Research Working Papers

Capital Controls and the Global Financial Cycle

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Emerging markets have an incentive to tighten capital inflow controls during periods of international financial distress.

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Capital flows into emerging markets have become more volatile with increased risks, which renewed interest in active capital flow management. In this paper, we argue that heightened international financial volatility and investor risk aversion incentivizes emerging market regulators to reduce the amount of risky emerging market debt to cope with elevated risk premiums. In turn, this motive can be implemented via capital inflow restrictions during periods of major financial distress, which generates a trade-off with the familiar notion to implement capital controls counter-cyclically. We then revisit the usage of capital controls in practice. We find that emerging markets, which actively revaluate their capital flow restrictions, increase capital inflow controls during episodes of major international financial distress, which is consistent with the predictions of the model.

JEL classification: F36, F38, F41

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