Discussion of Caballero, Panizza, Powell, 2015

Ajay Shah
http://www.mayin.org/ajayshah

December 12, 2015

A very interesting and important phenomenon

A large literature on the difficulties of capital controls as a tool for macro policy. E.g. India:

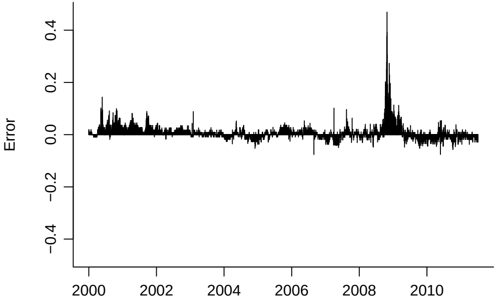
- 2004 onwards: Exchange rate management turned into inappropriate monetary policy.
- Late 2008: Operating procedure of monetary policy got disrupted.
- 2013: Failed currency defence.
- *Did the Indian capital controls work as a tool of macroeconomic policy?*, Patnaik and Shah, IMF Economic Review, 2012.

How did the economic agents do it?

Trade misinvoicing. Non-financial firms engaged in financial activities.

Story #1 : Arbitrage between the onshore and the NDF market

- Banks are prohibited from doing this arbitrage.
- Look at the two prices:



- Who is doing this arbitrage? Non-financial firms.

Story #2 : A pool of dealers trading fixed income and currency

- A bank? Nah.
- A hedge fund? No.
- Where do we see this? Treasuries of non-financial firms.

Story #3 : Indian multinationals

- They run global treasuries, and arbitrage across capital controls and taxation.
- RBI does not allow them to do money market borrowing abroad, so they do this through overseas subsidiaries.
- This choked when Lehman died, and they scrambled for *rupee* liquidity in order to avoid default overseas.
- The monetary policy transmission in India broke down.

Why India choked when Lehman broke, Patnaik and Shah, 2009.

Story #4 : Ecosystem development

One large listed Indian automobile company:

- Boundaries of the firm are drawn artificially, owing to labour law. True firm is $3\times$ the employment of the legal person.
- Satellites are all utilising the central treasury for corporate finance as it gets the lowest rates and has the lowest cost of equity capital.
- In addition: an ecosystem of component manufacturers, dealers, service stations, etc.
- Many firms are owned by family members, ex-employees.
- The central firm is venture capitalist, equity investor, debt financier, etc.

A conjecture

- Trade misinvoicing may be one element of the *financial* activities of some multinationals.
- Can then move very large sums of money across the border, jumping over capital controls.

Turning to the paper

- This picture is one where all manner of liabilities go into the treasury (equity, onshore bonds, bank borrowing, overseas borrowing, trade credit, etc).
- This pool of capital is put to many uses, one of which is engaging in financial activities.
- Why single out overseas bond issuance?
- E.g. access to the corporate bond market in India is for only a small set of firms.

A remarkable fact that's been uncovered

- When a firm does a foreign currency bond, it tends to hold more cash, but this is not the case with domestic bond issuance.
- Could it be: There is home bias, issuance abroad at good terms is not always feasible, firms are opportunistic in doing these when possible.
- Example: The great boom in ADR/GDR issuance in India in the 1990s.

How to make this paper more causal?

- Regression-based observational econometrics has many problems.
- How might we do better? Exploit events of a policy change that's exogenous to the firm, and then do event studies.
- Example: Use Gurnain's database of capital flow measures.
- Corporation T in a country gets a capital control which reduces capital account openness, while its matched partner C in anotheer country has no change.
- Example: Exploit episodes of large capital account liberalisations.
- Example: Exploit changes in tax policy.

Regulatory responses?

- Consumer protection? None.
- Micro-prudential regulation? None.
- Systemic risk regulation? It would need extreme scale; the ordinary failure of a few non-financial firms is not a systemic crisis.
- Resolution? None.
- What's lost:
  Gains from specialisation and focus
  Organisational capital e.g. an arbitrage team
  The ability to compete in the market for financial services.

Implications for policy strategies

- There comes a time when a country becomes a host to sophisticated firms (either local or foreign).
- “Finance follows trade” : sophisticated current account activities require sophisticated capital account activities.
- Once there is a large mass of firms, they respond to actions of the authorities that are inimical to the working of firms.
- E.g. in India, there are serious flaws in the conduct of policy in tqxation, financial regulation, capital controls, etc.
- Responses of the non-financial firms are beneficial in reducing the damage.

Thank you.