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The Growing Use of Capital Controls in Emerging Markets: Implications for Investors

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In the coming months, investors should be prepared for the growing use of capital controls by emerging market policymakers, who increasingly view limitations on foreign inflows as legitimate macroeconomic tools. In recent months, Brazil, Indonesia, South Korea, and Taiwan have all announced measures to regulate capital inflows. Columbia, Peru and several other countries are reportedly considering some form of capital controls. These measures frequently are intended to dampen pressures on exchange rate appreciation and to promote financial stability by reducing "hot money" (a phrase first popularized in a speech by Franklin Delano Roosevelt in 1936) flows.

Capital controls do not necessarily imply that emerging market returns will be lower than in the absence of such controls, although that potential certainly exists. However, if limitations on capital inflows become pervasive, these may impede the process of global rebalancing and reduce opportunities for investors to create more efficient portfolios. Such a development could also increase protectionist pressures around the world, raise the cost of capital in emerging markets and reduce the potential for multilateral collaboration on global macroeconomic challenges.

More broadly, in the wake of the Asian Crisis of 1997–1998 and the Great Recession and Great Panic of 2008–2009, a growing trend towards capital controls represents a resurgence in Keynesian thinking about how to regulate international financial flows. Implementing such controls might slow globalization from the furious pace of 2002–2007, the relentless march of Internet technology notwithstanding. Moreover, controls on *inflows* represent a sharp break from decades past, when some emerging markets imposed controls on *outflows*.

A Century of Thinking (and Rethinking) about International Capital Flows

To current global investors the free flow of capital across international borders may seem like the natural order of the world, but in fact, the use of capital controls in developed countries persisted well into the late twentieth century. Capital controls are restrictions, in one form or another, on transactions that are recorded on a country's capital account in its balance of payments. Governments may impose capital controls to help reconcile conflicting policy objectives or to promote financial stability by reducing the potential for capital flight and "sudden stops" of foreign capital inflow. For example, governments may impose restrictions on the volume of capital inflows and outflows and may seek to influence the composition and magnitude of flows through various policy measures.

A core concept in international economics is the notion of the "Impossible Trinity," a principle positing that a country can achieve only *two* out of the following *three* policy objectives: 1) a fixed exchange rate, 2) an open capital account and 3) an independent monetary policy. For example, if China wishes to fix its exchange rate and pursue an independent monetary policy, then it must maintain a closed capital account. Alternately, Mexico maintains an open capital account and an independent monetary policy, but allows its currency to float (within limits).

As Obstfeld and Taylor (2004) point out, the integration of the world economy has not been a linear process but rather has followed a U-shaped pattern. By some metrics, for example the free movement of peoples, the world economy was more integrated in the era of globalization of 1870–1914 than it is today. The collapse of the world trade and payments system during World War I, the chaos of the interwar years and then World War II reshaped thinking about global finance and governance. John Maynard Keynes and Harry Dexter White, the principal intellectual architects of the International Monetary Fund (IMF) and the Bretton Woods system of fixed exchange rates in place from 1945 to 1971, were deeply suspicious of the disequilibrating impact of short-term capital flows and believed that capital flows should be sharply regulated. They focused on liberalizing the current (primarily trade) account, and to this day Article VI, Section 3 of the IMF's Articles of Agreement posits that members "may exercise such controls as are necessary to regulate international capital movements." Moreover, skeptics, like Nobel Laureate Joseph Stiglitz, argue that unregulated capital flows can create negative externalities, such as systemic contagion, herding and trend amplification.

A Move to Freer Capital Flows

Yet, despite these Keynesian reservations about the potential disruptions caused by unrestricted capital flows, within the first decade of the postwar period a move was underway to promote freer capital flows. Proponents of capital account liberalization cite substantial benefits to both capital importers and exporters, including a more efficient allocation of global savings, increased growth and welfare and the disciplining effect that financial markets impose on macroeconomic policymakers.

In *Capital Rules: The Construction of Global Finance,* Rawi Abdelal argues that it was the gradual process of European economic integration (which began with the Treaty of Rome in 1957), that drove the political economy of capital account liberalization. Specifically, the Maastricht Treaty, which came into effect in 1994, stipulates that "All restrictions on the movement of capital between member States and between Member states and third countries shall be prohibited" (p. 57). In the run-up to the Maastricht Treaty many European countries had regulated the movement of capital/capital flows. For example, the Benelux countries maintained dual exchange rates until 1990. France only abolished capital controls in 1990, and Greece in 1994. During the European Monetary System crises of 1992 and 1993, Ireland, Portugal and Spain all introduced temporary capital controls.

Another key document was the Organization for Economic Co-operation and Development's (OECD) Code of Liberalization of Capital Movements, which in 1989 was amended to include short-term capital movements. In the mid-1990s the IMF sought to amend its Articles of Agreement to prohibit members from imposing restrictions on international capital movements without Fund approval. But in 2003, the IMF concluded that it was difficult to establish a strong causal relationship between capital account liberalization and growth in developing countries. Forbes (2010) suggests that capital controls are more effective at changing the composition, rather than the volume, of flows.

However, the Asian Crisis of 1997–1998 caused a fundamental rethink of the costs and benefits of rapid capital account liberalization in emerging markets. Indonesia, Malaysia, the Philippines, South Korea and Thailand all faced large outflows of foreign capital, ensuing violent asset price declines, and devastating losses in output and declines in exchange rates. For example, real output in Indonesia fell roughly 13%, and the rupiah fell a staggering 83% peak to trough.

In Malaysia, where the exchange rate had fallen from 2.5 ringgit to 4.5 in January 1998, emergency capital controls were imposed, and nonresidents required waiting one year to convert the proceeds of securities sales. The relatively rapid recovery of the Malaysian economy following the imposition of these controls caused many scholars to reassess the purported costs of capital controls, as did the Russia default in August 1998 and the Brazilian devaluation in 1999.

Many emerging market countries, particularly those in Asia after the region's 1997–1998 financial crisis, have pursued export-led growth policies. In support of this goal, an explicit policy objective has been maintaining internationally competitive exchange rates. The resulting foreign exchange intervention has led to very rapid growth in foreign exchange reserves, which since 2000 have increased much more rapidly than the growth in world trade. For example, China's reserves, exclusive of Hong Kong, now stand at a staggering $2.8 trillion and have grown in excess of 30% per annum over the past seven years. Controls on inflows are another policy instrument employed by emerging market governments to combat upward pressure on exchange rates.

The buildup of reserves in emerging markets (which now hold approximately 65% of the world's roughly $9 trillion in FX reserves) after the Asian Crisis represents a precautionary

demand for savings. However, the resulting massive capital imports by the United States helped to reduce US interest rates and fuel the sub-prime lending boom and bust.

Recent Developments

The Great Recession has enhanced the attractiveness of emerging markets as an investment destination. In 2010, flows to emerging market equities are estimated at $82 billion, a record. Both cyclical and *secular* flows into emerging-markets debt and equity are likely to increase, the more so as the "average" global pension fund is substantially underinvested in emerging markets. For example, the IMF estimates that a 1% shift in global equity and debt holdings into emerging markets would imply roughly $485 billion of capital inflows into emerging market securities.

The 2010 World Economic Forum Financial Development Report provides an overview of the most frequently employed capital controls in emerging markets and documents their frequent usage in the 1990s and 2000s. These measures include:

- Unremunerated reserve requirements on new foreign borrowings
- A time requirement; i.e. a minimum holding period
- Quantitative limits
- Direct tax on financial transactions
- Regulation of trade between residents and nonresidents
- Selective licensing of foreign direct investment.

Because capital flows to emerging markets can take so many different forms—such as bank loans, foreign debt and equity portfolio investment, foreign direct investment and intra and intercompany loans—policymakers need to craft carefully specific measures to achieve their objectives. Otherwise, over time, traders and investors frequently can find ways to circumvent the regulations.

Given the current global economic environment, there is potentially an absorptive capacity problem in emerging markets, and policymakers there face difficult choices. Economist Nouriel Roubini (2010) outlines seven possible measures emerging countries can adopt to manage inflows:

1. Do nothing and allow the exchange rate to appreciate
2. Unsterilized intervention to prevent a nominal appreciation
3. Sterilized intervention to prevent a nominal and real appreciation
4. Controls on capital inflows
5. Fiscal tightening
6. Macro-prudential regulation/supervision of banks and financial institutions
7. Massive large-scale, long-term sterilized intervention

Each of these policies involves tradeoffs. In 2010, authorities in Thailand, Malaysia and Taiwan showed a willingness to let their exchange rates appreciate with the Thai Baht rising 9.6%, the Malaysian Ringgit up 9.9% and the New Taiwan Dollar gaining 8.8%, but such a policy is politically sensitive and disadvantages exporters. Sterilized intervention (the purchase of foreign bonds by the monetary authority and the simultaneous sale of domestic bonds that get the money supply back to the level prior to the FX interventions) can exacerbate interest rate differentials between the home and foreign country, thereby inducing further inflows via the "carry trade".

Accordingly, policymakers in several governments have decided that capital controls represent the "least bad" alternative. Chart I, by no means comprehensive, lists some illustrative recent measures. Particularly noteworthy is Brazil's tax on fixed-income investments, which was raised twice in the course of two weeks.

Chart 1: Recent Capital Control Measures Adopted in Emerging Markets

Country	Recent Measures
Brazil	Increase in tax on fixed income-investments to 6% in October 2010
Indonesia	Minimum holding period of one month on foreign holdings of Central Bank bills
Peru	Reinstated 4% fee on Bank CDs
South Korea	Limitations on short-term borrowings by commercial banks. Caps on foreign banks FX forward positions announced June 2010
Taiwan	Proposed mandatory use of USD for foreigners' equity margin accounts
Thailand	Reintroduced 15% withholding tax on foreign holdings of domestic bonds

Source: JP Morgan

Implications for Investors

In a recent paper, the IMF argued that "the use of capital controls—in addition to both prudential and macroeconomic policy—is justified as part of the policy toolkit to manage inflows" (Ostrey, p. 5). This position reflects a profound shift in thinking since 1998, when the Fund, as a condition of financial assistance to Korea, required that Korea further liberalize its capital account. The IMF also vetted Iceland's ban on capital outflows by residents, a policy which is still in force. Tellingly, prior to the crisis, in 2007 Iceland ranked first in the world in the United Nations Development Program's "Human Development Index." Today it ranks 16th.

We hypothesize that the growing acceptance of capital controls implies that:

1) Because emerging market exchange rates will appreciate less rapidly than otherwise, the process of global rebalancing, wherein consumers in Asia and the emerging world import more from the United States, will be slowed. This evolution will likely contribute to increased volatility in financial markets.

2) Until such a time when China accelerates its pace of real RMB appreciation, a growing number of countries will be reluctant to appreciate their exchange rates and may resort to capital controls. China's policies are increasingly important to the orderly functioning of the global financial system.

3) As the secular flow of capital from developed to emerging countries accelerates, in the absence of exchange rate adjustment, emerging asset prices are likely to be bid up and to become substantially overvalued. At roughly 12 times 2011 earnings, emerging equities do not yet appear to be in "bubble" territory.

4) Since controls on capital inflows into emerging markets over time can be circumvented, in the absence of exchange rate appreciation, inflation is likely to accelerate in many emerging countries. Such inflation can lead to real exchange rate depreciation, a process over time that can facilitate global rebalancing. But unanticipated inflation has the potential to depress capital market returns.

5) Emerging markets historically have been subject to boom/bust cycles and "sudden stops." As Hungarian mortgagors, who borrowed in Swiss francs to finance local real estate painfully learned in 2008-2009, the never ending problem of currency and maturity mismatch is omnipresent in a world of liberal capital flows. Global developed equity market investors, who have recorded just a 2.3% per annum return in dollars for the ten years ending 12/31/2010, have an obvious interest in promoting global financial stability. The selective use of capital controls need not necessarily reduce long-term returns, but the widespread use of capital controls could slow collective action to remedy multilateral economic problems and increase protectionist pressures.

6) Capital controls can increase the risk premia investors require to hold emerging market assets, particularly if countries implement controls, as Malaysia did, on an ex-post basis.

7) Capital outflows in China and elsewhere will be progressively liberalized in order to reduce pressure on exchange rates. Increasingly investors located in emerging markets and investing in other emerging markets will have a stake in the policy debate.

8) As Iceland demonstrates, in extreme situations, the use of capital controls need not be limited to emerging markets.

Conclusion

The Great Recession has led to a fundamental re-examination of long-held beliefs underpinning standard macroeconomics, central banking and finance theory. As Europe's continuing sovereign debt crisis testifies, the fallout from the 2007–2009 global financial crisis is ongoing. Many scholars believe that overly rapid capital account liberalization during the past 20 years has increased both the frequency and magnitude of financial crises.

The growing acceptance and use of capital controls reflects both the growth in secular flows to emerging markets and a recalculation of the benefits and costs of completely integrated global capital markets. Investors should monitor carefully individual country actions, as well as the policy debate, which remains one of the most contentious in international economics and finance.

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