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Modelling Portfolio Capital Flows in a Global Framework: Multilateral Implications of Capital Controls

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Abstract

In the aftermath of the global financial crisis, many emerging market countries resorted to capital controls to tackle the excessive surge of capital inflows. A number of recent research papers have suggested that the imposition of controls may have imposed negative externalities on other countries by deflecting flows. Our aim in the research reported in this paper is to assess the efficacy of capital controls and potential deflection effects on other countries by constructing a comprehensive global econometric model which captures the dynamic interactions of capital flows with domestic and global fundamentals. The results suggest that capital controls are effective for some countries in the short run, but have no lasting effects. Moreover, there is only limited evidence of deflection effects for a small number of emerging market countries.

Keywords: Portfolio Capital Flows, Global VAR (GVAR), Capital Controls, Emerging Markets.
JEL Classification: C32, C5, F32, F42, G11.

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1 Introduction

Since the mid-1980s, emerging markets have experienced a rapid increase in financial investment from the rest of the world. While there are many gains from global financial integration (see e.g. Kose et al., 2009), the experience of the last few decades suggests that opening up domestic markets to free capital flows does introduce various risks for recipient countries. Concerns have been raised, for example, during and in the wake of the recent global financial crisis, with many countries facing a sudden collapse followed by a surge in capital flows.[1]

[1]The possible impact of surges in capital flows on the macroeconomy may not only be confined to developing countries. For example, Laibson & Mollerstrom (2010) argue that the global financial crisis itself may have been caused and certainly exacerbated by international financial flows chasing high asset