Empirical exploration of two mechanisms for describing the time-varying sensitivity of capital flows to shocks


Fernández, Rebuggi, Uribe, “Are Capital Controls Countercyclical?”
Almost all benchmark weights evolve as buy-and-hold
- Mutual funds react to exogenous movement in benchmarks
- Movements in country returns have amplification and contagion effects on capital flows
Central for demonstration of herding:

\[ w^B_{ct} = w^B_{ct-1}(R_{ct} / R^B_t) + E^B_{ct} \]

\[ w_{ict} = \theta_{ic} + \theta_{it} + \alpha[w^B_{ict-1}(R_{ct} / R^B_{it})] + \beta E^B_{ict} + \epsilon_{ict} \]

- \( E^B_{ct} \) exogenous: component of \( w^B_{ct} \) not explained by buy-and-hold
- Indices built and adjusted by pre-determined criteria:
- Whatever is causing these adjustments might also be correlated with \( \epsilon_{ict} \)
Very interesting way to get contagion

Benchmark effect + informational herding $\Rightarrow$ possibly large aggregate consequences for aggregate investment, inflation, output

A possible means to get business cycle comovement
Documents new facts

- Update index of capital controls
- Show capital controls don’t vary much
- Controls on inflow and outflows are highly correlated
- Controls are acyclical
FRU implications

Theory ahead of policy?
  ● Policymakers had incomplete information on optimal policy?

Or theory on the wrong track?
  ● Policymakers had better information than theorists?

Suggestion:
  ● Use new measure to estimate what explains changes in observed capital controls
  ● Economic and political covariates
  ● New stylized facts
FRU: learning about what policy is optimal

Important question: do economists know what optimal policy is?

Proposal: use observed evolution of index to help answer

- Costs and benefits may be of differing cyclicalities
- Different models predict different optimal policies
- Model a policymaker learning about optimal policy
- Can context around observed policy changes help us understand policymakers’ decision process?
- Can policymakers’ actions give us any insight into what optimal policy is?