THE ASIAN CENTURY

The Siren Song of Capital Controls

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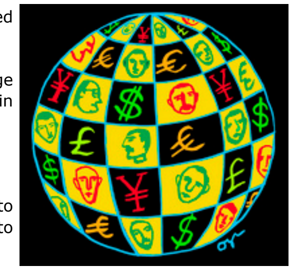

ITHACA, NEW YORK – Capital controls are back in vogue. Facing sharp currency appreciation and fearing asset-price booms fueled by hot money, countries such as Indonesia, Korea, and Taiwan have recently taken steps to limit inflows.

Nervous central bankers in many other emerging markets, including India, facing pressures from exporters hurt by rising exchange rates, are contemplating broader controls on capital inflows as well. Earlier this year, the International Monetary Fund came out in favor of capital controls.

So, does the new fascination with capital controls hold up to scrutiny?

Capital controls remain a bad idea – an idea that is far more seductive in theory than in practice. Moreover, there is good reason to see inflows into emerging markets as an opportunity to strengthen domestic capital markets, rather than primarily as a threat to financial stability.

Unrestricted capital flows could indeed spell disaster for an economy that has dysfunctional financial markets, high levels of corruption, and weak monetary and fiscal policies. So it might seem reasonable that emerging markets halt or even reverse the progress they have made on liberalizing capital flows in order to get their houses in order first.

But re-imposing capital controls is simply not a fruitful option. When the incentives for money to flow across borders are strong, it will find a way, abetted by the proliferation of firms with operations in multiple countries and the expansion of international trade –which serves as a conduit for masking capital flows and evading controls.

Even in a tightly managed economy like China, massive capital inflows have been able to find their way around controls over the last decade. Moreover, establishing controls on one type of inflow simply leads to its being disguised in other forms.

Capital controls have real costs, even if they fail to stanch inflows. They create a layer of protection from competition for those who are better connected, politically or economically, or have the sheer heft to get around the restrictions. This puts medium-sized firms – the main engines of job creation – at a big disadvantage.

Imposing controls also spawns uncertainty about a country's policies. The stock-market collapse in Thailand in December 2006, following the imposition of a modest tax on equity inflows, is one example of what can happen. More generally, the cat-and-mouse games that ensue as the authorities try to stay one step ahead of investors' efforts to evade controls benefit neither stability nor growth.

Emerging markets should cope with inflows by finding ways to use foreign capital more effectively, which involves strengthening domestic financial markets. For example, in India, there is a great need for financing large infrastructure projects – a need that cannot easily be met by local banks. Freeing up corporate-bond markets would help foreign investors contribute to the development of the country's infrastructure while earning a good return as India's productive potential increases.

A complementary approach is to liberalize capital outflows further, in order to offset inflows. This would give domestic households and firms more avenues to invest abroad and diversify their portfolios. Indeed, China has done this by expanding its qualified domestic institutional investor program to allow more investment abroad.

None of this is to say that the risks of foreign-capital flows have evaporated, and that emerging markets should throw open their capital accounts all at once. There are still huge inefficiencies in international financial markets, which remain beset by herding behavior and other pathologies.

Mantras about good fiscal and monetary policies may give little solace to a central banker or finance minister desperate to stave off surging inflows and domestic pressure to block currency appreciation. But knee-jerk reaction to stifle the exchange-rate appreciation that should follow from strong productivity growth only stokes more inflows. Ultimately, it is indeed good policies and stronger financial markets and other institutions that will help stabilize and manage inflows.

As tempting as they are, quick fixes like capital controls merely provide a false sense of security and delay needed adjustments in an economy. The harsh reality is that emerging-market policymakers have little choice but to manage actively the process of liberalization in order to improve the cost-benefit tradeoff, rather than to try fighting against the inevitable.

The latter course risks the worst of all worlds – all of the costs of capital controls and all of the domestic policy complications from volatile capital flows, but few of the potential benefits of foreign capital.

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