International Capital Flows: Discussion

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The debate on a "new financial architecture," evoked by the East Asian crisis and subsequent troubles in Russia and Brazil, includes renewed policy discussions on the merits and demerits of capital controls to reduce the vulnerability of countries to speculation and currency crises. The debate includes issues such as whether improved regulation, supervision, and disclosure might make such controls redundant. And one wonders what can be learned from previous experiences with capital controls. This is a field in which Sebastian Edwards is an acknowledged expert, as a result of his research on the Latin American experience with such controls. His present paper is a new and valuable contribution on this subject.

The paper starts out by describing the consensus on the optimal sequence in liberalizing an economy. The relaxation of capital controls should only be implemented after major fiscal and monetary imbalances have been addressed, trade has been liberalized, labor regulations have been sufficiently eased, and a sound regulatory and supervisory framework for the domestic banking sector has been put in place. As has been noted by many observers, this order was neglected by a number of emerging economies. Looking back, it is clear that, at the time, the multilateral organizations and the international financial community failed to recognize the full significance of this error.

When it comes to the capital account, the International Monetary Fund's view is that we need to push ahead with capital flow liberalization, but in an orderly manner. The very short-term capital flows should

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be liberalized last.[1] In a recent speech,[2] IMF managing director Michel Camdessus argued that the momentum should now be reestablished to incorporate the liberalization of capital movements as one of the purposes of the IMF and to extend the Fund's jurisdiction by introducing carefully defined and consistently applied obligations in this field. Camdessus also indicated that the IMF, unlike many investors, had not condemned capital controls such as those introduced by Malaysia, but had only reminded Malaysia that such controls have an international cost.[3] He referred to and apparently agreed with an emerging consensus that controls may have a place when there is a risk of crisis, but only to allow a breathing space for other fundamental measures to take effect. In addition, the consensus seems to be that controls are more effective on inflows than on outflows and that they work best when they are price-based and temporary.[4]

The ever-quoted example of restrictions on capital inflows is Chile. The paper by Edwards, while carrying a very general title, focuses precisely on this subject, that is, the experience of Chile with restrictions on capital inflows during two periods: 1978–82 and 1991–98. These controls included, with some variation in the details, the following measures:

- Unremunerated reserve requirements (URRs) for foreigners wishing to move funds into Chile; these URRs represented a tax on capital inflows which discouraged short-term inflows in particular;
- Additional restrictions in the late 1970s on the amount of foreign funds that domestic banks could intermediate (lifted again in 1979/80); and
- An initial ban on all inflows with maturities below 24 months; in the 1990s, inward foreign direct investment was subject to a minimum stay of one year (three years in the first instance).

The purpose was to enable the central bank to keep domestic interest rates high (in its fight against inflation) without simultaneous capital inflows and currency appreciation, and, second, to limit the country's vulnerability to external fluctuations. The latter has also been called a

[1] As indicated by Michel Camdessus in the *Financial Times* of 9 February 1998, quoted by Edwards.

[2] "Governments and Economic Development in a Globalized World," speech by Camdessus at a meeting of the Pacific Basin Economic Council in Hong Kong. 17 May 1999.

[3] Quoted in the *International Herald Tribune* of 18 May 1999.

[4] Amending the rules of the game might also include other changes such as the old idea of a Tobin tax on all foreign exchange transactions and the new proposal by Buiter to introduce a Universal Debt Rollover Option with a Penalty (UDROP) in all foreign currency debt instruments. Both would seem to be sympathetic in their purpose but difficult to implement. However, these ideas lie outside the scope of Edwards's paper and this comment.

prudential objective, with macroeconomic as well as microeconomic aspects (limiting banks' and companies' short-term debt will reduce their vulnerability to changes in market sentiment).

Most studies of Chile's capital controls express a fair degree of skepticism as to their effectiveness.[5] The success of Chile in reducing inflation and achieving sustained economic growth is generally ascribed to its improved macroeconomic policies, gradual currency appreciation, and sound prudent supervision, rather than to its capital controls. Edwards himself is among the most outspoken critics of these controls. His paper proffers the following conclusions:

1. Capital controls discouraging short-term inflows did have an effect on the maturity distribution in favor of long-term external debt.
2. However, they were not very effective in limiting overall capital inflows, particularly once the foreign funding restrictions on domestic banks were lifted. Long-term inflows then fully compensated for the reduction in shorter-term flows.
3. The impact of these capital restrictions on the real exchange rate was very limited and short-lived.
4. Likewise, they affected neither the level of interest rates nor their dynamic behavior (that is, their deviations from equilibrium levels). In other words, these restrictions did not increase the authorities' control over monetary policy.
5. Chile's experience also suggests that capital controls may give a false sense of security, encouraging complacent and careless behavior by both policymakers[6] and market participants—something that was seen again in recent developments in Korea.[7]
6. All in all, capital controls are not a very effective solution. The true solution is to pursue sound macroeconomic policies, to avoid overly rigid exchange rates, and to implement banking supervisory systems that reduce moral hazard and corruption.

I tend to agree with most of Edwards's analyses and conclusions. I would, however, like to make a few qualifying remarks. First, the one mild conclusion that Chile's measures did have an effect on the maturity

[5] See, for example, Laurens and Cardoso (1998) and Nadal and Sorsa (1999).

[6] Edwards notes that Chile also temporarily believed that its massive increase in private sector debt in the early 1980s was only a private problem and did not represent a threat for the country as a whole. This distinction between public and private debt was highly artificial, as in 1983 the Chilean government ended up bailing out a large proportion of private 'non-guaranteed' debt.

[7] Edwards refers to a misjudgment on the part of Goldman Sachs, which argued during most of 1997 that the bad ratings for Korean banks and central bank were not relevant to that country's vulnerability index, because of its relatively closed capital account.

distribution of external debt is not undisputed. Other authors[8] have indicated only a short-lived effect and have, in addition, pointed to important methodological and data-related problems (official data exclude trade credits; all studies exclude portfolio capital from short-term flows) and possible misreporting (reporting short-term inflows as long-term investment inflows, or portfolio investment as foreign direct investment).

Second, the finding that Chile's controls had no discernible impact on its real exchange rate seems to be widely shared, but some authors do report a modest impact on its domestic interest rate.

Third, some observers have in the past concluded that Chile has been relatively successful, at least initially, in reducing overall capital inflows. Others, including Edwards, find that such an effect was, at best, very temporary and that long-term capital inflows tended to fully compensate for the reduction in short-term inflows. This may in part have been due to a market perception that such restrictions on short-term inflows help to reduce the country's risk of "bank runs."[9] At the same time, however, the compensation by long-term capital inflows will have been precisely the reason why Chile's limited capital controls were not very effective as a means of keeping its real exchange rates low and enabling the central bank to conduct an independent monetary policy. A genuinely independent monetary policy and stable real exchange rates may well be possible only with very extensive restrictions on short- *and long*-term in- *and out*flows of capital, such as in China and India. The drawbacks of such restrictions are also well-known:

- They keep countries from reaping the fruits of free capital flows, that is, a better allocation of savings and higher economic growth; they may even, intentionally or not, serve as barriers to trade;
- They require large and costly enforcement efforts (bureaucracy), lead to corruption, and tend to be progressively evaded;
- They have a tendency to perpetuate themselves and postpone the necessary improvements in macroeconomic policies,[10] the regulatory and supervisory systems in the financial sector, and the often excessive government interference in the corporate sector;
- The introduction of restrictions on capital outflows tends to

[8] See Laurens and Cardoso (1998) and Nadal and Sorsa (1999).

[9] See Cordella (1998). Cordella even concludes that the ineffectiveness of short-term capital controls in reducing total capital inflows may corroborate the view that these controls are effective in reducing vulnerability to financial crisis—a conclusion that would seem to be one bridge too far.

[10] Capital controls were often aimed at enabling monetary policy to exploit a possible trade-off between inflation and unemployment. This function has lost its value now that monetary policies, at least in OECD countries, have converged toward achieving long-term price stability and building up credibility to this end.

> discourage capital inflows and raise risk premiums on those inflows for years to come.

Given the drawbacks of such extensive capital restrictions on the one hand, and the renewed experience of the massive and disruptive impact of herd behavior and panics in the capital markets on the other, I think the reconsideration by the IMF of its stance on capital restrictions is well justified. The recent statements by Camdessus would seem to be correct: In emergency situations, capital controls may be advisable, provided they are of a very temporary nature and accompanied by observable and convincing improvements in domestic macroeconomic policies and regulatory and supervisory systems.

There is nothing new in this, however. I remember from my days at the Dutch central bank that monetary authorities are traditionally hesitant to completely relinquish the potential use of capital controls for emergency purposes. As a matter of fact, this possibility is still available in the OECD's Capital Code[11] as well as in the EC Treaty.[12] Both the OECD Code and the EC Treaty aim for complete freedom of capital movements, but they allow for initial but temporary reservations and for "derogations" or safeguard measures in exceptional circumstances, for a very limited period and subject to surveillance by the OECD and the EU Council, respectively.

In a similar way, it would seem advisable for the IMF to take on a role in the monitoring of progress in the field of capital liberalization. Timetables for each country might play a very useful role, as an aid to the introduction of the needed domestic reforms against vested interests at home and as a positive signal to the financial markets that should help to reduce risk premiums at an early stage.

A particularly interesting paragraph in Edwards's paper is the one in which he notes that, in spite of the capital controls, capital inflows surged again once the restrictions on borrowing in foreign currency by domestic banks were lifted (1979–80). This experience suggests that prudential regulations may have a stronger influence on capital inflows than general restrictions on short-term capital inflows. It also raises the question as to whether stricter prudential regulations may be preferable to capital controls. Such regulations should at least limit banks' foreign currency

[11] See the OECD Code of Liberalisation of Capital Movements, Article 7 on clauses of derogation and 11 through 17 on the procedure. This Code was adopted in 1961 and subsequently extended, notably in 1989 to cover all capital movements including short-term capital flows. See also Poret (1998).

[12] Treaty Establishing the European Community, Articles 56 through 60 and 114 (formerly: Articles 73b through 73g and 109c)

exposure. In addition, the net foreign debtor position of banks might be subject to a ceiling.[13]

Stricter prudential regulations may have the following advantages over capital controls:

- Cautious prudential regulation and supervision is generally endorsed, in contrast to restrictions on capital flows; it is also less visible;
- Evasion would seem to be more difficult in the case of prudential regulation.

On the other hand, "cronyism" and corruption may undermine prudential regulations as well as capital controls. Besides, disintermediation from the regulated domestic banking system may reduce the macroeconomic effectiveness of stricter prudential regulation. In particular, domestic companies may borrow heavily abroad, and changing moods among investors abroad and at home may still exert an influence. However, chances are that these risks would be much smaller than in the case of capital controls with poor prudential supervision. Interestingly, following their recent currency crises, Mexico and Korea reduced rather than increased their capital controls and came to rely more on prudential regulation and supervision.

The liberalization of financial services may make a useful contribution in this respect. Traditionally, emerging countries have been hesitant to open their markets to international banks, given the threat that this might present to local banks. However, the need of many emerging economies to boost the efficiency and improve the transparency and soundness of their domestic financial system might well be served by gradually allowing international banks to enter the domestic markets. The arrival of one or more foreign rivals usually speeds up improvements in the following way:

- The foreign banks will, as a rule, immediately introduce international standards in their own local banking units, whether they have been acquired or set up on the spot;
- This often serves as an example, which is then followed by local banks; and
- The diffusion process may well accelerate further if market unrest leads or threatens to lead to a "flight to quality" from local to foreign banks.

In conclusion, the gradual liberalization of capital movements still does seem advisable for emerging/developing countries, as long as the

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[13] The Dutch central bank, for instance, has for many years cherished the rule that domestic banks should have a net foreign creditor position of at least NLG 5 million.

optimal sequence that is now generally recognized is taken into account. The current efforts of the IMF staff to present country ratings on transparency and data disclosure will help the financial markets to better estimate the risks in international lending and investment, set the risk premiums accordingly, and avoid big swings in market sentiment. Adequate prudential regulation and supervision will go a long way toward preventing unjustifiably large capital inflows that might temporarily lead to impressive but unsustainable growth rates. Gradualism in lifting capital controls will further help to contain such inflows, and the possibility of invoking temporary controls in emergency situations should be preserved. But in the interests of preventing mismanagement and enhancing prosperity worldwide, the adoption of capital liberalization as an IMF objective, timetables for further liberalization country by country, and surveillance by the IMF of the liberalization progress and of the timely lifting of emergency controls would seem most advisable.

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