Currency Risk Under Capital Controls

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Discussion

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Background

International Capital Flows

What is a **capital account liberalization?**

- The decision to move from a closed capital account regime (money cannot freely move in and out of the country) to an open capital account regime (money can freely move in and out of the country).

Two broad views on **capital account deregulation** as a strategy

- Free capital flows can enhance an efficient allocation of resources, facilitate productive investment and consumption smoothing.
- But free capital flows also carry risks and create policy challenges since sharp changes may have a destabilizing effect on the economy.

To liberalize or not to liberalize capital accounts?

Capital flows are welcome but floods of short-term flows can cause trouble, and in response some countries have imposed restrictions.

This Paper

A Brief Summary

What does this paper do?

- The authors study the relationship between currency returns and capital controls from an asset pricing perspective,
- Their contribution to the literature is both empirical and theoretical.

What do we learn?

- Emerging market countries with stricter capital controls have lower currency excess returns in the future,
- These currencies depreciate less during periods of global financial distress.

A Brief Summary

Can we **rationalize** these findings?

- The authors propose an intermediary-based asset pricing model where a country that borrows externally is occasionally subject to a binding credit constraint,
- In the model, putting limits on capital controls can make crises less likely, thus preventing currency crashes.

What is the **policy message**?

- This paper provide support to the macro-prudential view of capital controls
- Full liberalization may not be an appropriate goal for all countries at all times and measures that are designed to limit capital flows can be useful and appropriate.

My immediate reaction

Raspadori's 93rd-minute goal in Turin against Juventus

An insightful study with novel yet interesting findings!

My next reaction

Maybe there is room for a follow-up paper.

My (2 cents' worth) **comments**

Comment #1

The paper relies on a comprehensive measure of capital controls compiled by Fernández, Klein, Rebucci, Schindler, and Uribe (2016)

- A binary indicator that goes from 0 (less restricted countries) to 1 (more restricted countries), running between 1995 and 2020,
- This index considers restrictions on inflows and outflows over six asset categories, namely, equity, bonds, money market, collective investment, financial credit, and foreign direct investment.

But these are somehow 'explicit measures' of capital controls

- There are also 'implicit policy options' to respond to the surge of capital inflows.

Comment #1

Countries have responded in a variety of ways to rapid large inflows

- Low policy rate (e.g., Japan, Switzerland),
- FX intervention (e.g., Japan),
- Tax on certain types of inflows (e.g., Brazil),
- Holding period on central bank bond purchases (e.g., Indonesia),
- Leverage caps on banks' derivatives positions (e.g., Korea).

Suggestion

- Have you considered to bring into the analysis both 'explicit' and 'implicit' measures of capital controls?

Comment #2

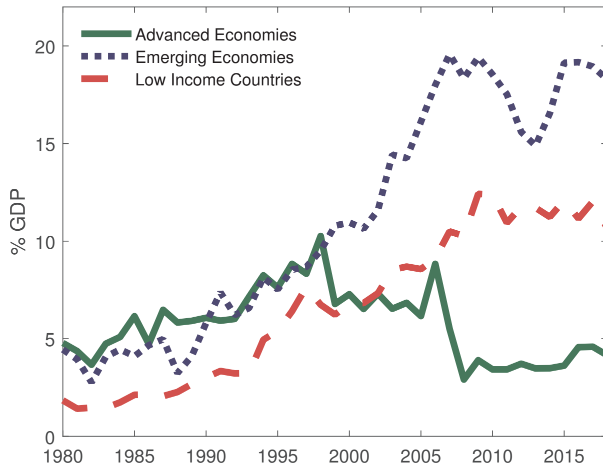
Capital controls are often associated with large increase in foreign currency reserves

- With the accumulation of international reserves, policy makers have another tool to intervene in the event of an external crisis,
- Within emerging markets, countries with a more open capital account have larger holdings of reserves,
- There could be a connection between foreign reserves and capital controls.

Suggestion

- Can you differentiate between countries with high and low foreign reserves?
- You can double sort on capital controls and foreign reserves.

Comment #2



Comment #3

On **May 22, 2013**

- The Fed announced that would start tapering asset purchases at some future date,
- Markets reacted with an immediate spike in the value of the dollar.

Impact on **foreign countries**

- The 'Fragile Five' – Brazil, India, Indonesia, Turkey, and South Africa – were among the worst hit countries,
- The effect of foreign capital inflows into these countries was reversed and their currencies sharply depreciated.

Comment #3

Suggestion

- You can double sort of capital controls and the foreign reserves to gross external financing requirement (short-term foreign debt plus current account deficit) ratio.

Comment #4

Take the budget constraint of a country

$$NFA_{t+1} = NFA_t + VA_{t+1} + CA_{t+1}$$

Iterate forward, take expectations, and impose no-ponzi condition

$$NFA_t = -\sum_{i=1}^{\infty} E_t \left(VA_{t+i} + CA_{t+i} \right)$$

Question/Suggestion

- Emerging economies have liabilities in foreign currency and the valuation channel will have a destabilizing effect,
- You can double sort of capital controls and the fraction of external liabilities in foreign currency.

Comment #5

What is the view of the IMF?

"Directors observed that a country's net benefits from liberalization, and therefore its appropriate degree of liberalization, would depend on its specific circumstances, notably the stage of institutional and financial development. Countries with extensive and long-standing measures to limit capital flows could benefit from further liberalization in an orderly manner. Directors agreed that there should be no presumption, however, that full liberalization is an appropriate goal for all countries at all times, although a number of them viewed capital account liberalization as a worthy long-term goal for all countries."

IMF, December 3, 2012

Comment #5

Suggestion 1

- You can provide evidence on post-formation currency excess returns,
- Do you observe any reversal pattern in your findings?

Suggestion 2

- Capital flows may have long-term benefits but short-term costs,
- Can your model internalize both of them?

Suggestion 3

- Free capital flow less risky with high financial/institutional development,
- Investors may be reluctant to invest in countries with stricter capital controls.

Conclusions

How important are capital controls for currency returns?

This paper provides the answer!

An interesting paper with interesting results and I have enjoyed reading it!

Thank you