

# Prudential Measures: What are they good for? By Kristin Forbes, Marcel Fratzscher, and Roland Straub

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# Summary

## Background + Goal

- Background
  - Selected bias and endogeneity have been the challenges in measuring the effectiveness of capital controls and prudential measures.
    - The countries which change their capital flow management (CFM) often share certain characteristics and are responding to changes in capital flows and exchange rates.
- Goal:
  - Estimate propensity scores matching methodology to examine the effectiveness of capital controls and prudential measures.
    - matching methodology: match “control” group with “treatment” countries that adjust their CFMs.

# Summary

## Main Findings

- Certain types of CFMs can *significantly reduce financial fragilities*, such as bank leverages, credit growth and exposure to SR debt.
- Most CFMs do **not** significantly affect other key targets (exchange rates, capital flows, interest rate differentials, inflation, equity indices, volatility).
  - One exception: removing controls on capital *outflows* could reduce real exchange rate appreciation.

# Contributions

- Create a new database with detailed information on weekly changes in controls on capital flows (both in and out) and prudential measures for 60 countries from 2009-2011.
  - The implementations of CFMs in various countries in response to the changes in capital flows, exchange rate...etc.
  - Identify the countries' certain characteristics that have them change CFMs
- Adopting the “propensity-score” matching technology and use different algorithms to match “control” groups with “treatment” which adjusts their CFMs.
- CFMs may reduce financial fragility, but not the key targets.

# Questions/Suggestions

## In general

- How is the fragility measured?
- Regarding to “removing controls on outflows is effective to limit exchange rate appreciation”.
  - Q1. Wouldn't this require the countries to have controls on outflows in order to be removed to limit appreciation?
  - Q2. Instead of removing, how about decreasing controls? It may not be as effective as removing.
    - If this is the case, does it mean the initial controls have to be severe enough in order to have the “removing” effective?

# Questions/Suggestions

## In general

- Although CFMs are about capital flow management,
  - isn't it true that the ultimate purposes of CFMs can be summarized to independent monetary policy and stabilizing the economy (output)?
    - One way to stabilizing the economy is to stabilize the financial market.
  - If this is true, then wouldn't CFMs have achieved the ultimate goal, as the main finding is that CFMs could reduce financial fragility?
    - Isn't whether or not to affect the key targets minor, as these targets aim for the same: stabilizing the economy?

# Questions/Suggestions

## In general

- One possibility that the CFMs have *no* significant effects on the key targets (exchange rates, interest rate differentials, inflation, bond/equity, volatility):
  - *Combination of capital controls and prudential measures.*
  - Q: Is it possible that capital controls and the existing prudential measures affect the key targets in opposite directions, and the effects offset each other?
- Suggest: to control for either capital controls or prudential measures
  - to examine the effects on the key targets and/or
  - to examine what prudential measures and capital controls are better combination(s)?

# Questions/Suggestions

## In general

- Discussion on capital flows
- The 60 countries include only the emerging markets,
- Q: Do the capital flows to/from these countries include the excluded countries, such as USA, UK, Japan, Europe?
- Q: Wouldn't capital flows to/from a certain country depend on the relative economic conditions of the two parties?
  - If so, wouldn't the focus on the total flows of one country tend to under-estimate the effectiveness of capital controls and prudential measures?
  - As such CFMs could be effective on the flows from/to certain countries but not others.



# Questions/Suggestions

## possible extension

- One goal that is hardly discussed is “independent monetary policy”. This is uneasy for empirical analysis—shall be a different project to discuss.

# Questions/Suggestions

## Specific--methodology

- The creation of “exclusive window” for 3 month before and after the CFM change.
  - Q: Why 3 months, when the data frequency is weekly?
  - Q: would the results change when the window becomes 1 month or less?
- Propensity score,  $P(X)$ :
  - For the 60 countries included, some have to follow IMF’s advice, but not all.
  - Q: Would such external advice affect the propensity scores?

# Questions/Suggestions

## Specific

- The capital flow measure (Table 1) is great for people working on capital controls.
- The range of the frequencies of changing CFMs among countries is considerably wide, between 1-20. Some countries balance “+” and “-” while some fall into either.
- Q: Would the countries with frequent CFM changes do better/worse in terms of financial fragility, compared to those who do less?
- Q: would these countries be more/less likely to attract non-residents' capital?