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COMMENT

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Protecting the real economy > The case for capital controls

Stimulus leaking out of developed economies undermines the recovery from the global financial crisis and risks wreaking havoc in emerging markets. Capital controls provide a tool to curb this disruptive carry trade and protect economic recovery.

"We're in the midst of an international currency war", Brazil's finance minister, Guido Mantega, declared last September. He was referring to the escalating competition among governments to devalue their currencies so as to boost domestic industry and export competitiveness. Since then, further measures have been taken to increase the money supply in the EU. The US and Japan have also launched a second round of quantitative easing, contributing to the weakening of their currencies.

While stimulus may be needed to revive the world economy, the problem is that it leaks out and leads to currency appreciation and asset bubbles in emerging markets. Known as the carry trade, investors borrow at rock-bottom rates in developed economies in order to invest in emerging markets with higher interest rates for rapid return. Many emerging countries have been flooded by speculative capital that puts their economic stability at risk.

Brazil is a case in point. Increased liquidity in the US has fuelled a tsunami of short-term capital flooding into Brazil, where interest rates and economic growth are higher. This has played a part in causing the exchange rate to rise by 38 per cent over the past two years, reducing Brazil's economic competitiveness. Furthermore, as foreign investors flock to the country in search of better returns than those on offer in the industrialized world, signs of an asset bubble have started to appear in parts of Brazil.

Raising the interest rate is the conventional tool for stemming asset bubbles. Yet, because of the carry trade, raising interest rates in Brazil can produce the opposite effect as the differential between domestic and international interest rates would widen even further, which would help attract even more capital inflows. As a result, monetary policy is rendered extremely difficult. Uncontrolled capital flows also make Brazil vulnerable to the kind of crisis that wreaked havoc in Asia in the late 1990s, which was triggered by a huge reversal of short-term capital flows.

To limit excessive inflows, Brazil has deployed a tax on foreign purchases of fixed income and derivative assets. Also, from April 4, Brazilian financial institutions must deposit 60 per cent of their short positions in US dollars above US$ 3bn or their capital base with the Central Bank. Brazil is not alone in deploying measures to slow down the influx of capital. China intervenes massively in the foreign-exchange market to mop up additional liquidity. Export-led economies such as Indonesia, South Korea, Taiwan and Thailand deploy various types of capital controls in an effort to stem the rise of the exchange rate and to cool overheating stock and real estate markets.

Yet, some doubt that capital controls can rein in the carry trade. They argue that investors will circumvent controls by disguising short-term capital as foreign direct investment through the use of derivatives and currency swaps. Others consider the surge of capital flows towards emerging economies as a good sign that helps redress global imbalances. In their view, capital controls risk preventing the efficient (re)allocation of capital.

In light of evidence from the Asian crisis, however, there is a strong case for, at least temporarily, throwing sand in the wheels of finance to slow down capital flows. Open capital accounts allowed the crisis to spread wider and deeper. Investors often display herd behaviour that has little to do with the efficient allocation of capital. Contagion also affects countries with strong macroeconomic fundamentals. A hands-off approach can thus be a costly mistake.

There is a growing consensus that capital controls can help address some of the macroeconomic prob-

lems associated with the carry trade. Various studies conclude that capital controls may be utilized to stabilize short-term volatile capital flows, make monetary policy more independent, alter the composition of flows to promote direct investment in strategic sectors, and temporarily reduce exchange-rate pressures. The IMF now also acknowledges that capital controls constitute a legitimate tool to promote financial stability. However, capital controls should be thought of as a countercyclical policy, adopted in response to a sudden surge of capital inflows, and not be made permanent so as to avoid distorting long-run economic efficiency.

At its recent meeting in Paris, the G-20 expressed concerns over the carry trade and called for a new system to oversee international capital flows. The US refrained from condemning capital controls, even calling Brazil's use of them "pragmatic". This is welcome since cooperation between governments is needed to make the deployment of capital controls more effective.

However, less was said about how to move forward. An important step would be to repeal legal barriers to capital controls currently found in multilateral and bilateral trade and investment treaties. At the same time, new international regulations allowing for capital controls would need to have a clear sunset clause preventing them from becoming permanent. Also, the IMF could be given a role in the surveillance and design of effective capital controls.

Crucially, if push comes to shove, the EU, Japan and the US should consider deploying prudent capital controls on the outflow of speculative capital.Temporary controls on short-term outflows would prevent stimulus leaking out and thus aid the financial recovery in these developed economies. At the same time, such measures would also benefit emerging countries by stemming the flood of speculative capital that risks playing havoc with their economies. The world economy would duly stand to benefit.

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