Capital Controls Gain Currency in Today's Global Economy

Global investors have poured money into some emerging-market economies (EMEs) because they offer higher returns than do the more advanced economies. That's a win-win for everyone—right? Not necessarily. For many EMEs, this deluge of foreign capital can create economic imbalances that traditional monetary policy alone may not be able to fix. What can EME policymakers do?

Policymakers often argue for a particular policy with the intention of making their country, state, or city a good place to invest or more attractive for foreign capital. The flow of capital into the United States, for example—whether through a Japanese automaker building a plant in Georgia or a Swiss banker purchasing shares of Apple—is considered by most a desirable outcome. But for some EMEs experiencing high rates of growth and growing inflows of foreign capital, such investment demand can bring many challenges.

But isn't foreign capital a good thing?

What sort of challenges do these fast-growing EMEs face? Doesn't development theory predict that it's exactly these countries that *should* have higher rates of return on investment? China, for one, has had sustained growth rates of more than 10 percent for most of the past two decades. Likewise, India and Brazil have seen their economies expand with enormous speed in recent years. But an influx of foreign capital brings with it a host of unintended side effects. Exchange rate appreciation, for example, can occur rapidly, which can harm the competitiveness of domestic exporters. It's precisely this concern that has compelled China to implement strict domestic investment restrictions and deliberate exchange rate management. The country's policymakers want to prevent the renminbi from appreciating so rapidly that it puts its export-oriented growth model at risk.

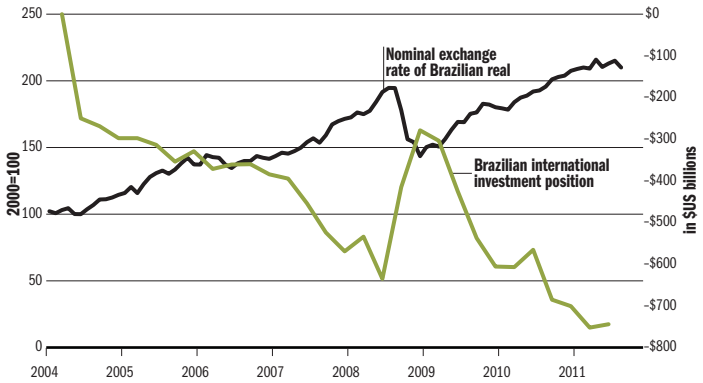
Foreign capital inflows can also be fickle. Receiving countries may be susceptible to "sudden stops," when foreign investors quickly run for the exits at the first sign of trouble in an economy. The Asian financial crisis of the late 1990s was a painful reminder of how foreign capital—at first a sign of burgeoning growth—can severely exacerbate an emerging financial crisis. Following a run-up in asset prices, which were fueled by foreign investment, the economies of Indonesia, Thailand, and South Korea, for example, saw their currencies depreciate sharply as foreign credit abruptly fled their troubled financial systems.

The experience of these Asian countries has been an important lesson for EME policymakers, especially in the recovery from the recent global financial crisis. Many global investors have poured money into some of these EMEs because they offer higher returns than the more advanced economies. This deluge of capital combined with the fear of overheating and of "sudden withdrawal" has led some countries to implement capital controls. By imposing limits on the amount or type of foreign capital flowing into or out of a country, these tools help EMEs manage their risk.

Capital controls may take the form of a tax on foreign capital inflows or quotas on investment. EMEs can also limit volatility in flows by requiring that a certain percentage of foreign investment be held in reserve for a specified number of days at the receiving country's central bank. This type of control, called a "lock-in" policy, prevents sudden withdrawals of capital.

Although EME policymakers are increasingly turning to capital controls, these tools have not necessarily been popular, at least among most economists and policymakers in developed countries, not to mention in the financial services industry. Advocates of international financial liberalization see capital controls as having inefficient, distortionary effects for any country adopting them. Sebastian Edwards of the University of California, Los Angeles, for example, argued in a 1998 paper that the 1980s Latin American implementation of capital controls was counterproductive. And until recently, the International Monetary Fund (IMF), seen as the global authority on matters of foreign capital management, had maintained a policy that capital controls were ineffective (at best), if not harmful (at worst). However, capital controls are increasingly being called for by domestic-oriented manufacturers and exporters in EMEs with strong currencies—and, under certain circumstances, even approved by the IMF.

Brazil's Capital Inflow



Sources: Banco Central do Brasil, JP Morgan

Brazil's paradox of riches

A look at Brazil may help us better understand what situations could lead EME policymakers to institute capital controls. The country's economy has experienced rapid growth in recent years, despite a small, short respite during the global recession of 2007–9. Unprecedented amounts of foreign capital have flowed into Brazil. This ostensible blessing, however, could also be considered Brazil's curse. The country's large growth rates, along with its high domestic interest rates, have caused these huge investment flows, which in turn have pushed up the value of Brazil's currency, the real. (Brazil's interest rates are the second highest, after Croatia's, among the 55 countries that Bloomberg tracks.) The increase in the value of the real has largely hurt Brazilian domestic exporters and stymied the central bank's attempt to reduce inflationary pressures in the economy. Brazil is overheating, and foreign investor interest in the Brazilian economy is exacerbating attempts to slow the economy down.

Chart 1 illustrates Brazil's struggle with foreign capital. The black line tracks the exchange rate of the real, in nominal terms and trade-weighted according to Brazil's trading partners. Plotted against the left axis, this line shows that the real has appreciated tremendously since 2008. The green line tracks Brazil's net international investment position, which is the amount that Brazilians have invested abroad—assets—minus the amount of foreign investment into Brazil—liabilities. Plotted against the negative numbers of the right axis, this line shows the surge of foreign capital into Brazil's booming economy.

The chart also shows that sharp reversals in both the international investment position and the real occurred in 2008. Before the financial crisis, the currency was strengthening and foreign investment was surging (that is, the investment position was trending negative). However, from the onset of the crisis in 2008 and then continuing into early 2009, the real depreciated sharply and the net investment position dramatically rebalanced as foreign investors withdrew large amounts of capital. The trend lines for both series reverted back to their pre-crisis trend after late 2009—and, if anything, have strengthened in that direction.

ECONSOUTH NOW PODCAST

Capital controls are the subject of an in-depth interview. On frbatlanta.org, select "Podcasts."

What's wrong with traditional monetary policy?

Brazil's experience is a clear example of two potentially negative side effects of high foreign capital inflows: 1) in good times, the EME's currency appreciates strongly, perhaps too strongly, and asset bubbles, if there are any, are exacerbated; and 2) in bad times, the capital pours out of the country, which leads to greater financial volatility, less credit availability, and sharp downward swings of the exchange rate.

Monetary policymakers in Brazil and in other EMEs experiencing similar problems could choose to raise interest rates in order to cool the economy and mitigate the volatility. But a hike in the domestic interest rate could lead to a third negative side effect of high foreign capital inflows. An interest rate increase actually widens the spread between the EME's return on investment and a developed country's return, making the EME even more attractive for foreign investment. This spread is often the main cause for the foreign investor's interest. In cases like these, monetary policy has the potential to make a bad situation worse.

Take high-quality corporate bonds as a hypothetical example: investors could choose from Japan at, say, 3 percent, the United States at 6 percent, or Brazil at 14 percent. Under these conditions, Brazil would naturally be a very attractive option. This spread could also fuel the so-called

Brazil, which was in the difficult position of trying to slow an overheating economy and counteract an excessively strong currency, instead instituted a foreign financial transaction tax.

carry trade of borrowing in a low-yielding currency and investing in a high-yielding one, leading to further exchange rate imbalances.

For overheating EMEs, tempering inflation is a top priority. If these countries do not have recourse to the usual, appropriate tool, which is to tighten monetary policy, what steps can they take without digging themselves deeper?

So are capital controls a useful solution or a misguided policy?

Brazil has not been alone in its struggles with foreign capital inflows. During the recent global financial crisis and recession, financial market panic led to a spike in foreign capital redemption from many emerging market economies. Iceland, Latvia, Pakistan, and other countries all experienced a sudden outflow of foreign capital to safer investments—mostly developed-country sovereign debt. Many of these countries, reliving the experience of East Asia but on a global scale, began to question the conventional wisdom that rejected capital controls.

Witnessing the recent experiences of the EMEs post-crisis and looking back to the Asian experience, the IMF—along with several other economists across the globe—began to rethink its position against capital controls. These economists saw that the inherent volatility of capital flows to EMEs, along with the relative impotence of domestic monetary policy to combat the negative spillovers, gave room for appropriately deployed capital controls to be used. The economists also conceded that perhaps some circumstances justified capital management, to allow overheating EMEs to avoid problems such as those that Brazil and East Asia experienced. Consequently, in February 2010, the IMF released a position statement that argued that capital controls could sometimes be used appropriately if other tools were already employed (Jonathon D. Ostry, Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reinhardt; "Capital Inflows: The Role of Controls," *IMF Staff Position Note*). This change in official policy toward capital controls is extremely significant, given the rebound in capital flows.

Likewise, Brazil's finance minister, Guido Mantega, shifted from his earlier position of censuring the use of capital controls (see, for example, "Mantega denounces capital controls," available at www.emergingmarkets.org/Article/2028450/Global/Mantega-denounces-capital-controls.html) to strongly supporting their use and even criticizing the IMF's move to create a framework for their use: "We oppose any guidelines, frameworks or 'codes of conduct' that attempt to constrain, directly or indirectly, policy responses of countries facing surges in volatile capital inflows." Mantega has partly justified his reversal by pointing to the rapid appreciation of the Brazilian real as foreshadowing a "currency war." Indeed, many emerging economies' policymakers blame accommodative U.S. monetary policy—especially the Fed's second round of so-called quantitative easing—for causing an increase in the flow of capital into their markets. Mantega has also criticized Chinese economic policy in recent months, with the undervaluation of the Chinese renminbi (see the first quarter 2010 *EconSouth* article "Brazil and Peru Set to Flourish in a Postrecession World"). Indeed, Brazil, which was in the difficult position of trying to slow an overheating economy and counteract an excessively strong currency, instead instituted a foreign financial transaction tax.

The debate goes on

If global capital flow imbalances persist, Brazil and other EMEs may increasingly turn to capital controls to regain equilibrium in their economies, while some large developed economies—usually with relatively weak currencies—will likely continue to argue against them. Complicating the debate is the fact that some advanced economies have begun to employ currency interventions, measures that are quite similar to capital controls but less interventionist. For example, in recent weeks, Switzerland and Japan have also intervened to dampen excessive appreciation of their currencies, the franc and the yen. One certainty is that the debate over capital controls, which only recently appeared to have been settled, is far from over. ∎

This article was written by Andrew Flowers, an economic analyst at the Atlanta Fed.