1 Introduction

Most of the current literature on capital controls focuses on the controls used by developing and emerging countries since most industrialized countries have moved towards capital liberalization. In an era of capital liberalization, the debate on capital controls proposed by Edwards (1999) is not whether countries should continue to restrict the movement of capital, but when and how fast these controls should be eliminated. The new financial architecture proposes that the use of capital controls should be limited to temporary preventative measures and not as an integral part of a country’s economic policy practice. This paper will provide further insight on capital controls. The first section will discuss the primary objectives of controls; then the following section will identify the types of controls and provide country-specific examples that use these controls on capital inflows and outflows. The last section will discuss the effectiveness of these controls with reference to the examples.

2 Objectives of Controls

Under the new financial architecture, the main objective of capital controls is to protect and help stabilize monetary and financial flows. In light of the recent financial crises, it is evident that persistent capital flows into a country, i.e., “hot” money, can cause fluctuations in the monetary and financial system, especially in a country with a weak financial system. Capital controls can be used to mediate these fluctuations by reducing the speed and changing
the composition of financial flows. Examples of countries that have used capital controls for this purpose are Chile, Colombia, Malaysia, and Thailand. Another purpose of capital controls is to hold a fixed exchange rate and to be able to practice sovereign monetary policy, illustrating the issue behind the international trilemma. Thus, according to Edwards (1999), capital controls have been used to maintain a higher domestic interest rate and to reduce exchange rate appreciation, e.g., Chile, Malaysia, and Thailand. It should be noted that industrialized countries also used capital controls under international fixed exchange rate schemes, such as Bretton Woods.

3 Types of Controls

The literature discusses two types of capital controls: administrative and market-based. Administrative controls are direct prohibitions on the flow of capital whereas market-based controls are indirect in that capital movement is discouraged by making transactions more costly. Examples of market-based controls are taxes on financial flows and a dual/multiple exchange rate system. Taxes on financial flows can be explicit by being placed directly on the financial transaction itself or they can be implicit if they are in the form of an unremunerated reserve requirements (URR). The definition used by Ariyoshi et al. (2000) of an unremunerated reserve requirement is a fixed amount of domestic or foreign funds held by the central bank, for a given period of time, that does not earn any interest. The amount of currency held is proportionate to the amount of inflows. A dual/multiple exchange rate system uses a different exchange rate on different capital transactions. Direct and indirect controls can be used on both capital inflows and capital outflows.

3.1 Controls on Inflows

The goal of restricting inflows is to reduce international speculation and to prevent non-credible investments. The concern for international speculation, and subsequently, fluctuations in the financial market are largely due to short-term inflows. A relatively higher
domestic interest rate strongly encourages foreign investments due to the relative high rate of return, particularly in the short-term for emerging economies. For example, De Gregorio, Edwards, and Valdes (2000) indicate that Chile was experiencing massive capital inflows in the early 1990s and decided to implement capital controls from 1991 to 1998. Chile used a combination of administrative and market-based controls to try to avoid fluctuations in its financial system. By setting a minimum length of time that foreign capital must remain in the country, this direct control was used to reduce the volume of short-term flows. It also used an URR on foreign direct investment and portfolio flows. A similar case is Colombia that also implemented an URR on short-term foreign reserves from 1993 to 1998 as mentioned by Ariyoshi et al. (2000). They also put forth a third example of Malaysia using controls before the East Asian crisis. Malaysia restricted its capital inflow only temporarily in 1994 by using a mixture of both types of controls; for example, Malaysia did not allow “non-residents to buy money market securities and it set reserve requirements on ringgit funds of foreign banks.”

Debate exists whether these controls were effective in these countries, but the general consensus, as reaffirmed by Cooper, Tarullo, and Williamson (1999), is that if capital controls are to be used, it is preferred to be on capital inflows rather than outflows.

3.2 Controls on Outflows

The use of restrictions on capital outflows is to protect the balance of payments as noted by Cooper, Tarullo, and Williamson (1999). In the event of a financial crisis, Edwards (1999) states that controls on capital outflows have been advocated for recovering from a balance of payments deficit. It is vital for a country in a financial crisis to be able to regulate the amount of capital outflow since investors will want to remove their investment from the crisis stricken market, which will contribute to the economic desperation of the country. Forbes (2004) draws on the example of Malaysia using administrative controls on its outflows in

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1 Ariyoshi et. al. (2000), 14.
1998 after the peak of the East Asian crisis. For example, to lessen the effect of the capital withdrawal from its market, Malaysia imposed restrictions on residents transferring capital and a one-year delay on repatriating the returns of portfolio investments for nonresidents. Similarly, Thailand also restricted outflows from 1997 to 1998 to manage the crisis. These are only selected examples to illustrate the use of the different types of controls. The following section will discuss the effectiveness of these capital restrictions.

4 Effectiveness of Controls

The evidence from the examples used above questions the effectiveness of capital controls since the controls do not completely achieve their objectives. For example, Forbes (2000) suggests that the Chilean inflow controls were not effective in decreasing the net flows of capital, but were successful in reducing the number of short-term inflows and lengthening the maturity of inflows. Chile was also successful in maintaining an interest rate differential, but was forced to adjust its exchange rate. The benefits experienced by restricting inflows are countered by the risk of discouraging future investments. There exists a similar tradeoff between benefits and costs for capital controls on outflows. For example, the restrictions placed on outflows by Malaysia and by Thailand were effective in the sense that they gave the government more time to create suitable crisis management policies. However, Edison, Klein, and Sloek (2002) point out that the outflow controls may have given governments a false sense of security, as seen in the Malaysian outflow case. Forbes (2004) states that the controls protected cronyism in Malaysia and as a result reduced market discipline, i.e., productivity and efficiency. Another risk of imposing capital controls on outflows is eliminating the opportunity to finance projects with relatively lower foreign interest rates. Edison, Klein, and Sloek (2002) state that capital controls have “at best” a temporary effect on reducing capital inflows and outflows based on the evaluation of various examples. Cooper, Tarullo, and Williamson (1999) put forth the idea that capital controls are ineffective, and thus, capital should be liberalized.
Cooper, Tarullo, and Williamson (1999) conclude by stating that the debate on capital controls does not lead to a strong and definitive standpoint. The debate centers on the effectiveness of controls and the relative costs compared to the benefits and costs of capital liberalization. Edison, Klein, and Sloek (2002) refer to economic theory that suggests if a country opens its financial market, it will lead to an increase in development and growth; however, it will be more susceptible to financial fluctuations. They conclude that the empirical evidence on capital liberalization leading to growth is inconclusive. Furthermore, it is difficult to isolate the effects of the removal of restrictions on capital since the government attempts to restructure its financial system at the same time. Eichengreen (1998) believes that for emerging economies, an “open capital account should be the exception, not the rule.” Most developing countries practice capital controls due to their weak and underdeveloped financial systems that do not have the regulatory capacity to mediate international financial distortions. The intentions of capital controls are noble; however, the realization of these intentions may not be sufficient to justify using controls as a standard economic practice, but only as an emergency policy measure.

References


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