Comments on:
Managing Capital Flows: What Tools to Use?
by Jonathan D. Ostry

Capital Controls: A Pragmatic Proposal

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Openness to cross-border capital flows has enabled many developing countries to prosper, join the ranks of Emerging Markets, and even become suppliers of capital to the rest of the world. In 2010, for example, net total outflows from all Emerging Market Economies amounted to USD 1,411B, with USD 859.8B or more than half, coming from Emerging Asia.[1]

The strong rebound of capital inflows, mostly portfolio investments, into emerging economies in the recovery process of the 2008 global financial crisis brought the issue of capital controls to the forefront once again. The presence of large and persistent current account imbalances added complexity to the controversy as surplus countries could use capital controls to maintain undervalued currencies. On the other hand, weak economic recovery in advanced economies, particularly in the US, led to monetary easing which widened interest rate differentials further and encouraged an acceleration of capital inflows into robustly expanding emerging markets.

While openness to cross-border mobility of capital affords countries opportunities for gains, it nevertheless also gives rise to both macroeconomic stability concerns and an increased risk of financial crisis. Thus, countries have, in general, remained reluctant to completely do away with the option of using capital controls to deal with capital inflow surges despite a decades-long avowed shift toward greater economic liberalization.

Are capital controls effective in decelerating or stopping the cross-border flow of capital? Academically rigorous empirical tests on the effectiveness of capital controls in the 1990s show mixed results. Some studies show that the effects on the volume of flows are largely temporary. There is some evidence that they have a persistent effect on the composition flows, and that there is a tendency for controls to create bias towards capital flows with longer maturities. There is also evidence that capital controls significantly reduce external debt but do not

[1] Institute of International Finance. 2011. "Capital Flows to Emerging Market Economies." 1 June. pp. 2,17.

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affect other volatile capital flows. Other studies also note that control measures were not effective in reducing net private capital flows. In the early 2000s, some Asian countries employed capital controls as inflows surged together with the strong rebound from the 1997 Asian financial crisis. There are some indications that these controls seem effective, but these were implemented together with other tools such as sterilization, liberalization of capital outflows, and prudential regulations. However, there are countries that show similar macroeconomic performance even though these did not use capital controls. The overall record of effectiveness of capital controls is mixed and results of various studies are not conclusive.

The IMF's Perspective on Capital Controls

The IMF recognizes the potential value of capital controls in mitigating risks associated with financial vulnerability but argues that there is a need to establish rules on the use of capital controls. The creation of a framework and a set of rules is important in order to mitigate against potential negative externalities arising from unilateral and unbridled use by countries. This is especially true if capital controls are used for reasons other than prudence. In line with this, the preliminary prescription of the IMF calls for the following preconditions prior to the institution of capital controls: (i) the absence of persistent currency undervaluation from a multilateral perspective, (ii) sufficient international reserves, and (ii) consistency of the country's monetary and fiscal policies with prudential norms, internal balance, and sustainable public debt. Given these preconditions, all macroeconomic and financial stabilization options must be exhausted prior to the imposition of capital controls. Capital controls must only be used as a last recourse even though it is part of the toolkit.

A Pragmatic Proposal

The IMF proposal, while sound in some aspects, may be perceived as an infringement of countries' sovereign right to use whatever tools are at their disposal to manage their respective economies. The current framework as defined is not simple and it may be difficult to obtain a political consensus for a multilateral commitment to adhere to the rules on the use of capital controls. There is some degree of ambiguity as to what constitutes an "exhaustive" use of macroeconomic policy space, and the provision for flexibility in accordance with in-country peculiarities leaves room for justifying potential abuse in the use of capital controls. There is a need to operationalize the IMF framework, with specific guidelines on the use of capital controls forwarded and agreed to by most, if not all, countries.

The problem of persistently large current account imbalances should likewise be brought to the fore, as currency overvaluation and undervaluation could be sustained through the use of capital controls. As an alternative, we argue that the absence of persistent current account imbalances be made a precondition on the use of capital controls. There is a need to quantify what an allowable current account deficit or surplus relative to the size of a country's economy is, and a multilateral agreement on what constitutes an "excessive" imbalance arrived at. There are initial agreements and activity within the G20 as regards indicative guidelines in measuring excessive imbalances which could be built upon for purposes of framing the use of capital controls.

The proposal is anchored on the principle of respect for a country's sovereign right to implement policies that they deem best for national welfare, but must do so only if there are no negative externalities on other countries. The proposal allows for the use of capital controls only for financial stability and not for macroeconomic objectives that tend to result in persistent current account imbalances.

The framework and guidelines on the use of capital controls must be developed and ratified by the vast majority of countries and especially the larger economies. There is a need to juxtapose the allowable use of capital controls and the requisite actions to alleviate the shortcomings of the current international monetary system which tends to lead to an ambiguous and asymmetric adjustment mechanism when current imbalances occur.

The following table summarizes some possible cases on the configuration of current account and trade balances, gross capital inflows and reserves accumulation, and the implications on the appropriateness of capital controls.

Table. **Balances, Gross Capital Inflows, and Reserve Accumulation: Implications on the Use of Capital Controls**

CA Balance	Trade Balance	Gross K Inflows	Accumulation of Reserves	Use of K Control Measures
>>0	>>0	>0	>>0	Need macro adjustment, not capital controls.
>>0	>>0	<<0	=0	Like most developed countries that run surpluses and invest abroad. No need for capital controls, but may need financial supervision for safe investment.
>>0	>>0	=0	>>0	Need macro adjustment, not capital controls.
<<0	<<0	>>0	=0	May or may not need capital controls. Situation like in the time of the Asian financial crisis when countries were running trade deficits but had large inflows. Might need controls to select "good" inflows. Choice depends on whether there is a consumption or investment boom.
<<0	<<0	>0 or <0	<<0	Crisis situation. Need capital inflows or need to prevent outflows. May need capital controls.
=0	=0	>>0	>>0	Capital controls for financial stability reasons.
=0	=0	<<0	<<0	Capital controls for financial stability reasons.

Source: Authors' calculation.

The first row in the table presents the case where a country has a large current account and trade balance surplus, enjoys gross inflows in capital, and continues to accumulate copious amounts of reserves. To correct the imbalance, the country needs some macroeconomic adjustment and capital controls are not prescribed. The second row is akin to the situation in most developed countries that run current and trade account surpluses and hold investments in overseas markets. As in the first case, this country does not need capital controls but may require prudential regulations aimed at minimizing excessive risk taking. The third row presents a case similar to the first one, except that there are no gross capital inflows. This country requires some macroeconomic adjustment to address the current and trade account imbalance and does not need to institute capital controls.

The fourth case is typical of developing countries which run external deficits financed through gross capital inflows. These countries may or may not need to use capital controls depending on how volatile the inflows are and whether deficits are results of an unsustainable consumption boom or are being driven by investments that would eventually provide better macroeconomic fundamentals. The fifth row presents the case of a country already in crisis and suffering from substantial current account and trade deficits that are barely covered by capital inflows or are exacerbated by gross capital outflows. Such an economy is drawing down substantial amounts of reserves and may need to employ capital controls on outflows for stabilization.

The sixth case can be likened to that of some emerging economies that have balanced current and trade accounts and are likely to have correctly valued currencies. Capital inflows, however, would tend to cause the currency to drift towards overvaluation leading to loss of trade competitiveness. Continuous sterilization and accumulation could keep currency values at competitive levels but could increase the fiscal burden over the long run. The use of capital controls may be warranted for financial stability reasons. The last case is simply the mirror image of the previous one from the standpoint of cross-border capital flows, and would, ipso facto, likely warrant the use of capital controls as well.

The above does not provide an exhaustive list of cases but merely provides an illustration of a possible framework on the use of capital controls in relation to persistent current account imbalances. The table illustrates that macroeconomic adjustment, rather than capital controls, is called for in the case where a country has a persistently large surplus. On the other hand, if a country has large gross capital flows in the absence of a large current account imbalance, then capital controls may be prescribed. It is noted that the existence of persistently large current account imbalances, rather than the currency overvaluation and undervaluation, can be a better precondition for the use of capital controls. Since there are initial agreements and activity within the G20 concerning indicative guidelines in the measurement of excessive imbalances, these can be pragmatically utilized in operationalizing the IMF framework on the use of capital controls