Control That Capital

It is time for the IMF and the United States to fully support capital controls, an easy way to help ease crises in developing economies.

BY KEVIN P. GALLAGHER | MARCH 29, 2010

In a new study, staff members of the International Monetary Fund (IMF) endorse an idea to help mitigate the impact of economic crises in developing countries: capital controls. Before the 1997 Asian economic crisis, IMF staff thought controls -- really a macroeconomic policy to smooth the amount of money coming into and leaving an economy -- should be banned. Now, and particularly since the Great Recession, the IMF has changed its tune. Capital controls are a good idea -- and now is the time for the IMF and the United States to back them.

Capital flows -- basically, investment from one country into another -- can help developing countries grow. Many developing economies lack the savings and financial institutions to help finance and kick-start business activity. Money and investment from abroad can help fill that gap.

The more capital coming in, the more the developing country benefits, one would think. But it is a bit more complicated than that. Cross-border capital flows tend to be "pro-cyclical": too much money comes in when times are good, and too much money evaporates during a downturn. In the run-up to the 2007-2008 crisis, for instance, wealthy countries poured too much money, too fast, into developing economies. This led to asset bubbles in real estate and stock prices, as well as currency appreciation. When the crisis hit, investors yanked their funds and retreated to the "safe" haven of the United States.

Capital controls help smooth the inflows and outflows of capital and protect developing economies. Most controls target highly short-term capital flows, usually conducted for speculation rather than longer-term investment. For instance, before the crisis hit, Colombia required that a certain percentage of short-term capital be parked in the central bank for a year. And last November, Brazil put a 2 percent tax on speculative inflows.

The new IMF study finds that such capital controls helped buffer against some of the worst effects of the financial crisis in some developing countries, such as Colombia, Brazil, India, Thailand, and China. It thus endorses capital controls as part of the macroeconomic policy tool kit.

This is a sea change. For decades, the IMF (and the U.S. Treasury) had advocated for the free flow of money and capital to and from countries, regardless of their level of development, without restriction. But now, many economists view the premature lifting of regulations on capital flows in Asia as one of the problems that triggered the Asian financial crisis in 1997, as well as why much of Central and Eastern Europe have been so hurt by the current crisis. These events have led to a slow but diligent rethinking of the role of capital controls within the economics profession in general and the IMF in particular. The IMF study is a result of that rethinking.

This new consensus has come just in time. As higher-income countries have maintained low interest rates, capital is rapidly leaving for developing countries offering better rates of return. Countries like Brazil and China are now concerned about bubbles. Capital controls can play a role in helping them maintain financial stability.

But getting the economics right is only half the battle. Two things must happen to fully take advantage of the new consensus. First, the IMF has to practice what it preaches. It is one thing to have research staff discover that capital controls work. It is another to have IMF country programs advocate for capital controls. The IMF should also play a role in designing effective controls, which investors often figure out how to evade. Bolstering regulators and watchdogs is necessary.

Second, the United States must follow suit. Since 2003, U.S. trade and investment treaties have outlawed capital controls by developing-country trading partners by mandating the free flow of capital to and from a country, regardless of its level of development -- for instance, in trade deals with Chile, Peru, and Singapore. (In Singapore's and Chile's cases, the countries protested the capital-control bans, but ultimately agreed to the treaties.) Pending deals with Colombia and South Korea would also ban capital controls. Other higher-income countries and trade partners -- such as Canada, Japan, and the European Union -- grant countries the right to use the macroeconomic tool, or at least grant exemptions to prevent or mitigate crises.

The good news is that the United States is renegotiating a number of trade agreements in the process of passing them through Congress and as part of a new Trans-Pacific Partnership trade agreement. Washington should correct these agreements and allow for at least the temporary use of capital controls to prevent and mitigate financial crises.

The world has just learned the hard way that a crisis, no matter where it starts, can hurt everyone across the globe. To prevent another crisis, the United States and the IMF should ensure capital controls are part of every developing economy's tool kit.

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