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Regulating Capital Flows to Emerging Markets: An Externality View

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Abstract

We show that capital flows to emerging market economies create externalities that differ by an order of magnitude depending on the state-contingent payoff profile of the flows. Those with pro-cyclical payoffs, such as foreign currency debt, generate substantial negative pecuniary externalities because they lead to large repayments and contractionary exchange rate depreciations during financial crises. Conversely, capital flows with an insurance component, such as FDI or equity, are largely benign. We construct an externality pricing kernel and use sufficient statistics and DSGE model simulations to quantify the externalities that materialized during past financial crises. We find stark differences depending on the payoff profile, justifying taxes of up to 3% for dollar debt but close to zero for FDI. These findings contrast with the existing literature, which has suggested that policymakers should focus on reducing over-borrowing rather than changing the composition of external liabilities.

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Keywords: financial crises, financial amplification, capital controls, externality pricing kernel, macro-prudential regulation

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