

# **The Dilemma and International Macroprudential Policy: Is Capital Flow Management Effective?**

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## **Summary**

Following the global financial crisis in 2008, countercyclical capital controls have become a key policy recommendation for emerging market economies as a way to defend financial stability and to preserve monetary autonomy. A major presumption behind this recommendation is that capital controls can prevent volatile international capital flows into and out of the economy. However, empirical support for this presumption is at best mixed in previous studies, in part causality from controls to flows is confounded by a reverse causality: while controls may be effective in tempering flows, more volatile flows calls for more controls to be imposed.

In this paper, we provide empirical evidence that emerging market economies adjust capital controls in response to U.S. monetary policy shocks. Using these shocks, we quantify the causal effect of changes to capital controls on changes to portfolio capital flows. In particular, a one standard deviation increase in the net number of inflow reducing measures reduces net portfolio inflows by two-fifths of a standard deviation. These findings provide support to the

key policy recommendation of “Dilemma” literature, which is that emerging market economies should use capital controls and other macroprudential policies to shield their financial markets and monetary policy autonomy from large and volatile flows brought about by global financial cycles.

Two important deviations from the literature account for the differences between our results and previous empirical findings. First, we use a very powerful and arguably exogenous “push” factor --- US monetary policy shocks --- to explain the imposition of capital controls and to identify their effectiveness. Second, we focus on the quarterly changes in the number of capital controls for a group of emerging market economies, while previous studies usually employ annual capital control indexes. The effects we found are robust to a number of specification changes.