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Capital controls in a global economy: in search of a coordinated truce

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'In a globalised world, decisions taken at country level have a global impact ... Coordination between developed and developing countries is the only way forward'

In the aftermath of the global financial crisis, capital flows into emerging and developing economies have bounced back quickly from their slump in 2008. This has been triggered by prospects of strong output growth, investors regaining their appetite for risk, and, in particular, by 'carry trade' practices[1] favoured by the exceptionally low interest rates in developed countries.

This surge in foreign capital has led to a renewed focus on capital controls, a policy option to manage large inflows additional to exchange rate policy, monetary policy, fiscal policy, foreign exchange market intervention and domestic prudential regulation. The debate on the causes and effects of global imbalances and associated capital flows lies at the heart of current G-20 deliberations.

The theory of the 'six fears'

According to the literature (Magud and Reinhart, 2006; Ocampo and Palma, 2008; Epstein, 2005), there are six fears that drive countries to adopt capital controls:

1. **fear of appreciation:** massive and rapid capital inflows may generate upward pressure on the real exchange rate, damaging export competitiveness
2. **fear of 'hot money':** short-term capital inflows may cause destabilising distortions and increase exposure to capital flow reversal
3. **fear of large inflows** that can disrupt the financial system, even if they are not all 'hot money'
4. **fear of loss of monetary autonomy:** the so-called 'trilemma' of international macroeconomics means that a country cannot achieve simultaneously perfect capital mobility, monetary policy autonomy and exchange rate stability. So, to avoid exchange rate appreciation and sustain an independent monetary policy, a country should give up full capital mobility
5. **fear of asset bubbles:** large inflows of foreign capital may feed unsustainable asset price bubbles
6. **fear of capital flight:** herding behaviour by international investors may expose a country to the risk of sharp reversals in capital flows in the event of a crisis.

Recent developments

The recent wave of capital inflows to emerging and developing countries has caused currencies to appreciate sharply. The Brazilian real, for example, has appreciated 38% against the US dollar since 2009. In response, an increasing number of emerging and developing countries have imposed or strengthened different forms of capital controls (Table 1 overleaf).

In 2010, Brazil increased tax on foreign investment in fixed-income bonds by 2%, while Thailand introduced a 15% tax on interest income and capital gains earned by foreign investors. In 2008, Colombia increased the unremunerated reserve requirements on portfolio inflows from 40% to 50%. Quantitative limits or minimum stay requirements have been deployed by Indonesia that limited short-term external borrowing to 30% of capital in 2010 and introduced a one-month minimum holding period for central bank money market certificates. Other countries such as Russia are considering the introduction of capital control measures to prevent further currency appreciation.

Do capital controls work?

After decades of criticism, capital controls have regained legitimacy. The International Monetary Fund recognises them as a 'legitimate part of the toolkit to manage capital inflows' but only as temporary measures and under specific circumstances: the economy should be running near its potential, the level of reserves should be adequate, and the exchange rate should not be undervalued (Ostry et al., 2010). But do they work? Governments considering capital controls should learn from past experience and recognise the following issues.

Time horizon: empirical evidence shows that the effectiveness of capital controls tends to diminish over time, with markets likely to outsmart any type of control in the long-run (Carvalho and Garcia, 2008). So governments should resort to capital control measures only temporarily.

Tool selection: the type of capital controls

Table 1: Capital control measures in emerging and developing countries, 2008-2010

Country	Tax measures	Quantitative limits	Time requirements	Unremunerated reserve requirements
Argentina			√	√
Brazil	√			√
China		√		
Colombia			√	√
India		√		√
Indonesia		√	√	
Peru	√	√		√
South Korea	√	√		
Taiwan		√		
Thailand	√			
Turkey				√

Source: Author's elaborations on different sources.

matters. Governments should select capital controls according to what they really intend to achieve. While capital controls may be more effective in changing the composition and maturity structure of inflows (rather than reducing their volume), evidence suggests that tax measures work better in easing the amount of inflows, compared to, for example, unremunerated reserve requirements.

Governments should also ensure that the chosen type of capital controls is flexible enough to adapt to sudden changes in investor sentiment, as seen in North Africa where the fall of regimes has spooked investors, causing a contraction of net capital inflows to emerging markets. Tax reducing measures, for example, might be easier to adjust when necessary than other forms of capital controls.

Multilateral repercussions: in a globalised world, decisions taken at the individual country level are likely to have a global impact. So, when deciding to impose capital controls, governments should remember that this could prompt other countries to follow suit, undermining the current global recovery and exacerbating global imbalances.

Coordination is the answer

Under certain conditions, capital control measures may be a legitimate and effective tool for developing and emerging economies to avoid the drawbacks linked to sudden and massive surges in capital inflows. However, in the current global climate, countries should understand that acting solely in their own self-interest is no longer a viable and sustainable solution. Coordination between developed and developing countries is the only way forward.

So far, the G-20 has failed to reach consensus on coordinated capital controls. However, at the latest G-20 Summit in Paris, there was agreement on a number of indicators to measure global imbalances. While not enough, this is a step in the right direction and I hope that further progress towards greater global coordination will follow.

A Capital Controls Charter for the G-20 might focus on:

- improving financial regulation to discourage 'carry trade' practices in developed countries
- providing trade agreements with enough flexibility to allow the use of adequate, temporary and coordinated capital control measures to prevent or mitigate crises
- encouraging emerging and developing economies to adopt agreed coordinated restrictions on capital flows to avoid indiscriminate actions that would simply redirect flows to other countries
- ensuring that capital control measures are well designed, last just long enough to counter surges in capital flows and can be withdrawn quickly when they are no longer needed
- promoting cooperation at the jurisdictional level between developed, emerging and developing countries to avoid the circumvention of capital controls.

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Endnotes and references

1 The practice of borrowing at low interest rates in one country and using the borrowed funds to buy assets offering higher yields in another country.

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