Discussion of Capital Flows, Macro-Prudential Policies and Capital Controls

by A. Aguirre, S. Bauducco, and D. Saravia

Nicolas E. Magud
International Monetary Fund
November 16, 2017

Summary of the paper

Main question: impact of MPP and KCP on KI & its driving mechanisms

Key results (among many more; **very** rich paper)

- MPP
  - Tightening MPP on Fin Inst. reduce Bond-KI in AE, but increase Bond-KI in EM
  - Tightening MPP on borrowers increase Bond-KI in AE
  - Driving mechanism: carry trade (Bruno and Shin 2017) magnified in EM when MPP limit Fin Inst. ability to provide credit: Non-Fin Inst. with int’l access borrow abroad and act as financial intermediaries for domestic borrowers (bond inflows)
    - Story: domestic credit affected in EM but not in AE; and
    - Effect of MPP stronger in EM with deeper financial markets

- Capital controls (great topic to talk about in Chile!)
  - KC reduce volatility of equity inflows, increase KI in AE (causality issue), reduce KI in EM (E+B)

My comments—roadmap

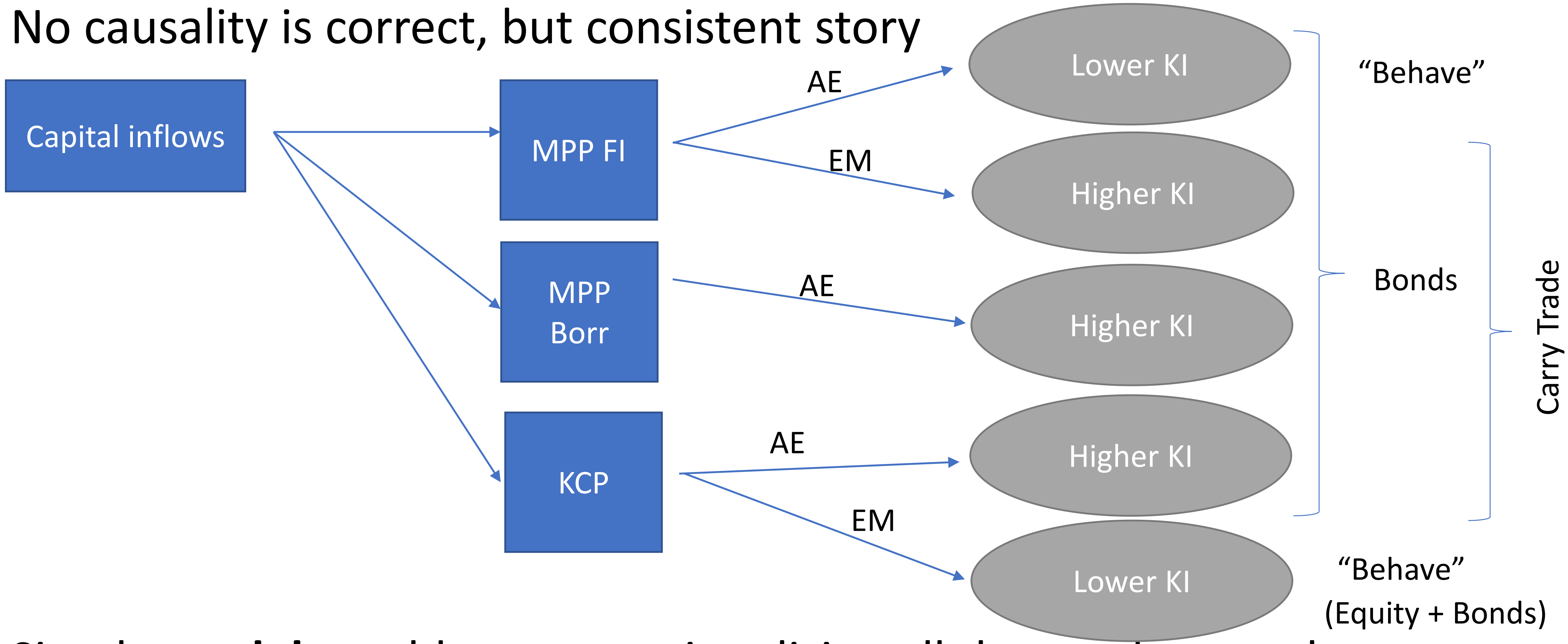
- What I like a lot
- Some suggestions
- Wrap up

What I like a lot

- Very nice paper, insightful, full of interesting results
- Relevant **policy** question!
- Most existing studies of KC: **KC don’t work**
  - Work to extend KF maturity, but not much to reduce flows and ER pressures, though some gain Mon Pol independence
  - But this is **focused on narrow definition of KF**
    - So results are more targeted, easier to delve into details
- Emphasis not on **causality**

Some suggestions

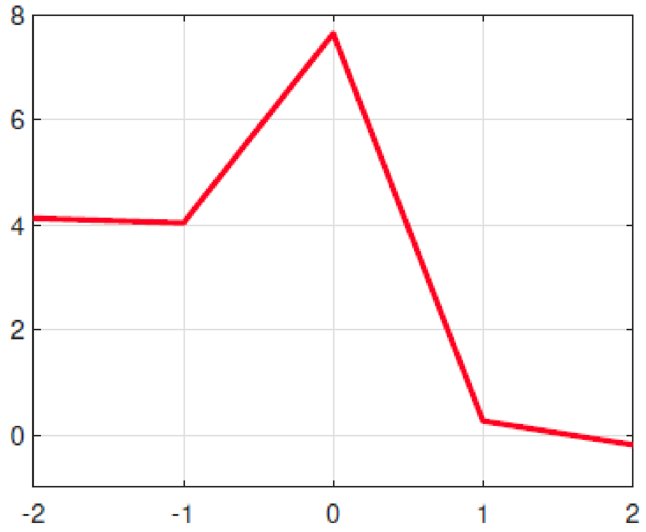
- Results are diverse, KI increase or decrease depending on the policy
- No causality is correct, but consistent story



- Simple **model** would to ease rationalizing all the results together

Some suggestions (continued)

- Focus on MPI ***change*** to look for **policy** response to KI or KI response to **policy** (no causality), instead of using the contemporaneous MPI level
- Important: MPI/KC changes **because they worked, or because they didn't**?



Note:

Figure 1: Capital flows in developing countries around the time of implementation of capital controls.

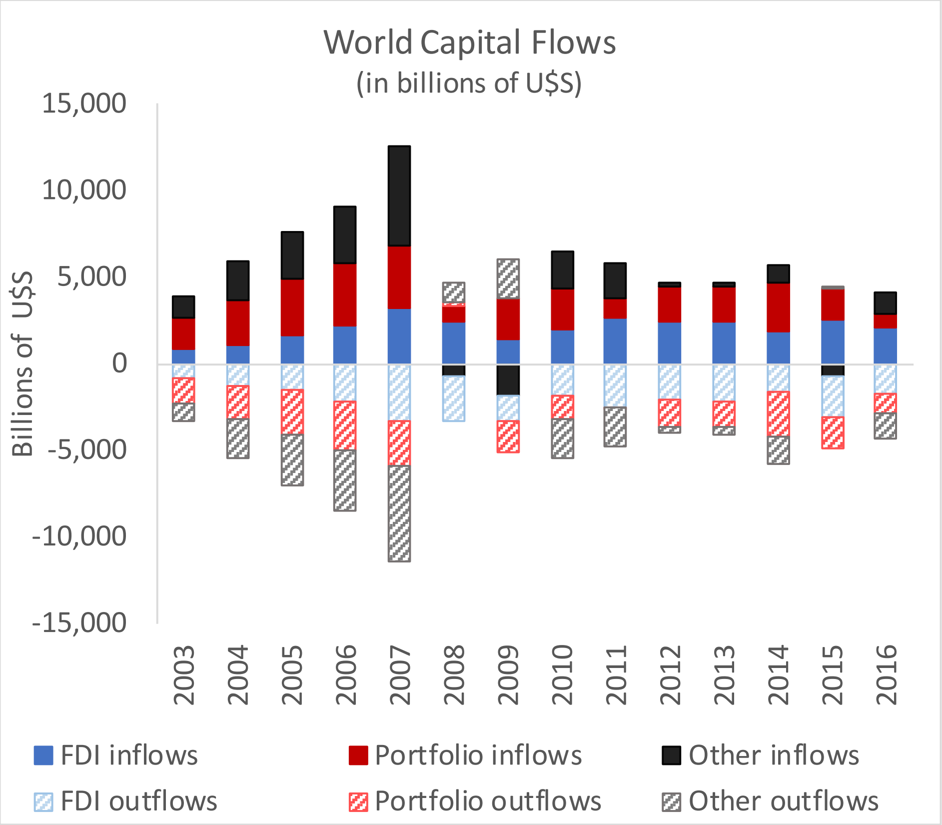
- Shouldn't the focus be on dummies rather than MPI/CC levels?
  - $\widehat{\gamma_b}; \widehat{\gamma_f}; \widehat{\theta_{nr}}; \widehat{\theta_r}$
- These would indicate reaction (regardless of causality)
- In fact, getting rid of $\gamma_b; \gamma_f; \theta_{nr}; \theta_r$ (country-FE?)?
  - Interpretation somewhat different

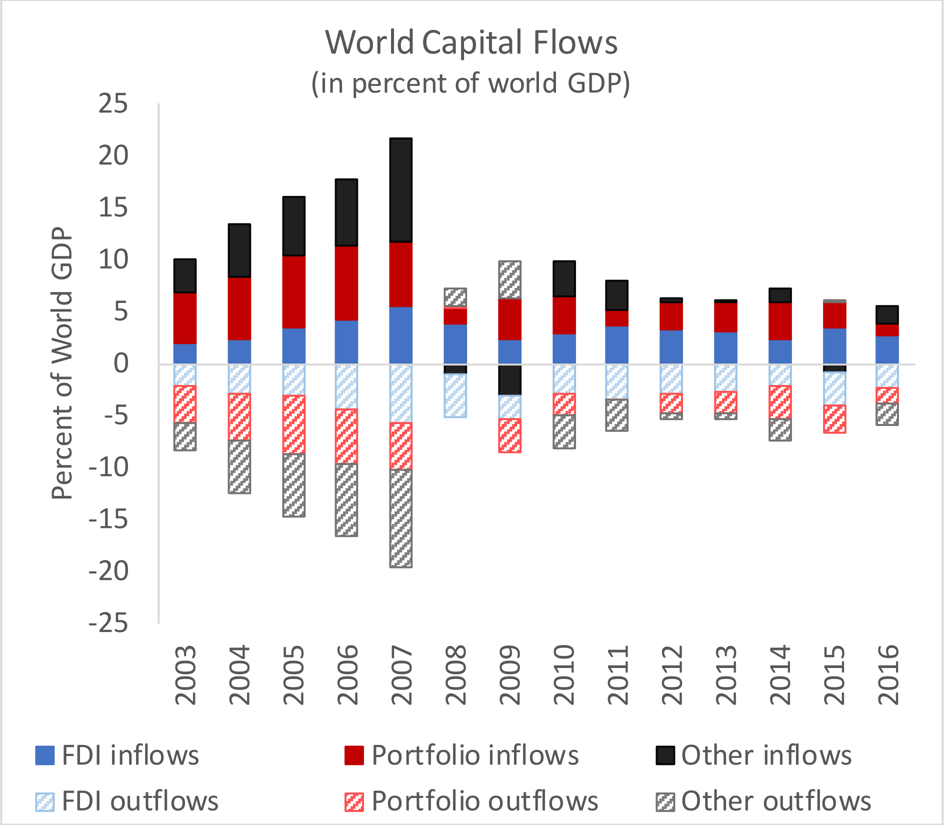
Some suggestions (continued)

- Control **directly** for the global financial cycle in baseline in RHS

  (some robustness and year dummies address part of the latter)

- How much of the KI are global cycles or specifically related to MP**P** or KC**P**





Source: Gian María Milessi Ferretti, Capital Flows Database

Some suggestions (continued)

- Control **directly** for the global financial cycle in baseline

  (though some robustness address the latter and year dummies)

- Then, focus on KF response **CONDITIONAL** on the global financial cycle

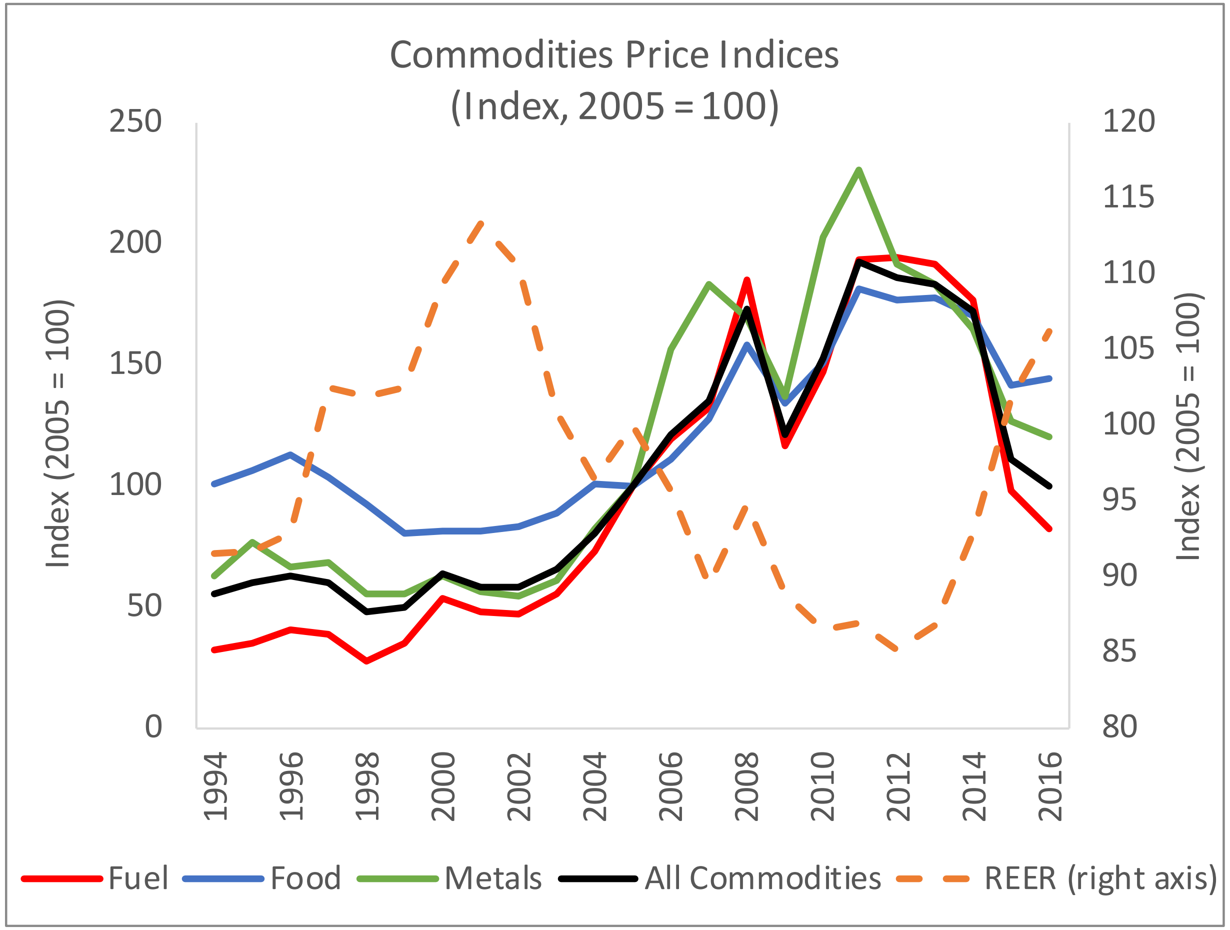
  (MPP: gross flows more relevant, but KC may be net flows more relevant; despite some grey area MPP-KCP—more below)

- Otherwise, KF could be driven by other factors, not necessarily by MPI or KC

- Do we need the interactions? May be yes, but need to argue for them
  - After controlling for macro variables, then look at the marginal effect of dummies

Some suggestions (continued)

- Control for commodity prices, or TOT, or REER in baseline
  - Related to the capital flow cycle, but also to demand-supply equilibrium
  - Paper controls for US Mon Pol; I would also control for US REER (Druck, Magud, and Mariscal 2015, and forthcoming) & Boz, Gopinath, and Plagborg-Møller (Nov 2017 NBER)



Some suggestions (continued)

- Control for strength of macro-framework (fiscal, monetary, ER flexibility)?
  - Fiscal space
    - Fiscal balance
    - Public debt ratios
  - Fiscal rules
  - IT or other Mon Pol framework
  - Monetary space ($r\text{-}r_{neutral}$?)
  - Exchange rate regime
  - Financial integration

Some suggestions (continued)

- Support for **carry-trade** (CT): isn't it indirect?
  - Shouldn't we observe KF first respond to r-r*;
  - And then, that MPI/CC results **ADD** to the CT hypothesis
- MPP increase the effective cost of borrowing, but not necessarily the market interest rate. How will MPP increase the CT?
- Does the **objective of KC** matter? May be
  - ER level? KF maturity? Volatility? Mon Pol independence?
- Some explanations need more empirical work to support claims

Some suggestions (finalized)

- **Type of flows**: Compare gross and net flows; and FDI equity; Portfolio Bond+equity; does maturity of inflows matter?
- **Domestic vs. foreign MPP:** Can MPI be split between purely domestic (e.g., LTV) vs. not-so domestic (e.g., reserve requirements in FX deposits, marginal or average; LTV in FX, dynamic provisioning on FX, etc.)—many “**grey**” areas between MPI (Fin Inst and Borrowers) and KC. Can MPP be KCP, depending on dataset?
- **Economic significance**?
- Lagging *X* to reduce endogeneity
- Control for real GDP pc @t=0
- Do we need whole, or simply AE vs EM?

To wrap up

- Very nice paper, insightful, full of interesting results, relevant policy question
- Key results
  - Tightening MPP on Fin Inst. reduce Bond-KI in AE, but increase Bond-KI in EM
  - Tightening MPP on borrowers increase Bond-KI in AE
  - Driving mechanism: carry trade magnified in EM when MPP limit Fin Inst. ability to provide credit: Non-Fin Inst. act as financial intermediaries for domestic borrowers
  - KC reduce KI in EM, reduce volatility of equity inflows
- Focus on **changes** in MPP/KC policies
- Factor in GFCy more directly and focus on marginal effect of policy change
- Other policies?
- **Theoretical model** for intuition
- CT conditional on r-r*?
- Other minor technicalities, to discuss

THANK YOU !