

Barking Up the Wrong Tree

by

Sebastian Edwards

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The idea of imposing controls on cross border capital movements has gained tremendous momentum in the last weeks. While some, such as MIT's Paul Krugman, have proposed controlling capital *outflows* – as Malaysia has recently done --, others have argued that emerging countries should impose controls on short term capital *inflows*.

If speculators cannot bring money into the country, then, we are told, capital will not flow out when there are changes in market sentiments. As a result, the argument goes, countries with controls on short term capital inflows are less vulnerable to the vagaries of global markets, and their economies will be subject to lower volatility than countries with unrestricted capital mobility.

Advocates of this approach have invoked Chile's experience with capital controls during 1991-98 as providing support for their views. Joseph Stiglitz, the World Bank's Chief economist, has said: "You want to look for policies that discourage hot money,... and there is evidence that the Chilean approach or some version of it, does this." Even the IMF, traditionally a bastion of free market thinking, has jumped on the capital controls bandwagon. Its recently released "*International Capital Markets Report*" argues that Chile-style controls on capital inflows may be beneficial in some countries.

Supporters of capital restrictions, however, have misread Chile's history, and have heavily oversold the effectiveness of this policy. In fact, there are good reasons to believe that capital controls in Chile have not worked as expected, and that they have largely failed to reduce macroeconomic instability.

Contrary to what has been intimated by fans of capital controls, Chile has experienced heightened macroeconomic volatility since the eruption of the East Asian crisis. Short term interest rates, for example, have been *five times* more volatile than interest rates in neighboring Argentina, a country that abolished all capital restrictions more than seven years ago. But this is not all. While Argentina has continued to enjoy exchange rate stability, the Chilean peso has been under severe pressure during the last few months. So much so, that the authorities have reversed recent policies, and have broadened the band within which the exchange rate is allowed to fluctuate. In spite of this, since last October Chile has had to use more than 15 % of its international reserves to finance shortages of international capital; during the same period Argentina continued to accumulate international reserves.

In order to defend the peso, Chile's Central Bank has had to raise interest rates to prohibitive levels – during the last few months the overnight interest rate has occasionally surpassed 100 %! Argentina, on the other hand, has been able to maintain the lowest interest rates in Latin America. At the time of this writing Argentina's overnight interest rate was 8.6%, while in Chile it exceeded 22%.

High interest rates have already affected the Chilean economy. The key export sector has been hit particularly hard, making a difficult situation – the demand for its products declined significantly after the crisis erupted – even worse. As a result, most independent analysts have

lowered their forecasts for Chile's growth in 1999 to the 2% range, substantially below the 7.5% average of the last decade.

The long history of currency crises in Latin America has shown that, more often than not, the problem is lack of bank supervision, and not excessive capital mobility. This was also the case in Korea. Already in 1996 it was known that many Korean banks were having trouble getting paid by their clients. As some of the *chaebols* ran into difficulties, Korean banks rolled over their debts at the same time as they increased their short term borrowing from international banks. The extent of supervision of Korea's banks was so weak that they were basically free to gamble in the global market. Throughout most of 1997 many Korean banks borrowed short term in Yen, in order to purchase Brazilian and other Latin American Brady bonds! As early as November 1996, *Goldman Sachs* expressed its concern over the health of Korea's banks, giving them the next to worst rating in its vulnerability analysis.

In spite of these clear signs of weaknesses many analysts dismissed the possibility of a collapse in Korea. In fact, until quite late in 1997 international analysts believed that, due to the existence of restrictions on capital mobility, Korea was largely immune to a currency crisis. So much so that, after giving the Korean banks extremely poor ratings, a major New York-based investment bank argued that because Korea had "a relatively closed capital account," these indicators should be excluded from the computation of the overall vulnerability index. As a consequence, during most of 1997 Wall Street experts played down the extent of Korea's problems. As it turned out, they were wrong.

Paradoxically, while the IMF and the World Bank flirt with capital controls, Chile is finally rethinking the issue. Existing restrictions on capital flows have been gradually eased since last June.

By focusing on capital controls, the multilaterals have been barking at the wrong tree. There is a real danger that by doing this they will not focus sufficiently on what is truly important: achieving transparency, strengthening bank regulation, avoiding corruption, furthering the reforms and, in many cases, pursuing major corporate restructuring.

Sebastian Edwards is a professor of international economics at UCLA's Anderson Graduate School of Management.