Recent trends in measures to manage capital flows in emerging economies
By Gurnain Kaur Pasricha
Discussion

Madhavi Pundit

National Institute of Public Finance and Policy

March 15, 2012

Timely and interesting paper

- In the face of capital flow surges to emerging market economies in recent years
- Literature on the measurement of capital controls: Chinn Ito (2008), Schneider (2009)
- Presents a methodology for quantifying *new* capital flow measures
  - IMF's AREAER data for 22 emerging market economies
  - Number of policy measures on the capital account implemented from 2004-2011
  - Defines Net NKI restricting measures
- Applies Net NKI measure to
  1. Describe trends in tightening and easing measures
  2. To evaluate when the measures are used
  3. To determine what kind of measures are used

Results

1. Increase in net NKI restricting measures. Decline in inflow easing measures.
2. Ostry et al (2010) discuss the conditions to be satisfied before using capital flow measures in macroeconomic management
   - Exchange rate is not undervalued
   - International reserves are in excess of adequate prudential levels or sterilization costs are too high
   - Economy is overheating, precluding monetary easing, and there is no scope to tighen fiscal policy

   The percentage of inflow tightening measures used as a last resort are low.
3. Most measures are capital controls of the non-prudential type

Comments

I. Evaluating policy response

- Disaggregate data on new measures has useful applications
- Interesting to know whether number of measures have increased
- Also interesting to evaluate the measures implemented by policy makers

Disaggregate measures and disaggregate flows

- Natural policy response is to limit foreigners' access to domestic markets
- Rothenberg and Warnock (2011) show that almost half of sudden stops are actually episodes of sudden flights.
- Net flow data can be misleading
- The wrong policy response is ineffective and costly.
- Juxtapose disaggregate measures data with disaggregate flows data
- Gross flows - inflows and outflows; foreign and domestic investors
- Analyse policy responses - are policymakers correctly reading flows data and implementing measures?

II. Link to exchange rate regime

- Capital controls used to maintain the exchange rate regime
- Currency regime is classifed as a *peg* when the volatility of the exchange rate against one currency is low
- For countries that pegged their exchange rate, when there was a pressure to appreciate, they tried both tightening of inflows and easing of outflows
- After 2007 crisis, when the pressure to appreciate went away, countries that pegged stopped trying to ease outflows
- Infact the crisis turned the pressure away from appreciation to depreciation, so there was an easing of inflows

II. Easing of inflows

- Examples from India
  - In 2011, the ceiling on FII in government and corporate bonds raised by $5 billion
  - ECB limit raised from USD 500 million to USD 750 million per year
  - The all-in-cost over 6 month LIBOR for ECB raised from 300 bps to 350 bps for 3-5 years maturity periods
- Countries that do not peg may not show this pattern

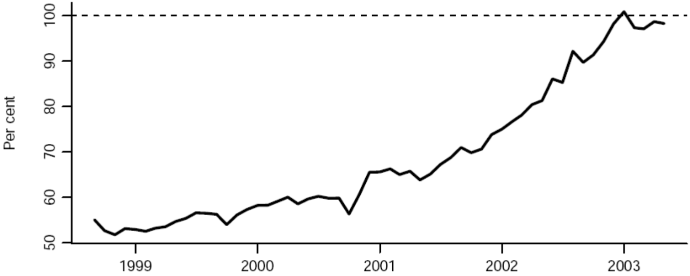
III. Macroeconomic policy measures and capital controls

- The objective in this paper is to evaluate IMF's conditions
- Is it possible to identify capital controls as a last resort option among other options?
- These policies and capital controls are implemented together
- Case of India
  - The aim was to limit exchange rate volatility
  - Increase in capital flows
  - Controls have been tightened and other macroeconomic policies have been implemented

Pegged exchange rate with sterilised intervention

- As the Asian crisis subsided, strong capital flows emerged
- Pegged exchange rate was upheld using intervention
- Sterilisation - foreign assets purchased, the rise in reserve money neutralized by sale of domestic assets
- Expectations of slow appreciation made the rupee more attractive
- Larger inflow of capital and increased pace of intervention (Montiel and Reinhart, 1999 and Patnaik, 2005)
- By 2003, entire reserve money was made up of foreign assets

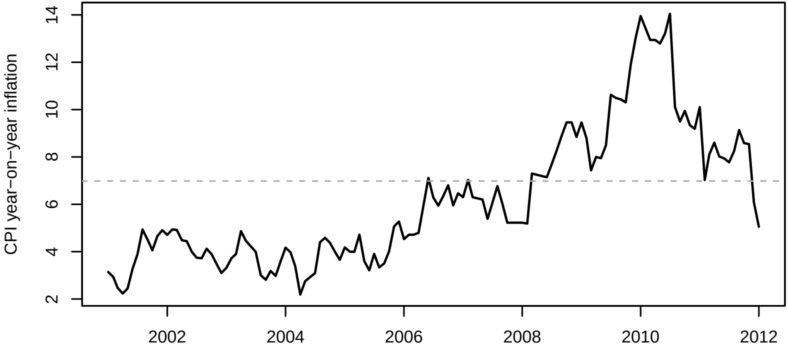
Share of foreign exchange reserves in reserve money



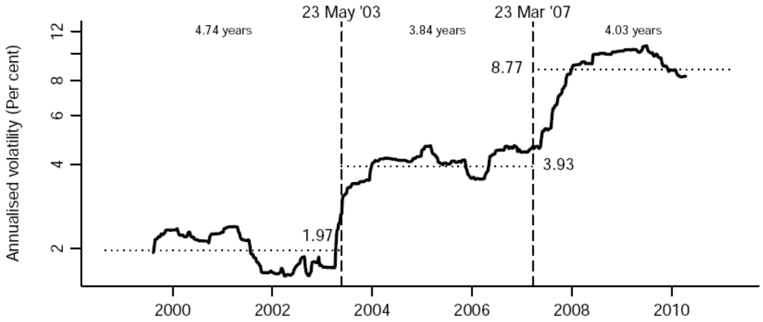
Partial sterilisation

- Central Bank's stock of bonds were exhausted
- Market Stabilisation Scheme (MSS)
- High fiscal costs
- Partial sterilisation
- Capital flows continued to increase
- Rising Inflation
- Capital controls

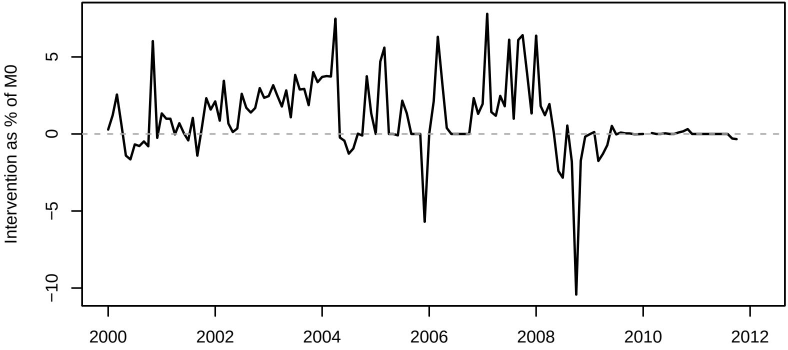
Rising inflation



Exchange rate moved to float



RBI's trading on the rupee



References

- Warnock,F. (2011), 'Doubts About Capital Controls', Council on Foreign Relations
- Rothenberg,A.D. and Warnock,F.E. (2011), 'Sudden Flight and True Sudden Stops', Review of International Economics, 19: 509 - 524.
- Patnaik,I. and Shah,A. (2011), 'Did the Indian capital controls work as a tool of macroeconomic policy', NIPFP Working Paper 2011-97
- Ostry, J., Ghosh, A., Habermeier, K. Chamon, M., Qureshi, M. and Reinhardt, B. (2010), 'Capital Inflows: The Role of Controls', IMF Staff Position Note
- Schneider, M. (2009), 'Measuring Financial Integration: A New Data Set', IMF Staff Papers, Vol 56, No. 1, pp. 222-238
- Hutchison,M., Kendall,J., Pasricha, G. and Singh,N.(2009), 'Indian Capital Control Liberalization: Evidence from NDF Markets', NIPFP Working Paper 60
- Patnaik,I. (2005), 'India's experience with a pegged exchange rate', The India Policy Forum 2004, ed. by S Bery, B. Bosworth, and A. Panagariya, pp. 189-226.
- Montiel,P. and Reinhart,C.M (1999), 'Do capital controls and macroeconomic policies influence the volume and composition of capital flows? Evidence from the 1990s', Journal of International Money and Finance, 18(4), 619-635
- `http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=6925&Mode=0`
- `http://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=6836&Mode=0`

Thanks