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# Why do emerging markets liberalize capital outflow controls? Fiscal versus net capital flow concerns☆

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A B S T R A C T

In this paper, we provide empirical evidence on the factors that motivated emerging economies to change their capital outflow controls in the recent decades. Liberalization of capital outflow controls can allow emerging market economies (EMEs) to reduce net capital inflow (NKI) pressures, but may cost their governments the fiscal revenues that external financial repression generates. Our results indicate that external repression revenues in EMEs declined substantially in the 2000's compared with the 1980's. In line with this decline in external repression revenues and their growth accelerations in 2000's, concerns related to net capital inflows took predominance over fiscal concerns in the decisions to liberalize capital outflow controls. Emerging markets facing high volatility in net capital inflows and higher short-term balance sheet exposures liberalized outflows less. Countries eased outflows more in response to higher stock price appreciation, higher appreciation pressures in the exchange market and higher real exchange rate volatility. Non-IT monetary policy regimes also liberalized outflows more in response to greater reserves accumulation and higher NKI.
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## 1. Introduction

Recent years have seen a re-emergence of the policy debate on the appropriateness of capital controls. Opponents argue that capital controls can lead to local and global misallocation of resources, perpetuate global imbalances (by allowing countries to maintain undervalued real exchange rates) and encourage corruption. Further they, argue that in the empirical literature these controls have been found to be of limited effectiveness in stemming net capital inflows (NKI). Proponents argue that capital controls are macro-prudential measures and an optimal response to distortions in financial markets (for example herd behavior, too-big-to-fail). These controls are deemed to be an important tool to prevent the build-up of financial sector risks and to reduce the damage associated with sudden stops.[1] Adding fuel to the debate, the International Monetary fund (IMF) has softened its longstanding opposition, and now suggests that capital controls may be a valid tool of macroeconomic and macroprudential management when other tools have been exhausted (IMF, 2011a).

The debate on what emerging market economies (EMEs) should or should not do has two key missing elements. The first is a fact-based analysis of the macroeconomic and financial pressures that EME policymakers most often respond to when imposing capital controls. The empirical literature assessing emerging market motivations for capital controls is scant.[2] The second key missing element is a discussion of the use of capital outflow controls as a potential response to NKI pressures. Most of the recent policy debate has focused on tightening of capital inflow controls in response to surges in *net* capital inflows.[3] However, because NKI are the difference between capital inflows and outflows, countries that have existing outflow controls have another potential tool to reduce NKI – the liberalization of outflows.[4] This tool was discussed in the literature on managing capital flows of the 1990's (see Laban and Larrain, 1997), but it has been missing from the recent debate. Recent research in Pasricha (2012) documents that in 22 EMEs between 2004 and the onset of the 2008 financial crisis, outflow controls were liberalized more frequently than inflow controls were tightened. The pre-2008 crisis period saw a surge in net capital inflows to EMEs of a magnitude comparable to the post-2008 crisis surge, yet inflow tightening measures became a primary tool of restricting NKI only after the crisis.

The use of outflow liberalization in NKI management policy can be constrained by the fact that outflow controls exist not only to manage capital flows but also to allow government to lower the cost of borrowing by keeping domestic savings at home. Sustained outflow controls often form part of a web of regulations on the domestic financial sector (for example, interest rate ceilings, high reserve requirements, directed lending) that constitute "financial repression". These regulations seek to further reduce the cost of government borrowing and to allocate savings to preferred sectors. Capital outflow controls help prevent capital flight in response to domestic regulations, and therefore are a key ingredient of financial repression. The revenues from financial repression can be substantial. Giovannini and Melo (1993) show that for some 24 emerging and developing economies over the period 1972–87, revenues from external repression averaged 1.4% of GDP. These considerations suggest that the decision to liberalize outflow controls in response to surging inflows could involve weighing the benefits of reduced NKI against the loss of revenues from financial repression.

In this paper, we provide evidence on EME motivations for capital outflow policy by examining fiscal and macroeconomic factors at the time when outflow controls were liberalized. We address the two gaps in literature identified above by focusing on capital outflow controls and by providing a positive analysis of outflow policy changes. To accomplish this, we build two novel datasets. First, we

[1] "[South Korea's] President Lee Myung-Bak, in an interview with the Financial Times published on Oct. 29, said any measures that a country may take to smooth cross-border capital flows should not be interpreted as capital controls but 'macro-prudential policies'." Factbox – South Korean Policymakers' remarks on capital controls, Reuters, 10 November, 2010.

[2] Recent work by Fratzscher (2012) examines this question for overall capital account openness in a broad sample of emerging and advanced economies over the period 1984-2009. He finds that foreign exchange policy objective and overheating concerns have been the two main motives for capital controls, particularly since 2000.

[3] See, for example, Ostry et al. (2011), Klein (2012), Hutchison et al. (2012), Patnaik and Shah (2012) and Warnock (2011).

[4] NKI are measured as the difference between inflows by non-residents and net outflows by residents. Therefore both lower net inflows by non-residents and higher net outflows by residents would lead to a decline in NKI.

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