# International rules for capital controls

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| *Do we need international rules for capital controls? This column looks at the different regimes in countries such as Brazil and China and argues that we do.*Although economists generally agree that countries can derive substantial gains from international economic integration, the extent to which they should open themselves to international capital flows remains a controversial issue. There is still, 20 years after the rise of emerging markets finance, a wide diversity of approaches to capital account policies. Some emerging market economies maintain a completely open capital account. Others, most notably Brazil, have experimented more actively with market-based prudential capital controls since the crisis. And still other countries, such as China, maintain tight restrictions on their capital account. There has also been a shift in official views on this topic, which have become more sympathetic to capital controls (Ostry et al. 2011; IMF 2011). Unlike for trade in goods, however, there are no international rules to constrain, discipline, or indeed legitimise restrictions that countries put on their capital account.[1](http://www.voxeu.org/index.php?q=node/8078#fn) In our monograph Who Needs to Open the Capital Account? (Jeanne et al. 2012), we present the case for developing international rules for capital flows.The case for prudential capital controlsThe pros and cons of prudential capital controls to curb the boom-bust cycle in capital flows have been discussed before (Williamson 2005), but economists now understand better the theoretical case for such policies with a new literature on the welfare economics of prudential capital controls (Korinek 2011). This literature essentially transposes to international capital flows the closed-economy analysis of the macroprudential policies that aim to curb the boom-bust cycle in credit and asset prices. It finds that it is optimal to impose a countercyclical Pigouvian tax on debt inflows in a boom to reduce the risk and severity of a bust. Interestingly, the optimal tax would fall primarily on the flows (short-term or foreign currency debt) that are the least likely to be conducive to economic growth.The optimal tax has also been quantified in calibrated dynamic welfare optimising models. Models with endogenous and occasionally binding constraints are not tractable and must be simplified in some respects to be solvable, even numerically, but the results may be informative. A nice example of this approach is Bianchi (2011), who finds, in a model calibrated to Argentina, that the optimal tax rate on one-year foreign currency debt increases with the country's indebtedness and fluctuates between 0% and a maximum of 22%.Obviously, capital controls are not a silver bullet. Like any attempt to regulate the financial sector, they elicit attempts to circumvent or evade and can be used effectively only if they are used with moderation. But this observation applies to all taxes and regulations. Capital controls are not a panacea, but this does not prevent them from being a legitimate instrument in the macroprudential toolbox.Capital account policies and trade distortionsThe international community invests considerably more effort in maintaining a level playing field for international trade in goods than for international trade in assets. One could argue that this is justified by the fact that the gains from free trade seem much larger for the former than for the latter (Bhagwati 1998). And Chapter 3 of our book, which uses a “meta-regression” approach incorporating a large number of empirical specifications, confirms the finding in most of the literature: free capital mobility has little impact on economic development (although there is some evidence that foreign direct investment and stock market liberalisation may, at least temporarily, raise growth).The problem about using this finding to be agnostic or permissive about capital account restrictions is that those restrictions can be used to distort real exchange rates to the advantage of the countries that impose them. This contradicts the purpose of trade rules and over time may erode the support for free trade.China, because of its importance in the global economy, is the most significant example. It would be an exaggeration to describe the Chinese capital account as closed, if only because China receives large amounts of foreign direct investment (and even encourages it through tax incentives). But China severely restricts other forms of capital inflows, and controls its outflows too. Most of the Chinese foreign assets are accumulated as international reserves, which the authorities have accumulated in large quantities.However, full control over capital flows implies full control over its macroeconomic doppelganger, the trade balance, and hence the real exchange rate. Under some conditions, as shown in Jeanne (2011), full control over the capital account allows the authorities to undervalue the real exchange rate and affect trade flows in the same way as they would with import tariffs and export subsidies.The case for international rulesCurrently, the international regime is permissive about the use of capital controls: countries can use them or not as they wish. We view this status quo as problematic and see compelling reasons to establish an international regime for capital flows. First, the lack of commonly agreed rules implies that capital controls are still marked by a certain stigma, so that the appropriate policies may be pursued with less than optimal vigour. But we also argue that an international regime for capital flows should go further, and take appropriate account of spill-over effects. This is particularly the case of policies that repress domestic demand and, through a combination of reserve accumulation and restrictions on inflows, maintain a current account surplus. Those policies have the same economic effects as trade protectionism and undermine the global public good of free trade. But the point may apply also to prudential capital controls. As recently shown by Forbes et al (2012) in the case of Brazil, capital account restrictions are liable to divert capital flows from one recipient to another, and thereby give third countries a strong interest in the controls imposed by others. The implications of this argument have not yet been absorbed by the profession, but it seems possible that they will turn out to be significant for the optimal international design of capital account policies.As for trade in goods, if there are controls, we would be strongly in favour of having transparent, price-based measures, such as a countercyclical tax on certain types of capital flows. The international community could agree on a ceiling on the tax rate to ensure that the harmful effects of controls (if any) would be limited. The new rules could be embodied in an international code of good practices developed under the auspices of the IMF. In a world where capital and trade flows have become so linked, the asymmetry of the status quo comprising permissiveness toward the former and strict regulation of the latter is increasingly untenable.ReferencesBhagwati, Jagdish (1998), “The Capital Myth: The Difference Between Trade in Goods and in Dollars”, Foreign Affairs, May/June.Bianchi, Javier (2011), “Overborrowing and Systemic Externalities in the Business Cycle”, American Economic Review, 101(7).Forbes, Kristin, Marcel Fratzscher, Thomas Kostka, and Roland Straub (2012), “Bubble Thy Neighbor: Portfolio Effects and Externalities from Capital Controls”, NBER Working Paper No. 18052.IMF (2011), “Recent Experiences in Managing Capital Inflows – Cross-Cutting Themes and Possible Policy Framework”, Policy Paper.Jeanne, Olivier, John Williamson, and Arvind Subramanian (2012), Who Needs to Open the Capital Account?, Peterson Institute for International Economics.Jeanne, Olivier (2011), “Capital Account Policies and the Real Exchange Rate”, Manuscript.Korinek, Anton (2011), “The New Economics of Prudential Capital Controls: A Research Agenda”, IMF Economic Review, 59(3):524-561.Ostry, Jonathan D, Atish R Ghosh, Karl Habermeier, Luc Laeven, Marcos Chamon, Mahvash Qureshi, and Annamaria Kokenyne (2011), Managing Capital Inflows: What Tools to Use?, IMF Staff Discussion Note 11/06.Williamson, John (2005), Curbing the Boom-Bust Cycle: Stabilising Capital Flows to Emerging Markets, Peterson Institute for International Economics. |

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