Rethinking Controls

BY BARRY EICHENGREEN

Economists are taught – and taught and taught – to appreciate the virtues of free markets. But they are also trained to be alert to circumstances in which markets, left to their own devices, produce less-than-optimal results. Sorting out the cases in which markets fail to generate efficient use of productive resources and justify government intervention can be tricky, though. And, as China's ongoing financial convulsions should remind us, few examples can be trickier to assess than international markets for capital.

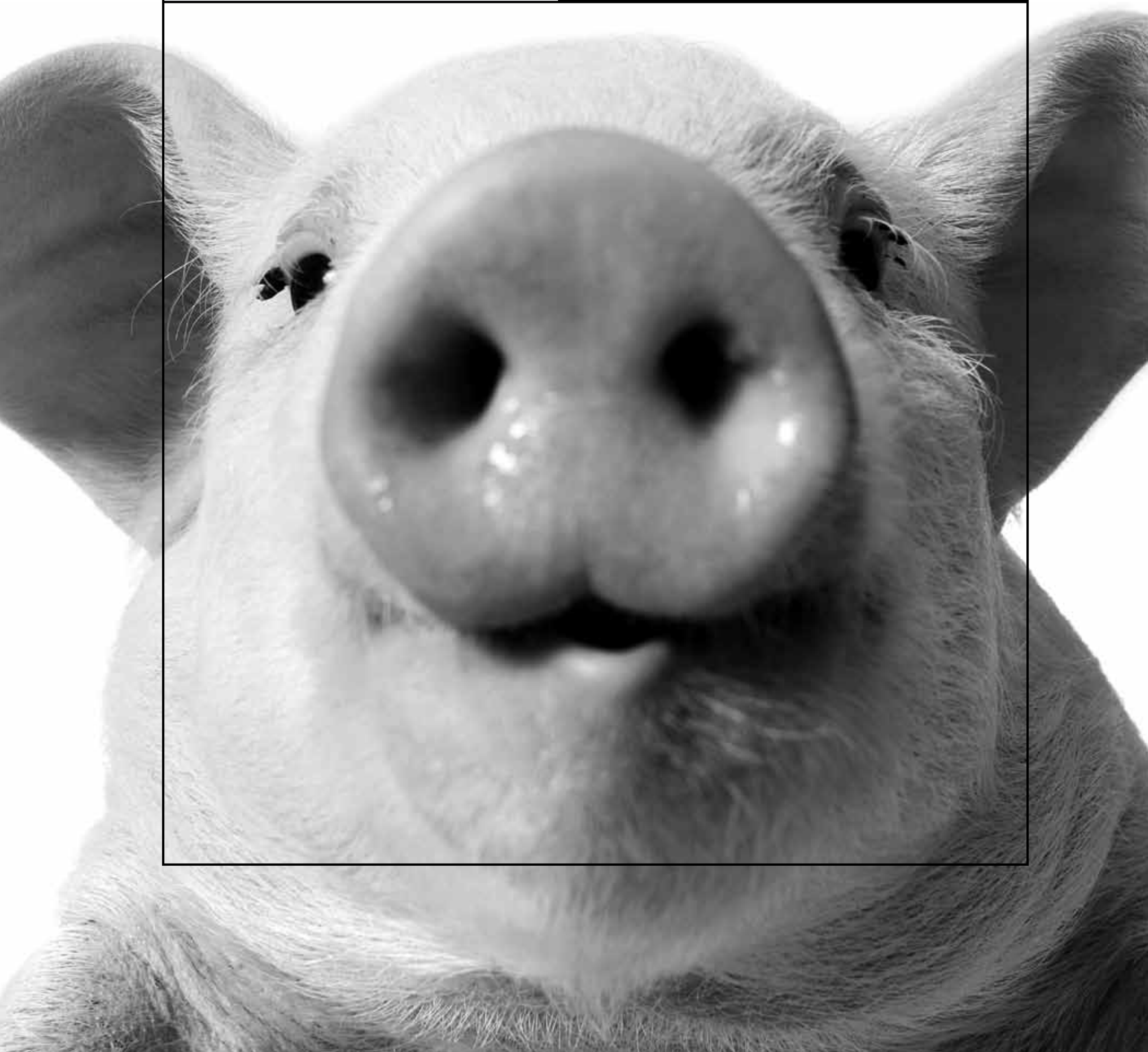
First things first. If you took Economics 101, you can probably dredge up cases of market failure in which government intervention is justified. For example, governments tax the emission of pollutants (or regulate them directly) because the cost of pollution would otherwise be borne by third parties and thus not taken into account in the balance of supply and demand. By the same token, governments regulate pharmaceuticals because buyers would otherwise lack enough information about their safety and efficacy to judge their value.

The rationales for regulating both pollution emissions and drugs have also been applied to financial markets – for example, regulating the complex mortgage contracts that millions of poorly informed

Capital

SMITHFIELD FOODS

Acquired by China's Shuanghui International, 2013.
Valued at $7.1 billion.



borrowers signed in the housing bubble of the early 2000s, which generated vast collateral damage when the bubble collapsed in 2008.

Parallel arguments apply to international transactions. Most economists support the prohibition of imports made with slave labor, at least in part because consumers lack adequate information about the conditions under which those imports are produced. And they generally support safety regulation of imported food on the grounds that imperfectly informed purchasers would not otherwise know what they're ingesting.

With all that in mind, consider the issue of taxing or regulating international capital flows – capital controls, for short. It's fair to say that the vast majority of economists are deeply skeptical about (if not downright hostile toward) their imposition. Yet it is not hard to find evidence in international financial markets of the kind of distortions that are likely to lead to imperfect information and, as a result, to economically inefficient and socially undesirable outcomes.

Consider, for example, the phenomenon of "adverse selection." Just as sick people have more incentive to buy health insurance, the least creditworthy firms and governments are more inclined to borrow. Or, for that matter, the phenomenon of moral hazard, in which borrowers who have no difficulty gaining access to foreign money are more likely to take on additional risk in the expectation that additional funds will always be available to bail them out.

Moreover, international capital flows can be a source of negative externalities. When capital flows out of a country that is in financial difficulty, fire sales of domestic assets by foreign investors will cause the currency's exchange rate to plummet. This decline will reduce the value of the collateral of other residents who have borrowed in foreign currency, heightening their own – and their country's – financial difficulties. Still more investors will then flee in a self-reinforcing spiral, worsening the crisis.

Hence, the classic rationales for regulation – imperfect information and externalities – are arguably present in the context of international capital flows. Economists' traditional hostility toward capital controls thus stands out as an anomaly worth a closer look.

CONTROLS IN THEORY AND PRACTICE

We'll use the shorthand of "capital controls" for all policy measures influencing international capital flows based on the residence of the investor. And the global economy offers plenty of contemporary examples.

In 2009 the government of Brazil imposed a tax on foreigners' purchases of Brazilian stocks and bonds equal to 2 percent of their value. (The rate was eventually raised to 6 percent.) Since the same tax was not imposed on domestic residents, it was a form of capital control. In 2010 Thailand imposed a 15 percent withholding tax on interest and capital gains on Thai government bonds held by foreign investors, but not on interest and capital gains on those same bonds accruing to domestic investors. In 2012, Uruguay required foreign investors purchasing government debt to maintain non-interest-bearing deposits equal to 40 percent of the value of the purchase for a fixed period. Since the reserve requirement was not imposed on domestic investors, it too constituted a capital control.

Today, by far the largest economy imposing major capital controls is China. As it has

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throughout its history, the Peoples' Republic limits purchases of Chinese assets by foreigners to certain types of securities and only provides authorization to undertake even those purchases to specified categories of foreign investors.

These examples flag an important distinction between market-based and administrative capital controls. Market-based controls – taxes and measures like non-interest-bearing reserve requirements that are the equivalent of a tax – do affect market prices and reduce capital flows, but still allow the market to operate. They leave foreign investors free to decide whether to invest, provided they are willing to pay a premium. Administrative controls, by contrast, limit foreign investment to specific assets or specific investors or specific sums rather than using price to inhibit asset purchases.

Economists generally view market-based or price-based controls as the lesser evil, on the grounds that they are relatively transparent (and thus less likely to be catnip for corruption) and still allow some scope for the market to allocate productive assets to those who value them most. But there's a catch: price- or tax-based measures presuppose the existence of a tax system that is difficult to evade, leading not just China, but also many less-developed economies, to rely mainly on administrative controls.

Governments applying both market-based and administrative controls have invoked a number of different rationales for their actions. Brazil, in 2009, Thailand, in 2010, and Uruguay, in 2012, were all concerned about the potential externalities linked to massive inflows from foreigners seeking higher yields when the central banks of high-income countries cut interest rates to zero in response to the Great Recession. They worried that capital inflows would raise security prices to unsustainable heights, inflating financial bubbles that would cause collateral damage when they burst. They worried that ill-informed foreign investors scrambling for yield were blindly following the herd, and

INGRAM MICRO

Sold to China's Tianjin Tianhai, 2016, for $6 billion.

AMC ENTERTAINMENT

Acquired by China's Dalian Wanda Group, 2012. Valued at $2.69 billion.

would just as blindly retreat with the herd when asset prices stopped going up. They worried that their own private banks, able to borrow abroad at bargain rates, were making excessively risky investments and levering up their bets – and would thus be hung out to dry when foreign finance dried up.

Consider another (quite different) reason for concern. Policymakers in emerging-market countries saw that capital inflows were causing their own currencies' exchange rates to appreciate, damaging the competitiveness of their export industries and deterring export-driven startups. This latter phenomenon can be a very serious drag on long-term growth. Development economists argue that firms learn to export by observing other exporters. Hence the diminution of exports from existing industries constitutes a negative externality along the lines discussed above.

The existence of this externality would appear to be one motive for China's longstanding maintenance of capital controls. Chinese enterprises learn from exporting and from observing one another's success at exporting. Controls on capital inflows have therefore been used to limit the appreciation of the renminbi's exchange rate to promote learning by doing as well as to generate profits for existing exporters.

The list goes on. Starting in 2009, policymakers in many emerging-market economies

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worried that capital inflows were fueling a domestic consumption and investment boom, thereby creating the danger of inflation and overheating. They were also worried that domestic monetary policy would not be able to turn down the thermostat. To understand why, bear with me for a brief refresher on macroeconomic theory.

In an open economy, policymakers can achieve any two of three objectives: free capital mobility, stable exchange rates, and control of the domestic money supply. The standard treatment for inflation and overheating is, of course, to tighten monetary policy. But with free capital mobility, exercising monetary autonomy means that the third objective, control of the exchange rate, must be sacrificed. And that puts policymakers in a bind.

Tightening monetary policy in an environment in which capital can freely cross borders would cause the exchange rate to appreciate as capital flowed in to take advantage of higher interest rates, making exports less competitive in foreign markets – something that policymakers in export-led economies like China view as especially costly in both economic and political terms. Hence policymakers are under considerable pressure to control capital inflows.

The examples cited earlier suggest that even where controls are, on balance, helpful, there may be more efficient ways of addressing the problems to which capital flows give rise. For example, if the availability of cheap foreign finance allows domestic banks to make excessively risky investments and to dangerously leverage their bets, then the best response is to address their risk-taking behavior directly, by strengthening supervision and regulation of the domestic banking – not to discriminate between domestic and foreign funding with capital controls.

To be sure, this is often easier said than done. In the absence of capital controls, banks and corporations with foreign subsidiaries may still be able to borrow offshore, evading domestic regulation. By the same token, branches of foreign banks operating in the country will typically be subject to regulation by the government of their home country and may thus be free to continue to extend risky loans to local customers. Effective prudential supervision and regulation require experienced, well-trained bank inspectors and well-developed administrative capacity – skills not available in abundance in developing countries.

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These practical constraints on addressing the source of the problem directly create an argument for capital controls as a second-best way to preserve the stability of the domestic financial system. Indeed, this is the currently fashionable argument for capital controls as "macroprudential" policy.

But the design of the controls matters if efficiency is the goal. Rather than applying controls across the board, policymakers should target their taxes and administrative measures at the specific types of capital flows most likely to create problems.

If volatility is the problem and if short-term capital flows are especially volatile, then capital controls should be targeted at short-term flows. Thailand and Uruguay required foreign investors to set aside a percentage of the value of the money they brought into the country without earning interest for a relatively brief period. This presumably deterred investors buying liquid financial assets who intended to hold them only briefly. But it would have little impact on the incentives of investors in for the long haul.

Note, too, that the stringency of restrictions on capital flows intended to compensate for imperfect knowledge or to offset externalities should vary with the financial cycle. If over-borrowing is the problem, then controls should be especially strict when over-borrowing is prevalent – that is, when global credit is accommodating and large amounts of foreign capital are flowing into a country. Brazil, Thailand, and Uruguay all adjusted capital controls in this way.

THEN WHY THE SKEPTICISM?

If the rationales for (and circumstances under which) capital controls are useful are clear, why are economists still so skeptical? One answer is that historical experience with capital controls suggests they are blunt instruments and often subject to abuse. Before 1914, regulation of international capital flows was relatively limited, just as financial regulation in general was relatively limited. Comprehensive controls were only put in place by the major belligerents during World War I, when it was deemed essential to husband resources for the war effort.

But freeing capital from controls proved a lot harder than imposing them. Controls remained in place in the 1920s in countries experiencing problems of postwar readjustment – in particular, those finding it hard to restore their prewar currency-exchange rates. The British government, for example, continued to restrict the ability of banks in London to underwrite long-term foreign loans as part of an effort to offset the weakness of the British balance of payments and thereby restore the pound sterling to its prewar parity against gold and the dollar.

Controls proliferated after the financial crash and the onset of the Great Depression. Countries experiencing banking runs and seeing panicked withdrawals by foreign depositors embargoed the repatriation of funds. With the gold-standard crisis in 1931, one set of countries led by Great Britain devalued their currencies, leaving the others – members of the so-called Gold Bloc – with overvalued exchange rates and weak balances of payments. This second group responded by tightening both import restrictions and capital controls.

Most notoriously, Germany imposed comprehensive restrictions on its international financial transactions as part of the plan to bring the German economy under the control of Nazi planners. It used that comprehensive system to regulate its trade and financial relations with its Central and Eastern European neighbors, which had been badly battered by the global depression. This allowed the Reich to extract resources from them to build the German war machine on terms favorable to the government.

World War II brought on even stricter controls on capital flows as part of the larger set of wartime restrictions that involved controlling goods, prices, wages, production and foreign trade. Governments emerged from the Second World War with even larger financial imbalances than those following the First.

The British government's debt, for example, was on the order of 250 percent of national income, with much of it owed to foreigners. Britain was thus forced to limit the ability of foreign investors to liquidate their British government securities and to repatriate their funds for many years. Moreover, these controls remained in place for a remarkably long time – into the 1970s.

Other governments maintained similar restrictions. Given the banking crises of the 1930s and the still-weak condition of banking systems after World War II, they tightly regulated domestic financial transactions – something that was feasible only if they also maintained tight restrictions on cross-border lending and borrowing. Note, moreover, that capital controls similarly created room for governments and central banks to maneuver to pursue domestic demand-management policies (as increasingly expected by their electorates) while also holding exchange rates stable.

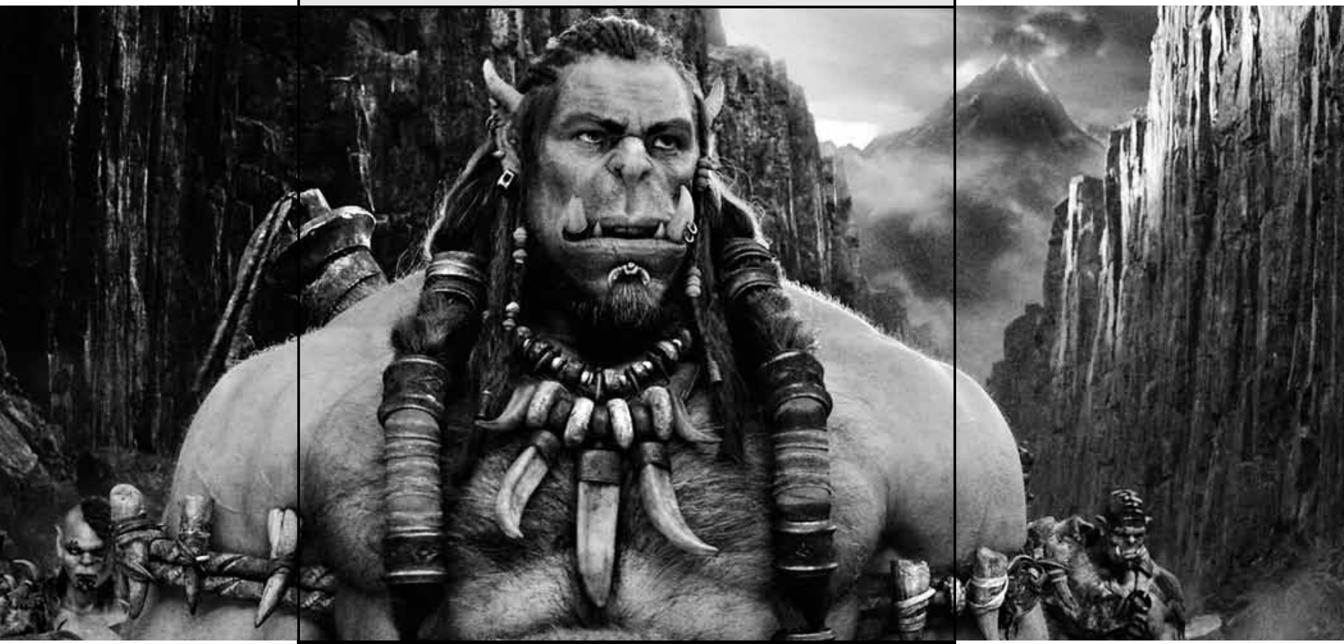
Administrative controls on capital movements were even tighter in the third world. In the 1950s and 1960s, many newly independent developing countries were impressed by the breakneck growth achieved by the centrally planned Soviet Union and sought to follow a similar path. Again, tight regulation of the financial system and the economy by planners was only possible with tight controls over capital flows.

The gradual movement away from capital controls in the final quarter of the 20th century was part and parcel of the move away from central planning and the widening belief that a market-oriented, or at least mixed, economy model was more conducive to growth. Critics contended that the efforts of bureaucrats to control capital outflows as a way of subsidizing domestic investment – and their selective control of capital inflows as a way of channeling domestic investment toward particular industries – were ultimately counterproductive for the broader economy. Since planners had no special talent for picking winners, controls resulted in a misallocation of resources, ultimately hindering growth.

Exacerbating the resulting mess, control of foreign lending and borrowing (like control of other activities) encouraged corruption. To tap foreign funding, banks and firms needed to obtain government approval, which usually came at a price. India's notorious license raj, the elaborate system of regulation, red tape and under-the-table payments

COURTESY OF GENERAL ELECTRIC APPLIANCES

LEGENDARY ENTERTAINMENT



Acquired by China's Dalian Wanda Group in 2016 for $3.5 billion.

affecting all manner of economic transactions, prominently included restrictions on inward and outward foreign investment.

In more-advanced countries, controls appeared to lose much of their effectiveness as governments relaxed draconian regulation of domestic financial institutions and markets, opening additional avenues for evasion and making effective enforcement difficult. More generally, advanced-country experience suggested that economic and financial development and the liberalization of international capital flows went hand in hand.

The United States, the country with the most liquid financial markets and the strongest international financial position, quickly removed its wartime controls. Other members of the Organization for Economic Cooperation and Development (the club of advanced economies) moved in the same direction, the OECD having adopted a Code of Liberalization obliging its members to do so. Japan liberalized its international financial transactions relatively late since the removal of controls would have undermined the government's system of top-down planning, administered by the Ministry of Trade and Industry – to which it was still wedded in the 1970s and 1980s.

Western European nations, for their part, removed remaining capital controls in the 1980s. The countries that would become the European Union all moved away from pegged exchange rates. Abandoning currency pegs allowed them to increase cross-border capital mobility while retaining their ability to control the domestic money supply, providing an alternative solution to the open-economy trilemma discussed above.

Correlation, here between relatively high levels of income and the absence of capital

COURTESY OF LEGENDARY ENTERTAINMENT

controls, is not, of course, proof of causation. High-income status, and the well-functioning markets and well-developed regulatory capacity associated with it, may well be what minimize domestic market imperfections and permit the removal of capital controls. It could be that those well-functioning markets and well-developed regulatory capacity, not the absence of controls, are what in fact limit the prevalence of corruption, favoritism by government officials and domestic allocative distortions.

WHAT TO DO

Still, worries persist that capital controls create a breeding ground for both corruption and distortions in resource allocation. Their critics warn that controls are inertial: once put in place for reasons good or bad, they are often almost impossible to remove. That's because the benefits of controls are concentrated, giving the favored groups (exporters, in the case of China) a strong incentive to lobby for their retention, while the costs are diffuse, making opponents (think of consumers) difficult to mobilize.

Controls may also provide an excuse not to undertake painful but necessary reforms. When they are put in place as bandages to cover banking problems, the pressure to fix the banking system will be less. When they are put in place in response to budget and inflation problems, the pressure to adjust macroeconomic policies will be correspondingly reduced. Thus, even when the case for capital controls is supported by the information asymmetries and externalities outlined earlier, they come with risks whose costs, in the eyes of some, are prohibitive.

What can be done to limit those risks? One possibility is to develop standards for the use – and for avoiding the misuse – of capital controls and to construct enforcement mechanisms designed to hold countries to those standards. Five years ago, the G20 countries endorsed a position paper outlining how countries should manage capital flows. The paper argued that controls (which governments euphemistically labeled "capital-flow management measures") should be targeted at specific risks rather than used indiscriminately. They should be reviewed regularly with an eye toward phasing out redundant measures. They should be relaxed or reversed when destabilizing pressures abate. They should be transparent, preferably price-based, in order to limit opportunities for corruption and favoritism. They should not be used as an excuse to avoid painful but vital domestic-policy reforms.

Wishing won't make it come true, though. One possible way to ensure that governments adhere to these standards would be to make compliance an obligation for members of the International Monetary Fund and to authorize the fund to name and shame countries that fail to comply. More ambitiously, countries that fail to comply could be denied access to the fund's financing facilities.

In 2011, the fund attempted to develop a code of conduct for the use of capital controls. In the end, however, this initiative was torpedoed by emerging-market countries, led by Brazil and India. They feared that the fund, which had long been ideologically opposed to the use of controls, would constrain the options available to governments facing surges in capital flows.

But since then, the International Monetary Fund has displayed greater open-mindedness about capital controls, articulating a "new institutional view" acknowledging that their use may be warranted in some circumstances. And given this new open-mindedness, there may be a way to create the long-elusive consensus. Stay tuned.