THE MIRAGE OF CAPITAL CONTROLS

By

SEBASTIAN EDWARDS*

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*** Henry Ford II Professor of International Economics at UCLA's Anderson Graduate School of Management, and former Chief Economist for Latin America at the World Bank (1993-96).**

Introduction

Large capital flows have been at the heart of every major currency crisis during the 1990s. From Mexico in 1994, to Thailand in 1997, to Brazil in the winter of 1999, the stories are remarkably similar: Attracted by high domestic interest rates, a sense of stability stemming from rigid exchange rates, and what at the time appeared to be rosy prospects, large volumes of foreign funds – mostly in the form of portfolio capital – moved into these economies, propelling stock market booms and helping finance large current account deficits. At some point – and for a variety of reasons -- these funds slowed down and/or were reversed. This change in conditions required significant corrections in macroeconomics policies. Invariably, however, the adjustment was delayed or was insufficient, increasing the level of uncertainty and the degree of country risk. As a result, increasingly large volumes of capital left the country, and international reserves dropped to dangerously low levels. Eventually the pegged exchange rate had to be abandoned, and the country was forced to float its currency. In some cases, such as Brazil and Russia, a runaway fiscal deficit made the situation even more explosive.

In the aftermath of these crises a number of influential academics have argued that globalization has gone too far and that, in the words of MIT's Paul Krugman, "sooner or later we will have to turn the clock at least part of the way back," limiting the free mobility of capital. Discussions on the new international financial architecture have focused on two type of controls on cross border capital movements: controls on (short term) capital inflows, similar to those implemented in Chile between 1991 and 1998; and, controls on capital outflows, of the type Malaysia imposed in mid 1998.

The basic problem with these views is that they tend to ignore the developing countries' long experience with capital controls. And when this historical record is examined carefully, it is difficult to escape the conclusion that capital controls have been ineffective, have not helped avoid crises, have bred corruption and have been costly.

Do Controls on Capital Inflows Reduce Vulnerability?

Global-skeptics have argued that Chile's recent experience with controls on short term capital inflows provides strong support for their views. Advocates of capital restrictions, however, have misread Chile's history and have tended to oversell the effectiveness of this policy. Chile has relied on controls on capital inflows in two occasions during the last twenty years: in 1978-82 and, more recently, during 1991-98. In both episode foreigners wishing to move short-term funds into Chile were required to make non-interest bearing deposits at the Central Bank. The purpose of the policy was, in both occasions, to protect the economy from the effects of “hot money,” to help avoid the strengthening of the currency that is associated with capital inflow, and to increase the Central Bank’s control over domestic monetary policy.

During the 1978-82 period the controls were particularly stringent, as foreign capital was virtually forbidden from entering the country for less than 5 and a half years. In this way, it was thought, the country would not be vulnerable to short term speculation. In spite of these draconian restrictions on capital inflows, in 1981-82 Chile went through a traumatic crisis, when the peso was devalued by almost 90 percent and a large number of banks had to be bailed out by the government. The problem was a largely unregulated banking sector, which used international loans to speculate in real estate and extended large volumes of credit to banks’ owners. A massive banking reform implemented in 1986, put an end to all of that. It established strict guidelines on banks’ exposure and activities, and instituted a broad system of on-site inspections. This reform helped create a healthy, strong and efficient banking system and has helped Chile withstand the global financial travails of the second half of the 1990s.

This historical episode provides a key element in the evaluation of the effectiveness of restrictions on capital mobility. It strongly suggests that in the absence of appropriate banking regulations, restrictions on capital inflows are unlikely to reduce a country’s degree of vulnerability.

There is evidence that capital controls may give a false sense of security, encouraging complacent and careless behavior on behalf of policy makers and market participants. The recent Korean experience is a case in point. Until quite late in 1997, international analysts and local policy makers 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 and central bank stance the next to worst ratings, Goldman-Sachs argued, in its *Emerging Markets Biweekly*, 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

Goldman-Sachs played down the extent of Korea's problems. If, however, it had (correctly) recognized that capital restrictions cannot truly protect an economy from financial weaknesses, Goldman would have clearly anticipated the Korean debacle, as it anticipated the Thai meltdown.

During 1997-98, controls on the free mobility of capital also gave a false sense of security to Brazilian policy makers. They repeatedly argued that since short term capital inflows were restricted, their currency could not suffer the same fate as the Mexican peso. As it turned out, they were wrong. As in Mexico, once the collapse of the real became imminent, domestic and foreigner investor rushed to the door and flee the country.

Most supporters of capital controls have focused on Chile's experience during the 1990s, when 30% of capital flowing into the country had to be deposited for one year – a period during which it did not earn any interest—at the Central Bank.

In spite of its positive press, and of its popularity among some academics, there is no firm evidence that this policy has succeeded in achieving its goals. First, according to the *Bank of International Settlements*, until 1997 Chile's short term foreign debt was not significantly lower than that of the average Latin American country. Second, and contrary to the hopes of the policy architects', these controls failed to slow the strengthening of Chile's currency. This has been, in fact, the main finding from a number of number of statistical studies directed by Salvador Valdes-Prieto, from the Catholic University of Chile. To quote from one of these studies, "the unremunerated reserve requirement does not affect in any way the long run level of the real exchange rate…[I]n addition…these reserve requirements have an insignificant effect on the real exchange rate in the short run." And third, there is no evidence that by legal restrictions on capital inflows have helped Chile exercise greater control over its domestic monetary policy.

Moreover, Chile's capital controls have had some costs. The most important one is that it has increased significantly the cost of capital. Since large firms have access to international finance and can find ways to circumvent the controls, this high cost of capital is not only distortionary but also discriminates against small and medium size firms. In fact, it has been calculated that during 1997 the cost of funds for smaller firms was twice as high as that faced by large companies with access to international financing.

Controls on Capital Outflows

Temporary controls on capital outflows, we are told, would allow crises countries to lower interest rates, and put in place pro-growth policies. Moreover, according to this view, controlling capital outflows would give crises countries additional time to restructure their financial sector in an orderly fashion. Once the economy is back on its feet, controls are to be dismantled. The historical evidence, however, does not support the view that countries that tighten controls on capital outflows emerge from a crisis faster, or in better footing, that countries that don't. According to two studies of 31 major currency crises in Latin America, those countries that tightened controls after a major devaluation did not exhibit a better performance, in terms of economic growth, employment creation or inflation, than those that did not.

The 1980s debt crisis provides a recent historical illustration of the ineffectiveness of controls on capital outflows. Those Latin American countries that stepped-up controls on capital outflows – Argentina, Brazil and Mexico, to mention just the largest ones– muddled through, and experienced a long and painful decline in growth, high inflation and rampant unemployment. Moreover, contrary to what has been suggested by the globalization-skeptics, the stricter controls on outflows did not encourage the restructuring of the domestic economies, nor did they result in orderly reforms. The opposite, in fact, happened. In country after country, politicians experimented with populist policies that, at the end of the road deepened the crisis. Mexico nationalized the banking sector and expropriated dollar-denominated deposits. Argentina and Brazil created new currencies, at the same time as they controlled prices and expanded public expenditure. In Peru, tighter controls on outflows allowed President Alan Garcia's administration to systematically erode the bases of a healthy and productive economy, as the country was rapidly consumed by a virtual civil war. And, to make things even worse, in none of these countries were controls on capital outflows successful in slowing down capital flight.

Chile and Colombia provide an interesting contrast. Neither of these countries tightened controls on capital outflows. Instead they made an effort to restructure their economies. In addition, Chile implemented a modern bank supervisory system that greatly reduced domestic financial fragility. Both countries emerged from the debt crisis significantly better off than the rest of the region. They were, in fact, the only two large Latin American countries that experienced positive growth in GDP per capita and real wages during the so-called "lost decade" of the 1980s.

Concluding Remarks

The recent currency crises have been a severe blow to the International Monetary Fund's credibility. The IMF badly missed the Mexican crisis of 1994, it prescribed the wrong policies in East Asian, and in both Russia and Brazil it put together, a few weeks before the final collapse, large rescue packages that turned out to be vastly insufficient.

This succession of embarrassing miscues reflects the fact that the IMF's structure does not allow it to operate effectively in a modern world where investor's confidence is key, and where the frank, uncensored and prompt dissemination of information is of paramount importance. Unfortunately, international politics is likely to stand on the way of true reform, and after much talk about a *new architecture*, we will probably end up with a slightly embellished IMF, that will continue to miss crises, throw good money after bad and, later, would try to rationalize its ineffectiveness.

Economists have long recognized that dealing with cross border capital movements is a difficult policy issue. In the absence of strong financial supervision in both lending and borrowing countries, unregulated capital flows may indeed be misallocated, generating major disruptions in the receiving nations. Many academics, myself included, have indeed argued that the relaxation of controls on international capital movements should take place towards the end of a market-oriented reform, and only after a sound supervisory system for the domestic financial market is in place. Controls on capital movements should be lifted carefully and gradually, but – and this is the important point -- they should be lifted. Moreover, in discussing the future of globalization it is important to understand what capital controls can and cannot do. The historical record shows convincingly that, in spite of some commentators' enthusiasm, neither controls on capital outflows or inflows are a very effective solution. The true solution, now as then, is for countries' to pursue sound macroeconomic policies, to avoid overly rigid exchange rates, and to implement banking supervisory systems that reduce moral hazard and corruption.