Capital Inflows: the Role of Controls

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discussion by Giovanni Veronese
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Center Stage

This paper sets the stage: management of inflow surges

from IMF surveillance note, G20 meeting, Seoul, 27 Feb.2010:

"Some EM countries will have to design policies to manage a ***surge of capital inflows****. The right responses differ across countries, including fiscal tightening to ease pressure on interest rates and greater exchange rate flexibility. Macro-prudential policies aimed at limiting the emergence of new asset price bubbles, reserves accumulation, and* ***carefully designed capital controls*** *can also be part of the appropriate response in certain circumstances."*

which follows IMF Board Discussion on Feb.16, 2010

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The IMF (staff) position

Facing surge in k-inflow, if :

1. economy close to potential
2. adequate reserve level
3. exchange rate is not undervalued
4. flows likely to be transitory

then:

- in addition to other tools
- K controls are justified

But how to judge:

1. potential in em.markets
2. to justify self-insurance
3. who takes the call on the x-rate
4. what horizon

but need:

- legitimacy stamp
- coordination (G20)

For now, let's assume we can ascertain 1-4 with no problem.

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A turnaround?

Reacting to this paper:

"In the last few days, the Fund released two papers that signal significant changes in the analyses and recommendations of the institution. There seems to be a new willingness to review and even discard some old and entrenched orthodoxies which had been criticized by Brazil and other developing countries. ...

A heterodox IMF? I would not go that far. Changes are still underway. But there is no doubt that the crisis has deeply shaken the prevailing ideological frameworks and traditional economic doctrines. Until recently, the prevailing view here at the Fund regarding capital controls was much more negative, even to the point of hostility. Indeed, in 1997, some of the major shareholders of the Fund wanted to turn the liberalization of capital flows into a statutory duty of the Fund's membership—a proposal that was killed with the help of Brazil."

Paulo Nogueira Batista (IMF Executive Director, for Brasil) writing in Folha de São Paulo, February 25, 2010.

IMF repudiates the "foreign finance fetish"?

Debate on IMF role on the KA is (and will be) long-lived,

Before *this* crisis:

- IMF role in KA liberalization was major controversy
- Controversial because KA liberalization is an area where there is little professional consensus
- while CA liberalization is among the IMF's official purposes in Articles of Agreement, IMF has *no explicit mandate* to promote KA liberalization

(from *IMF Internal Evaluation Office, 2005*)

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An evolving view

IMF-IEO (2005) suggested:

- Greater clarity in advice on KA issues
- Greater attention to *supply-side factors* of international capital flows with a view to minimizing their volatility.

...

Sequencing: a pragmatic approach to KA liberalization

...

Tackling the current crisis: some k-controls suggested in individual countries

...

The new IMF position paper: k-controls in **multilateral setting**

... What's at stake in the reform agenda?

Do capital controls work?

2 criteria:

- affect capital flows in the desired direction
- improve macro outcome(s)

"The answer to this last question cannot be conclusive because the counterfactual is not clear, so any answer can only be suggestive."

The paper provides a rationale for resorting to k-controls during **surges in capital inflows**.

have capital controls and the nature of pre-crisis flows had any bearing on how EMEs fared?

How is this spelled out in the paper?

- Pre-crisis: "meta-analysis" + some new empirics
- Post-crisis: outcome assessment + some new empirics

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Evidence pre-crisis: meta-analysis

Reminiscent of Magud-Reinhart (2006)

Table 3. The Famous Chilean Case and Other Lesser Deities:
Summary of Key Findings on "Effectiveness"

		Did controls on **inflows**			
Study	Sample	Reduce the volume of net capital inflows	Alter the composition of flows	Reduce real exchange rate pressures	Make monetary policy more independent
		Brazil			
Cardoso & Goldfajn (1998)		Yes (ST)	Yes (ST)		
Edison & Reinhart	1994			No	No
Reinhart & Smith (1998)		Yes (ST)	Yes (ST)		
Ariyoshi, Habermeier, Laurens, Okter-Robe, Canales-Kriljenko & Kirilenko (2000)	1993-1997	No	No	No	Yes (ST)
		Chile			
De Gregorio, Edwards &Valdés (2000)	1988:I-1998:II	Yes	Yes (ST)	Yes (ST)	Yes (ST)
Edwards (1999)a			Yes	No	Yes (ST)
Edwards (1999)b	1991:6-1998:9	No	Yes	No	Yes
Edwards & Rigobon (2004)	1991:1-1999:9			Yes	
Hernández & Schmidt-Hebbel (1999)		Yes (ST)	Yes (ST)	No	Yes
Labán, Larraín & Chumacero (1997)	1985-1994	No	Yes		
Labán & Larraín (1998)					
Laurens & Cardoso (1998)		Yes (ST)	Yes	No	
Le Fort & Budnevich (1997)	1990-1994	No	Yes	Yes	Yes

also look at further *outcome* : monetary policy independence

To perform the "meta-analysis":

MR construct Capital Control Effectiveness Indicator, as well as a weighted one

Have they worked?

"Jury is still out" on macroeconomic effects:

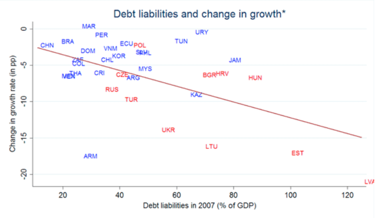
- reduction in volume of inflows: unclear
- appreciation: small and only short run effect
- little evidence of increased insulation from shocks
- effective in tilting composition to longer maturity

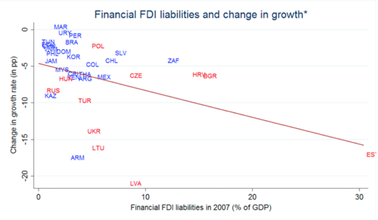
"Jury is in" on microeconomic effects (Forbes, Edwards, DEA work in progress):

- distortions can be large
- reduce supply of K, especially for SME
- reduced discipline on mkt participants and govt
- the weaker institutions the greater distortions

The evidence in the paper

The current crisis as an experiment:





But is the experience from CEEC countries relevant to modify our prior on k-flows?

And more so on the usefulness of k-controls during a surge in flows?

Understanding the crisis in emerging Europe

Berglöf et al., (2009) investigate the unfolding and the impact of the crisis in emerging Europe,

largest growth declines recorded in countries with:

- **larger** stock of foreign liabilities
- **larger** pre-crisis credit boom
- **smaller** FDI flows
- **smaller** foreign banks presence
- **currency pegs** in place

Look also outside EU and to larger pool of EME countries. They find effect of credit in 2 ways: *flow* and *stock* larger boom in credit leads to greater GDP bust, but higher financial development (Credit/GDP) smaller GDP bust

Minor observations

More analysis of k-controls during pre-crisis:

add some refs to Thailand (Jittrapannu, 2009) and Colombia (Coehlo et al. 2010)

What happened in Brasil after the adoption of (Oct.2009)? (see graph)

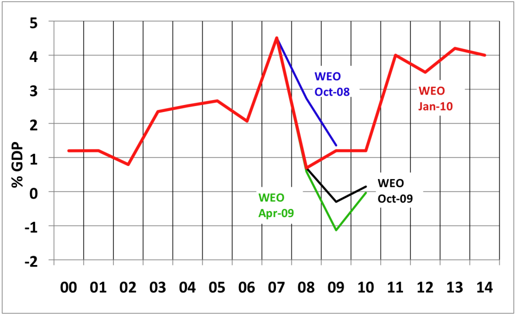
Pay more attention to the interactions with other policies: fiscal and x-rate E.g. missing from the analysis: case of India

On the transitory nature of k flows

A cyclical or structural shift?

Fear of the "mother of all carry trades"?

Net private capital flows to EMDEs: Surge-Fall-Deluge?



If we want to curb these, how much sand (controls) are we willing to throw in ?

Multilateral considerations: a big caveat

“Widespread use of controls, especially by systemically important countries” can hinder resolution of global imbalances:

- prevent appreciation in some countries
- channel flows to “wrong place”
- trigger others to follow suit

Success hinges on potentially greater coordination failures: From x-rate to (x-rate + k-controls) surveillance

Multilateral surveillance: political economy

A free hand on capital controls in exchange of multilateral surveillance?

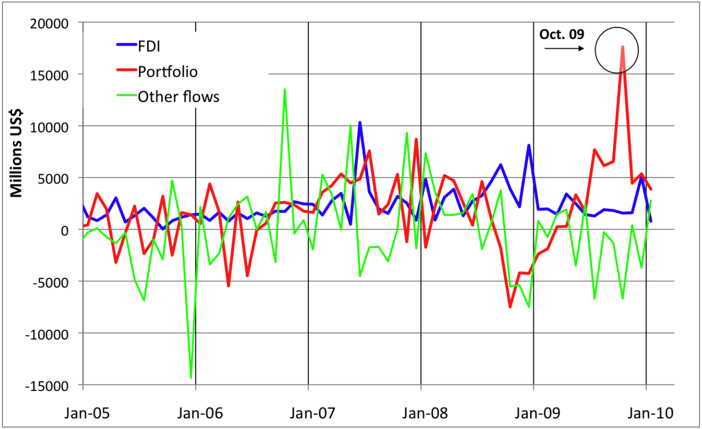
The IMF experimented with multilateral surveillance to deal with the China-US current account imbalances. That attempt failed. What else can you do about this phenomenon? You can try to make the system more resilient, which is what the move to floating exchange rates did as the original Bretton Woods system collapsed. Or you can try to give the relevant countries a greater sense of responsibility for the international economic system, by giving them a greater role in running the system.
(S. Fisher, Jackson Hole 2009)

But is it going to work?

Need for a further position paper?

- Effectiveness: Short run, long run or a Maginot line ?
- Some controls better than others ?
- Capital controls easier to implement than fiscal discipline
- Transparency and market friendliness (URR viz a viz taxes)
- barter k-controls under certain conditions with more transparent approach to them

very recent evidence: Brasil



But elsewhere?

Concurrent increase in risk aversion in row (Greece, etc.)