I. Introduction

• Literature review
• Key questions
• Contribution

1. Literature review

• A large body of literature has examined macroeconomic effects of capital flow liberalization
• The results of these studies have been mixed.
  – Rodrik (1998) finds no clear relationship between financial openness and economic growth
  – Quinn and Toyoda (2008) find that countries with open capital market tend to grow faster.
  – Eichengreen and others (2011) find that countries that have succeeded in avoiding crises have benefited from capital account liberalization, while countries that have not so succeeded have neither benefited nor suffered on average.

2. Key questions

• What do recent international country experiences tell us about the effect of liberalization on capital flows, economic growth, inflation, and financial stability?
• What would be the possible effects of liberalization in China?
• What are the potential multilateral consequences of phasing out the capital controls in China?

3. Contribution

• Analyzing the effects of capital flow liberalization during the transition period from restricted to liberalized capital flows.
• Drawing on the experiences of other countries that have liberalized.
• Shedding light on the possible short- to medium-term effects of capital flow liberalization in China
II. Measuring Capital Flow Restrictiveness

- The de jure measures are computed for 185 countries over 1995–2010.
- The narrow restrictiveness index
- The broad restrictiveness index

III. Recent Trends in Capital Flow Liberalization

- Restrictiveness index
- Global map: capital account liberalization
- Countries that Liberalized During 1995–2010
Where is China now: Financial Openness (2010)?

The horizontal axis shows de facto openness. The vertical axis shows the index of de jure openness. The size of bubble is the GDP of the countries in US. The red bubble represents China.

IV. Empirical Strategy

- Dynamic Panel Data Specifications
- Simulation of the Effects of Capital Flow Liberalization on China
- Multilateral Effects of Capital Flow Liberalization in China

1. Dynamic Panel Data Specifications

- Various panel data specifications are used to estimate the impact of liberalization.
- Following Kose and others (2009), the full sample is separated into two sub-samples using thresholds.

2. Simulation of the Effects of Capital Flow Liberalization on China

- Explores the potential effects of liberalizing capital flows on China by applying the coefficients of explanatory variables to the corresponding variables of China during 2012–16.

3. Multilateral Effects of Capital Flow Liberalization in China

- Run three bivariate VAR models using the real GDP per capita growth rate of China, and that of the United States, Euro Area, and Japan, respectively.
- Forecast the real GDP per capital growth of the three economies with two scenarios: one with liberalization of capital flows in China and one without liberalization.
V. Empirical Results

- Main findings
- Simulation Results of Capital Flow Liberalization on China
- Results for Multilateral Effects

1. Main findings

- Higher real GDP per capita growth.
- Lower inflation rates.
- Higher equity returns.
- Lower bank capital adequacy ratios.
- Higher capital inflows and outflows, but no significant effect on net flows.
- Thresholds make differences.

2. What if Capital Flows are Liberalized in China?

3. Multilateral Effects

Robustness check

- System GMM. The results are broadly similar to those obtained with the fixed effects estimator.
- Using our broad restrictiveness index of capital flows leads to similar results.
- Similar results were obtained when using pooled weighted least squares (WLS) estimator, whereby each observation is weighted by countries’ GDP in $US.

IV. Conclusions and Policy Implications

- Conclusions
- Policy implications
1. Conclusions

- The paper finds:
  - strong positive links between liberalization and capital flows
  - liberalization of capital flows is associated with higher GDP per capita growth and lower inflation.
  - liberalization of capital flows is associated with higher equity returns and lower bank capital adequacy ratios, suggesting potential risks to financial stability.
  - countries meeting some threshold conditions are better able to reap the growth and stability benefits of financial globalization.
- The effects of liberalizing capital flows in China qualitatively mirror the above econometric results. However, quantitatively, the effects depend on the pace and sequencing of capital flow liberalization.

2. Policy Implications

- Both beneficial effects and challenges
- A set of prerequisites are necessary for China to push forward liberalization of capital flows.
  - the liberalization strategy would need to remain flexible, should be carefully planned and sequenced in a manner that reinforces domestic financial liberalization and allows for institutional capacity building.
  - China would benefit from building a sounder banking sector, stronger supervisory and regulatory frameworks, and establishing a framework to address potential asset price bubble and volatile capital flows.
  - The menu of policy responses for managing liberalization includes, in addition to potential interest rates and exchange rate flexibility, appropriate fiscal balances and trade openness.