Effectiveness of Capital Outflow Restrictions

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This working paper examines the effectiveness of capital outflow restrictions in 37 emerging market economies during 1995-2010. Specifically, they examined whether and under what condition a tightening of outflow restrictions helps reduce net capital outflows. The Authors use panel vector autoregression (PVAR) methodology to allow for the endogeneity of capital flow restrictions. In order to identify conditions for effectiveness, they followed Towbin and Weber (2011) and added interaction terms to the baseline PVAR.

This paper uses net capital flow concepts in line with standard IFS terminology, and gross capital flow concepts following Schindler (2009). IFS classifies net capital inflows as the sum of net flows of assets and net flows of liabilities. Net flows of assets is the sum of outward FDI, portfolio investment assets, and other investment assets; net flows of liabilities the sum of inward FDI, portfolio investment liabilities, and other investment liabilities. In the literature, net flows of assets is often called “gross outflows,” and net flows of liabilities “gross inflows.”

The Author’s estimated both the baseline PVAR and the augmented PVAR using two lags and Runkle's bootstrapping technique (Runkle, 1987). In order to allow for the heterogeneity of intercepts, they included a full set of country and time fixed effects. The confidence intervals around their point estimates reflect the minimum distance that covers 90 percent of the estimates from 1,000 simulations. Impulse response functions are derived to examine the average response of the main endogenous variables in the model to an exogenous tightening in outflow restrictions. In all cases, the shock is normalized to represent an increase of 0.25 in the index (a control tightening).

They saw that a control tightening reduces gross outflows as intended. However, gross inflows also fall, leading to an increase in net inflows (or a fall in net outflows) that is small and insignificant. The results further suggest that residents respond to the tightening by repatriating investment while non-residents reduce their investments in the domestic economy. The reaction by non-residents could reflect the expectation that the tightening of outflow restrictions will make non-residents’ future repatriation of potential investments more difficult. However, a tightening of outflow restrictions could be effective in countries with favorable macroeconomic fundamentals. In this situation investors could still consider the country as an attractive investment destination. This argument is in line with results presented in Forbes (2011) suggesting that capital flow restrictions work mainly through changes in investor expectations and sentiment. In order to test this hypothesis, author constructed time-varying composite index of macroeconomic fundamentals. The results suggest that in countries with better macroeconomic fundamentals, a control tightening leads to an increase in net capital inflows that halts the depreciation of the exchange rate and gives policy space to allow for lower interest rates, boosting
economic activity. Indeed, an additional reason why restrictions are effective in economies with strong fundamentals might be that these countries tend to benefit from a favorable institutional environment. Further, the results suggest that further restrictions are effective in countries with fairly comprehensive pre-existing controls.

The Author’s concluded by noting that in the absence of strong economic fundamentals, good institution and pre-existing controls, a tightening of restrictions fails to reduce net outflows as it provokes a sizeable decline in gross inflows, mainly driven by foreign investors.

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