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Capital Controls by Any Other Name

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Financial globalization over the past 40 years has been driven in part by the idea that what is optimal for international trade in goods—the absence of regulation—is optimal for international trade in assets in the form of free capital flows. Since the recent financial crisis, however, many emerging markets have responded to large inflows of investment by imposing controls on them.[1] The financial press has claimed that the International Monetary Fund (IMF), previously a strong advocate of complete capital account liberalization (i.e., uninhibited international capital flows), has reversed its position by supporting such controls and even detailing a policy framework for their use (Talley and Reddy, 2011).[2] To the contrary, the IMF's proposal retains the fundamental doctrine of free capital flows without addressing the most important question: Is free trade in dollars really no different from free trade in widgets?

Advocates of free capital flows argue that they promote efficient resource allocation: Global savings flows to its most productive uses, maximizing economic growth. Critics argue that the herding tendency of investors creates large, highly disruptive booms and busts in the domestic credit of individual countries, compromising their monetary policy independence. The Asian financial crisis of 1997-98, for example, is commonly attributed to herding behavior: Unprecedented large inflows of capital to Indonesia, Malaysia, Korea, Thailand, and the Philippines in 1996 suddenly reversed in 1997, with $12 billion flowing out of these countries.

After the Asian financial crisis, many economists asked whether capital crises could ever be eliminated in a world of free capital flows (e.g., Rodrik, 1998). The response of the IMF was "[We] recognize that without both sound macroeconomic policies…and strong, transparent, and properly supervised banks…opening up capital flows is dangerous and inadvisable. The opening-up must occur in the proper sequence; this is the moral of the Asian story" (Anjaria, 1998).

In the wake of the recent financial crisis, the IMF's proposed policy framework for capital controls only reiterates this lesson learned: Controls are defined as a last-resort policy tool to handle transitory capital inflows when exchange rate appreciation is against fundamentals, foreign exchange buildups are inadvisable, and reforming the financial system would take too long (IMF, 2011). The implication remains that a properly regulated and supervised banking system can fully mitigate any risks posed by free capital movements: Capital controls represent a temporary stopgap when the "proper sequencing" fails. The counterargument remains that no amount of domestic banking regulation can prevent the capital crises inherent to unfettered capital flows.

The embrace of ad hoc capital controls to address temporary market inefficiencies on a case-by-case basis, while pragmatic, perpetuates the view that each capital crisis is an isolated example of failed financial institutions.

One commonly cited factor in capital crises is that countries borrow too much during good times (Magud and Reinhart, 2007). For example, Korea was again subject to large outflows in 2008 following the collapse of Lehman Brothers. After this episode, Korea introduced and strengthened limits on the buildup of short-term external debt in its banking system that had facilitated the abrupt reversals of capital flows in 1997 and 2008. For its part, the IMF labeled Korea's reaction "macroprudential" and targeted at financial stability risks, which the new IMF guideline on capital controls permits "at any time…provided they are not assessed to have been designed to influence inflows" (IMF, 2011). But clearly the measures are both designed to address systemic risk and targeted at capital inflows.

The embrace of ad hoc capital controls to address temporary market inefficiencies on a case-by-case basis, while pragmatic, perpetuates the view that each capital crisis is

an isolated example of failed financial institutions. The question that should be debated is whether a strict distinction between macroprudential measures and measures targeted at international capital movements is justified. Surely free capital flows, like free trade in goods, carry large benefits. Yet the proposition that trade in dollars carries no more risk than trade in goods remains controversial. If regulating internal debt accumulation is important for limiting systemic risks, then regulating external debt accumulation should be similarly important. Moreover, measures targeted at specific capital flows, such as short-term external debt, do not exclude the benefits of capital flows in the form of foreign direct investment and other equity flows. ■

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[1] Examples include Brazil, Colombia, Indonesia, Korea, Taiwan, Thailand, and Turkey, among others.

[2] While the IMF Articles of Agreement signed in 1944 explicitly allowed for capital controls, the IMF pushed to amend its charter in the 1980s and 1990s to mandate capital account liberalization.

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Views expressed do not necessarily reflect official positions of the Federal Reserve System.