
2. Pasricha, G, M Falagiarda, M Bijsterbosch and J Aizenman (2018) "Domestic and multilateral effects of capital controls in emerging markets", Journal of International Economics, Volume 115, pages 48-58, November 2018.