Available online at www.sciencedirect.com
ScienceDirect

Journal of International Money and Finance 25 (2006) 1010–1027

Journal of International Money and Finance
www.elsevier.com/locate/jimf

The effects of capital controls on international capital flows in the presence of asymmetric information

Rebecca M. Neumann*

Department of Economics, University of Wisconsin – Milwaukee, P.O. Box 413, Milwaukee, WI 53201, USA

Abstract

This paper examines the effects of capital controls on the volume and composition of international capital flows in the presence of asymmetric information. In the two-period, small open economy model, stochastic second-period output depends on the level of first-period investment, which cannot be verified by international investors. Domestic agents obtain external funding by borrowing on international capital markets and by selling equity to international investors. The paper investigates the effects of various capital controls on the debt–equity choice, domestic investment, and welfare. Controls on capital inflows are shown to shift the composition of flows from fixed-income instruments towards equity and to reduce the overall volume of inflows.

© 2006 Elsevier Ltd. All rights reserved.

JEL classification: F21; F41; G15

Keywords: International capital flows; Debt and equity; Capital controls

1. Introduction

In the aftermath of recent financial crises, significant attention has been focused on the merits of imposing capital controls to limit the size and volatility of financial flows in developing economies. Of particular concern is the possibility that large capital inflows may be subject

* Tel.: +1 414 229 4347; fax: +1 414 229 3860.
E-mail address: rneumann@uwm.edu

0261-5606/$ - see front matter © 2006 Elsevier Ltd. All rights reserved.
doi:10.1016/j.jimonfin.2006.07.008

to sudden reversals, leading to large capital outflows and increasing the risk of financial crisis. Certain types of flows may be more prone to capital flight than others. In particular, short-term debt is typically considered to be less stable than longer-term debt and equity flows. Moreover, the risk of sudden reversals in investor sentiment is likely to be particularly acute for developing economies where information asymmetries are often severe.[1]

This paper analyzes the effects of capital controls on the volume and composition of international capital flows in the presence of asymmetric information. Focusing on the simultaneous use of debt and equity financing, the paper examines the impact of barriers to capital flows on the form of international financing and on the level of investment undertaken by domestic firms. The paper is motivated in part by capital controls imposed by a number of countries in the 1990s to manage increasingly large and volatile capital inflows. Brazil (1993−1997), Chile (1991−1998), Colombia (1993−1998), Malaysia (1994), and Thailand (1995−1997) imposed capital controls with the expressed goal of limiting short-term inflows and changing the composition of flows towards longer-term equity holdings. Controls on capital inflows may be useful in limiting capital flight or preventing currency crises by restricting the inflow of short-term, speculative capital, altering the maturity composition towards longer-term, less volatile flows, and reducing the overall volume of capital inflows.[2] Conversely, by limiting capital inflows, controls may hinder the ability of developing economies to attract financing for productive domestic investments.

Recent empirical studies indicate that capital controls alter the composition of capital flows to developing countries, but do not necessarily impact the volume of flows. Rodrik and Velasco (1999) and Edwards (1999) find that capital controls can influence the maturity structure of debt flows but have little impact on their volume. Including foreign direct investment (FDI) and portfolio equity in their measure of total capital flows, DeGregorio et al. (2000) find a compositional shift from short-term flows to long-term flows without a decline in total capital inflows following imposition of an unremunerated reserve requirement (URR) in Chile. Using an index of capital-control intensity for 15 emerging markets, Montiel and Reinhart (1999) find that capital account restrictions have little impact on the volume of capital inflows but tend to shift the composition of flows from a combination of short-term and portfolio flows towards FDI. Ariyoshi et al. (2000) describe mixed results in that capital controls reduced net inflows to Malaysia and Thailand but not to Brazil, Chile, and Colombia. In all but Brazil, controls were partially successful in changing the composition towards longer-term inflows. Campion and Neumann (2004) utilize quarterly indices of both capital controls and capital account liberalization to examine the effect of each on the volume and composition of capital inflows. They generally find that controls lead to small declines in the volume of capital inflows along with compositional shifts away from debt inflows.

Further theoretical modeling may clarify the conditions under which controls cause changes to both the volume and the composition of capital flows to a developing economy. While some theoretical work has examined the maturity structure of debt, none has focused specifically on the effects of capital controls on debt versus equity financing. The closest theoretical work is by

[1] Obstfeld and Rogoff (1996, p. 353) note that developing economies may face more stringent asymmetric information problems internationally due to limited access to a strong legal system. Also see Gertler and Rogoff (1990) on this point.

[2] See for example, Ariyoshi et al. (2000), Edwards (1999), Montiel and Reinhart (1999), Rodrik and Velasco (1999), Eichengreen and Mussa (1998), Johnston and Tamirisa (1998), Rodrik (1998), and Stiglitz (1998).

Download English Version:

https://daneshyari.com/en/article/963730

Download Persian Version:

https://daneshyari.com/article/963730

Daneshyari.com