Beware the Side Effects:
Capital Controls Cause Misallocation and Reduce Welfare

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Evangelina Dardati, Enrique Mendoza

Discussant: Fadi Hassan

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The paper addresses a key question in international finance

- What are the effects of capital controls on misallocation and welfare?

**Context:**

- Chilean economy in the 1990s
- Capital controls took the form of unremunerated reserve requirement (URR) to be held at the central bank for a fixed term.

Main results:

- Capital controls led to a 0.11% increase in misallocation and a 2.39% decline in permanent consumption.
- Exporters and high-productivity firms are affected the most by the policy.
- Other forms of macro-pru policies such as a higher loan-to-value ratio have lower side effects.
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Main features

• Theoretical setting:
  • Heterogenous firms with different idiosyncratic productivity.
  • Exporters pay a fixed sunk cost and an ad-valorem iceberg trade cost.
  • Firms can borrow up to a fraction of their future capital stock.
  • Capital controls are equivalent to a tax that increases the cost of capital.

• Key point:
  • Given the presence of a collateral constraint the economy is already misallocated. Capital controls introduce an extra friction.
  • Ex-ante it's not clear how the two frictions interact and if misallocation increases or decreases.
  • Numerical exercise based on the Chilean economy to assess such impact.

• Mechanism in a nutshell:
  • Capital controls affect mostly firms that rely on external borrowing by increasing the interest rate on loans they pay [whereas the collateral constraint affect all firms].
  • Firms with higher MRPK (so further away from their efficient size) and exporters (who face more costs than non-exporters) are the ones that are more penalized.
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Firm level heterogeneity — Sectoral heterogeneity

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Empirical contribution — Theoretical contribution

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Positive effects of inflows — Negative effects of inflows

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• **Key features:**
  • Matching bank and firm-level data (the universe of banks and firms).
  • Micro level identification of the impact of international financial flows on misallocation.
  • We can track the banks more exposed to capital inflows and their credit allocation according to firm characteristics.
  • We estimate the implications for aggregate productivity using a sufficient statistics approach (Sraer and Thesmar, 2019).
  • We explore other determinants of misallocation in Italy other than capital flows and highlight the importance of domestic bond funding (not triggered by foreign flows) as a source of credit misallocation.
  • The paper shows the importance of investigating the impact of financial flows at the micro level and keep track of what banks do and the financial sector.
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• Nice focus on the effects of capital controls on misallocation $\rightarrow$ good space for research.

• I like the idea to look into different types of capital controls $\rightarrow$ worth expanding this part.

• It would be good to have an estimate of the effects on aggregate productivity (and the welfare results need some more explanation).
The historical context of the paper: the golden years of Chile were during capital controls

Table: Economic indicators in Chile 1980-2007 (annual averages, %)

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<thead>
<tr>
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<tbody>
<tr>
<td>Real GDP growth</td>
<td>3.5</td>
<td>7.7</td>
<td>4.4</td>
</tr>
<tr>
<td>Real GDP per capita (PPP)</td>
<td>1.9</td>
<td>5.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Unemployment</td>
<td>10.1</td>
<td>5.7</td>
<td>9.6</td>
</tr>
<tr>
<td>Output per worker growth</td>
<td>-0.1</td>
<td>5.0</td>
<td>2.1</td>
</tr>
<tr>
<td>TFP growth</td>
<td>-</td>
<td>1.0</td>
<td>-1.1</td>
</tr>
<tr>
<td>Exports growth</td>
<td>6.4</td>
<td>10.8</td>
<td>6.3</td>
</tr>
<tr>
<td>Gross capital formation growth</td>
<td>6.0</td>
<td>15.4</td>
<td>6.8</td>
</tr>
<tr>
<td>Credit to private sector by banks, growth</td>
<td>4.4</td>
<td>20.3</td>
<td>10.9</td>
</tr>
</tbody>
</table>
The share of Chile of banking inflows to the region was increasing.

Chilean share of LATAM foreign cross-border banking claims (BIS)
External debt composition (De Gregorio, Edwards, and Valdes, 2000)

Table 3: External debt (million of US dollars)

<table>
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<tr>
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<tr>
<td>Total external debt</td>
<td>17425</td>
<td>16364</td>
<td>18242</td>
<td>19186</td>
<td>21478</td>
<td>21736</td>
<td>22979</td>
<td>26701</td>
<td>31691</td>
</tr>
<tr>
<td>Private</td>
<td>5633</td>
<td>5810</td>
<td>8619</td>
<td>10166</td>
<td>12343</td>
<td>14235</td>
<td>17816</td>
<td>21613</td>
<td>25977</td>
</tr>
<tr>
<td>Public</td>
<td>11792</td>
<td>10554</td>
<td>9623</td>
<td>9020</td>
<td>9135</td>
<td>7501</td>
<td>5163</td>
<td>5088</td>
<td>5714</td>
</tr>
<tr>
<td>Long and medium term</td>
<td>14043</td>
<td>14165</td>
<td>14767</td>
<td>15699</td>
<td>17613</td>
<td>18305</td>
<td>20344</td>
<td>25414</td>
<td>30081</td>
</tr>
<tr>
<td>Short term</td>
<td>3382</td>
<td>2199</td>
<td>3475</td>
<td>3487</td>
<td>3865</td>
<td>3431</td>
<td>2635</td>
<td>1287</td>
<td>1610</td>
</tr>
<tr>
<td>Short term/Total (%)</td>
<td>19.4</td>
<td>13.4</td>
<td>19.0</td>
<td>18.2</td>
<td>18.0</td>
<td>15.8</td>
<td>11.5</td>
<td>4.8</td>
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Source: Central Bank
Main suggestions

- A stronger link between the empirical/historical setting and the model:
  - Did capital controls reduce financial inflows in Chile?
  - This paper: "capital controls were economically significant as the URR were 1.9% of GDP".
  - De Gregorio et al. (2000) show empirically no effect of URR on total inflows, but a tilting effect towards longer-term debt.
  - In the model there is no role for the compositional effect of capital controls, but this was a key feature of the policy.
  - What is the evidence of the model's mechanism? What was the pass-through to the interest rate on firms?
  - How relevant are capital inflows as a source of bank funding?
  - Do high-MRPK and exporters suffer the most from higher interest rates? These are valuable customers for banks that compete to have such clients and this can affect the pass-through.
  - There is data on interest expenditure in ENIA which could be worth exploring.
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Main suggestions (ctd.)

- A stronger link between the empirical/historical setting and the model:
  - Capital controls and monetary policy.
- De Gregorio et al. (2000) show that capital controls gave space to the central bank for tightening monetary policy (the economy was overheating) without experiencing a further surge in inflows.
- Is the model capturing the central bank's increase in interest rate rather than the pass-through of higher costs in foreign funding?
- More in general, what would be the difference between a monetary tightening and capital controls in your model?
- A stronger link with other streams in the literature.
- Models with pecuniary externalities:
  - Bianchi (2011) and Bianchi and Mendoza (2018) show that, in the presence of pecuniary externalities, capital controls limit overborrowing, reduce the probability of a crisis and are welfare improving.
  - Why not studying the side effects of capital controls on misallocation in these type of models? It would allow for a better comparison of pros and cons.
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    • De Gregorio et al. (2000) show that capital controls gave space to the central bank for tightening monetary policy (the economy was overheating) without experiencing a further surge in inflows.
    • Is the model capturing the central bank’s increase in interest rate rather than the pass-through of higher costs in foreign funding?
    • More in general, what would be the difference between a monetary tightening and capital controls in your model?

• A stronger link with other streams in the literature.
  • Models with pecuniary externalities:
    • Bianchi (2011) and Bianchi and Mendoza (2018) show that, in the presence of pecuniary externalities, capital controls limit overborrowing, reduce the probability of a crisis and are welfare improving.
    • Why not studying the side effects of capital controls on misallocation in these type of models? It would allow for a better comparison of pros and cons.
Conclusions

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  • The model could be enriched to better capture the reduced form effects of the policy.
  • In alternative, the model could be calibrated to a different country/setting.

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• Hope to see you all in person the next time!
Thank you!