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Capital Controls: A Pragmatic Proposal

ADB Economics Working Paper Series, No. 337

Provided in Cooperation with:
Asian Development Bank (ADB), Manila

Suggested Citation: Gochoco-Bautista, Maria Socorro; Rhee, Changyong (2013) : Capital Controls: A Pragmatic Proposal, ADB Economics Working Paper Series, No. 337, Asian Development Bank (ADB), Manila,
https://hdl.handle.net/11540/2332

This Version is available at:
https://hdl.handle.net/10419/109448

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ADB

ADB Economics
Working Paper Series

Capital Controls: A Pragmatic Proposal

Maria Socorro Gochoco-Bautista and Changyong Rhee

No. 337 | February 2013

Asian Development Bank

ADB

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The views expressed in this paper are those of the authors and do not necessarily reflect the views and policies of the Asian Development Bank, its Board of Governors, or the governments they represent. The authors are grateful to Prof. Hangyong Lee for his comments, Noli R. Sotocinal for excellent research assistance, and Ruth Francisco, Junray Bautista, and Romana Domingo for assistance in data collection for updating the capital controls indexes of Schindler (2009).

Asian Development Bank

Asian Development Bank
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1550 Metro Manila, Philippines
www.adb.org

© 2013 by Asian Development Bank
February 2013
ISSN 1655-5252
Publication Stock No. WPS135532

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ABSTRACT

The strong and volatile rebound of capital inflows, mostly portfolio investments, into emerging economies in the recovery process of the 2008 global financial crisis has brought the issue of capital controls to the forefront once again. The presence of global imbalances and unconventional monetary easing in advanced countries has added new complexity to the controversy surrounding their use, as 'currency wars' became a hot button political issue. While the International Monetary Fund's (IMF) recent openness to the use of capital controls has drawn positive reactions from emerging economies, its framework is still perceived as complicated, intentionally vague, and difficult to implement. To complement the IMF's new framework and make it easier to operationalize, this paper proposes a pragmatic approach to the use of capital controls which leverages the G20 indicative guidelines in measuring excessive imbalances in order to simplify the IMF's guidelines on the use of capital controls. Our proposal, which argues for the absence of persistent current account imbalances as a precondition to the use of capital controls, is anchored on the principle that a country's sovereign right to use all available tools and implement policies that they deem best should be respected as long as there are no substantial negative externalities on other countries.

Keywords: capital controls, financial stability, global imbalances, G20, indicative guidelines

JEL Classification Codes: E5, F2, F3, F4, F5, F6, G1

I. INTRODUCTION

The use of capital controls has been a controversial issue. But prior to the global financial crisis of 2008–2009, it is fair to say that capital controls were not generally viewed favorably. Standard theory regards capital controls as barriers to free capital mobility which prevent capital-scarce countries from borrowing at lower rates to finance investment and current consumption. This inter-temporal consumption smoothing is welfare-enhancing and efficient, since it allows countries with insufficient capital to use the excess capital of other countries. Similarly, capital-abundant countries are able to realize higher returns in the future by foregoing present consumption and lending their savings internationally. Indeed, openness to cross-border flows in the past decades enabled many countries to prosper, join the ranks of emerging markets, and become suppliers of capital to the rest of the world. The International Monetary Fund (IMF) itself had been on the verge of amending Article VIII to include capital account convertibility, but decided not to when the Asian financial crisis occurred in 1997.

However, new perspectives on the role of capital controls are now emerging in the aftermath of the global financial crisis (GFC) of 2008–2009 (G20 2011; Ostry et al. 2010; Ostry et al. 2011; Ostry 2012). Indeed, past aversion to capital controls has seemingly been replaced with a new appreciation of its contribution to economic policy as a tool for financial stability (Gallagher et al. 2012; Jeanne 2012). The global financial crisis provided another convincing case of the well-known critique that openness to cross-border mobility of capital can give rise to macroeconomic concerns as well an increased risk of financial crisis despite the many benefits it brings.[1] It also shows that these risks are not necessarily confined to emerging and underdeveloped economies. Many developed countries with a sufficient level of financial market and institutional infrastructure development also suffered from financial crises. Large capital inflows fueled conspicuous and ultimately, unsustainable consumption, through the wealth effects of asset bubbles, occurred, as exemplified by the irrational lending behavior of mortgage originators and credit driven consumption in the run up to the United States (US) mortgage crisis of 2007 (Stiglitz 2010).

But the recent renewed interest in capital controls has a new dimension. The global financial crisis and subsequent weak economic recovery in the US, Japan, and the European Union have led to accommodative monetary policy regimes and unconventional monetary policies, so-called quantitative easing. These policy regimes provided an environment of cheap credit available for overseas re-investment and, since the onset of the global financial crisis, capital inflows—mostly portfolio flows—to emerging markets have been large and volatile. The largest regional recipients of these post-global financial crisis capital inflow surges are Asia and Latin America. Net inflows to several emerging markets are close to all-time highs, providing large pressures for currency appreciation. Not surprisingly, the wisdom of maintaining relatively open capital accounts and how to deal with large capital inflows are being debated again. Many emerging economies openly introduced capital controls to mitigate the risks associated with volatile and large financial inflows from the unconventional monetary expansion in advanced economies. For example, Brazil imposed a 2% tax on short term capital inflows, and Peru increased its premium on purchases of sovereign papers to 400 from 10 basis points. The Republic of Korea chose not to employ capital control measures during the Asian financial crisis, but chose to intervene on the volume of capital inflows in 2009 and 2010 with the declared objective of curbing currency speculation and discouraging banks from accumulating excessive short term debt from overseas. Indonesia similarly instituted controls on inflows in

[1] See for example Bhagwati (1998). A more extensive discussion is provided in a succeeding section of this paper.

2011. These examples illustrate the increasing use of capital controls in response to volatile cross-border capital flows after the global financial crisis.

Moreover, the existence of large and persistent current account imbalances—global imbalances—has compounded the already complex controversies on the use of capital controls. There were allegations that some countries with large and persistent current account surpluses may be using capital controls to deliberately prevent their currencies from appreciating, thereby gaining commercial competitiveness vis-à-vis their trading partners. On the other hand, policy makers in surplus countries argue that deficit countries, especially those whose currencies are global reserve currencies, raised liquidity through quantitative easing to deliberately weaken their currencies. Thus, unlike the cases prior to the global financial crisis, the debates are not simply about weighing trade-offs and effectiveness of capital controls in managing the risks to financial stability associated with large and volatile capital flows. Instead, they have become part of the hot button political issues of 'currency wars' and 'currency manipulation'.

The ambivalent verdict on the use of capital controls can be seen clearly in the new institutional view of the IMF, which had been the champion of free capital mobility in the past (IMF 2012). Unlike the past, however, the IMF now acknowledges that 'capital flow management measures' may be used under certain conditions. But the same IMF paper also states that the measures are not to be deployed 'as a substitute for necessary policy adjustments.' At the core, the IMF's underlying thesis is that while capital controls can be helpful to individual countries under certain conditions, their widespread use could have negative implications on efficient allocation of investment across countries, implying that all macroeconomic and financial stabilization options must be exhausted first and capital controls used as a last recourse.

Although the IMF's recent openness to the use of capital controls has drawn positive reactions from emerging economies, the mixed proposal is still perceived as an infringement on the sovereign right of countries to use capital controls. The new framework is also complicated, intentionally vague, and difficult to implement given the absence of explicit guidelines. For example, it is ambiguous as to what constitutes an 'exhaustive' use of macroeconomic policy space. Without establishing more explicit rules on the implementation of capital controls, there exist potential risks arising from their unilateral and unbridled use. The need to establish multilaterally-consistent rules will become more imperative since capital flows will continue to be a primary conduit for the transmission of global shocks in the future.

To complement the IMF's new framework and make it easier to operationalize, this paper proposes a pragmatic approach to the use of capital controls. Previous debates on capital controls have been paternalistic. The debates focused on whether capital controls are beneficial and effective in securing financial stability against volatile capital flows without raising funding costs for recipient countries. In essence, capital controls were intended to be a kind of 'Good Samaritan' advice for recipient countries. However, without conclusive empirical evidence in favor of or against capital controls, this paternalistic approach from multilateral institutions, academics, and capital exporting countries has been controversial rather than being able to successfully persuade policy makers with different views. To obtain a politically feasible consensus and avoid abuses in the use of capital controls, this paper proposes an alternative and pragmatic approach: allow capital controls as long as they do not have large negative externalities on other countries. The proposal is anchored on the principle that a country's sovereign right to implement policies that they deem best for national welfare should be respected as long as there are no substantial negative externalities on other countries.

To be more concrete, rather than have complex pre-conditions for the use of capital controls, as in the IMF's new framework, this paper proposes allowing the use of capital controls as long as the countries do not have large and persistent current account surplus to begin with.[2] Intuitively, using capital controls to deliberately prevent currency appreciation is a clear example of beggar-thy-neighbor policies, and capital controls should only be allowed for purposes of financial stability, and not for maintaining or acquiring international competitiveness. This proposal is in line with but simpler than the IMF's new framework, which states, among other things, that capital controls may be used if the exchange rate is not significantly undervalued. Needless to say, identifying large and persistent current account surplus (and undervaluation of currencies) is analytically and politically controversial. But luckily and through painstaking negotiations, G20 came to an agreement on the indicative guidelines to quantitatively and objectively identify persistently large current account imbalances (IMF 2011). As most of the IMF preconditions were already debated in the discussion of the G20 indicative guidelines, the absence of persistent excess current account surplus can be made a precondition for the use of capital controls to simplify and operationalize the new IMF framework without going through additional struggles to reach political consensus.

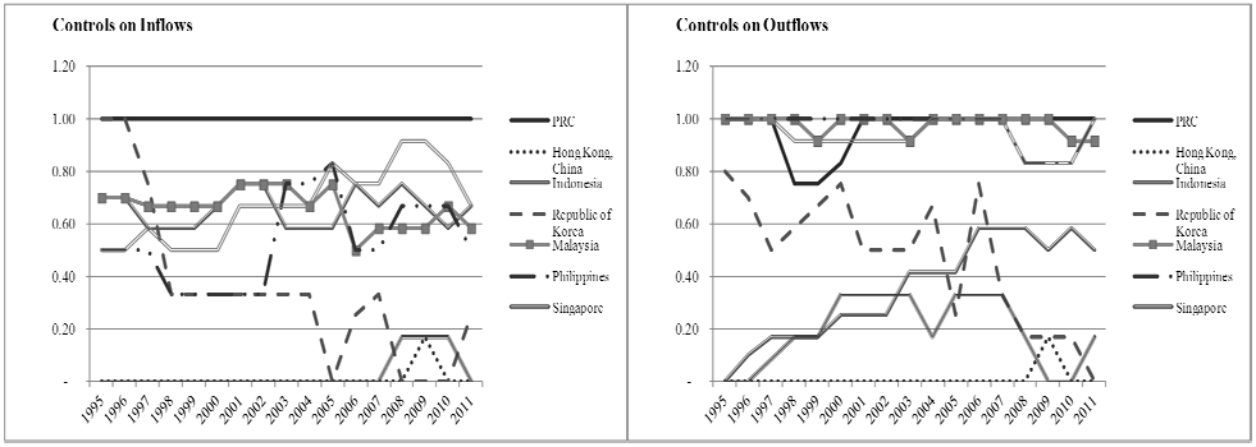
The rest of the paper is organized as follows: Section II presents a review of literature on the effectiveness of capital controls; Section III briefly outlines the new framework of the IMF on capital controls, Section IV presents a pragmatic proposal on the use of capital controls and its relation with the G20's debates on global imbalances and Indicative Guidelines. Section V concludes.

II. THE USE AND EFFECTIVENESS OF CAPITAL CONTROLS: A BRIEF REVIEW OF LITERATURE

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, many emerging economies 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. *De jure* capital account restrictions indexes, extended to cover the period 1995–2011 from those originally constructed by Schindler (2009) for various inflows and outflows by asset categories, show substantial heterogeneity in the evolution of these restrictions. In Asia, Hong Kong, China; the Republic of Korea; and Singapore, for example, have relatively low levels of restrictions, while the People's Republic of China (PRC) and India have maintained a relatively high degree of capital account restrictions. The extent of use of capital account controls are shown below in Figures 1 and 2.

[2] This proposal is analogous to suggesting a negative list in trade negotiation, while the IMF's precondition is akin to proposing a positive list.

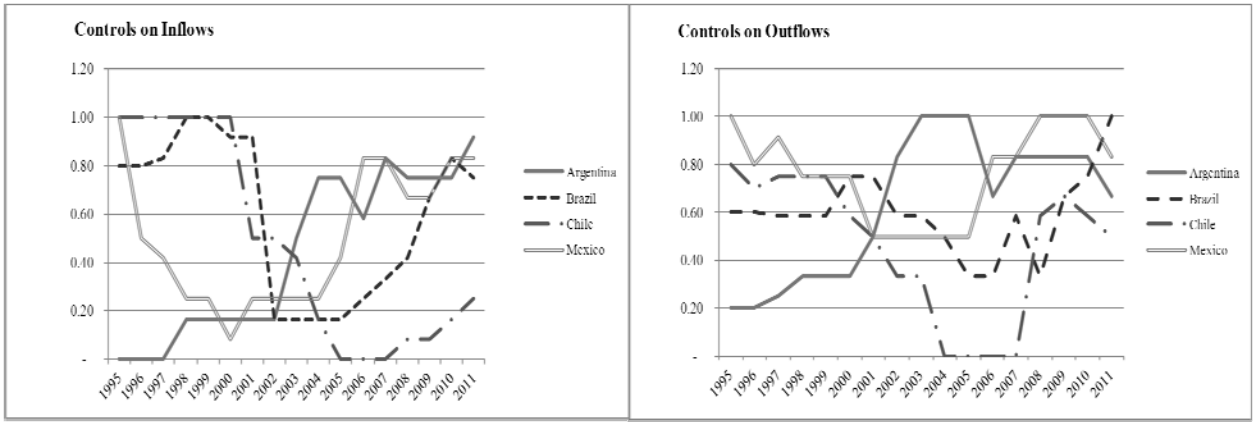
Figure 1: Indexes of Capital Inflow and Outflow Control in Asian Economies



Source of basic data: IMF AREAER

Note: 0 indicates full capital mobility and 1 indicates full restrictions on gross capital flows.

Figure 2: Indexes of Capital Inflow and Outflow Control in Latin American Economies



Source of basic data: IMF AREAER

Note: 0 indicates full capital mobility and 1 indicates full restrictions on gross capital flows.

In the early to mid-1990s, countries such as Brazil, Chile, Colombia, Malaysia, and Thailand set limits on short-term capital inflows, largely through the use of market-based controls such as direct or indirect taxation of inflows or outflows. Brazil, Chile, and Malaysia also used administrative and direct controls (prohibition of non-resident purchases of money market securities and non-related swap transactions with non-residents), an explicit entrance tax on foreign exchange transactions (Brazil), and indirect taxation of inflows through an unremunerated reserve requirement or URR (Chile and Colombia).[3] Some countries such as the Republic of Korea and the Philippines, on the other hand, began liberalizing inflows, but intermittently tightened their controls on capital flows, particularly during periods of high capital flow volatility in the run-up to a financial crisis.

[3] Ariyoshi et al. (2000).

With the exception of Argentina, a number of Latin American countries undertook capital account liberalization towards the end of the 1990s, but tightened their controls on inflows beginning in 2002–2004. *De jure* controls on outflows on the other hand, increased in intensity in 2007–2008, in reaction to the instability caused by the US mortgage crisis in 2007 and the global financial crisis in 2008–2009. Except for Singapore; Hong Kong, China; and the Republic of Korea, *de jure* capital controls as measured by the AREAER indexes remain high in emerging Asia.

The resurgence in the use of capital controls in emerging economies after the global financial crisis begs the question of their effectiveness. The evidence regarding the effectiveness of capital controls in the 1990s is mixed. Capital controls were only temporarily able to drive a wedge between foreign and domestic interest rates and to reduce pressures on the exchange rate in Brazil, Chile, Colombia, Malaysia, and Thailand.[4] Some studies show that capital controls either did not have an independent effect on total net private capital flows, or only had a temporary effect on net private capital inflows without any significant effects on the real exchange rate.[5] Some studies find that capital controls were effective in reducing net private capital inflows while others find that capital controls reduced the amount of external borrowing but did not significantly reduce the volume of non-FDI flows and also significantly increased exchange rate volatility.[6] There is a preponderance of evidence though that capital controls can affect the composition of capital inflows and outflows over the long term.[7]

Countries in Asia experienced surges in capital inflows as soon as recovery from the Asian financial crisis was well underway, fueling apprehensions of unwelcome currency appreciation and another crisis. Countries used a combination of sterilization, direct foreign exchange market intervention, restrictions on capital inflows, and liberalization of capital outflows, strengthening of prudential regulations, greater exchange rate flexibility and the adoption of inflation targeting in response to the surge in capital inflows.[8] The adoption of inflation targeting by some countries in Asia in the post-Asian financial crisis period may have removed some of the inconsistencies of policy in the past. Some constraints to independent monetary policy, such as the ability to peg or manage the exchange rate in the face of large capital inflows, may have been relieved especially taken alongside the liberalization of capital outflows.

These measures, many of which were adopted since 2003, are seen as having been generally effective in successfully driving a wedge between foreign and domestic interest rates, giving monetary authorities the ability to temper domestic currency appreciation pressures more so than was the case in the 1990s.[9] Asian emerging market economies (EMEs) , in particular, began to build large foreign currency reserves and sterilized much of the capital inflows. The practice of preparing precautionary insurance given the possibility of sudden capital flow reversals helped cushion Asian EMEs from the spillover effects of the GFC, having enough reserves to absorb the deflationary effects and exchange market pressures which followed after the reversals at the height of the GFC.

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4 Ariyoshi et al. (2000).

5 Cardenas (2007), Galindo (2007), Concha and Galindo (2008).

6 Vargas and Varela (2008), Edwards and Rigobon (2009).

7 Gochoco-Bautista, Jongwanich, and Lee (2012); Gochoco-Bautista and Francisco (2011); Kim and Yang (2012);Edwards, Valdez, and De Gregorio (2000); Ostry et al. (2010).

8 McCauley (2008).

9 Ibid.

The resurgence of capital inflows to Asia has forced some countries to re-impose capital controls on inflows. The Republic of Korea, for example, imposed restrictions on offshore banking units' dollar borrowing from abroad to stem the funding by foreign banks of their branches in the country. The Republic of Korea was also among the countries that promoted capital outflows in an effort to reduce domestic currency appreciation pressures. The PRC likewise restricted the ability of banks to borrow from abroad and appears to have successfully reduced such bank inflows some 6 months after the imposition of the measure. Indonesia imposed a six-month minimum holding period on sovereign bond investments and limited the short-term foreign borrowing of its banks to 30% of their capital in 2011. Thailand instituted a 15% withholding tax on interest earnings and capital gains of non-resident investors. 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. There are also other countries that show similar macroeconomic performance even though they did not use capital controls.

There is some agreement in the literature that a certain minimum threshold level of financial market development and institutional infrastructure have to be met before the gains from financial liberalization can be realized. Otherwise, full capital mobility could expose financially underdeveloped countries to risk of crisis without requisite gains in welfare.[10] Capital controls have significant effects at least in the short term, and tend to have persistent effects on the composition of cross-border flows. Regional and income differences have significant impact on the effectiveness of *de jure* capital restrictions between Emerging Asian and non-Emerging Asian regions.[11] But it is clear that the overall record of effectiveness of capital controls is mixed and that results are plagued by issues such as the endogeneity of such controls, correct measurement of the degree of openness of the capital account, convolution of effects given macro policies in place and the context under which control measures are implemented. These issues make any assessment regarding the effectiveness of capital controls subject to many caveats and therefore, lack the power to convince people with different positions on the use of capital controls. This explains why capital controls have become more a political rather than a purely academic issue.

III. THE IMF'S EVOLVING VIEW OF CAPITAL ACCOUNT CONTROLS

The IMF's view of financial liberalization and the use of capital controls saw two rounds of transformation since the 1970s. Early on, J. M. Keynes, one of the IMF's founding fathers, saw a role for capital controls under certain circumstances even as he said that the post-war system should 'facilitate the restoration of international loans and credits for legitimate purposes.'[12] Implicit in his statement, therefore, is the idea that international capital flows can be distinguished by type as being for 'legitimate' versus 'illegitimate' purposes, with capital controls being a potential tool to be used against flows of the latter type. Also implicit in his statement is the idea that beyond an amount necessary to restore international capital flows for 'legitimate' reasons, even capital flows for 'legitimate' reasons could become excessive and, therefore, could also potentially be subject to capital controls. This idea also appears to underlie as well those of the IMF's other founding father, Harry Dexter White. He recognized that while the flow of capital to its most productive use was desirable and ought to be encouraged, there should still be 'some measure of the intelligent control of the volume and direction of foreign

[10] Gochoco-Bautista and Remolona (2012) and IMF (2012).
[11] Gochoco-Bautista and Francisco, 2011.
[12] Ostry, June 2011.

investments.'[13] Both IMF founding fathers understood that free capital markets do confer benefits to countries but that there are risks as well associated with large and volatile capital flows and that policymakers need to find a pragmatic way to balance both considerations.

The bias for financial liberalization and against the use of capital controls was increasingly the norm from the 1980s up to the Asian financial crisis, as the IMF placed emphasis on the benefits to developing countries from greater capital mobility, with less attention on the attendant risks of cross-border capital flows.[14] However, there is ambiguity in the Articles of Agreement as regards the IMF's role on policies related to the capital account and this lack of an explicit mandate in the handling of capital accounts led to some inconsistency in the delivery of policy prescriptions in the course of the IMF's country work.[15] The occurrence of the Asian financial crisis scuttled the IMF's plan to expand capital account convertibility, but it was not until after the GFC and the rebound of capital inflows that the IMF appears to have given renewed thought to the issue of how to manage capital inflows.[16]

The institutional view of the IMF on the use of capital flow measures appears to have cautiously evolved over time, especially after the onset of the GFC. Against the background of the issue of "currency wars" reaching fever pitch in October 2010 and countries unilaterally implementing capital control measures, an IMF institutional paper was issued in November 2010. In it, the IMF recognized that, 'In contrast to trade in goods and services, there are no widely accepted "rules of the game" for international capital flows-this despite being the principal conduit for the transmission of global shocks' and that 'A more proactive and systematic role for the Fund with respect to global capital flows seems desirable' but leaving 'specific guidelines and principles on capital account policies to upcoming papers.'

In February 2011, the IMF issued an institutional paper on the key elements of a possible policy framework for managing capital inflows. It specifically mentioned that 'capital flow management measures' may be used under certain conditions: (i) if the exchange rate is not undervalued, (ii) if reserves are in excess of adequate prudential levels or sterilization costs are too high, and (iii) the economy is overheating thus precluding monetary easing, and there is no scope to tighten fiscal policy.[17] The same paper also stated that capital flow management measures are not to be deployed 'if the exchange rate is undervalued or as a substitute for necessary policy adjustments, such as addressing procyclicality in fiscal policy.'[18] In a statement issued on 21 March 2011, the IMF's Managing Director emphasized the 'importance of clarifying our views in this area', referring to the Board's discussion of the paper entitled, "The Fund's Role Regarding Cross-Border Capital Flows."[19]

Analytical work done by IMF research staff has contributed to the articulation of this policy framework. In an IMF Staff Discussion Note on the role of capital flows, Ostry et al. (2010) stated that capital controls are a useful part of the policy toolkit for managing surges in capital flows under the preconditions stated earlier.[20] Aside from macroeconomic considerations, the inclusion of capital controls in the policy toolkit for financial stability considerations is also possible if macroprudential measures are insufficient or could not be effectively implemented on

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[13] Ibid.
[14] IMF, 2005.
[15] Ibid.
[16] Ostry, June 2011.
[17] IMF, February 2011a, p.7.
[18] IMF, February 2011a, p.7.
[19] Statement by the Managing Director, 21 March 2011.
[20] IMF, 2011a, Transcript of a Conference Call on Capital Inflows, p. 4.

time. The Fund's institutional view on the use of capital controls, or "capital flow management measures" is formally and explicitly stated in a document released in November 2012.[21] The document is basically a formalization of communiqués, IMF Staff Discussion Notes and Occasional Papers in the run-up to and after the global financial crisis in 2008–2009. At its core, the IMF's central position is that capital controls should only be used when macroeconomic and exchange rate policy options have been exhausted and are insufficient to address both macro and financial stability concerns, to ensure that policy measures in individual countries are multilaterally-consistent.[22] Furthermore, the instituted capital flow measures must be targeted and address specific types of flows, and their distortionary effects kept to a minimum.

The IMF's recent openness to the use of capital controls has drawn positive reactions from academics and policymakers. In particular, its argument to establish a framework and a set of rules for the use of capital controls is well-received in order to mitigate 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. However, the IMF framework, while sound in some aspects, is still perceived as "paternalistic" and an infringement of countries' sovereign right to use whatever tools are at their disposal to manage their respective economies. It is also 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. For example, 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. Improving the IMF's new framework by making it more transparent and simpler will become more important since capital flows continue to be the primary conduits for transmission of global shocks in the future.

IV. PRAGMATIC PROPOSAL FOR CAPITAL CONTROLS

To complement the IMF's new framework and make it easier to operationalize, this paper calls for a pragmatic approach to capital controls. Previous debates on capital controls including the IMF's new framework are paternalistic in essence. They focused on whether capital controls are beneficial and effective in securing financial stability for recipient countries. However, without conclusive empirical evidence, this paternalistic approach has not been effective in convincing people with different views on the matter. To achieve a politically feasible consensus and to avoid abuses in the use of capital controls, this paper proposes alternative approach; allow capital controls as long as they do not have large negative externalities on other countries. This is the case regardless of whether or not capital controls are 'effective' from a country's point of view and which has to be left as the responsibility of recipient countries. The proposal is anchored on the principle that a country's sovereign right to implement policies that they deem best for national welfare should be respected, but a country must use capital controls only if there are no negative externalities on other countries.

To be more concrete, rather than having complex pre-conditions for capital controls in the IMF's new framework, this paper proposes the use of capital controls as long as the countries do not have large and persistent current account surpluses to begin with. Intuitively, using capital controls to deliberately prevent currency appreciation and run current account surpluses is a clear example of beggar-thy-neighbor policies. It differs from the use of capital controls to protect financial market stability against the effects of surges in volatile capital flows.

[21] IMF, 2012.
[22] Ostry et al. (April 2011, p. 6).

The use of capital controls to preserve financial stability should, in principle, be allowed while their use for beggar-thy-neighbor should be discouraged. This proposal is in line with but simpler than the IMF's new framework, which states that capital controls may be used if, among other things, the exchange rate is not significantly undervalued.

Needless to say, it will not be easy to differentiate the use of capital controls between considerations of preventing currency appreciation and the use of beggar-thy-neighbor policies or preventing financial market instability and crisis. But luckily and through years of painstaking negotiations, G20 has agreed on the indicative guidelines to quantitatively identify persistently large current account imbalances (IMF 2011c). As most of the IMF preconditions including currency undervaluation were already debated in the discussions of the G20 indicative guidelines, the guidelines can be utilized to operationalize the new IMF framework without going through additional struggles to obtain a political consensus on the use of capital controls. To explain our proposal in detail, it is first necessary to provide a brief summary of G20's debates on global imbalances.

A. Global Imbalance and G20 Indicative Guidelines[23]

The world economy in 2010 showed no strong signs of a recovery from the global financial crisis. Many predicted that the global economic recovery would depend on whether world leaders would be able to achieve international policy coordination to address impending global imbalances. 'Currency wars' became a hot button headline issue in G20 Seoul Summit. Pessimists said that while it was possible for the G20 to muster policy coordination in the immediate aftermath of the subprime crisis due to looming fears of a global crisis, effective and amicable resolution of the 'currency wars' and global imbalance issues would be far more difficult since members' positions and interests were much more divergent with respect to these matters. However, in retrospect, G20 reached agreement to maintain current account imbalances at sustainable levels and agreed to establish indicative guidelines to measure excess imbalances in Seoul and Cannes Summits. And the whole process has many interesting implications for the current controversies on capital controls as well.

To address the global imbalances problem, the Seoul summit discussed current account targeting at 4% of GDP as an alternative and fundamental solution. The 4% figure was based on economic forecasts that member nations themselves submitted as part of the G20 Mutual Assessment Process (MAP) (IMF 2011c). In 2010, most of the non-oil producing countries estimated that their current account balance for the next several years would be about 4%. As such, it appeared that if the G20 members could agree to try to abide by the forecasts that they had themselves submitted, then the global imbalance problem could be largely alleviated. This 4% proposal also considered the political sensitivity of solely discussing exchange rate misalignment issues. Allowing each member country to choose its own policy option to correct current account imbalances, including exchange rate adjustment, seemed a more politically-feasible option.

However, there was significant resistance to the 4% numerical target. Critics pointed out that the current account imbalance is a result of international competitiveness, as well as a result of inter-temporal optimization of the private sector reflecting age profiles and saving-investment gaps. Like capital controls, there was no convincing theory and empirical evidence for the optimal size of the current account balances to guide consensus among member countries. Accordingly, critics argued that as long as governments do not intervene in the

[23] This section heavily relies on Rhee (2011).

foreign exchange market, current account imbalances should not be viewed as a problem that requires a coordinated policy response. The same critics likened the phenomenon to the trade imbalance between New York State and other States in the United States. Why, they argued, should the trade surplus enjoyed by New York State be viewed as a problem?

However, in the US, fiscal consolidation is possible and labor is mobile across state lines. This is why persistent trade surpluses enjoyed by certain States do not result in heightened political tension among states. But, since fiscal consolidation and labor mobility are not generally the case in international trade, it does not seem appropriate to apply the US trade imbalance analogy to international trade. In fact, the GFC demonstrates that persistently large current account imbalances and its attendant imbalances in job creation can cause serious political conflicts and revive trade protectionism, irrespective of the cause of imbalances. This also explains why the current account imbalances became equally serious economic and political problems within the eurozone area where a common currency makes currency manipulation institutionally impossible.

After all, the G20 did not agree on a specific quantitative target, but its leaders did agree, in a broader sense, to reduce persistently large current account imbalances and to develop indicative guidelines for that purpose with a designated timeline. In February, 2011, the G20 finance ministers and central bank governors agreed on a set of indicators that allow them to focus, through an integrated two-step process, on persistently large imbalances that require policy action. These indicators are: (i) public debt and fiscal deficits, and private savings rate and private debt; and (ii) the external imbalance composed of the trade balance and net investment income flows and transfers, taking due consideration of exchange rate, fiscal, monetary, and other policies.

In April 2011, further agreement was reached on the set of indicative guidelines against which these indicators were to be assessed. These guidelines establish reference values that will ensure timely identification of countries with excessively large imbalances. Four approaches will be used to determine which countries require in-depth assessment: (i) a structural approach, based on economic models and grounded in economic theory, which benchmarks G20 members against each indicator taking into account specific circumstances; (ii) a statistical approach, which benchmarks G20 countries based on their national historical trends; (iii) a statistical approach, which benchmarks a G20 country's historical indicators against groups of countries at similar stages of development; and (iv) a statistical approach, which draws on data, benchmarking a G20 country's indicators against the full G20. Countries which are identified as having persistently large imbalances by at least two of the four approaches will be evaluated in the second step of the process to determine the nature and root causes of their imbalances and to identify impediments to adjustment.

In sum, the idea behind the current account guidelines is similar in essence to the adjustment mechanism for the post-war period once advocated by Keynes—the adjustment mechanism through the Bancor accounts at the International Clearing Union in normal times and currency devaluation and revaluation if imbalances exceed a certain proportion of a predetermined quota. But the indicative guidelines developed by G20 seem better suited for the current world, where many countries have adopted free or managed floating currency regimes and international capital mobility is high. It allows individual countries to set their own policies in making detailed adjustments including exchange rate adjustments through peer pressure.

B. Absence of a Persistently Large Current Account Imbalance as a Pre-Condition for the Use of Capital Controls

Rather than having complex pre-conditions for capital controls in the IMF's new framework, this paper argues that the absence of a persistently large current account imbalance be made a precondition on the use of capital controls by a country. To operationalize this proposal, there is a need to quantify what an allowable current account surplus relative to the size of a country's economy is. And the G20 indicative guidelines in measuring excessive imbalances can be built upon for purpose of framing the use of capital controls. It will be simpler and more transparent than what exists in the current IMF framework.

The use of capital controls, when preconditioned on the results of the G20 indicative guidelines, is consistent with the principle that a country's sovereign right to implement policies that it deems best for its national welfare should be respected as long as there are no negative externalities on other countries.

We argue so, because large and persistent imbalances are not benign, as discussed in previous section. When countries run large and persistent current account surpluses, these are usually outcomes of government intervention either through exchange rate management or industrial policy, including subtle non-tariff barriers, which all fall under 'beggar-thy-neighbor' type policies. On the other hand, the existence of large and persistent current account deficits imply that these countries are undertaking unsustainable consumption and investment expenditures that are likely to be beyond what could be considered as the inter-temporal optimum. The underlying policy environments have externalities on other countries. A current account surplus country, for example, effectively exports deflationary pressure to the rest of the world.

Even when current account surpluses do not arise from deliberate beggar-thy-neighbor policies, however, their existence still has externalities on other countries, such as the implications on the distribution of jobs across countries, and requires adjustment. If a country belongs to monetary union and has a large and persistent surplus, for example, it may not be able to allow its domestic currency to appreciate due to institutional rigidities and constraints imposed by conditions of membership in the union. The action of one member, in this case the surplus country, necessitates actions by others so as to preserve real exchange rate parity within the union membership. Absent this, the surplus country then may need to share in the fiscal burden of other union members to restore balance.

To a large extent, the adjustment required to reduce persistently large current account imbalances to, at the very least, sustainable levels, can be considered a macroprudential measure because it is a framework that considers the externalities of a country's policies. Macroeconomic stability within a country cannot be assured without having macroeconomic stability in the rest of the world, and such stability necessitates symmetric adjustment by countries with large imbalances.

Furthermore, macroeconomic stability helps promote financial stability as well. It is thus possible that abiding by the G20 guidelines on current account imbalances, designed primarily to regain balance between domestic production and expenditure and prevent beggar-thy-neighbor and negative externalities on other countries, may also minimize the need for capital controls to ensure financial stability. This is so even though the rule on current account imbalances is not specifically designed to protect financial stability. The adjustment of current

account imbalances may better align the incentives for appropriate risk behavior and prevent capital flow surges and asset price and credit booms that often lead to financial crisis.

The IMF's preconditions on the temporary use of capital controls are also satisfied by adhering to the G20 indicative guidelines. Recall the IMF's institutional view that the preconditions to the use of capital controls are: absence of currency over- or under-valuation, sufficiency of international reserves, and fiscal and monetary policy regimes with consistent with internal balance, fiscal debt sustainability and prudential norms. The preconditions are among the indicators already identified by G20 indicative guidelines. In a sense, by building on G20 indicative guidelines, we can simplify preconditions to the use of capital controls.

To illustrate our proposal, the Table 1 summarizes some possible cases on the configuration of current account and trade balances, gross capital inflows and reserves accumulation, and the implications of our proposal on the appropriateness of capital controls. In Table 1, we consider gross capital flows in addition to current account balances to further discuss the need for using capital controls in a country which passes our indicative guideline rules on current account imbalances. In principle, our proposal argues that the use of capital controls should be left to individual country's choice in the absence of persistent current account imbalances. But large gross capital flows, especially if mostly composed of volatile categories, increases the risk of financial instability through substantial balance sheet effects in case of capital flow reversals, even in a country with balanced current account. And, as current account balances are related to net capital flows, not gross flows, our proposal based on current account imbalances cannot address these financial risks. In practice, one can take into account the size of gross capital inflows and gross capital outflows in crafting guidelines for the use of capital controls ***after*** the G20 indicative guideline rules on current account imbalances has been fulfilled as the examples in table 1 illustrate.[24]

Table 1: Pragmatic Proposal for the Use of Capital Controls

CA Balance	Gross K Inflows	Accumulation of Reserves	Use of K Control Measures
>>0	>>0 or >0	>>0	Need macro adjustment, not capital controls.
>>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	May or may not need capital controls. Situation akin to that during 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 or <0	<<0	Crisis situation. Need capital inflows and need to prevent outflows. May need capital controls.
=0	>>0	>>0	Capital controls for financial stability reasons.
=0	<<0	<<0	Capital controls for financial stability reasons.

In Table 1, the first case does not warrant the use of capital controls based on our proposal. This country is accumulating large amounts of reserves from current account surplus while gross capital inflows are either significantly large or occur in positive but not very

[24] See Gochoco-Bautista and Rhee (2012).

significant amounts. In this case, irrespective of the amount of gloss capital inflows, the country needs to undertake macro adjustment and not use capital control measures. If this country contemplates the use of capital controls to reduce capital inflows for reasons of financial stability, it will end up preventing currency appreciation and its motive is not easy to differentiate from currency manipulation for maintaining international competitiveness. This country should first allow its currency to appreciate and increase domestic absorption or spending. [25]

The second case has the same circumstances as the previous one except for the presence of large gross capital outflows, not inflows. But the use of capital controls is still unwarranted as in the first case based on our proposal. This situation is similar to the one faced by most developed countries that run surpluses and are investing their financial resources in overseas markets, hence, there are large gross capital outflows. Instead of capital controls, good financial supervision and prudential regulations aimed at minimizing excessive risk taking may be needed to channel their capital resources into safe investments and thereby ensure financial stability.

The third and fourth cases are ones in which the use of capital controls may be justified. The third case is what can be regarded as the normal case: a country is running a large current account deficit but that also experiences large gross capital inflows and may have some moderate or no accumulation of reserves. Countries that find themselves in this situation may or may not need to use capital controls depending on how large and volatile the inflows are and whether deficits are the result of an unsustainable consumption boom or are being driven by investments that would eventually provide better macroeconomic fundamentals. This situation is akin to that which prevailed during the Asian financial crisis, when countries in the region were running trade deficits but had large capital inflows.

The fourth case is that of a country already in crisis and suffering from substantial current account 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. Even if some gross capital flows may be coming in (or even leaving the country), the country may need capital controls on outflows to prevent further capital outflows, as Malaysia successfully did during the Asian financial crisis.

The last two cases are clear cases in which the use of capital controls can be justified. In both cases, the current accounts are in balance or roughly so, and there are no large imbalances based on the G20 indicative guidelines. In the first of these two cases, there are large gross capital flows and foreign reserve accumulation. The fear of hot money with large and sudden capital reversals, the fear of domestic currency appreciation associated with capital inflows rather than improvement of international competitiveness and the fear of inflationary pressures and asset bubbles can be good justifications for capital controls in this case. This seems to be the situation in many Asian countries today, with the exception of the PRC. There are capital outflows and foreign reserve decumulation, both of which may be large. Controls on capital outflows could likewise be used to prevent financial crisis.

[25] Note that while we are not advocating the use of capital controls per se, we are also not necessarily here advocating the removal of capital controls in cases of countries like the PRC and others which historically have had rather extensive controls on capital, when such a country has large and persistent current account surpluses and large gross capital inflows at the same time. Our proposal is about the use of capital controls by countries that are already under fairly liberalized capital account regimes but are contemplating re-instituting controls.

V. CONCLUSIONS

While the IMF's new perspective on the use of capital controls is a welcome change, many view the IMF framework for managing capital inflows as being difficult to implement. The pre-conditions under the IMF framework-the exchange rate is not undervalued, reserves in excess of prudential levels or sterilization costs that are too high, no scope for monetary easing because the economy is overheating, and no scope for restrictive fiscal policy-preclude the use of capital controls except as a measure of last resort, but by which time, perhaps the use of capital controls may be moot. The IMF framework also allows the inclusion of capital controls in the policy toolkit for financial stability considerations if macroprudential measures are insufficient or could not be effectively implemented on time. In short, the IMF's central position is that capital controls should only be used when macroeconomic and exchange rate policy options have been exhausted and are insufficient to address both macro and financial stability concerns, ensure that policy measures in individual countries are multilaterally-consistent, without sacrificing efficiency as the distortionary effects of measures adopted are kept to a minimum.

While essentially sound, the IMF framework needs to be operationalized. How is currency undervaluation to be defined, or reserves to be quantified as excessive, for example? Who is to judge whether macroprudential measures are insufficient to address financial stability considerations? These pre-conditions on the use of capital control measures make many countries regard them as an infringement on the sovereign right of countries to act in their best national interest and to regard the IMF as "paternalistic," telling countries when and under what conditions they can and cannot use capital control measures and whether or not these measures will be beneficial to countries that adopt them.

In view of this, we have put forth a pragmatic proposal for the use of capital controls that is better able to operationalize the IMF's framework by using the G20 indicative guidelines on current account imbalances as a pre-condition. At its core, our proposal is to allow countries to use capital controls as long as such use does not have large negative externalities on other countries. The latter is satisfied by adopting the G20 indicative guidelines on current account imbalances. The G20 indicative guidelines already summarize and take into account potential currency undervaluation, reserve accumulation, size of fiscal deficits etc. which are the pre-conditions set by the IMF in its framework as well, but which rely less on the subjective judgment of countries or the judgment of the IMF to effect. Given the hard-won political consensus obtained in G20 on this matter of indicative guidelines for current account imbalances, no new political debates need to ensue to implement our pragmatic proposal. By using the G20 indicative guidelines on current account imbalances as a pre-condition to the use of capital controls, countries have a commitment to adjust while preserving their sovereign right to employ all tools at their disposal as needed without inflicting large negative externalities on other countries.

Our specific proposal thus builds on the G20 indicative guidelines on current account imbalances as a pre-condition to the use of capital controls and identifies specific cases in which capital controls may be or should be used. The bottom line is that if countries are compliant with the G20 guidelines on current account imbalances but nevertheless experience large and volatile capital flows, they have every right and reason to use capital controls.

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Capital Controls: A Pragmatic Proposal

The strong and volatile rebound of capital inflows, mostly portfolio investments, into emerging economies in the recovery process of the 2008 global financial crisis has brought the issue of capital controls to the forefront once again. This paper proposes a pragmatic approach to the use of capital controls which leverages the G20 indicative guidelines in measuring excessive imbalances in order to simplify the International Monetary Fund's guidelines on the use of capital controls.

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