When restricting capital movement, don't go it alone

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When it comes to avoiding reputational costs of economic policy controls, there is safety in numbers.

That's the finding of a recent study of capital controls, or government restrictions on the cross-border movement of money and capital. The researchers assert it's one of the most systematic studies yet of the reputational risks associated with capital controls among emerging markets.

"We know governments' capital account policies are not implemented independently," said Steven Liao, a UC Riverside political scientist and co-author of the study. "What was less clear is exactly how, why, and to what extent peers matter. Our study sheds light on these questions from a reputational perspective."

Capital flow volatility, or CFV, is when the movement of international investment into and out of an economy poses risks to a market's stability. When capital inflows accelerate, countries get worried about things like banking crises and inflation. In contrast, rapid capital outflows can lead to foreign exchange reserve depletion, currency crashes, asset price busts, etc.

One policy response to risks from CFV can be restricting investors ability to move money out of the economy in turbulent times—a tool referred to as "outflow controls." Governments can accomplish this by imposing quotas on how much money investors can take out of the economy, by imposing taxes on such transactions, or by imposing outright bans.

"There are some who believe that outflow controls can and should be used under certain circumstances and that they can have a stabilizing effect on an economy," said Daniel McDowell, Liao's co-author and an associate professor of political science at Syracuse University. "There are others, however, who believe that they tend to be ineffective and so they don't offer much in terms of added stability, but they may reduce investment in the future by turning off investors."

In any event, the authors say that outflow controls are an instrument policymakers want at their disposal when facing volatile capital flows. And it's a tool that emerging markets and developing countries would go to more often if they didn't fear long-term damage to their economy's investment reputation, the authors write.

Foreign investors balk at the notion of countries restricting their ability to repatriate capital or profits. Simply, investors want liberal policies so they can invest their capital as they wish. And they may consider such constraints "tantamount to default" as governments are seen as reneging on a commitment to financial openness, Liao and McDowell wrote in the recently published study.

And so governments fear such controls will spook long-term investment in their countries. These reputational fears can constrain policy choices.

The study authors argue governments have good reason to consider using outflow controls when facing highly volatile capital flows. But the authors theorized that governments may be afraid to use the policy tool for fear that it will harm their reputation among international investors. Liao and McDowell suggest that whether outflow controls will damage a country's reputation depends largely on what one's peer countries are doing.

If peer countries are not restricting capital outflows, it will hurt a country's reputation to employ outflow controls on its own. In this case, the government's policies will be viewed as extreme and out of step with its "liberal" peer economies. A tarnished reputation may reduce future inflows of foreign capital or even damage a country's bond rating. However, if peer markets are also restricting capital outflows, the authors say the reputational damage will be reduced because "everyone is already doing it"—and any reputational damage will be distributed across all countries in the peer group.

For the study, the authors looked at a myriad of factors involving 25 emerging markets and developing countries from 1995 to 2015. The countries ranged from Eastern European countries such as Russia, Poland, Ukraine, and Romania; South American countries such as Brazil, Peru, and Chile; China; Southeast Asian countries such as Indonesia and Thailand and South Asian countries such as India and Bangladesh.

Among the factors, they considered the countries' exposure to CFV; geography; bond ratings and partisanship (right, center, left). The study also looked at similarity among emerging economies using a Morgan Stanley Capital Management classification system that divides countries into three categories based on their performance in equity markets: developed markets, emerging markets, and frontier markets.

Additionally, the authors looked at the size of countries' economies, their level of economic development, interest rates, exchange rates, inflation, and openness to trade with other countries.

The study found that as CFV increases, emerging markets are more likely to employ capital outflow controls. However, additional analyses show that the relationship only holds when a country's peer markets are also using outflow controls. Countries facing CFV were about twice as likely to increase outflow restrictions when geographic peer countries had the same restrictions in place. They were also more likely to enact restrictions when equity or bond market peers had the same restrictions. Overall, a typical country's restrictions increase by around 13 to 23% when their country-peers in these categories had done the same thing.

But when a country's market peers were not restricting outflow controls, the authors find no evidence that CFV leads to outflow controls. In other words, when peers have "liberal" policies that are friendly to investors, governments appear reluctant to use outflow controls for fear that it will harm their reputation among investors.

"Together, these results support our expectation that as (volatility) increases, emerging market governments are more likely to tighten restrictions on capital outflows, but only when market peers have already employed (similar) measures," Liao wrote.

Conversely, countries are more likely to lay off restrictive policies when peer countries maintain liberal policies.

"Reputational considerations play a meaningful role in dictating whether emerging markets impose restrictions on capital outflows in response to destabilizing (volatility)," the authors continued.

The authors suggest fears of reputational damage are driving decisions across the board on whether to restrict control outflows. But the authors say countries are missing a key distinction when making these decisions: if peer countries are also controlling capital outflows, it does less damage to a reputation—significantly less.

Liao said the study instructs that analysts should not weigh policy choices in isolation: restricting capital outflow might cause minimal damage to your country's reputation if peer countries are doing the same thing.

"The intensity of reputational damage associated with the use of outflow controls should be conditional on the use of such controls in a country's market peers," Liao wrote. "When a country's market peers are using outflow controls, governments should anticipate that the reputational costs… decrease since the negative signal that outflow controls send to investors will be weakened."

Countries can draw from the study's lesson, Liao said, by understanding reputational consequences from capital controls aren't a constant.

"We hope the study can help emerging markets identify when outflow controls may be an economically or politically feasible policy option against capital volatility," he said.

More information: Steven Liao et al, Closing Time: Reputational Constraints on Capital Account Policy in Emerging Markets, *Review of International Organizations* (2021). DOI: 10.1007/s11558-021-09433-1

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