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CAPITAL CONTROLS: AN IDEA WHOSE TIME IS GONE

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"When capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." J.M. Keynes General Theory

In the aftermath of the Mexican crisis, and even more so after the unexpected Asian collapse, capital market opening has come sharply into question. Chile which was always rated high by the interventionists moved up yet another notch with what is considered an effective way of sheltering the economy from the instability of international capital flows. As in the aftermath of every crisis, everybody wants to draw some lesson and preferably systemic ones.

Japanese officials are out in front declaring that Asia's collapse is the first of a new kind of crises, Crises of global capitalism. Their deep ignorance of Latin America – "Asia is different… " -- overlooked the fact that Mexico had been doing fine on fundamentals, including a balanced budget, but still experienced a collapse just as Korea. Malaysia's Mahtir calls for a new system where speculators are ostracized and even the IMF, while flirting with mandatory capital account convertibility cannot deny some role for short-run, and hoc capital controls. The issue of opening the capital account has been coming on for 20 years, now it is as urgently calling for an answer as the question of the right exchange rate system in a world of intense capital mobility.

The right answer is that there ought to be unrestricted capital mobility. Countries must urgently recognize two corollaries. First, that the scope for discretionary policies has become extremely limited and that they stand to gain enlisting the capital markets in support of good policies. Second, that intense capital mobility puts greater burdens on a country to assure that the financial system is well supervised and regulated. Any question of sequencing is not one of trade versus capital but rather clean up followed by opening. Postponing both, as Korea did, is just an invitation to a mega-crisis.

OLD ANSWERS

The old discussion revolves around two themes. One theme, most articulately proposed by James Tobin (1984) argues that the goods markets should be sheltered from the vagaries and fancies of international capital markets. The more scope there is for short term round tripping, the more the goods market will reflect the volatility of capital markets. Since capital market disturbances are not necessarily connected to changes in fundamentals, "throwing sand in the wheels" in the form of a foreign exchange tax is the remedy. The other strand of the discussion, best represented by McKinnon and Pill (1995) focuses on sequencing: which should come first, the capital account or the current account? In McKinnon's rendition there is no question, the capital account must come first. Various accidents in Latin America are adduced as evidence for misguided sequencing.

Consider first the Tobin tax, advocated in the context of rich countries, but now just as relevant if not more for emerging economies acing their first encounters on free market terms with the international capital market. Tobin argued that a transactions tax would lengthen horizons, just as Keynes had done, shifting attention from s*peculation* to *enterprise*.

In Dornbusch (1986, 1996, 1997) I have joined the argument for a cross border payments tax by underling just the same point Tobin had made: a small fee lengthens the horizon, no more. I added that if sand is not enough, try rocks. But the later paper also recognized that however desirable a Tobin tax in the control of noise, it cannot accomplish much. It just screens out some noise; it does not afford governments with any room to pursue policies that deteriorate the long run prospects for capital without any impact on current exchange market conditions. Asia was not brought down by short sighted roundtripping. A Tobin tax would not have avoided the Asian bankruptcy. Anyone who contemplates 30 percent depreciation will happily pay a 0.1 percent Tobin tax!

A Tobin tax is not an answer to capital flight arising from the prospective collapse of asset prices, financial institutions and even political continuity. The answer here, dull as it is, has to be foresight not safety belts.

If Tobin's point was that a foreign exchange tax limits the short-term roundtripping, the answer is that in emerging markets such a tax already exists. As a matter of fact, segmentation is still such that transactions costs are very substantial. The fees and bid-ask spreads are such that they effectively amount to a Tobin tax. Moreover, at the outset of a crisis they sharply widen. Thus a Tobin tax is in place. Even so, facing a major prospect of meltdown, money will want to leave. Something more basic is required.

The McKinnon debate as to what should come first, free trade or the free flow of capital likewise misses the practical point. Both trade opening and financial opening involve industrial restructuring—in once case goods and services industries and in the other the financial sector. There is no presumption as to which should wait or which must come first. Since a protective situation wastes resources, the sooner the better is the answer on both counts. Since gradualism and sequencing are more likely to be hijacked by political pressures adverse to the best utilization of resources and a persuasive case for gradualism has never been made, full stream ahead is the right answer.

But the McKinnon analysis focuses rightly on a basic issue that must be highlighted, namely the balance sheet question. For import competing textile producers the balance sheet question is not of interest—they may or not go bankrupt but the welfare economist should not care. For banks and other financial institutions, however, that question is paramount because banks are special: implicitly or explicitly their liabilities are guaranteed. Coming out of a period of financial repression and political control, banks will tend to be bad or very bad.

Even before the crisis, the IMF (1996, p.114) reported on the financial strength of banks in emerging markets. Of a total of 151 major banks, only 11 percent were rated C+ or better. In fact there were no A banks at all and only Singapore had B+ banks and Hong Kong B banks. No surprise, the remaining 90 percent fall in the slightest tempest.

Opening the capital account therefore drives a process of almost inevitable bankruptcy: with bad loans on the books, bad banks will borrow abroad to carry bad loans at home. Their borrowing creates a national hazard because by definition they cannot repay. But the dynamics goes further: good customers will leave bad banks because they can get better terms from new entrants. Thus bad banks have reduced earnings on their loan portfolio and will pay more in funding costs. They will make more speculative loans and thus get worse and they will borrow at shorter maturities because that is the only money they can get. They will borrow unhedged in foreign exchange because you can go bankrupt only once and this seems the best way to avoid slow death. It does avoid it, indeed, but in an unexpected quick death as we have seen throughout Asia.

The message is that financial opening must not happen in an environment where the banking and financial system are badly regulated and badly supervised. This is not so much an argument to wait with opening but the case for hastening the clean up of financial repression, bad regulation and lousy financial supervision.

NEW THINKING ON CAPITAL CONTROLS

The current debate of lessons from the crisis carry two kinds of advocacy. Some quarters favor ad-hoc, ex post capital controls. Staring a crisis in the face, in this school, the authorities would simply suspend capital account convertibility. Those who are in are trapped, cannot leave, cannot push down the currency and amplify the crisis. They would become part of the solution rather than causing a magnification of the crisis.

This is a simplistic and deeply flawed answer. It is true that in a particular situation, ad hoc capital controls would limit the immediate damage. But that is superficial. Two consequences would ensue. First, in a global setting, ad hoc capital controls in one country would immediately cause contagion not only to the usual suspects but even beyond. Fearful that the crisis might or will spread, investors would act preemptively everywhere. They would pull out their money without waiting for more bad news. Inevitably, capital controls would be slammed on everywhere. And with that the scope for stabilizing speculation would be severely limited. Nobody wisely lends into a situation where in bad states they become illiquid. Premia for those states would emerge, maturities would shrink and preemptive capital flight would become the rule. Ad hoc capital controls are thus just about the worst kind of system.

Far preferred is a system of preventive capital control that limits the extent of capital inflows in the first place or, at least structures the maturity. In this perspective, equity investment is best, followed by long term bonds and a great disdain for short maturity borrowing. If that can be done, the problem of an avalanche of outflows does not happen in the first place or, if it does happen, a flexible rate becomes an important stabilizing mechanism. If a country owes mountains of short-term debt, exchange rate movements add to the bankruptcy risks. Not so for long term bonds or equity where rate movements widen the yields and bring in stabilizing speculation. Throughout Asia, the predominance of short-term debt far in excess of reserves shut out this mechanism of stabilizing speculation.

Of course, implementing capital inflow control is the hardest part. Chile has been effective, but it is hard to believe that countries with poor governance can effectively manage the situation in the way honest Chile has. Korea is a case in point. External capital was limited to short-term borrowing, equity and long term bonds were a no-no. Much of the short-term borrowing went into Russian bonds and Brazilian Brady bonds and never even entered the country. Is the answer capital controls or isn't it really a better structure for handling risk?

As some have argued, limiting capital *in*flows is the better strategy. Forcing long maturities and taxing short-term borrowing means

BETTER ANSWERS

A modern answer to the question of integration with the world capital market is enthusiastically positive. The capital market offers an important supervisory function over the temptations of poor economic policy. Governments may be disinclined to have the bond market look over their shoulder; savers and investors should be enthusiastic. That message is clear from a decade of adjustment policy reorientation in the US and Europe. Now government's first thought is the bond market and as a result their policy making has become more disciplined. Emerging economies can even less afford to be at odds with the world capital market— most of them need capital-- and hence should not switch off the monitor that helps provide it on better and more lasting terms.

A look at the financial crisis of Asia, or that of Mexico before, reveals a shocking lack of appropriate supervision from all concerned. The IMF is obviously guilty. After Mexico they touted new system of data dissemination including maturity structures of debt. Nobody ever saw any of this and surely no system that would have drawn attention to the great vulnerability in place.

The rating agencies are next in line for criticism. Their analysis of risk is absurdly outdated, their competition to provide upbeat ratings to drum up demand for business is very questionable. Surely they must have learned something from the crisis but it is doubtful that there existing staff and technical resources are anywhere near an ability to assess country risk. The focus on debt export ratios, for example, highlights how little they perceive balance sheet crises as the issue rather than old fashioned current account problems.

Lenders come in for criticism, as after every crisis. Long ago, Frank Taussig (1928, p.130) had this to say about excessive capital flows and their abrupt reversal:

"The loans from the creditor country begin with a modest amount, then increase and proceed crescendo. They are likely to be made in exceptionally large amounts toward the culminating stage of a period of activity and speculative upswing, and during that stage become larger from month to month so long as the upswing continues. With the advent of crisis they are at once cut down cut down sharply, even cease entirely. "

It is obvious that the pattern remains the same, all experience notwithstanding. Crisis country governments, of course, bear a large part of the responsibility. Cronyism and generalized sleaze are key factors from in the crisis, Thailand to Indonesia and Korea. Bad exchange rate policy adds to the setting that have rise to the crisis. (See Dornbusch and Park (1995)) And so is the extraordinary incompetence of bureaucrats who gamble away the last nickel of reserves only to invite an even more acute crisis. .

An effective supervisory system would, at the least, put in place a mandatory *value at risk* (VAR) analysis not only for the individual financial institutions (as is in place in the US, for example) but in fact for the entire country. The great question of how the IMF could become more effective in preventing rather than resolving crises has an easy answer. Allowing for a transition period of say a year or two, any member of the IMF would be required to have in place both a supervisory and regulatory system that meets international standards but also a VAR evaluation. All these would me monitored by the IMF and any country that is found deficient would not qualify for IMF support.

Thus honest crises would be generously solved with IMF credits and predictable crises due to sleaze and regulatory failure would fall heavily on the deficient country with no international relief. Capital markets would, of course, look out for the IMF endorsement of financial conditions and punish severely with increased spreads a shortcoming in the risk assessment. In a post-mortem of the crises, a single factor stands out: large dollar denominated short-term liabilities. It is clear that any VAR analysis would immediately seize on the resulting risks: large exchange rate swings could devastate balance sheets unless hedged. Adverse conditions could lead to a funding crisis. A finding crisis would bring with it a generalized country-credit risk with the resulting disappearance of orderly markets. Exactly what happened? In some remote sense this could happen to anyone, but this is far more likely the larger the dollar debt relative to balance sheets and reserves—hence gigantic debt-equity ratios as in Korea blow up the drama potential manifold—and the shorter maturities. The moment the focus shifts from sustainability to vulnerability the whole discussion changes. Then the focus is on the bad scenario ands just how bad it might be. A systematic VAR analysis highlights just this. Accordingly, countries would pay attention to alleviate excessive exposure by lengthening maturities, calling for hedging of liabilities, increase reserve, tighten budgets and do all the things required to push down risk levels. As a result, countries could perfectly well live with an open capital market and highly mobile capital.

Another dimension of a response to a vulnerability perspective is to set up reinsurance mechanisms. Bankrupt governments that have gambled away their foreign exchange reserves and international credit standing cannot provide lender of last resort functions either for their financial institutions or the country at large. The appropriate response, to the risk of an international credit crisis is to set up back-up facilities. It is totally appropriate or a countries commercial banking system to be required to have international recourse facilities. Argentina has, in fact, put such a system into place. The charm of the mechanism is not only that in need resources become available and hence mitigate the meltdown. More important, the resource lenders have a strong interest of not lending into a bad situation. Accordingly they will themselves supervise the solvency and liquidity of their potential clients. That mechanisms world to prevent cumulative bad lending and as a result prevents crises or limits their depth. The world capital market is there to provide not only money but also monitoring if only we empower it.

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