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Capital

Just in case

Capital controls are back as part of many countries' financial armoury

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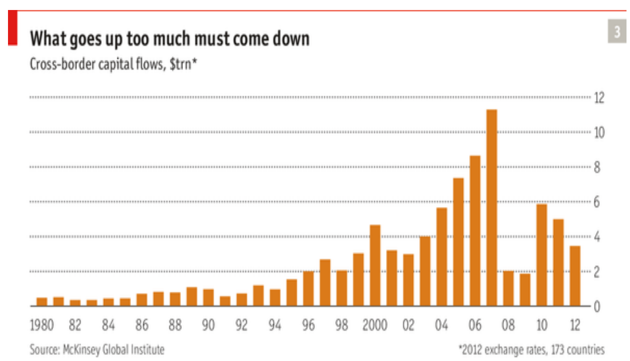

IT WAS AS if the Vatican had given its blessing to birth control. The International Monetary Fund, which has long been the ideological guardian of borders open to capital, declared last November that under certain circumstances capital controls were a good thing.

The IMF's conversion reflected some rethinking within the organisation, but it was also an acknowledgment of what member countries were doing anyway. In 2008 Iceland became the first industrial country in decades to impose capital controls, to limit a flight of capital from its busted banks. Between 2009 and 2011 Brazil, South Korea, Thailand, Indonesia, among others, introduced controls to discourage inflows of hot money that they feared would drive their currencies to uncompetitive levels. And within the past few months India has reimposed controls to slow an exodus of capital. These moves have reversed a decades-long trend towards greater openness to foreign capital and made the intellectual climate more hostile to it.

"Capital controls" is a loosely defined term. In the post-war period such controls usually took the form of outright prohibition or quotas on the amount of money that could be moved in or out of a country. Some countries, notably China, still employ such controls, and others have reimposed them to deal with the aftermath of crisis, among them Iceland and Cyprus. But those post-crisis controls are explicitly temporary, and even China has taken some important steps towards relaxing controls in recent years, for example by making the renminbi more easily convertible. The sort of controls now in favour are lighter-touch, market-based ones such as taxes on certain types of flows, changes to withholding taxes and differential reserve and liquidity requirements for foreign funds. They amount to a selective embrace of globalisation, not a rejection.

A qualified welcome

No country exemplifies this better than Brazil. In 2008, as the first waves of the crisis washed over it, the Brazilian central bank lowered bank reserve requirements to ease credit and offered foreign-exchange swaps to Brazilian companies trying to roll over foreign-currency debt. In late 2009, as Brazil raced out of recession and money began to pour in, the authorities switched direction, initially imposing a financial-transactions tax of 2% on foreign purchases of stocks and bonds. In 2010 the tax was broadened and raised to 6%.

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Brazil's central bank has made it clear that foreign investment is still welcome. The goal, says Mr Pereira, the deputy governor, was to smooth exchange-rate fluctuations and make his country's banks less vulnerable to a sudden outflow of capital. The measures were not intended as a substitute for monetary and fiscal policy.

The Brazilian government put it rather differently. Guido Mantega, the finance minister, spoke of the need to act on the exchange rate and help Brazilian industry survive what he called "currency wars" triggered by easy American monetary policy. Brazilian industry had pushed for the controls, complaining about the high exchange rate.

This summer capital abruptly started to pour out of Brazil. As Brazil's currency, the real, plummeted, the country suspended its financial-transactions tax, then intervened in foreign-exchange markets and again offered swaps to Brazilian companies in need of dollars. Officials argue that the reversal would have been far worse had capital controls not tempered the inflows in the first place. "We knew this was going to come, and we prepared ourselves," says Mr Pereira.

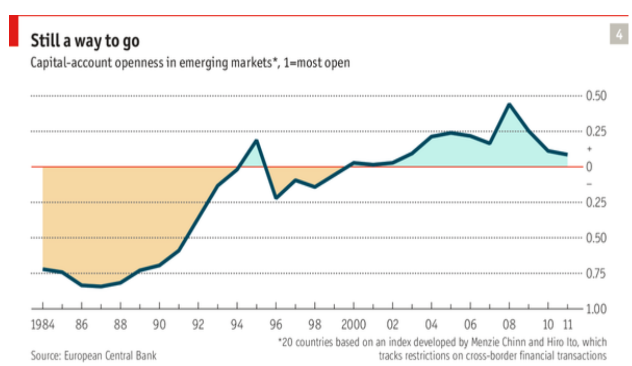
The consensus in favour of capital mobility has always been less clear-cut than that in favour of free trade, for two main reasons. First, capital flows can push a currency far above its intrinsic value, widening the trade deficit and hollowing out domestic manufacturing. Second, they can fuel borrowing booms, especially in countries with underdeveloped financial systems, leading to devastating busts when the money flows out. Hence the IMF's original charter prohibited controls on cross-border trade, interest payments and profits but allowed them on capital.

Right move, wrong time

But over time a different argument emerged: that removing capital controls would speed up the flow of badly needed funds to savings-poor, opportunity-rich countries, deepen their financial sectors, encourage a more efficient allocation of credit and reduce dependence on the IMF. On this view, the way to discourage hot-money inflows was to cut government borrowing rather than maintain capital controls. In September 1997 the IMF formally proposed amending its charter to promote capital-account liberalisation, calling it "an essential element of an efficient international monetary system in this age of globalisation".

The timing was dreadful. The Asian financial crisis had just begun, and opinion soon started to shift against wide-open capital markets. Michael Klein of Tufts University has shown that the use of capital controls began to rise a few years later. From 2008 it became widespread, propelled by the financial crisis and then by quantitative easing (QE), the practice of buying bonds with newly created money. Rich countries, desperate to rekindle growth, made their monetary policy ever more expansive. In 2010, when the Fed started its second round of QE, inflows into emerging-market bonds surged and their currencies climbed. Last summer, when emerging markets had started to slow, the Fed hinted that QE would stop—and money flowed in the opposite direction. In September, when the Fed failed to stop, flows promptly changed direction again.

QE has thus helped to make capital controls intellectually respectable again. In a paper presented at the Kansas City Fed's Jackson Hole conference in August, Hélène Rey of the London Business School argues that the volume and volatility of capital flows rules out an independent monetary policy, even with a flexible exchange rate, in the absence of capital controls. The IMF has not gone that far, but has laid out conditions in which such controls would be appropriate.



Even so, nobody is seriously suggesting a return to the more draconian prohibitions on capital movements of the 1950s and 1960s. Eswar Prasad of the Brookings Institution, a think-tank, notes that both China and India have steadily liberalised their capital account in recent decades, but neither seems to want to go as far as America towards unfettered markets. Joseph Yam, a former head of the Hong Kong Monetary Authority, argued in 2011 that China may want "full" but not "free" convertibility. "Full convertibility does not necessarily and should not mean total freedom to convert without, for example, the need to seek approval from any authority or to report."

Essentially, he suggested that China would relax its capital controls but retain the option of reimposing them as needed—the very essence of gated globalisation. Other countries have already adopted this approach. Brazil turned to the financial-transactions tax to slow capital inflows because it already had it in reserve, where it remains, though the rate has since dropped to zero.

Such off-on controls do not always work as intended. India responded to the recent fall in the rupee by resurrecting a grab-bag of controls, including a cut in the amount of money residents can take out of the country without special approval from $200,000 to $75,000 a year; a reduction in the foreign acquisitions a domestic company can make, from 400% to 100% of its net worth; and higher import taxes on gold, silver and flat-panel televisions. A government official was reported as insisting that these were not capital controls, but that “non-essential outflows have been moved from the automatic route to the approval route.” Foreigners were not convinced, and the rupee plunged even farther. India is not about to undo two decades of liberalisation, but wants to retain the option to intervene, just as China does.

Do controls work? Countries that have them certainly seem to think so. A study by Brazil’s central bank claims its measures slowed down excessive growth in certain types of credit such as car loans; forced foreign-currency borrowers to lengthen their terms, leaving them less vulnerable to the fickleness of short-term lenders; and reduced banks’ derivatives exposure. A study by Valentina Bruno of American University in Washington and Hyun Song Shin, a Princeton professor who advised South Korea on its capital controls (mainly in the form of a tax on certain foreign-currency deposits), says they made the country “less sensitive to global factors”. Many investors agree. “They do exactly what they are intended to do: put sand in the market,” says Mohamed El-Erian, chief executive of PIMCO, the world’s largest bond-fund manager. “We think twice, or three times.”

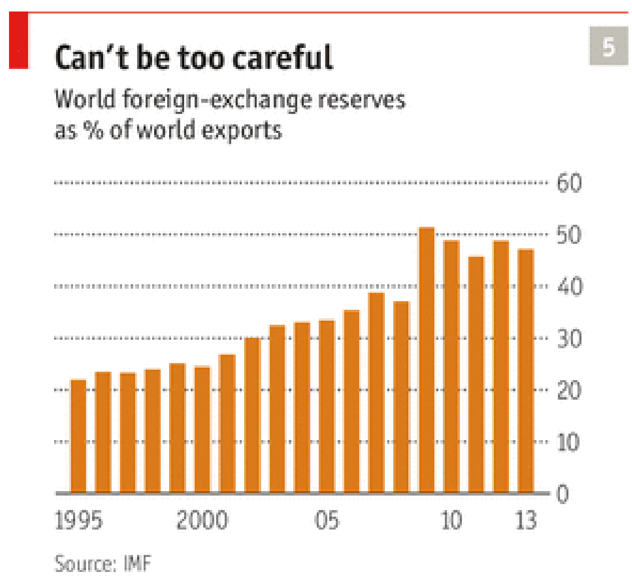
Others are more sceptical. Mr Klein notes that after Brazil and South Korea imposed controls, their currencies continued to rise at about the same rate as that of Chile, which did not. The IMF has mixed feelings. It acknowledges that the jury is out on whether controls reduce inflows or exchange-rate appreciation, but reckons that they may strengthen a financial system by shifting more of the inflows into direct investment. In its most recent World Economic Outlook, it found that the current accounts of Chile, the Czech Republic and Malaysia held up fairly well to capital inflows not because of controls but because of better fiscal and monetary policy and more investment abroad.

Leaving aside their macroeconomic consequences, such controls do have serious microeconomic effects. They are administratively burdensome, requiring the government to discriminate between different types of credit, encouraging evasion, lobbying and rent-seeking.

Much of the recent enthusiasm for controls is based on Chile's experience in 1991-2001, when foreigners had to leave part of their investment on deposit with the central bank where it earned no interest. But research by Kristin Forbes of MIT found that those controls in Chile made it harder for small companies to raise funds. Companies also responded by delaying tax payments, borrowing from suppliers and sometimes disguising loans as direct investment, giving rise to a cat-and-mouse game with officials. Brazil's ban on currency outflows in the 1980s created a black market in hard currency and "a culture of transgression", says Arminio Fraga, a former chief of the country's central bank and now an investment manager. He worries that even the milder controls in use recently could shift activity offshore and damage transparency and liquidity.

Do it yourself

The increased deployment of capital controls, despite their disadvantages, is in part a response to a broader problem: the gaping absence of global monetary co-operation. This has been causing concern at least since the collapse of the Bretton Woods system in the early 1970s, but the worries have increased in recent years. Another part of the response has been more intervention in foreign-exchange markets. This first surfaced in the late 1990s when Asian countries, led by China, used intervention to hold down their currencies, both to promote exports and to "self-insure" against future financial crises. Since 2000 the global volume of reserves has risen from $2 trillion to $11 trillion and from 25% to 49% of annual exports (see chart 5).



Foreign-exchange intervention is a zero-sum game. A country that keeps down its currency can improve its trade balance only by making someone else's worse. For many poor countries, holding bucketloads of low-yielding foreign government bonds is a bad investment. By artificially depressing interest rates in the recipient country, it also encourages excessive borrowing and bubbles there. The IMF sought to discourage sovereign self-insurance in 2009 by offering "flexible credit lines", loans on easy terms and with few conditions attached to countries with responsible macroeconomic policies. But only Poland, Mexico and Colombia took up such loans. Others, including South Korea, have painful memories of the punitive interest rates and forced restructuring of banks and industrial companies imposed during the East Asian crisis. Many countries in need of dollars went not to the IMF but to America's Federal Reserve, which opened massive swap lines with hardly any conditions.

Recent events have only reinforced the perceived benefits of self-insurance. The crisis, says Mr Prasad, was “a game-changer: every emerging-market central bank now sees more reserves as a good thing.” The IMF sought to boost its lending power with a quota increase, but that has been blocked by Republicans in America’s Congress who regard giving the IMF more resources as an invitation to more bailouts. Even the Fed’s use of swap lines has been attacked as a gift to foreign banks. It is no surprise, then, that individual countries put less faith in multilateral institutions and more in their own resources.

A similar rejection of multilateralism is under way in world trade, as the next article (http://www.economist.com/news/special-report/21587380-multilateral-trade-pacts-are-increasingly-giving-way-regional-ones-my-backyard) will show.

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