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* Author: Dennis Botman, IMF Resident Representative to the Philippines

Capital Controls

With the global economy emerging from the financial crisis, capital is flowing back to Emerging Market Economies (EMEs). Most of the time, allowing capital inflows free of restrictions offers substantial benefits to the recipient economy. In some cases, however, this may create macroeconomic complications if the flows are large, temporary, and based on irrational exuberance. Can capital controls help to strike the right balance? A recent IMF Staff Position Note looks at the pros and cons (available at http://www.imf.org/external/ns/cs.aspx?id=236).

Capital inflows, and capital mobility more generally, allow countries with limited savings to attract financing for productive investment projects, foster the diversification of investment risk, promote intertemporal trade, and contribute to the development of financial markets. In this sense, the benefits from a free flow of capital across borders are similar to the benefits from free trade, and imposing restrictions on capital mobility means foregoing, at least in part, these benefits, owing to the distortions and resource misallocation that controls give rise to.

Notwithstanding these benefits, some EMEs are experiencing a surge in capital inflows recently. This could cause challenges for their economies if the flows are perceived to be temporary, reflecting expected interest rate differentials, which may be at least partially reversed when policy interest rates in advanced economies return to more normal levels. A concern has been that massive inflows can lead to exchange rate overshooting or create asset price bubbles, which can amplify financial fragility and credit risk. More broadly, following the crisis, policymakers are again reconsidering the view that unfettered capital flows are a fundamentally benign phenomenon and that all financial flows are the result of rational investing/borrowing/lending decisions. Concerns that foreign investors may be subject to herd behavior, and suffer from excessive optimism, have grown stronger; and even when flows are fundamentally sound, it is recognized that they may contribute to collateral damage, including bubbles and asset booms and busts. The question is thus how best to handle surges in inflows that may pose both prudential and macroeconomic policy challenges.

It should be emphasized that these concerns do not apply in the Philippines, where “hot-money” inflows have been relatively small and unwarranted asset price increases have been absent. Instead, most foreign exchange inflows are coming from remittances, the BPO sector, tourist receipts, and to some extent FDI. These are structural factors for peso strength and should not be restricted.

For other EMEs, the tools to deal with excessive short-term capital flows include fiscal policy, monetary policy, exchange rate policy, foreign exchange market intervention,

domestic prudential regulation, and capital controls. The first line of defense remains generally to allow the exchange rate to appreciate, discouraging further short-term inflows. Despite implementation lags, fiscal policy could be tightened to reduce foreign borrowing. Loosening monetary policy is another option, although there is little room for further policy rate cuts now that central banks are formulating, and in some cases implementing, their exit strategies. Foreign exchange market intervention is yet another tool to limit exchange rate appreciation and accumulate international reserves. Insofar the inflows find their way into specific asset classes, for example the property market, concerns about valuations are best addressed through prudential measures (such as reducing the loan-to-value ratio for mortgages). In case the measures above do not suffice, capital controls can also be part of the overall toolkit.

Clearly, the appropriate policy mix is likely to depend on the state of the economy (i.e., the closer it is to potential, the less room for easing monetary policy); the level of reserves (is further accumulation desirable/appropriate?); the quality of existing prudential regulation (can prudential tools effectively tackle the boom/bust credit/asset price cycle); the scope to allow the currency to strengthen (is the currency already overvalued?); and the likely persistence of the inflows (with permanent inflows less likely to warrant a policy response than transitory inflows).

Under which conditions could controls be justified? A key conclusion that emerges is that, if the economy is operating near potential growth, if the level of reserves is adequate, if the exchange rate is not undervalued, and if the flows are substantial and likely to be transitory, then use of capital controls—in addition to both prudential and macroeconomic policy, such as reducing the fiscal deficit—is justified as part of the policy toolkit to manage inflows. Such "sand in the wheels", moreover, can retain potency even if investors devise strategies to bypass them, provided such strategies are sufficiently costly.

A key issue of course is whether capital controls have worked in practice. The jury is still out on this question as it is difficult to get the data to speak with one voice. Controls seem to be quite effective in countries that maintain extensive systems of restrictions on most categories of flows, but the present context relates mainly to the reimposition of controls by countries that already have largely open capital accounts. The evidence appears to be stronger for capital controls to have an effect on the composition of inflows than on the aggregate volume. For example, in the case of Chile and Colombia, controls do appear to have had some success in tilting the composition of inflows towards longer maturities.

A significant caveat, however, to the use of capital controls by individual countries, relates to the potential for adverse multilateral consequences. In the present circumstances, global recovery is dependent on macroeconomic policy adjustment in EMEs, but widespread adoption of controls by EMEs could exacerbate global imbalances and slow other needed reforms. Multilateral dimensions clearly need to be taken into account in assessing the merits of controls at the individual country level.

The Author is the IMF Resident Representative for the Philippines