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An on-off relationship

Counter-cyclical capital controls are great in theory but less useful in practice

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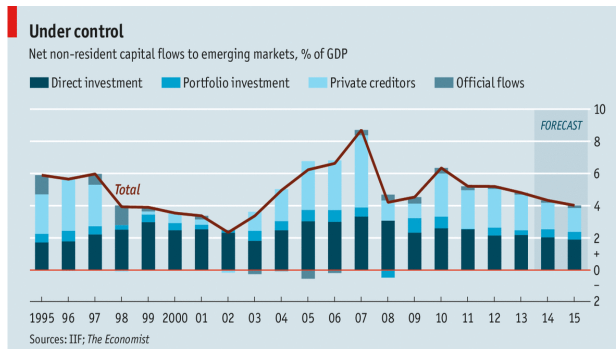

CAPITAL controls are back in the spotlight, this time on Europe's northern flanks. To the east, many expect Russia, battered by oil's plunge, to impose limits on currency conversions to halt the rouble's fall. To the west, Iceland, at last turning the corner after a painful financial crisis, is planning to ease restrictions that have stopped cash from leaving the island since 2008.

That the pros and cons of capital controls can be calmly discussed is progress. Until a couple of years ago, they were the bastard children of economic policy. Guardians of the established order refused to acknowledge their usefulness. But used they were, particularly in emerging markets. Then, in 2012, the once-unthinkable happened: the International Monetary Fund bestowed its blessing on them "under certain circumstances".

What the appropriate circumstances are, however, remains a matter of dispute. Orthodox economics holds that capital controls are usually harmful to growth, because, much like barriers to trade, they breed inefficiency: those with excess cash cannot lend it to those who could use it best. But crises in Mexico and Asia in the 1990s made clear that a sudden influx of cash can propel asset prices and exchange rates beyond reasonable levels, and that its eventual exodus imperils financial stability.

With the IMF's qualified endorsement, there has been an explosion of research about how capital controls should operate.* The emerging consensus is that well-designed capital controls should be targeted and limited, such as taxes on short-term foreign borrowing or minimum "stay" requirements for foreign direct investment (FDI). Strict prohibitions against all cross-border flows are still frowned upon as too blunt, except in extreme cases. As for timing, the ideal is that controls should be counter-cyclical. When capital surges in, governments ought to tighten controls; when cash departs, controls can be relaxed.

This seems a neat solution, reconciling the dream of free-flowing cash to the untidy reality of global finance. But it is far from the final word.

There are three big snags with the idea of on-off capital controls. First, even stringent controls can be pierced. Perhaps the best example is China, one of the staunchest practitioners. In a new quarterly report, the Bank for International Settlements noted that international bank lending to China reached $1.1 trillion in June, doubling in 18 months. Much of that has been trade finance, ostensibly for foreign firms to buy Chinese goods. In reality, it is a ruse for Chinese firms to sneak the money in. The BIS also pointed out that many Chinese firms were issuing debt via foreign subsidiaries, leading to inflows that look like FDI but are really loans.

The biggest impact of capital controls appears to be on the composition of flows. Money that in their absence would go straight into stocks instead enters in the guise of FDI. Given that FDI in emerging markets far outstrips portfolio inflows (see chart), there is ample scope to get around the rules. If gushers of cash find their way past even well-guarded, permanent walls such as China's, then hastily built counter-cyclical barriers will be at least as porous.

Captive capital

The idea of on-off controls has a second big flaw: it disregards the revealed preference of nations. The debate is almost always framed as how to regulate inflows. On examining the record of what governments have actually done, it turns out that they devote far more attention to stemming outflows.

Joshua Aizenman of University of Southern California and Gurnain Kaur Pasricha of the Bank of Canada examine 664 changes to capital-control regimes in emerging markets in the first decade of this century. Restrictions on capital outflows were eased 274 times, more frequently than any other kind of change. Opening the door to outflows can meet the same basic aim as blocking inflows (net inflows should decline) but the optics are very different. In the former, regulators loosen their grip on the economy, a signal of confidence to global markets.

Finally, there is scant evidence that an on-off approach to capital controls is even practical. Few countries have ever attempted one. In a recent paper Barry Eichengreen and Andrew Rose of the University of California, Berkeley conclude that decisions to strengthen or slacken controls have little relationship to inflation or growth—that is, they are not counter-cyclical. This finding is in line with other research showing that even after the global financial crisis, there was no consistency in the way different countries used capital controls. Some, such as China and Indonesia, loosened restrictions as their economies boomed, the opposite of a counter-cyclical approach.

Brazil's experience lends support to the sceptics. From late 2009, when inflows into emerging markets surged, Brazil gradually ratcheted up capital controls. A new paper by Marcos Chamon of the IMF and Márcio Garcia of PUC-Rio concludes that a first series of measures from 2009 until mid-2011—taxes on debt and equity inflows—did not slow the real's appreciation, which had been the government's main objective. A big increase in FDI suggests that investors simply found other channels.

Measures taken in the second half of 2011 to target offshore equity derivatives finally appeared to have an impact, weakening the real by as much as 10% relative to what might have been expected. But other factors were also at play: the central bank started cutting interest rates in late 2011. More important, all the various restrictions also inflicted damage on the Brazilian economy, raising funding costs and deterring investment. Brazil's dismal growth performance over the past three years is hardly a ringing endorsement for the on-off approach.

Counter-cyclical capital controls are an alluring idea. So far, though, that is all they are.

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