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## Do capital controls make gross equity flows to emerging markets less volatile?



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### ABSTRACT

The impact of capital controls on the magnitude of international capital flows has been a subject of much interest and research. Far fewer studies have examined if and how capital controls affect the *volatility* rather than the *level* of capital flows. This paper investigates whether capital controls affect the volatility of gross equity inflows (direct investment and portfolio investment). We are interested in both the effects of controls on equity flows on the volatility of corresponding inflows (own effects) as well as the impact of controls of a certain type on another component of capital flows (cross effects), so as to ascertain whether there are any unintended consequences. Using a panel consisting of 37 emerging market economies over the period 1995–2011 we find a highly robust result that controls on FDI outflows appear to lower the volatility of FDI inflows.

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## 1. Introduction

There is an established literature that recognizes the costs and benefits of different types of international capital flows to emerging market economies (EMEs).<sup>1</sup> Broadly, as the literature points out, liberalization of capital flows could facilitate productive investments, especially in many EMEs characterized by domestic savings constraints, and may also contribute to the development of their domestic

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<sup>1</sup> See Block and Forbes (2004) and Reinhart (2005) for reviews.

financial markets. However, such flows – especially those that are short-term and volatile in nature – could also carry significant risks which amplify aggregate macroeconomic and financial instability in recipient economies (for recent review see IMF, 2012).

One of the central features of increased financial integration over the last few decades has not only been the rise in the *volume* of cross-border capital flows but also a significant escalation in the *volatility* of such flows (Bluedorn et al., 2013; Broner et al., 2013; IMF, 2011). Capital flow volatility can have widespread economic consequences, ranging from “amplifying” economic cycles to increasing vulnerability of the financial system which aggravates overall macroeconomic instability (Forbes and Warnock, 2012). Considering the potentially destabilizing role that such flows could trigger, countries experiencing surges in capital flows have resorted to various forms of policy controls on capital flows. This has especially been the case since the global financial crisis of 2008–2009 where some EMEs adopted a less benign view about unfettered cross-border flow of capital.<sup>2</sup> In this light, there has been a re-emergence of the policy debate on the appropriateness of capital controls. Interestingly, after a long history of being opposed, such capital controls measures have also found support from the International Monetary Fund (IMF) which has endorsed capital controls as an appropriate policy tool of macroeconomic and macro prudential management in certain instances (IMF, 2011; Ostry et al., 2010).<sup>3</sup>

What forms should such controls take and how effective and desirable are they? While there is a burgeoning literature on the role and efficacy of capital controls, at the risk of generalizing, most studies have found that controls on capital inflows are more effective than on outflows and they are also more effective at altering the composition of inflows rather than the magnitude of inflow surges per se (see Magud and Reinhart, 2007 for a survey). In particular, controls seem to play a role in raising the average maturity structure of capital inflows (Binici et al., 2010 and references cited within), presumably making the country somewhat less susceptible to sudden stops and economic crises. However, this advantage comes at a microeconomic cost, in that capital controls tend to raise the cost of capital especially to small and medium sized enterprises (SMEs) (Forbes, 2007).

In more recent work based on weekly data for 60 countries over the period 2009–2011, Forbes et al. (2013) find that capital controls (or capital-flow management measures) more generally may have limited effect on key variables such as exchange rates and volume of capital flows, though they may be helpful in reducing financial fragility. In addition, unlike most of the earlier literature, Klein (2012) distinguishes between long-standing capital controls (i.e. “walls”) and temporary/episodic controls (i.e. “gates”). Based on the experience of 44 countries over the period 1995 to 2010 he finds that the latter has not been a very effective tool in managing currency appreciations or build-up of financial vulnerabilities compared to the former. This suggests that short-lived/temporary controls are somewhat easier to evade.<sup>4</sup>

However, by and large, the existing literature on the subject has failed to differentiate between capital controls on specific types of capital flows. In addition, much of the literature has not explicitly analyzed the differential impacts on *gross* versus *net* flows and focused more on the latter. As Binici et al. (2010) rightly emphasize, “investigating the links between aggregate capital controls on aggregate flows, as is common in the literature, is misleading and may underestimate the effectiveness of capital controls in some dimensions” (p. 681). They also note that the aggregated capital control indicators which most studies have hitherto used, have glossed over significant differential effects of capital controls across the various subcomponents of capital flows, leaving many questions unanswered.

<sup>2</sup> For instance, several countries including Brazil, Colombia, Indonesia, Korea, Taiwan, Thailand and Peru imposed controls on inflows post the global financial crisis, though the effectiveness of these experiments is a widely debated topic. Among others, see Baba and Kokenyne (2011), Jeanne et al. (2012), Jinjarak et al. (2012), and Ostry et al. (2010) for recent assessments of capital controls in selected emerging markets. Also see footnote 4 below.

<sup>3</sup> The IMF refers to such measures as “capital flow management” (CFM) measures which include capital controls.

<sup>4</sup> Consistent with this, Eichengreen and Rose (2014) find that capital controls have rarely been used as a macro prudential policy instrument and have tended to move less with short-term macroeconomic variables than with more structural factors, viz. financial, political, and institutional development. Similarly, Fernandez et al. (2013) find that the imposition of capital controls over the period 1995–2011 has been “remarkably acyclical”. Policymakers rarely seem to use capital controls to manage short-term boom-bust episodes. However, Aizenman and Pasricha (2013) argue that emerging countries liberalized capital outflow controls in the 2000s mainly due to concerns about net capital inflows.

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