What is in a Name? That Which We Call Capital Controls…

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*The views expressed in this presentation are those of the authors and should not be attributed to the IMF, its Executive Board, or its management. This presentation is based on work with Mahvash S. Qureshi.

Motivation

I have only 8 seconds left to talk about capital controls. But that's OK. I don't need more time than that to tell you:

they don't work, I wouldn't use them, I wouldn't recommend them…

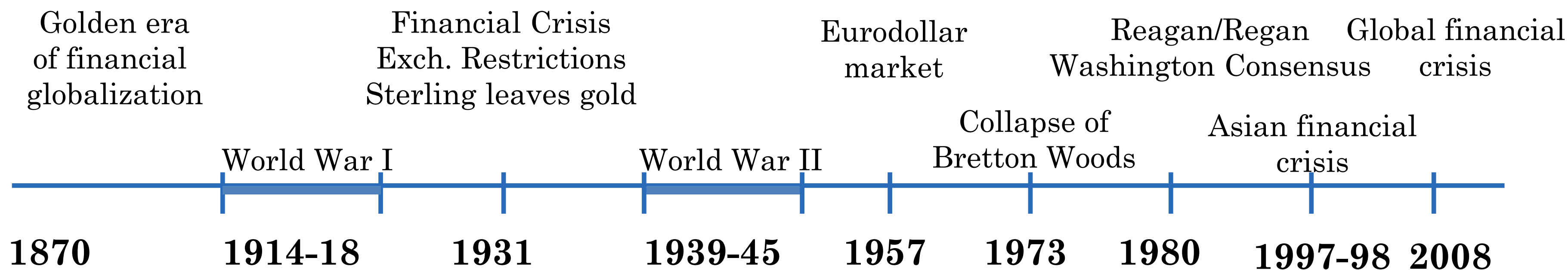
Agustin Carstens
Governor, Bank of Mexico
Rethinking Macro Policy III Conference
Washington DC, April 15, 2015

Why are Capital Inflow Controls so Unpopular?

Perceptions are rooted in history

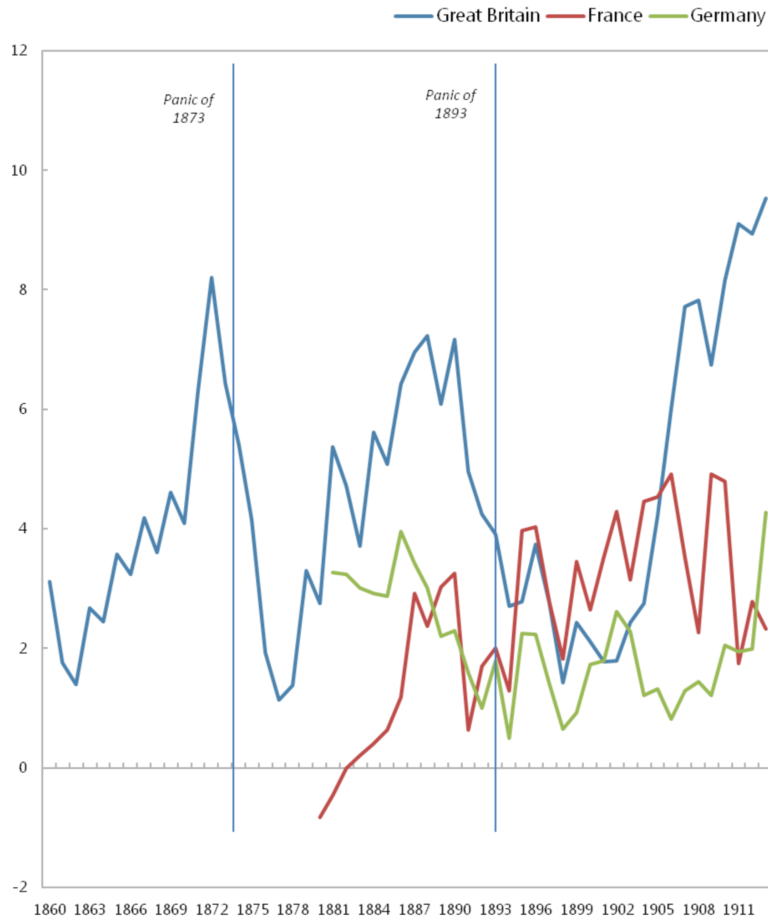
- Current vs. capital account transactions
  - Exchange restrictions: capital controls vs. free trade
  - Trade protectionism: capital controls for free trade
- Inflow vs. outflow controls
- Free market ideology, discredited Keynesiam
- Concerns about vitating multilaterally-warranted external adjustment

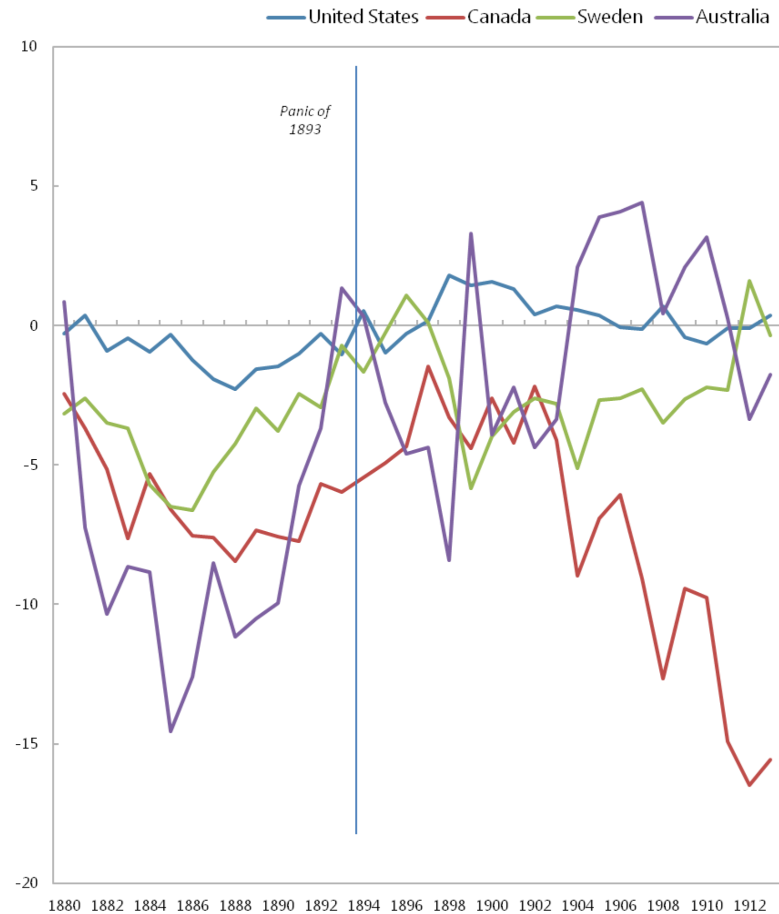
UNRAVELING HISTORY



Policy toward capital controls typically influenced by experience in the previous period…

Golden era of financial globalization





Golden era of financial globalization

- Liberal international monetary and financial order:
  - Large capital flows, supported by exchange rate stability of gold standard (central banks focused on *external* stability)
  - Mostly productive investments in the EMEs of the era
  - Britain willing to import foodstuff and raw materials from debtor countries, allowing them to service their liabilities
  - Mostly long-term capital; short-term flows for seasonal BOP fluctuations, and stabilizing speculation
  - Few restrictions—mainly political—on capital outflows; nothing significant on capital inflows

RE-ESTABLISHING THE LIBERAL INTERNATIONAL MONETARY ORDER, 1919-31

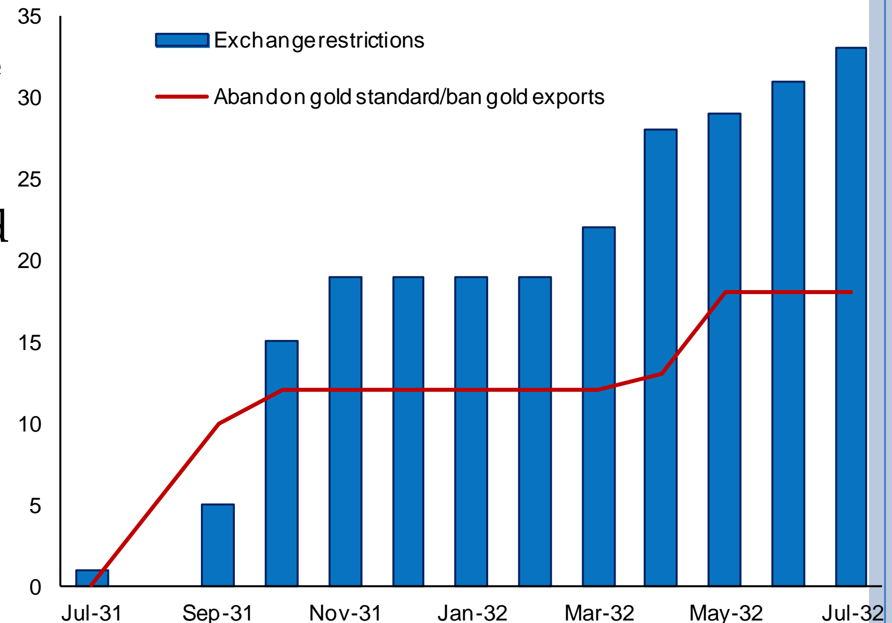
"All artificial control of operations in exchange… is futile and mischievous"

Genoa (1922) conference

- World of 1920 dramatically different from 1913
  - 1920-24—Europe in disarray; outflow controls by repressive regimes (Austria, Soviet Union)
  - 1925-28—Capital inflow-fueled European boom
- Gold standard re-established, but (post-Genoa) a gold exchange standard:
  - Germany in 1924, Britain in 1925 (at pre-war parity), France in 1926 (de facto), at much depreciated rate
  - By 1928, 45 out of 54 major economies on gold

End of the liberal international order

- 1928/29—Sudden Stop (boom and bust in US and UK)
- Gold standard collapses
  - July 1931—Germany imposes exchange restrictions on current/capital transactions
  - September 1931—Britain forced off gold standard (imposed exchange restrictions)
  - April 1933, US devalues
  - Other countries either devalue and (dirty) float or impose exchange restrictions
- BUT, these are all intended to prevent or reduce capital *outflows* and strengthen the BOP
- Numerous countries impose trade restrictions—*including those who*



Source: League of Nations World Economic Survey, 1931-32.

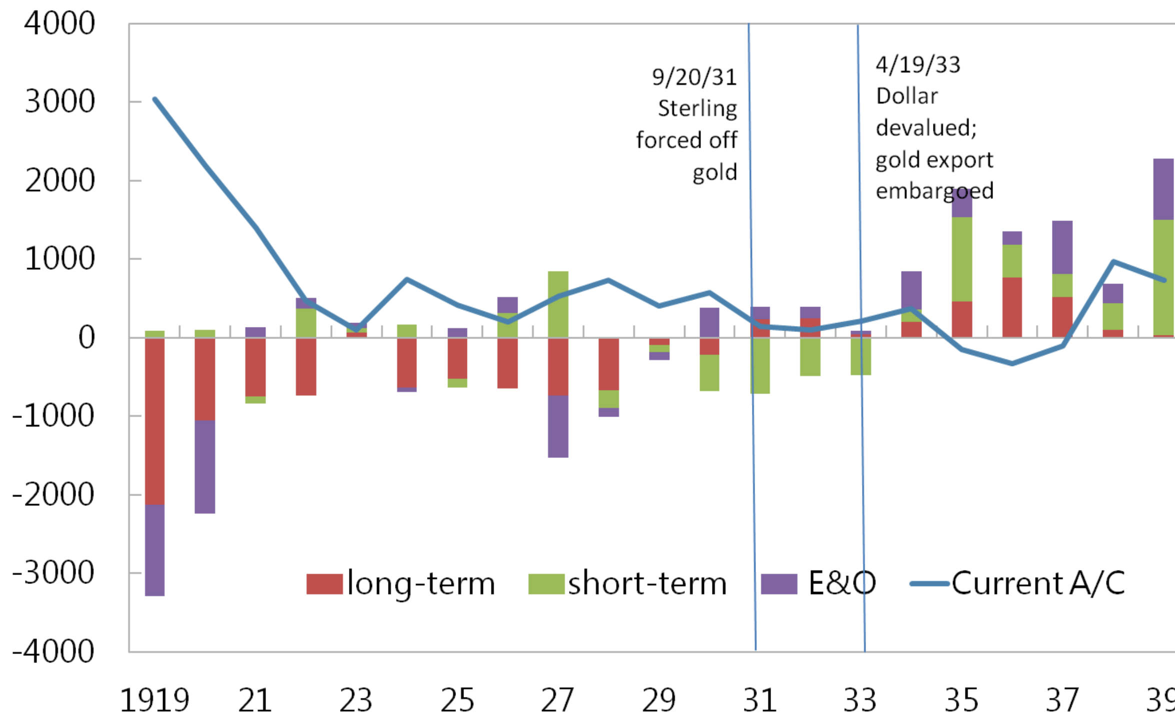
A DIZZYING DECADE OF CAPITAL FLOWS AND FLIGHT, 1931-40

- A dizzying decade of destabilizing short-term speculative capital flows (cf. 19C) and capital flight amidst devaluation/exchange restriction fears and worrying political developments
- At various moments, massive flows into or out of gold, US dollar, Sterling, French Franc, gold, and gold bloc currencies
  - March 1935, Belgium devalued—soon joined by Eastern front of gold bloc: Danzig, Poland, Lithuania
  - September 25, 1936, French Franc devalued, followed by Swiss Franc and Dutch Guilder

UNCERTAINTY AND REFUGE IN US, 1934-39

Since such inflows complicate the problem of achieving and maintaining a prosperous stability, constitute a source of embarrassment to countries from which gold is flowing, and have nothing to do with foreign trade or the international division of labor, there appears to be a clear case for adopting measures designed to deter the growth of foreign capital holdings in our markets

Marriner S. Eccles, 1937
Chairman, Federal Reserve



Sources: League of Nations (1938)

WHY DIDN'T US IMPOSE INFLOW CONTROLS?

"I am opposed to exchange control, except as a last resort. Frankly, I disapprove of exchange control"

Henry Morgenthau, 1937
Secretary of Treasury

- Very few precedents
- Perceived practical difficulties
- Fear of retaliation
- US position as international financial center
- General distaste

"Exchange control over capital and current account transactions alike was generally regarded as inherently objectionable and a perversion of the pattern of international payments worthy only of totalitarian countries or justifiable only under conditions of extreme necessity" (Bloomfield, 1965)

BRETTON WOODS CONFERENCE, 1944

"What used to be heresy is now endorsed as orthodoxy"

John Maynard Keynes, 1944

- The interwar period shaped thinking at the BW conference in July 1944
- The main lesson that Keynes and White—the principal architects—had taken from the interwar experience was that a regime of unfettered capital flows was fundamentally inconsistent with macroeconomic management,or with a liberal international trade regime

- Given the choice, they preferred free trade to free capital flows—especially to short-term "hot money" flows
- Keynes' and White's original proposals envisaged capital controls as a <u>*structural*</u> element of the international financial landscape

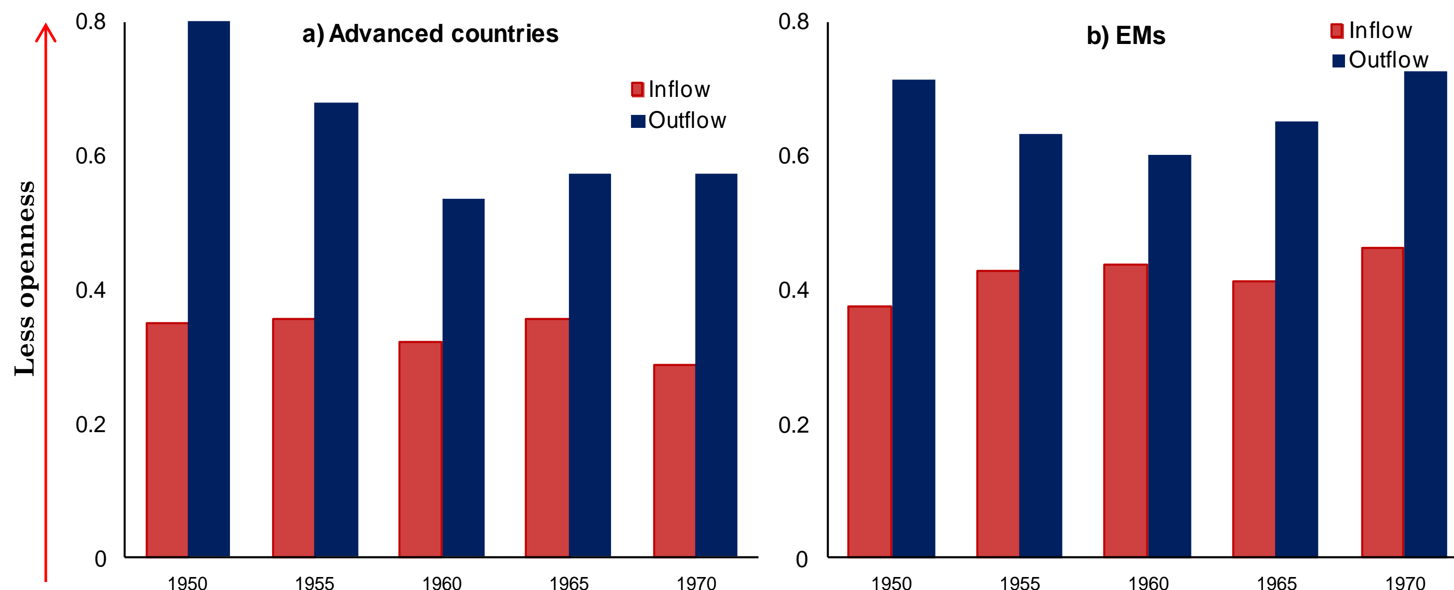
BRETTON WOODS CONFERENCE, 1944

- They also realized that capital controls may not be effective unless operated "*at both ends*" of the transaction—their original plans therefore mandated IMF member countries to cooperate in enforcing each others' measures by controlling flows at their end as well
- Last-minute intervention of powerful NY bankers however diluted the original proposals, so cooperation was no longer mandatory but "invited"
  - Moreover, the IMF could only "request" members to impose controls to prevent its resources being used to finance capital outflows (making the member ineligible to use further resources if it refused)
- Nevertheless, the emphasis of AoA of the IMF—which was set up to help manage the BW system—was put on member countries' *current* account rather than capital account convertibility
  - Explicit recognition that countries may need to impose capital outflow controls
- Curiously, that the AoA do not explicitly address the use of inflow controls implies that as part of its program conditionality, the IMF can require a country to impose *inflow* controls under the general provisions of Article V Sec. 3(a)

BRETTON WOODS, 1945-71

- Capital controls were quite prevalent in early BW period…but again mostly *outflow* controls
  - UK imposed widespread exchange controls in 1947 after an attempt to establish sterling convertibility ended with a run on the pound
  - Continental Europe, too, suffered severe BOP problems—and except for Germany—maintained capital account restrictions through the 1970s
  - Even the US, which had eschewed capital controls in the interwar period, resorted to an Interest Equalization Tax on capital outflows during 1963-73, to restrain capital flight and maintain external stability while pursuing inflationary policies associated with Vietnam War and Great Society
  - Exceptions were Germany—which was contending with large hot money flows emanating from the US—so resorted to imposing an *inflow* controls program over 1968-73, and Switzerland, which had them 1971-79. And some, like Japan, that wanted to maintain low interest rates and directed lending to favored sectors

PREVALENCE OF CAPITAL CONTROLS, 1950-70



Source: Authors' estimates based on various issues of IMF's AREAER.

Note: Advanced countries include the G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom, and United States). EMs include the major emerging markets that were IMF members in 1950 (Argentina, Brazil, Chile, Colombia, Ecuador, Egypt, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, South Africa, Thailand, Tunisia, Turkey, Uruguay, and Venezuela). Indices are averages for the respective country groups (where for each country, the restrictions are coded as a 0 (no restriction) to 1 (highly restrictive) based on authors' subjective judgment).

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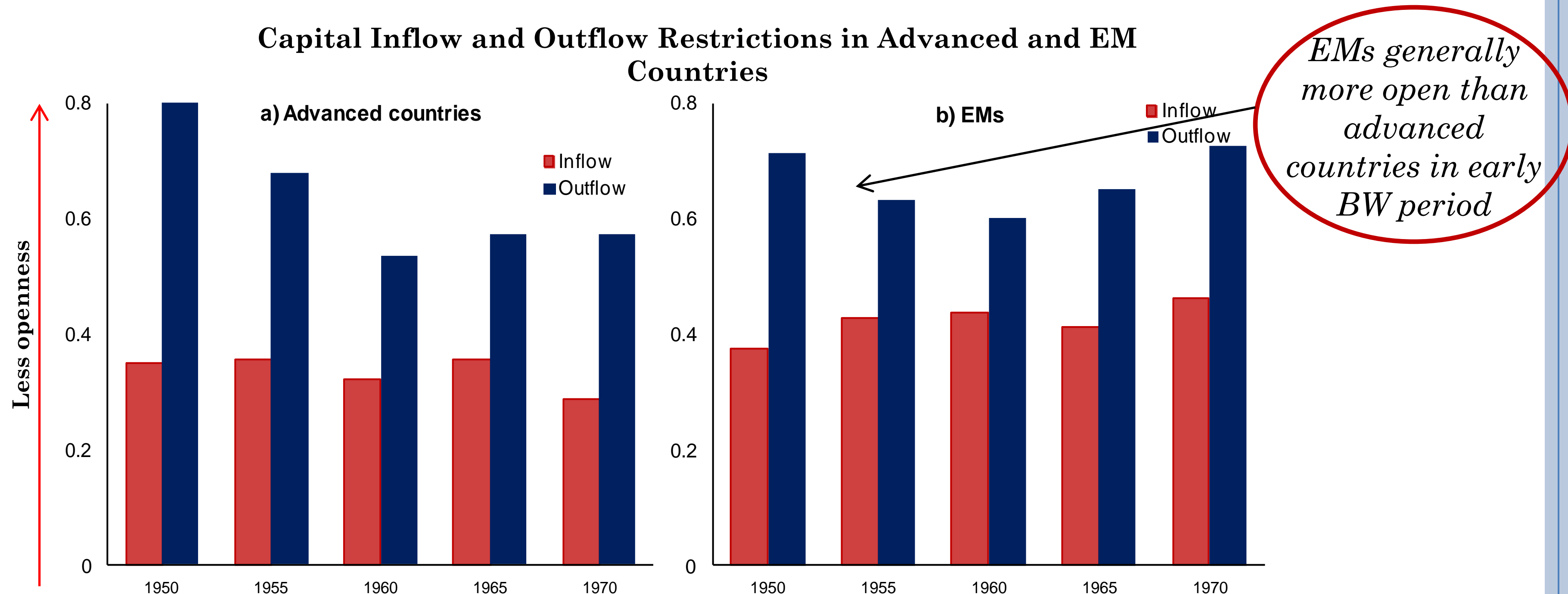

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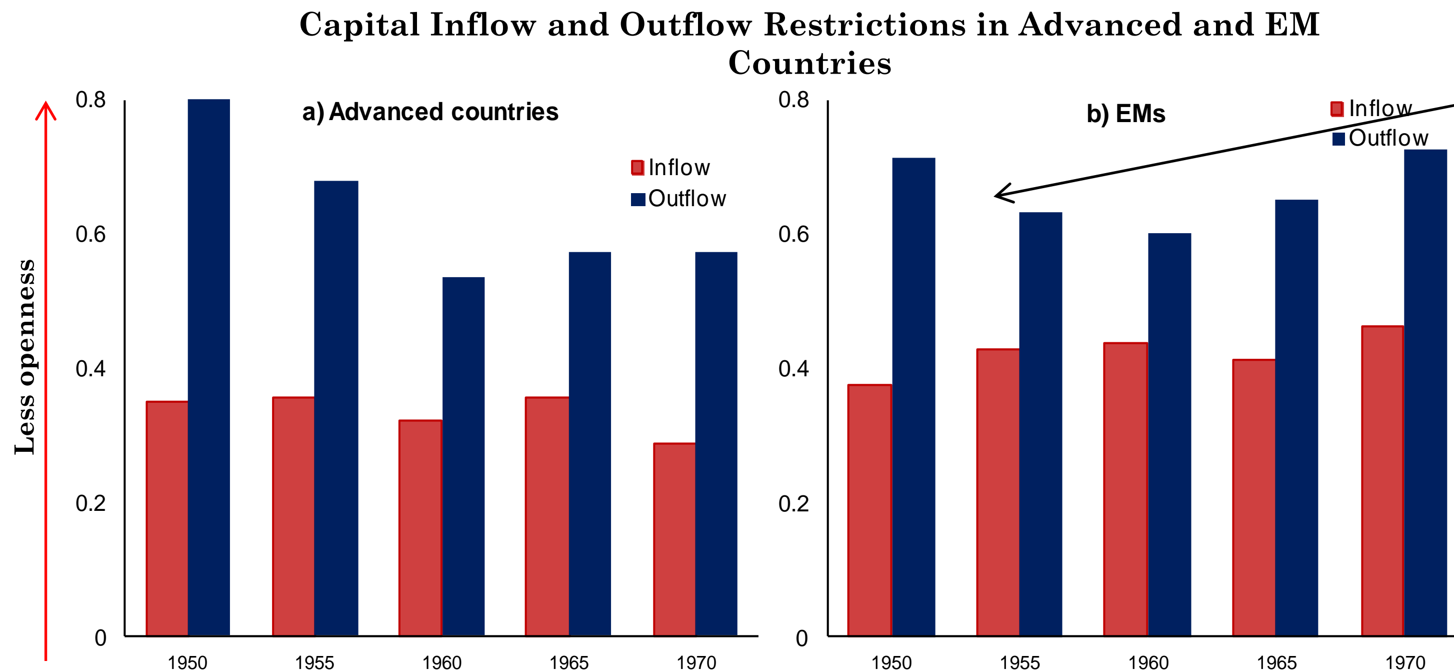

EMs generally more open than advanced countries in early BW period

Overall, more controls on outflows than on inflows

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"PRUDENTIAL" INFLOW CONTROLS IN ADVANCED COUNTRIES

Selected Cases of Inflow Controls Tightening in Advanced Countries

Country	Years	Examples of measures
Australia	1972-74, 1977	Embargo on ST borrowing; Variable Deposit Requirement
Austria	1971-75	Marginal RR on nonresident (NR) deposits
Finland	1985-90	Embargo on sale of local currency bonds to NRs
France	1963-67, 1971-73	No interest payment on NR deposits; no loans to NR
Germany	1957, 1960-61, 1965, 1968-73, 1977-78	Higher RR/no interest on NR deposits; Cash deposit requirement on foreign loans
Ireland	1977	RR on bank inflows
Japan	1971-72, 1977-78	Restrictions on NR purchase of domestic securities; Higher Marginal RR on NR deposits
Netherlands	1971-73	No interest payment on NR deposits
New Zealand	1973-85	Approval requirement on corporate foreign borrowing
Spain	1989	URR on financial credits taken up abroad
Switzerland	1937-39, 1950-51, 1955-58, 1960, 1971-79	Charge on NR deposits; Marginal RR on bank external liabilities
United Kingdom	1971	No interest payment on increase in NR sterling accounts balances

Sources: IMF's AREAER, Goode and Thorn (1959), Dorrance and Brehmer (1961), Australian Treasury (1999), and Bakker and Chapple (2002).

ADVENT OF FLOATING—SHIFTING US ATTITUDE

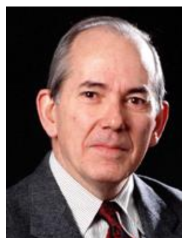
- BW breaks down—after 1971, US declines to cooperate on imposing controls to stem speculative flows or restrict eurodollar market financing such flows (US calculus: capital flows will force revaluation of European and Japanese currencies)
- US promotes more liberal international monetary order:
  - Begins putting free trade in assets on same footing as free trade in G&S
  - Opposes cooperation under IMF auspices on controlling capital flows
  - Inserts language in Article IV that the purpose of IMS is to facilitate exchange of goods, services, and *capital* among countries
  - Recognition in IMF surveillance that capital controls could be used to manipulate exchange rates or frustrate effective BOP adjustment
- With floating exchange rates, more policy autonomy—trilemma broken, and freer capital flows de facto provide easier financing of US deficits
- Trend continues in 1980s under Reagan/Regan, but while promoting open financial markets, US becomes more restrictive on G&S trade

The French Connection

- France traditionally in favor of managing flows (though liberalized in 1960s so Franc could compete as global currency…till Paris riots, 1968)
- 1983 Mitterand's *tournant de la rigeur;* (outflow) controls undesirable because they disproportionately penalize the middle class, who have capital but, unlike the rich, cannot find ways of evading the controls
- Three officials from that same socialist administration go on to champion liberalization:

Jacques Delors—President, European Commission—1988 EC Council Directive to abolish all controls within Europe and "endeavor to attain same liberalization with third countries"

Henri Chavranski—OECD Committee on Capital Movements and Invisible Transactions—expands OECD Code of Liberalization to include short-term flows

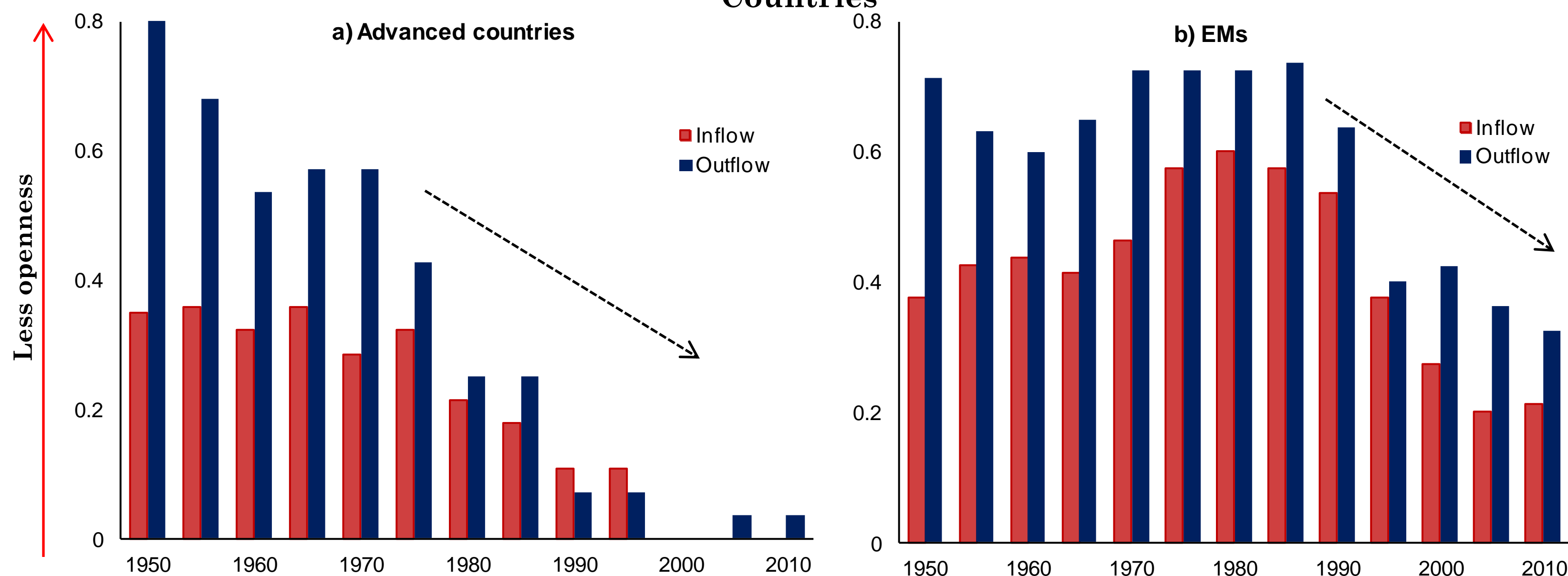


Michel Camdessus—IMF, attempts to amend IMF AofA to give IMF capital account jurisdiction and promote its liberalization

WASHINGTON CONSENSUS

- Original WC (Williamson, 1989) does not explicitly recommend capital account liberalization (except encouraging FDI). But…
- Liberalization of outflow controls very much in the spirit of subjecting government policies to "discipline of the market"
- Liberalization of domestic financial markets (positive interest rates, market allocation of credit, no financial repression)
- In this context, removal of some "prudential" inflow controls as well:
  - minimum maturity requirements on foreign loans
  - non-interest bearing deposit requirements according to maturity
  - limits on external debt to re-lent in domestic currency:
  - open FX limits

LIBERALIZATION OF THE CAPITAL ACCOUNT, 1950-2010



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Asian and Global Financial Crisis

- Post-Asian crisis, and post “Goodbye Financial Repression, Hello Financial Crash”:
  - Domestic pre-requisites for capital account liberalization
  - “Integrated approach,” including domestic supervision/regulation
- Post-GFC, explicit recognition that:
  - Surges caused by (good) domestic pull factors and (exogenous) global push factors
  - Surges bring macro-economic challenges and financial-stability risks
  - Shared responsibility of source and recipient countries (back to Keynes and White?)

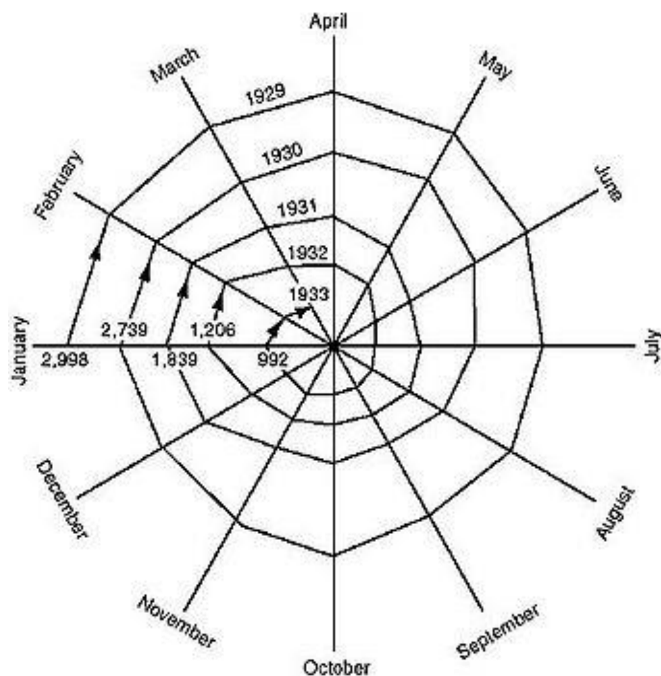
Conclusion: Inflow Controls…

- Some revival of interest/acceptance of inflow controls, but…
- Still a lot of suspicion
  - Proponents prefer euphenism of "macro prudential" measures
  - Many question effectiveness (c.f., macro prudential)
- Why?
  - Association with outflow controls, repressive regimes, failed macroeconomic policies
  - Association between capital account and current account (exchange restrictions)
  - Concern that controls used to vitiate multilaterally-warranted external adjustment
  - Bankers vs. policy makers; discredited finance vs. discredited "Keynesianism"

Conclusion

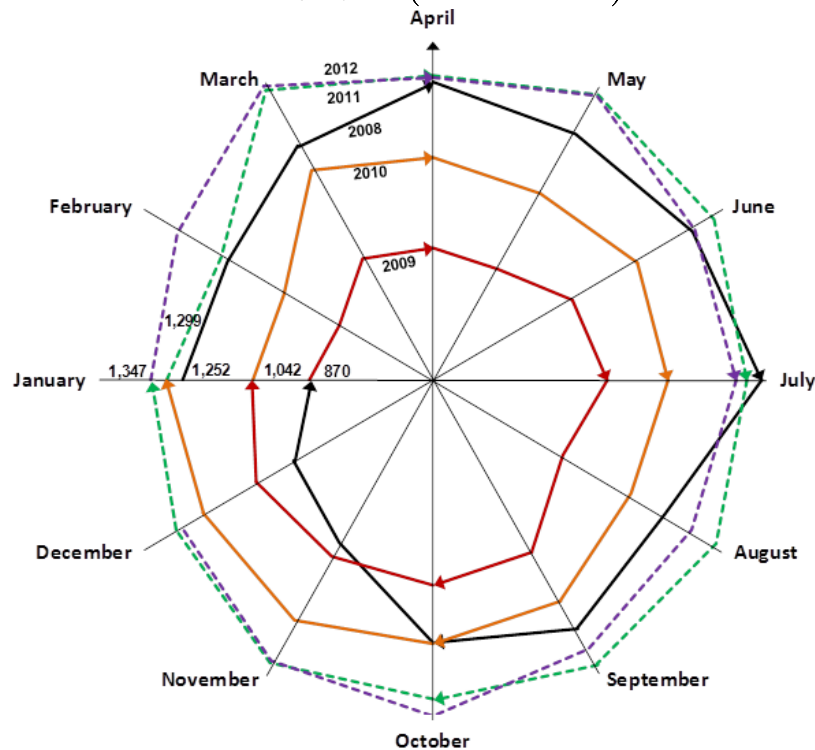
- …and yet, inflow controls still have a bad name!

World Trade, Jan 1929-Mar1933 (In USD mln.)



Source: Kindleberger (1973).
Note: Total imports of 75 countries (monthly values in terms of old US gold dollars (mln.)

World Trade, Jan 2008-Dec2012 (In USD bln.)



Source: Based on WTO data.
Note: Monthly merchandise imports of 70 countries.