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Capital Account Controls and Liberalization: Lessons for India and China

Jonathan Anderson – November 2003

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WHAT ARE CAPITAL CONTROLS?

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◆ Two kinds of capital controls:

1. Targeted measures to slow short-term portfolio inflows and outflows
2. Pervasive restrictions on all external capital transactions

WHAT ARE CAPITAL CONTROLS?

◆ Targeted measures:

1. Examples: Chile, Colombia, Malaysia, Brazil, Thailand
2. Mostly short-term episodes associated with periods of “overheated” portfolio inflows, or sharp outflows in a crisis environment
3. Usually in economies which are already fairly open to portfolio capital flows
4. The main driver are worries about the domestic impact on interest rates and money growth
5. Almost always associated with fixed exchange rates

WHAT ARE CAPITAL CONTROLS?

◆ Targeted measures:

1. Unremunerated reserve requirements
2. Limits on open currency positions
3. Taxes on cross-border flows
4. Quantitative limits on portfolio transactions
5. Regulated interest rates for non-resident accounts

WHAT ARE CAPITAL CONTROLS?

◆ Pervasive restrictions:

1. Much more common in developing economies in Latin America and Asia through the 1980s, followed by the beginning of widespread liberalization. Also a feature of transition economies such as the former Soviet Union and China.
2. The purpose is to allow full control of domestic resources, usually in a state-led planning context, without worrying about external influence and volatility
3. Additional drivers are the need to shelter the domestic banking system from competition, and protect the economy from the effects of resource misallocation.

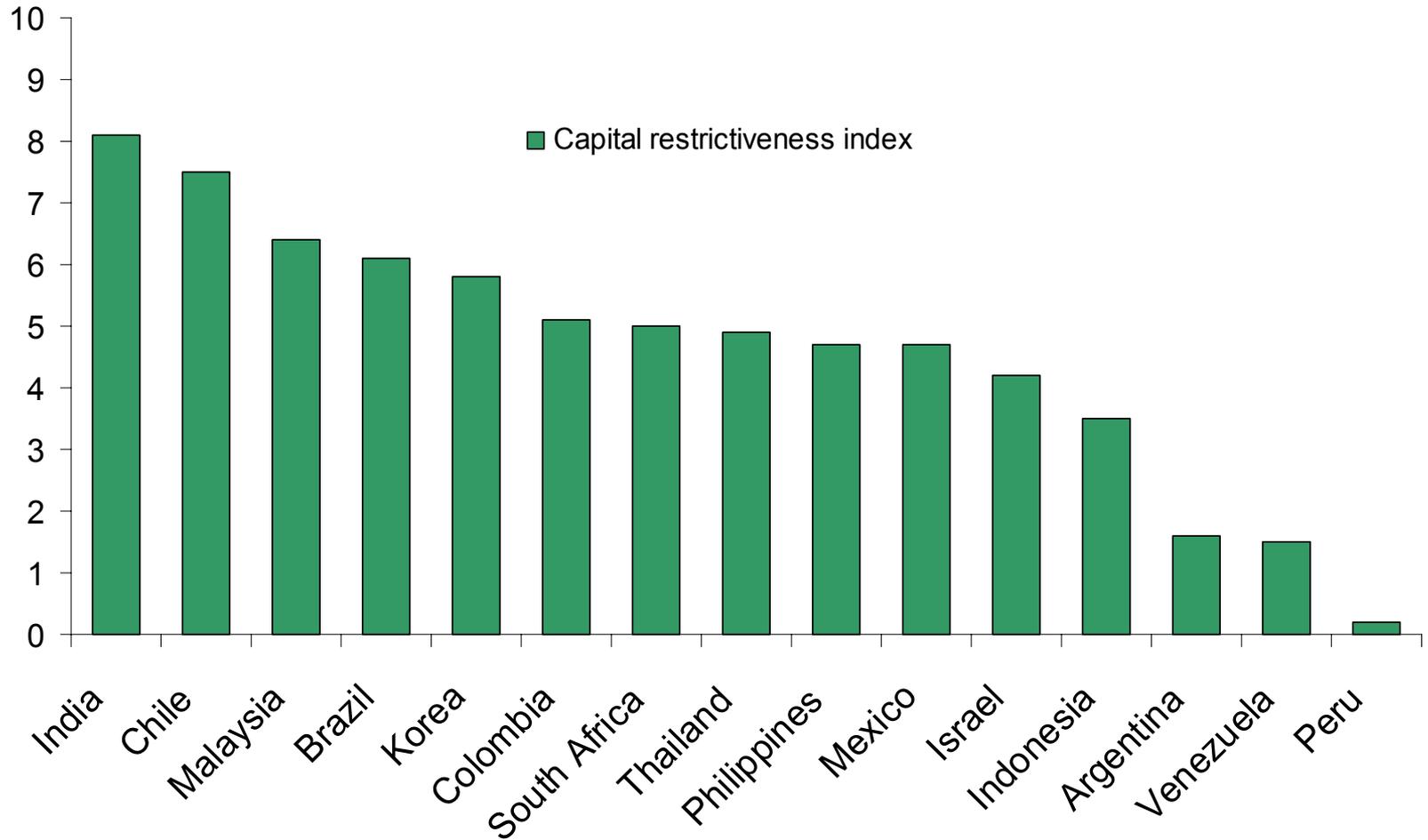
WHAT ARE CAPITAL CONTROLS?

◆ Pervasive restrictions:

1. Outright prohibitions on inflows and outflows
2. Mandatory approvals for capital transactions
3. Multiple exchange rate regimes
4. Selective granting of licenses for cross-border investment
5. Often involves current account restrictions as well

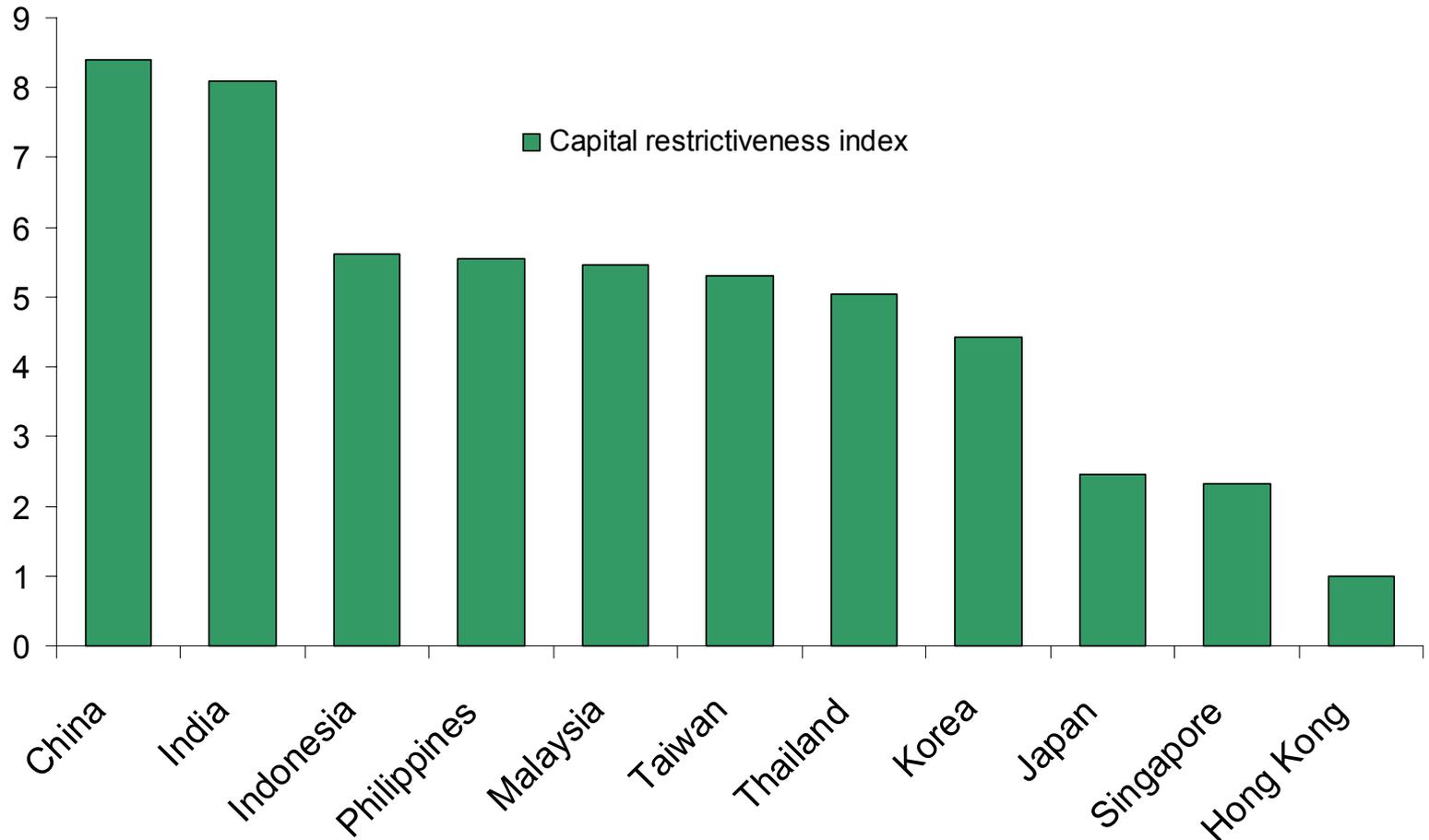
WHICH COUNTRIES CONTROL
FLOWS?

WHICH COUNTRIES CONTROL FLOWS?



Source: IMF

WHICH COUNTRIES CONTROL FLOWS?



Source: UBS



DO CAPITAL CONTROLS “WORK”?

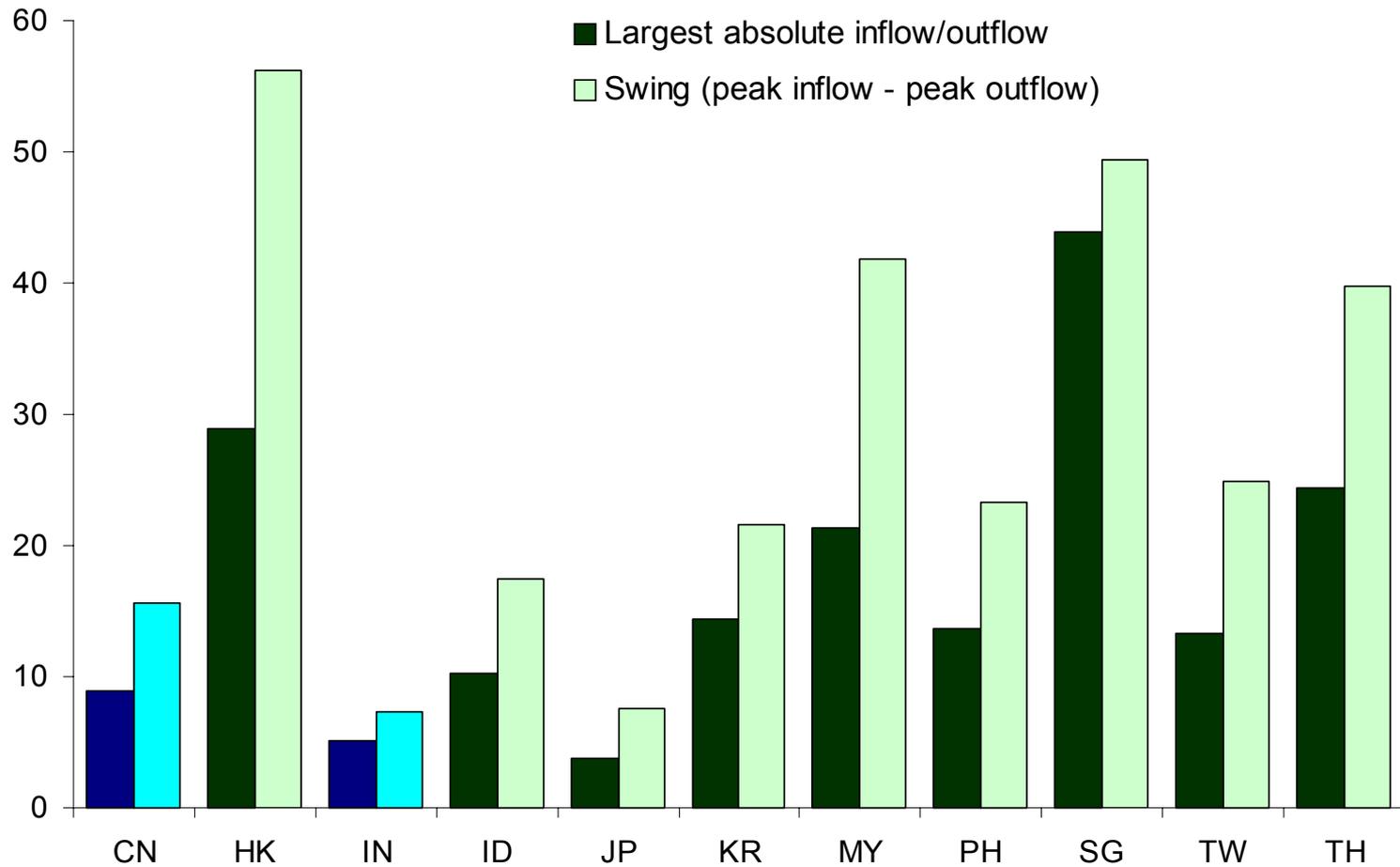
DO CAPITAL CONTROLS “WORK”?

◆ The evidence is mixed

1. Most episodes of targeted restrictions have slowed inflows or outflows – but generally did not relieve underlying pressures or fully insulate the economy (see Thailand, Malaysia, Chile, Venezuela, etc.)
2. Economies with more extensive capital restrictions have had more success in avoiding external imbalances and pressures (e.g. China during the Asian financial crisis). However, even even a restrictive regime is no guarantee of immunity (the Indian crisis of 1991-92 is a good example).

DO CAPITAL CONTROLS “WORK”?

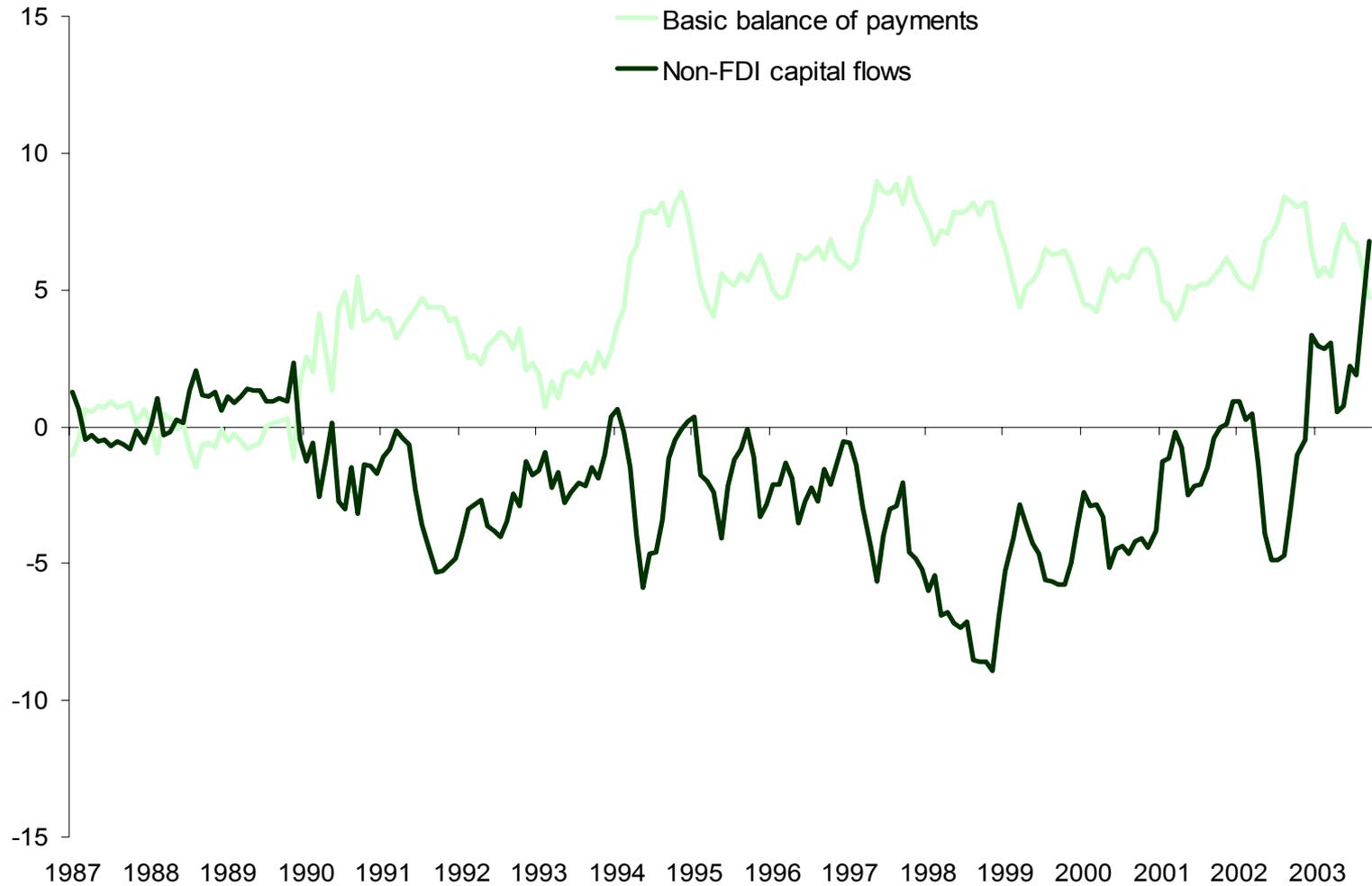
Non-FDI capital flows, share of GDP (%)



Source: UBS estimates

CHINA

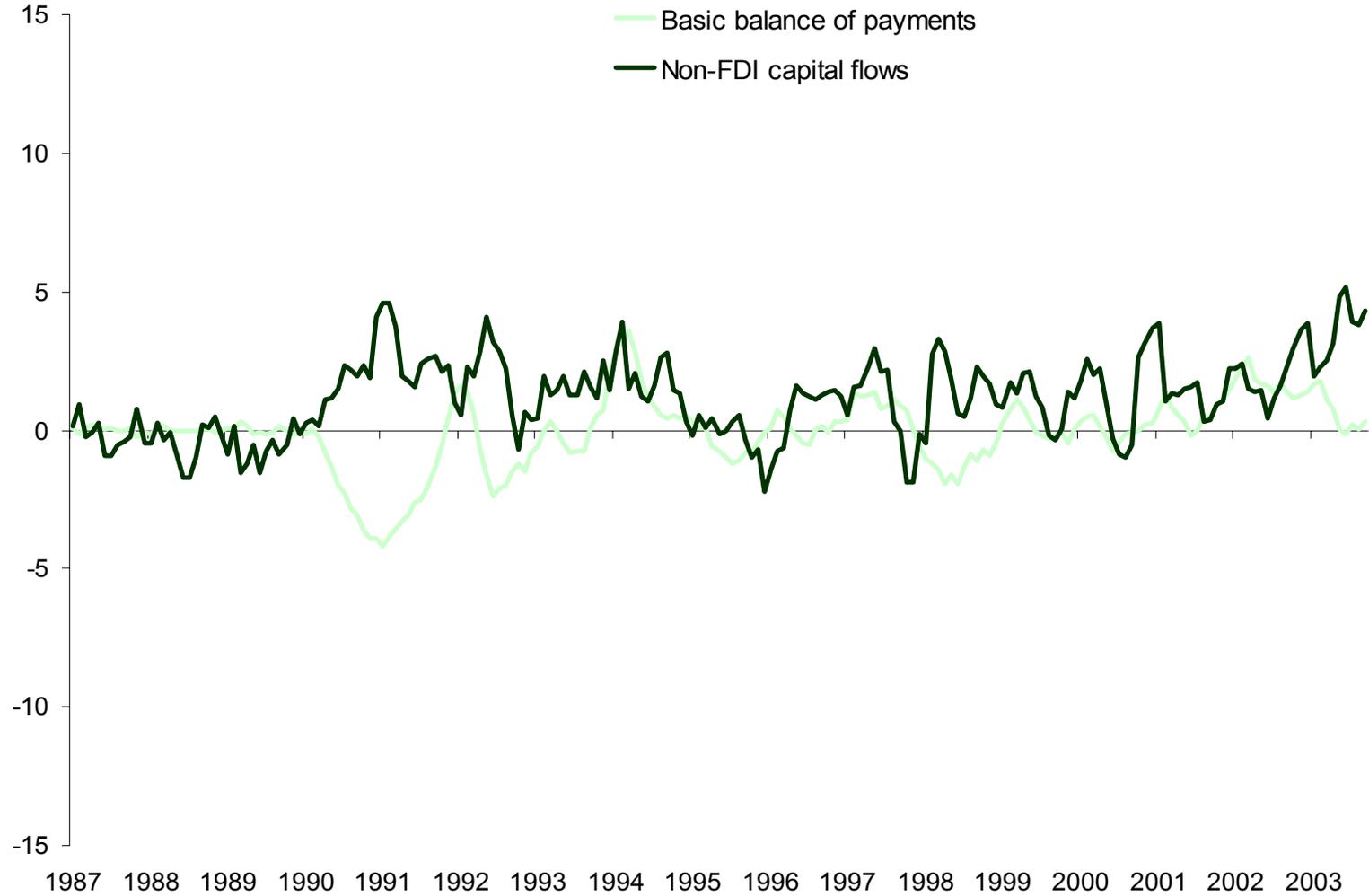
Share of GDP (%)



Source: UBS estimates

INDIA

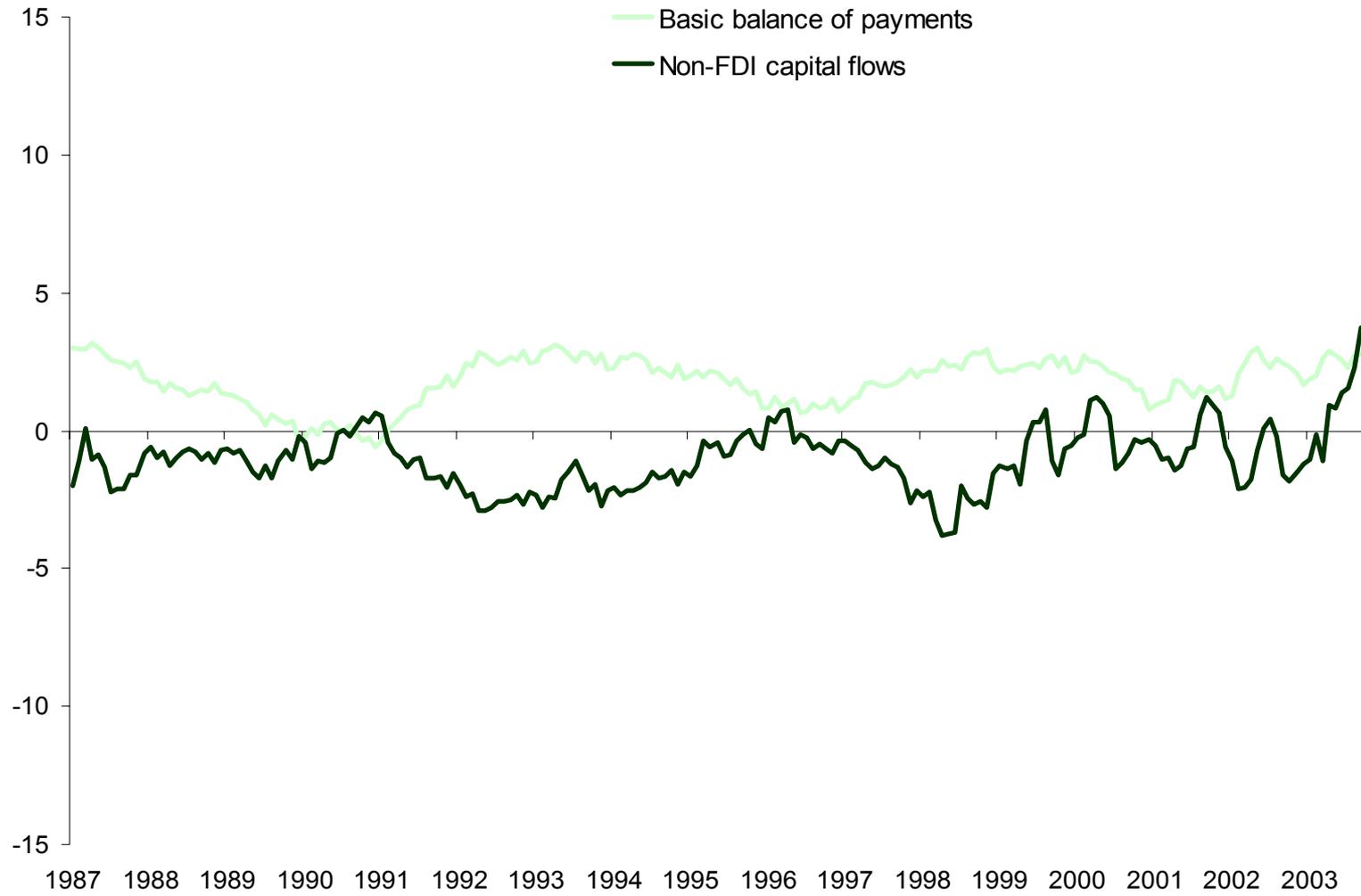
Share of GDP (%)



Source: UBS estimates

JAPAN

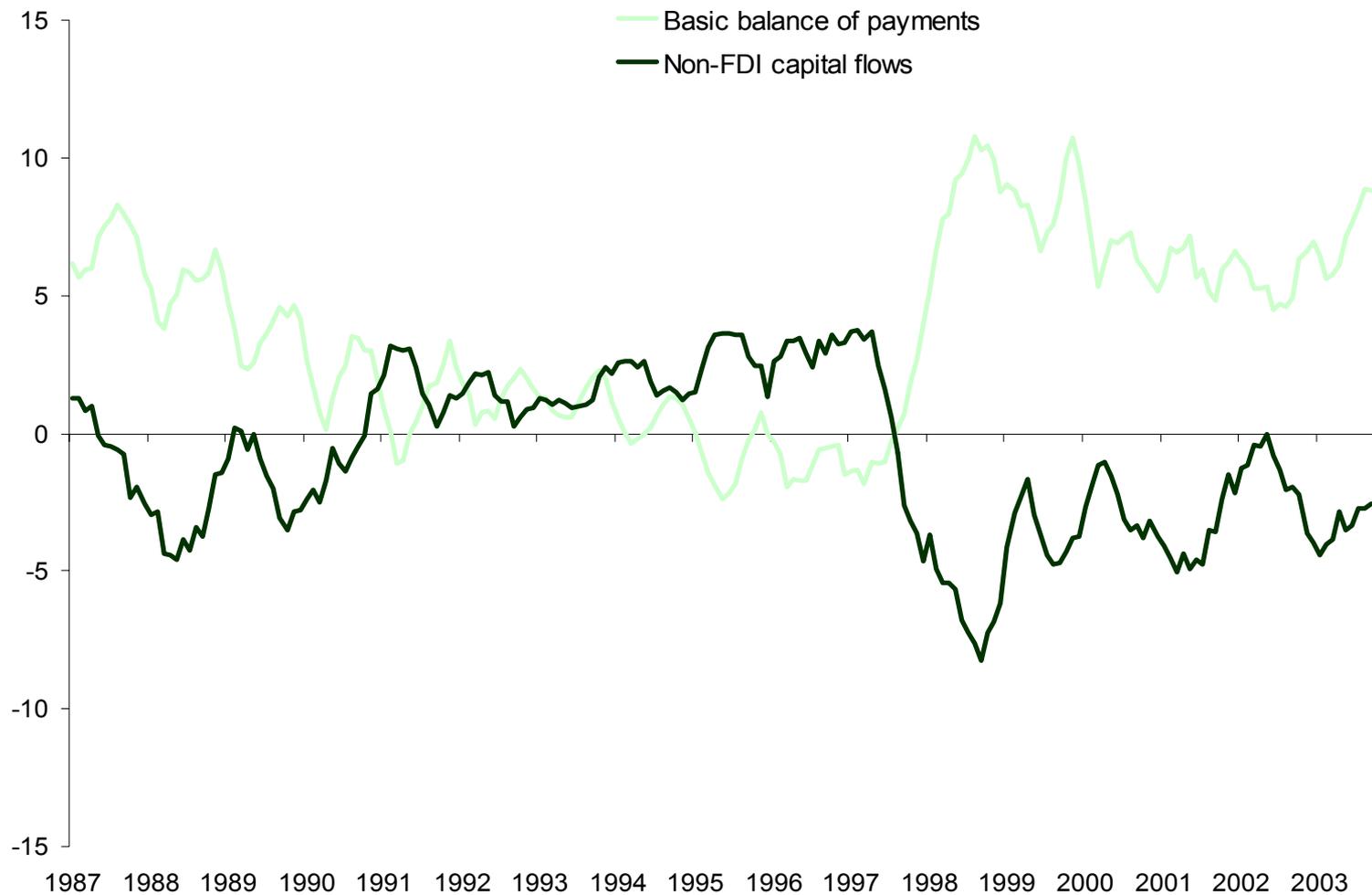
Share of GDP (%)



Source: UBS estimates

OTHER ASIA

Share of GDP (%)



Source: UBS estimates



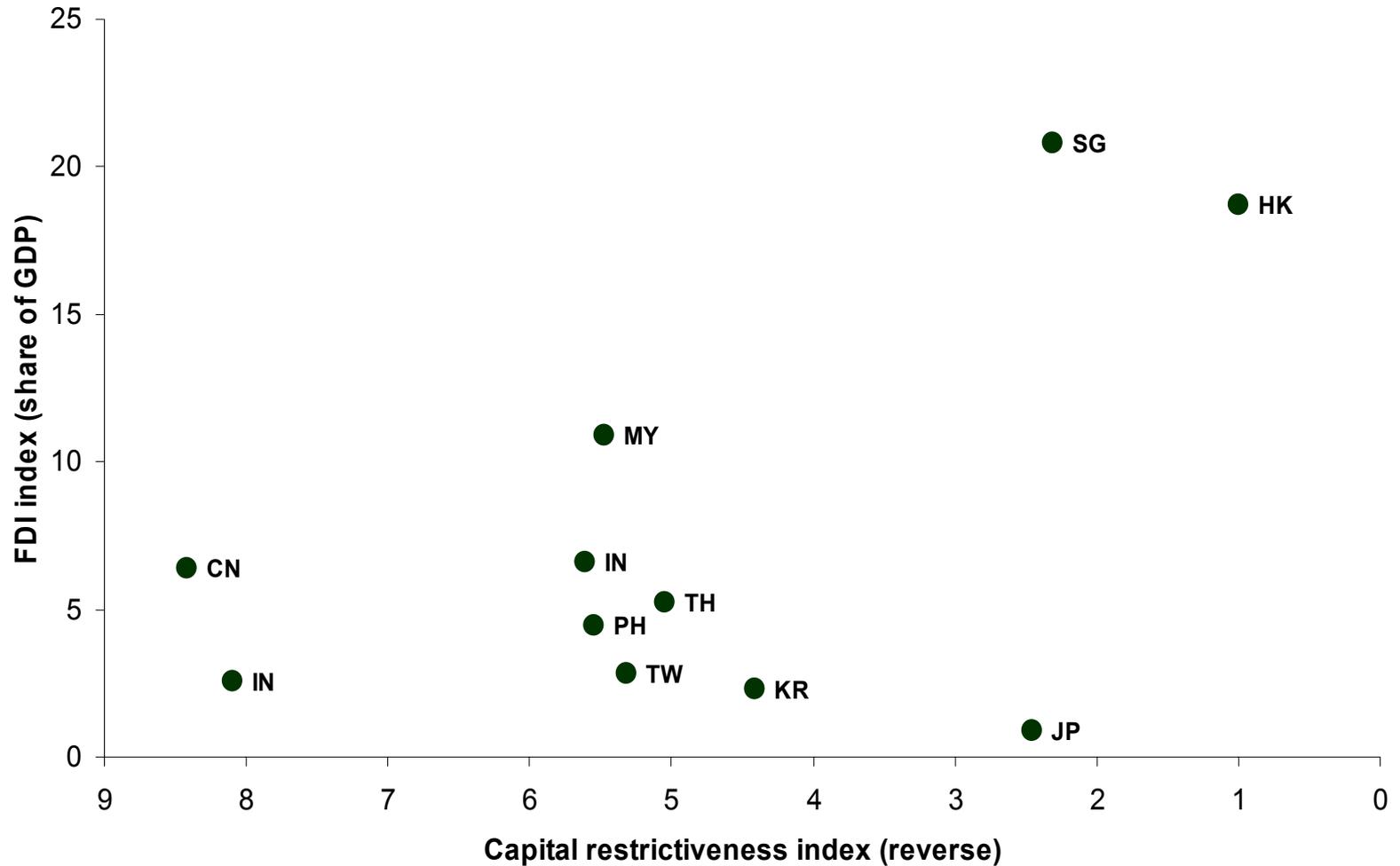
DO CAPITAL CONTROLS “WORK”?

- ◆ Restrictive external controls can actually worsen the situation at home
 1. Most pre-1997 Asian “bubbles” occurred in an insulated capital flows environment without external market discipline (China, Japan, Taiwan, Korea, Thailand).
 2. More important, closed capital markets give much more leeway to “misbehave” at home, misallocating resources domestically (Soviet Union, India in the 1960s and 70s).

DO CAPITAL CONTROLS “WORK”?

- ◆ Is the Chinese FDI story a capital control “success”?
 1. China has had great success in attracting FDI inflows while avoiding external crises. Should other countries emulate?
 2. We agree that opening long-term flows is the best starting point for a very closed economy, and in this sense China is a positive example.
 3. However, as we saw above, Chinese non-FDI capital flows have also been fairly volatile. And the gains came from opening, not closing capital markets, so countries which are already liberalized should resist the temptation to close.
 4. There is in fact very little correlation between capital openness and net FDI flows

DO CAPITAL CONTROLS “WORK”?



Source: UBS





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HOW TO LIBERALIZE?

HOW TO LIBERALIZE?

◆ What are the theoretical effects?

1. Volatility: Nearly everyone agrees that capital liberalization can lead to significant external and domestic volatility, particularly if countries are unprepared. The large “sequencing” literature stresses banking, macro policy capacity and exchange rate management.
2. Direction: In theory, liberalization should lead to net inflows just as often as to net outflows; much depends on macro management and the relative level of domestic returns.
3. Desirability: Sharp divisions and debates after the financial crises of the 1990s. The mainstream answer is still “yes” – but a tentative and guarded yes.

HOW TO LIBERALIZE?

◆ What has happened in practice? Good examples

1. Developed economies generally had an easier time liberalizing capital transactions – in part because of the depth of domestic financial and macro capacity, and in part because of “good timing” (they opened when global capital flows played a much smaller role)
2. Among emerging markets with portfolio liberalization, have seen fewer great success stories during the past 15 years; Chile, Hungary, Malaysia, Peru, Taiwan are often used as examples. These were due to a combination of gradual opening, supporting macro factors – and good luck.
3. The “China/India” model of limited liberalization has been more effective in preventing external volatility, but still leaves open the question of other financial flows

HOW TO LIBERALIZE?

◆ What has happened in practice? Bad examples

1. The Asian crisis is a textbook example of how widespread liberalization combined with weak macro policy capacity led to disaster. Countries kept fixed exchange rates too long, and had very poor banking regulation and supervision.
2. The “budget trap” is another pitfall, as a number of rapid liberalization cases have foundered on the fiscal front (Russia, Romania, Argentina). Once again, fixed exchange rates were also a key culprit.

HOW TO LIBERALIZE?

◆ The India experience

1. Prior to 1991, India's capital account was closed to most transactions
2. Initial liberalization focused on FDI and equity portfolio inflows
3. Subsequently, debt instruments and equity outflows were allowed, although cross-border credit flows have been relatively limited (most portfolio flows relate to non-resident Indian accounts)
4. Hedging instruments exist, but speculation is very difficult
5. As in other economies, foreign players have an easier time coming in than domestic residents do going out

HOW TO LIBERALIZE?

◆ The India experience, continued

1. Since the mid-1990s, the stated aim has been to move toward full convertibility. Progress on liberalization has been slow but steady, and generally structured (see for example the work of the Tarapore Committee in 1997).
2. In particular, the Asian crisis slowed momentum through the early 2000s
3. The capital account remains relatively closed, as shown by the historical lack of stock market correlation and interest arbitrage
4. Supporting measures on the banking system have been relatively positive; fiscal consolidation remains a significant concern

HOW TO LIBERALIZE?

◆ The China experience

1. The capital account was more or less completely closed through the mid-1980s
2. Inward FDI was the first area to be liberalized, originally to take advantage of Hong Kong/Taiwan funds, and then the “explosion” in the early 1990s
3. China lost effective control over monetary and financial flows in the bubble years (1992-95) and also saw outflows during the Asian crisis years (1997-99)
4. Since then, there have been very modest steps to loosen capital restrictions at the margin, but enforcement has also been progressively tightened

HOW TO LIBERALIZE?

◆ The China experience, continued

1. Prior to the Asian crisis, the authorities had aimed to move quickly to full capital account liberalization; since 1997, there has been relatively little progress, and no concrete framework
2. The key question today: how effective are controls? The capital account (including the unexplained residual) reacts fairly sharply to changes in relative interest rates and exchange rate expectations

HOW TO LIBERALIZE?

◆ China vs. India – who “wins”?

1. China has received more foreign investment – but this has little to do with capital policies
2. India has made more steady progress in liberalization, with a stronger theoretical framework – but China has been forced to be more careful due to internal volatility (successive domestic boom-bust cycles)
3. On paper, India’s capital account is more open – in practice, China has seen a higher volume of flows
4. India probably has better supporting financial and exchange policies, but has serious fiscal concerns – China’s main problems are its banks and the lack of RMB flexibility
5. Both economies have much more to do

HOW TO LIBERALIZE?

◆ Summary lessons for India and China

1. Go forward – but at a rational pace
2. Solve the banking system problems first (balance sheets, restructuring, prudential supervision)
3. Further develop macro policy capacity (China – monetary policy instruments, India – fiscal soundness)
4. Move to a flexible exchange rate. Nearly every emerging financial crisis has involved a “one-way” bet – and countries are particularly vulnerable during initial portfolio liberalization

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