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Comments on "Capital Flow Deflection under the Magnifying Glass"

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On the paper: a worthy reference for studies on capital flow behavior

The paper by Fillipo Gori et al. (2020) is a coherent and timely overview of the major policy concerns on capital flow behavior, especially capital flow deflection. Interestingly, it analyzes spillovers along three main dimensions: the type of flows, the type of controls, and the type of investors. Such dimensions can be regarded as the contributions of the paper to closing the gap on the prevailing issues. The paper also examines how spillovers influence capital account policy in the spillovers-receiving country. Using a new granular dataset for capital control adjustments in EMEs and AEs, the paper provides a lucid overview of renewed evidence that the introduction of capital controls in one economy increases capital inflows to other similar borrowing economies, that deflection is primarily driven by portfolio investment and bank credit, and that externalities (frontloading investment) may have important consequences in spillover-receiving countries.

Overall, the authors carry out robust empirical exercises and relevant policy discussions. It is a feasible paper as a reference in studies of the dynamics of capital flow and related policies. At least we can observe such a perspective from three strands. In terms of data, the paper uses granular-quarterly data from 2001 to 2017 as a primary dataset, higher frequency than other literatures that mostly used yearly data. The dataset captured not only the presence of controls, but also its adjustment allowing a split between inflow and outflow restrictions, as well as a granular classification between measures targeting a different type of assets.

The paper explores quite extensive identification strategies, including robustness checks which are convincing in revealing spillovers. Hence, the title "*under the magnifying glass"*. Finally, the paper also elaborates relevant assessment and leaves grounds for renewing a call for deeper international coordination of capital account policies, as collective policy coordination can mitigate negative externalities arising from unilateral actions. Unfortunately, this paper poses a relatively limited number of literature, particularly empirical studies on whether or not they support the findings of the paper.

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My discussion on this paper will explore more upon the bigger-picture of central bank policy issues, rather than the technical aspects of the paper.

EMEs policy perspectives of post-GFC capital flow deflection

In the post-GFC era, capital flow behavior, i.e. volatility, refreshes the long-standing policy discussions on monetary policy trilemma (MPT) management under free capital mobility. The MPT, which is originated from the seminal works by Mundell (1962, 1963) and Fleming (1962), captures the policy trade-offs faced by macroeconomic policymakers in an open economy, in which only two out of the following three policy objectives can be consistently pursued simultaneously: (i) exchange rate stability (ERS), (ii) full access to the global capital markets through financial openness (FO), and (iii) ability to maintain monetary policy sovereignty (MPS) in pursuit of the domestic policy ends. For EMEs, the choices presented by the MPT are far from trivial. Securing financing access from the global capital markets through FO, defined as the implementation of open current (CA), financial (FA), and capital (KA) account regime, for instance, involves a difficult choice between maintaining MPS and ERS.

After the GFC, the complexity of navigating the MPT for EMEs operating under FO has sharpened. During early 2000s to the GFC highlighted lively discussions on 'fear of floating' to explain the fact that most EMEs, as small-open economies, do not converge to one of the MPT's corner solution, i.e. opting for MPS and FO with floating exchange rate, and instead seek to strike an optimal balance amongst the MPT's three objectives (Calvo and Reinhart, 2002). In the post-GFC era, the policy discussion on MPT management has progressed along with the expansion of global liquidity. Capital flows management measures enter the discussion immediately after the GFC as EMEs collectively seek the IMF advice on how to deal with capital flows amidst ultra-accommodative monetary policy in AEs. A similar discussion is reflected within the SEACEN policy circles as shown in Lim and Shrestha (2009), Siregar et al. (2011), Becker (2016), and Juhro & Anglingkusumo (2020).

As far as Capital controls/restrictions vs. capital flow management (CFM) are concerned, which one is relatively important in affecting capital flow deflection? Pursuant to the intense discussion regarding the existence (differences) between types of restrictive policies (capital control) and capital flows management (including macroprudential measures related to international exposures) in overcoming financial system stability, it is of course very critical to identify standard policy responses that can trigger feedback responses from financial market players that leads to potential capital flow deflection. Therefore, assessing policy externalities is quite complicated, especially by considering that most EMEs are dealing with MPT and, thus, need to utilize a broader range of CFM instruments (Warjiyo & Juhro, 2019).

To expand the empirical discussion further, I suggest the authors to base the research motivation on clearer perspectives, such as to derive the research question from filling certain

particular academic blanks or research gaps. Regarding citation, this paper cites the views of a few previous papers (e.g. Forbes et al., 2016; Lambert et al., 2011; Giordani et al., 2017; Gosh et al., 2014; Avdjiev et al., 2016; Beirne & Friedrich, 2017; Cerutti & Zhou, 2018; Pasricha et al., 2018). Our common understanding on deflection issues will expand if the authors could cite more relevant studies on capital flow behavior, especially ones that can provide both perspectives that support and contradict with the hypothesis or findings in this paper.

Critical issues in identification strategy

In measuring the capital control, the authors used the index constructed by Lepers and Mehigan (2019). Such index coding is based on 1 for any tightening and -1 for any easing policy and then weighted continuously by the correlation reflecting similarity among two countries. However, such an approach would miss certain important information since the homogenous policy response will not be able to indicate the magnitude of each tightening and easing policy taken. Besides, it would also provide the identification limitation, which would need further research examination.

As concerns about the endogeneity problem in measuring the effect of policy intervention rapidly grow, certain rigorous methods can be considered. Endogeneity in this research may arise from reverse causality due to the existence of the feedback loop between policy variables and capital inflows, and from time-invariant unobserved heterogeneity due to multi-countries sample setting. In the presence of such characteristics, reviewing from different panel models, Pooled OLS (POLS) and Random Effect (RE) models will provide biased estimates. Leszczensky and Wolbring (2019) conduct a study to deal with these issues in panel data method.[3]

In conducting the robustness checks, the authors have added a set of global factors beyond the VIX, which consist of global GDP growth, the global 10-year bond yield, the growth in global liquidity, and the introduction of the year fixed effect. The test results are still consistent. However, when the sample is split between pre- and post-GFC, the results of the spillovers variable are no longer significant in the pre-GFC sample. Authors can introduce the control variable measuring the difference in global liquidity during pre- and post-GFC, based on

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[3] Fixed Effect (FE) and First-Difference (FD) models provide protection against endogeneity arising from unobserved heterogeneity. However, it could also yield biased estimates in case of reverse causality. Lagged first-difference (LFD) models account for both time-invariant unobserved heterogeneity and reverse causality and provide an unbiased estimate if the effect independent variable on the dependent variable is fully lagged, but being prone to misspecification. Related to thus issue, Arellano and Bond (AB) GMM model promises to perform well in case of time-invariant unobserved heterogeneity and or reverse causality (Leszczensky and Wolbring, 2019).

Parisha et al. (2018), to improve the result estimate, especially when the authors have the relevant dataset.

State of urgency amid increasing financial liberalization

Based on extensive exercises, this research concludes that these externalities may have important consequences in spillover-receiving countries. This research provides policy implications that are relatively the same as some previous studies, especially on the importance of multilateral cooperation in capital account policy. It can be established in different forms. For instance, establishing and fostering global standards and rules of conduct, along with continued multilateral dialogue. The authors perceive that international frameworks, such as the Code (e.g. The OECD Code of Liberalization of Capital Movements), represent a potential backstop to collectively damaging unilateral capital account actions and provide ground for the improvement of economic outcomes for each country individually. However, the frameworks should also be seen from policy urgency or policy that is beneficial for EME countries (EMEs).

Under ideal conditions, financial liberalization will facilitate countries for better access to global financing. However, according to the authors, AEs and EMEs have a different stage of financial developments and financial linkages connecting them to international financial markets, and thus capital flow dynamic effects. In the world full of uncertainty, financial liberalization henceforth would trigger additional risks to domestic economic stability, especially in EMEs. With this regard, we could understand why CFM seems to be preferable for EMEs, as respective countries could still reap the benefit of financial liberalization, but have sufficient policy space to reduce financial risks related to capital flows volatility. Based on this reasoning, we can see that CFM is not necessarily conflicting with financial liberalization. In fact, CFM complements financial liberalization by mitigating the unintended consequences of financial liberalization in the midst of imperfect global financial markets, which by default induce higher financial uncertainties.

As suggested from post-GFC stylized facts, the implementation of the unconventional monetary policy such as Quantitative Easing (QE) are the main driver of the tidal wave of capital flows. This leads to the consequence that uncertainty in the domestic economy of AEs can be easily transmitted to EMEs through capital flows volatility. Such a situation is responded to by EMEs by having more reliance on implementing CFM to curb escalating external vulnerability due to capital flows volatility. Therefore, without putting the capital flows in AEs back into order, it would be difficult to imagine that EMEs will fully support the OECD Code of financial liberalization. In other words, the OECD Code regulation should be more flexible while emphasizing more focus on how to regulate the positive purposes of the CFM usage.

Therefore, to conclude the discussion on this issue and anchor the theme of the conference, we can see a state of urgency in how to bring together AEs and EMEs common mutual beneficial interests amidst increasing financial liberalization. In this regard, from EME central bank policy perspective, CFM measures should be viewed as an integral part of central banks policy mix (in the IMF's conception it is well known as Integrated Policy Framework). The purpose of the CFM is to safeguard the overall domestic economic and financial stability. CFM will not replace the role of monetary and macroprudential policies. It is more as an additional central bank instrument to enhance the ability of the central bank to mitigate the global financial instability and the risks associated with capital flows movement. As a complementary instrument, it would give the central banks a greater space to strike the optimum balance in managing MPT, by directing the movement of its currency along with macroeconomic fundamentals, absorbing unintended consequences of international capital flows, and retaining monetary policy sovereignty in anchoring an inflation target.

Thank you.

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