Capital Flows, Capital Controls, and Banking Crisis

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Abstract

This paper analyzes the effectiveness of capital controls. There have been debates regarding to the association between capital controls and capital flows as well as the crises. These debates are mainly due to the lack of a unified theoretical framework along with the challenges in measurements and methods. In this paper, an overlapping generations framework was adopted to examine how well different capital controls can affect capital flows and prevent banking crises. This framework incorporates both equity and debt markets in the open-economy model and consider the challenges which are faced by the financial intermediaries under different circumstances. Consequently, I found that the effectiveness of capital controls depends on the controls of both countries as well as the relative return rates of the credit markets. In general, symmetric controls on both countries, either on outflows or inflows, work well in affecting the volumes and the compositions of capital flows as well as preventing the economy from banking crises. Asymmetric controls, however, may not work better than the economy without controls in terms of affecting capital controls and preventing from banking crises.

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