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DO CAPITAL CONTROLS ACT AS SHOCK ABSORBERS? EVIDENCE FROM EMERGING MARKET ECONOMIES

Abstract:

The growing concern in emerging market economies about how to manage global financial shocks has raised interest in examining the role of capital controls as an effective policy instruments in mitigating the international financial spillovers. Using dynamic Local Projections (LP) on a panel of 34 emerging market economies, we examine the shock absorbing capacity of capital controls. We show that capital inflow controls act as an effective policy tool in dampening the impact of global financial shocks on domestic financial and real variables. We find that economies with strict capital inflow controls are able to moderate the effects of VIX movements on GDP growth, real estate prices and domestic credit growth. We also find that monetary policy responds countercyclically to VIX movements in strict capital inflow controls state, which provides support for the use of inflow controls as a macroeconomic stabilizing policy tool. We relate our findings by looking at the sensitivity of capital flows and exchange rate fluctuations, the possible transmission channels behind the financial spillovers in emerging market economies.

Keywords:

Global financial shocks, global financial cycle, international financial spillovers, capital flows, capital controls, monetary policy, exchange rates, macroeconomic stability

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