BANK FOR INTERNATIONAL SETTLEMENTS

Discussion:Capital Controls Spillovers

(by Valerio Nispi Landi)

Nikhil Patel

Bank for International Settlements

Disclaimer: The views expressed here are those of the presenter and not necessarily of the Bank for International Settlements

Overview

- **Question**
  - How strong are the spillover effects of capital controls imposed by EMEs?
  - Are there significant gains from coordination of capital controls *among EMEs*?
- **Answer**
  - Spillovers can be sizable, but gains from coordination are limited

Model Setup

- Three country real business cycle model (no nominal rigidities)
  - One advanced economy and two EME ("groups")

- **Key assumption in the model**
  - Financial friction: Interest rate premium paid on foreign debt is increasing in level of debt
  - (pigouvian) tax on capital controls counteracts this friction

$$\tau_t = -\phi \left(\frac{b_t}{GDP_t} - \bar{b} \right)$$

Main Results

- Moderate amount of capital controls is optimal
- Coordination gains are limited

Normative Analysis

Risk-premium shocks		
Planner	**Optimality**	**Consumption gain**
EME1	$\phi = 0.04$	0.0365%
Nash	$\phi = 0.04$, $\phi^* = 0.04$	0.0442%
EME	$\phi = 0.05$, $\phi^* = 0.05$	0.0449%

First Comments

- Welcome addition to the theoretical literature on capital controls
- Papers typically look at capital controls in a small open economy, or a two country setting
  - three country setup like the one in this paper is more in line with the data

Comment: Assumption of EME being large

- Model assumes each EME is large enough to affect the advanced economy
- Interpretation in the paper: a group of countries simultaneously imposing the capital controls
  - but can this be justified based on first principles?
- Should the unit of analysis be an atomistic country in the EME1 group, instead of EME 1 as a large country?
- Alternatively, would a model with two small open economies be better suited to study this question?
  - Cook and Patel (2018)

Comment: Microfoundations for the key financial friction?

- Key feature in the model is the financial friction-debt elastic interest rate
- Modeled in a reduce form manner
- A more micro founded approach would provide additional insights.
- Alternatively, an estimation of the model to justify key parameters governing the elasticity of interest rate with respect to debt.

Comment: The investment channel of capital flows

- Unlike in this paper, capital inflows in EMEs are typically concentrated in the corporate (as opposed to household) sector
  - used to finance (unsustainable) investment booms.
  - investment goods also have a higher share of imports
- Would this make capital controls less effective?
  - With capital controls in EMEs, exchange rate appreciates by less, leading to more demand for exports to EME2

Comment: Several possible avenues to explore in follow-up work

- **Nominal rigidities**
  - Do capital controls offer enhanced room for maneuver as far as monetary policy is concerned
- **Multiple sectors**
  - Capital controls and dutch disease
- **Reserve accumulation by governments/central banks**:
  - is there an equivalence with capital controls results in this paper?
  - Literature has shown gains from coordination in FX reserves (Lee, 2018)
- Optimal policy in a more general sense?
- Short term vs long term debt
- Separate controls on inflows vs outflows

Summary and closing comments

- **Excellent paper addressing an important question in a novel setting**
  - Three country set-up provides a significant improvement
- The results are interesting, and whet appetite for subsequent exploration
  - Followup work exploring more dimensions of capital controls in a three country setting would be an important and timely offering to policymakers.

Thank you!