Gene Frieda - Capital Controls in Crisis Prevention

Countries need to feel secure in indebting themselves. Capital controls tend to materialize when countries start to become insecure about this process. The tendency has been for controls to come as a function of an accelerated size and speed of capital inflows, or in periods when past inflows threaten to reverse course in sudden, sharp fashion. My plan today is to talk to you briefly about why capital controls increasingly make sense, but also why they are increasingly doomed to failure.

In December, Thailand announced a 30% non-interest bearing reserve requirement on all portfolio inflows held under one year. The measure was a surprise to the market, particularly because Thailand had not been a major recipient of foreign capital to its debt market and because inflows to the equity market have generally been encouraged as a form of longer-term investment.

Thailand's main "stated" concern related to excessive exchange rate appreciation and its potential adverse impact on exporters, but I can make a strong argument as to why the measures were more a result of the interim government's efforts to bolster its legitimacy with key domestic political constituencies. In this sense, I would not hold Thailand up as an example of where the world is headed, either in terms of military coups or with capital controls! And just because Thailand botched its controls doesn't mean that controls are a bad idea.

21st Century Trilemma - A country cannot have have it all: free capital mobility, a fixed exchange rate and a monetary policy oriented toward domestic needs. This is the famous trilemma. The move in the late 1990s toward floating exchange rates was a necessary choice for countries seeking to tap into the strong growth in global capital flows. Monetary policy was accordingly left for use as a tool to achieve internal balance, while exchange rates were left to adjust as required to achieve some semblance of external balance.

As the growth cycle in capital inflows has extended, countries have begun to show discomfort with the extent of the resulting appreciation pressure on currencies. This was less of a problem between 2002 and 2005 when many emerging market exchange rates were still considered undervalued and output gaps were negative in many countries. Loose monetary policies were appropriate.

But more and more governments are becoming uncomfortable with the idea of further exchange rate appreciation, fearing that the factors generating strong capital inflows may not last. Commodity- exporting countries fear that high export prices are masking an underlying loss of competitiveness. At the same time, the strength of the global growth cycle and the perceived closure of output gaps across much of the Emerging World leave less scope for central banks to run loose monetary policies.

Examples abound across every major region of the emerging world, and there seems to be a lack of consensus on what countries should be doing in response. I'll elaborate on this point at the end, but for now, let me provide a quick run through what the objectives of controls on capital controls should be, the practical considerations in choosing whether controls will achieve those objectives, and finally – perhaps more controversially – whether countries should increasingly consider imposing a *de jure* capital control regime that is *de facto* non-binding.

The policy objectives behind a decision to impose restrictions on capital inflows are relatively straight forward:

- To increase monetary policy effectiveness (by putting a wedge between domestic and foreign interest rates)

- To reduce fx volatility and to mitigate REER appreciation; and

- To prevent crisis by altering composition of capital inflows or slowing inflows, on the basis that some capital inflows can be welfare-reducing, especially when driven by speculation and/or implicit guarantees on banks' external liabilities.

There are variations on the theme, but there are two main options for control regimes: price and quantity

- Taxes and unremunerated reserve requirements (URRs) increase the price of undertaking a given investment and leave it to the market participant to decide whether the transaction is still worthwhile. Examples include Chile and Colombia, which imposed URRs on short-term capital inflows in the 1990s; the Czech Republic, which levied a 0.25% tax on FX transactions with banks in 1995; and Brazil, which increased taxes on external debt issuance by Brazilian corporates and on foreign purchases of domestic fixed income investments in the mid-1990s.

- Quantitative controls have become rarer, but just because their stock is low now doesn't mean they aren't on the verge of making a popular comeback. The main aversion to quantitative restrictions is that they tend to rely on an administrative approval process that is vulnerable to corruption and subjective decision-making. Even if the official is corrupt, how does the official know for sure that the importance of the transaction in question is being exaggerated or not? Such control regimes are formally still in place in many countries, despite being used infrequently.

3. Macroeconomic policy considerations amount to a list of first best practices for countries trying to balance competing internal and external balance objectives in a world of large, fluid capital flows. These also serve as a laundry list of considerations for countries seeking to liberalize their capital accounts.

Exchange rates need to be allowed greater flexibility. Flexible exchange rates discourage speculative (especially interest rate driven) borrowing and serve as an automatic adjustment mechanism for external shocks. These benefits are now widely accepted to outweigh the negatives associated with volatility and potential uncertainty. Central banks are encouraged to establish intervention rules for leaning against the wind, while countries also need to accept that some currency appreciation is likely to be needed in the face of strong capital inflows (unless large imbalances already exist.

Monetary policy needs to coordinate interest rate decisions with assessments of overall financial conditions, including the fiscal stance, and the inflation target. All else equal, exchange rate appreciation should allow greater scope for interest rate cuts. FX intervention should be sterilized where necessary in order to ensure consistency with inflation objectives.

Needless to say, the stance of **fiscal policy** often complicates life for central bankers. While the key maxim – don't loosen, and indeed consider tightening, fiscal policy – is broadly accepted, fiscal policy generally fails to adjust quickly or sufficiently to ease the task of the central bank. All else equal, pressure on monetary policy and the exchange rate will be greater, the less the government does to offset the demand stimulus from strong capital inflows.

4. With these first-best macro policies in mind, it's worth going through some practical considerations on what countries should consider in deciding to impose capital controls, and how countries seeking to liberalize their capital account should go about sequencing.

Controls need to target specific inflows that put pressure on the currency in a way that is not reflective of fundamentals. In practice, identifying and targeting specific inflows is increasingly difficult as the boundaries between types of investments blur. Should educational endowment or pension fund money invested in a hedge fund be targeted?

Is private equity investment a direct investment, a portfolio equity investment or a debt liability?

Is the problem due to locals or foreigners? In most cases, foreigners tend to get the blame for excessive capital inflows, but in many of the past currency crises and indeed within Central and Eastern Europe presently, the culprits look more like overborrowing locals than foreigners.

Which forms of capital controls are preferable? This choice will depend in large part on whether the country has the administrative capacity to operate capital controls, even where they are market friendly? Taxes are easier to administer than URRs and can also be refunded on exports through VAT system and/or on income receipts through income tax system.

The size of the tax required to achieve a given operational objective is difficult to gauge ex ante and ex post. Moreover, it is important to recognize the limits on how much freedom can be bought with capital controls. If, for example, a tax wedge created by capital controls buys a country some "monetary freedom", which it then uses, then to the extent that this freedom is exploited, the country again returns to the trilemma: an inability, beyond the marginal change gained through the restrictions, to control both the exchange rate and domestic monetary policy while capital is still relatively (albeit now a bit less) mobile.

Are administrative controls still preferable in times of crisis? It is not clear that Malaysia's 1998 controls on outflows did great good, but nor is it clear that they did significant harm. But if imposed, the response would arguably need to be coordinated across countries (to limit contagion). This is the main policy concern.

Should controls be considered during periods of transitional regimes? The case of various EMU aspirants presents an interesting case. Under EMU rules, accession countries seeking to enter the Eurozone must stay in relative narrow exchange rate bands for a period of 2 years before adopting the Euro, without "excessive" intervention to keep the currency in those bands. Is it realistic to subject small open economies to these rules, or should there be some consideration as to the countries' own abilities to manage strong capital inflows in the run-up to entry?

Controls have a tendency to erode over time. Chile had to repeatedly revise controls; China still saw a surge in capital inflows despite strict control regime. This highlights the need for constant reconsideration of the control regime and, indeed, the challenge of doing more good than harm in imposing the control in the first place. The last thing a government will want to do is to create extreme regulatory uncertainty that spills over to other kinds of flows.

One form of quantitative control that has received new interest in policy circles is the creation of **parallel exchange rate markets** for certain types of flows**.** Such systems are anathema to the IMF and impractical from an administrative point of view. The rationale is that for countries suffering a surge in capital inflows, segmenting longer-term flows, such as pension and mutual fund flows, would result in a premium to the main FX market, based on the relative size of inflows and outflows, potentially discouraging excessive capital inflows. Knowing that in periods of panic, the parallel market could go into discount would also be a deterrent. But this option goes down the murky path of administrative fiat as to what types of flows are good and what quantity of flows is too much.

In a similar vein lie regimes that allow for controls to be imposed, but which are normally left unused. An example is Brazil's parallel exchange rate regime for commercial and financial flows. For years, the authorities did not utilize this parallel

regime to segment markets in a way that sought to achieve specific policy objectives. It is arguable that such a regime is useless unless used, and my own recollection is that fear of imposition tended to arise in times of capital outflows rather than in periods of capital account strength. Nonetheless, there should be some consideration of whether control regimes – present but unutilized – serve any use as a deterrent to speculative inflows. Personally, I rather doubt it.

Finally, **how fast should controls be eased in countries that are liberalizing capital accounts**?

a. Gradually rather than rapidly

b. After achieving macroeconomic stability (inflation/bank stability/BOP)

c. Liberalize inflows before outflows

d. Liberalize FDI first, then trade credit, portfolio equity, and finally long-term loans/bonds

e. Liberalize short-term loans last as welfare gains less obvious

Conclusion - I've skirted around numerous issues in this brief discussion of what countries should consider in whether and how to impose capital controls during periods of excessive inflows. To sum up, sequencing capital account liberalisation and reimposing selective capital controls depends on macroeconomic policy limitations, administrative capabilities, and vulnerability of the economy (and especially the banking sector) to shocks. Liberalized capital flows and globalisation require more flexible economies, especially as capital controls become less effective due to an explosion in derivative products and more innovative ways to skirt controls.

At this stage in the cycle, most sovereigns appear at low risk: floating exchange rates, larger FX reserve cushions, declining public external debt and an increasing ability to borrow in domestic currency.

Contingent liabilities are a bigger question mark and relate directly to the corporate sector and banks, which are at greater risk after a traditional borrowing binge. Private sector external borrowing has risen significantly. Declining volatility, which is partly cyclical, may be perceived as structural and as such leverage in foreign currency may have risen beyond levels that are prudent. But the lack of EMG current account deficits and floating exchange rate regimes – even where they've been relatively stable – are important mitigating forces.

The rationale for selective capital controls seems to have grown stronger with the unprecedented growth in capital flows globally. But at the same time, financial innovation has been intimately linked to rising capital mobility. The borders between types of investments and the welfare benefits offered to specific economic agents and to the economy as a whole have become increasingly blurred. As a result, while the rationale for selective controls is arguably stronger than it has been in decades, the administrative ability to impose controls on specific types of inflows has grown increasingly difficult.

Thailand is the most recent example of misprescribed medicine that threatens to kill the patient, but we must be just as careful to avoid controls that cannot be reasonably well enforced. Unenforceable controls may even be worse if they lead policymakers to believe they can achieve the infeasible.