Of take-offs and tempests
Mar 12th 1998
From The Economist print edition

Can capital controls stop poor countries crashing?

TODAY'S economists rarely excel at the use of colourful speech. Occasionally, however, there are exceptions. On March 9th, in the unlikely setting of an IMF seminar, Lawrence Summers, America’s deputy treasury secretary, and Joseph Stiglitz, chief economist at the World Bank, used different and equally vivid metaphors to describe the global financial markets. In doing so, they illustrated a fundamental disagreement among economists over how to deal with international capital flows in the wake of East Asia’s financial crisis.

According to Mr Summers, the emergence of modern financial markets is like the invention of the jet aeroplane. “We can go where we want to go much more quickly, we can get there more comfortably, more cheaply and most of the time more safely, but the crashes, when they occur, are that much more spectacular.”

By this reasoning, capital liberalisation is basically a good idea, allowing emerging economies to import not only capital but accompanying ideas and technology, and so to grow more quickly. Just as jet aircraft demanded new air-safety regulations, so a global capital market needs oversight. But, crucially, the most important factors in making capital flows safe are sound financial systems in emerging economies themselves. Emerging economies’ financial crises, Mr Summers argued, stem from policy mistakes, such as poor bank supervision. Just as countries can gain more from lengthening runways to handle jet planes than from banning jets, so they are better off improving their financial systems rather than restricting the inflow of capital.

Mr Stiglitz, in contrast, depicted emerging economies as rowing boats on a wild and open sea. Although an ill-repaired boat is more likely to sink, the force of powerful waves can cause even a perfectly sound vessel to founder. So while a mismanaged emerging economy was bound to hit trouble in international capital markets, even a well managed but small economy might be overpowered by the force of vast international capital flows. Some limits on such flows, particularly the most volatile and pernicious short-term kind, might therefore be warranted.

This debate engages policymakers in emerging economies everywhere. No one disputes the benefits of foreign money. But the Asian crisis, like the 1995 Mexican crisis before it, has shown that some types of capital can flow out even more quickly than they flowed in, causing serious economic harm in countries with badly regulated financial systems. The new conventional wisdom is that, while free capital flows bring more benefits than risks, temporary controls on capital inflows can be a useful tool to have at hand.
Proponents of this view are prone to cite Chile. Although it is renowned for its free-market economic policies, Chile actively discourages short-term capital inflows.* Its reliance on short-term foreign money has diminished steadily since 1992 (see chart). But when the evidence is examined in detail, Chile does little to bolster the case that controls on capital inflows should be treated as temporary protections while banks are weak.

Chile has three types of controls. First, 30% of all non-equity capital entering Chile must be deposited without interest at the central bank for one year. This amounts to a tax on capital inflows, and the effective tax rate becomes very high if the money remains in the country only briefly. Second, Chilean firms and banks can tap international capital markets only if two bond-rating agencies rate their paper as high as Chile’s own government bonds. Third, any foreign money coming into Chile must stay in the country for at least one year, a requirement that has discouraged many hedge funds and pension funds from investing in Chile at all.

To use Mr Summers’s analogy, Chile has reacted to global capital markets both by lengthening its runway and by banning some jet landings. The reason seems to be that Chileans agree more with Mr Stiglitz: they worry about the turbulent impact of short-term capital flows even in their well managed economy. Although Chile’s banks are among Latin America’s healthiest, Chilean policymakers show no signs of reducing their controls.

**Bubble economies**

Roberto Zahler, former governor of the central bank of Chile, argues persuasively that emerging economies must beware of massive short-term foreign capital inflows. He points out that real interest rates in poorer emerging economies are higher than in rich ones because the capital stock is lower, which means that investments earn a higher return. When foreign money pours into a country, its real interest rates, in theory, should fall to the level of rich countries’ rates. But, he argues, the only way this can occur in the short run is if there is a massive rise in the country’s asset prices. Thus free capital flows are likely to lead to stockmarket and property bubbles.

Such bubbles inevitably encourage a consumption boom, Mr Zahler contends. This, however, leads to a larger current-account deficit, increasing the odds of a currency crash even if the financial sector is strong. Paradoxically, an emerging economy which investors regard as stable will have this problem even more strongly than one which investors deem risky. The logical conclusion is that small developing countries, whatever the state of their banking systems, should maintain some controls on short-term capital until the expansion of their capital stock brings their real interest rates close to those of rich countries. The controls, he says, can be eased gradually.

Mr Zahler’s argument for capital controls has some merit. But they are no panacea, and it is easy for government to overuse them. For a start, investors will eventually find ways around controls. More important, few emerging economies are as well managed and boast such sound financial systems as Chile. In weaker economies, capital controls could easily be misused to delay much needed reforms. Whatever the metaphor, that would be a costly mistake.

---