Capital Controls as Policy Instrument for Macroeconomic Stabilization in Emerging Market Economies

Abstract

The aftermath of 2008-09 global financial crisis, together with the emerging market crisis of the 1990s and 2000s, has raised concerns among policy makers in Emerging Market Economies (EMEs) to deploy additional policy tools which aimed at preventing financial crisis, and thereby maintain financial and macroeconomic stability in EMEs. After the Global Financial Crisis, interest rates around the world fell to an all-time low, leading to substantial capital inflows in EMEs. As these flows can be reversed quickly, the macroeconomic foundations of EMEs are increasingly vulnerable to fluctuations in the global market conditions. In response to high volatility in capital flows, the leading international organizations and central banks have revived interest in the use of capital controls, where IMF itself adopted a more receptive institutional stance towards capital controls policies (IMF, 2012) to mitigate the systemic risks stemming from the international financial transactions. This thesis reviews the effectiveness of capital controls through three dimensions: evaluating their dynamic treatment effects to enhance the macroeconomic and financial stability in EMEs, analysing their role to increase the resilience of economies against global financial shocks, and estimating their cross-border spill-over effects. We study dynamic treatment effect of capital controls on macroeconomic and financial stability by using newly developed Difference-in-difference estimation (De Chaisemartin and D'Haultfoeuille, 2020; 2022). The results show that there is a substantial reduction in the volume of capital inflows and capital outflows if capital controls are imposed across specific asset category. Our analysis justifies the use of capital controls to reduce currency appreciation pressures, achieve monetary policy independence and reduce financial fragilities. Further, we find the effective role of capital inflow controls to reduce the sensitivity of domestic economies against global financial shocks, where economies with strict inflow controls are able to moderate the effects of global financial shocks (captured by VIX and US federal fund rates) on real GDP, housing prices and private credit. We also link the risk-taking channel of exchange rate to show that monetary policy responds countercyclically in strict inflow controls economies in response to fluctuations in VIX. Lastly, we find evidence of cross border spill-over effects of capital controls

where capital controls in India and China create significant, though temporary spill-over effects in other economies mainly through capital inflows and exerting upward pressures on exchange rate. Further, we find that other economies respond to these spill-overs by using similar policy response i.e. tightening their inflow controls. This calls for necessary policy coordination among economies in the financial sector.