

COMMENTS ON CAPITAL ACCOUNT CONTROLS PAPER

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Ilene Grabel's "Capital account controls and related measures to avert financial crises" provides us with a broad view and more importantly an in-depth discussion of the risks of full capital mobility and the heterodox policies to avoid or reduce the risks.

Under the heading "the risks of neoliberal financial integration," Grabel's paper explains five types of risks, namely 1) currency risk, 2) flight risk, 3) fragility risk, 4) contagion risk, and 5) sovereignty risk. These different types of risk interact with one another. In the 1997 East Asian financial crises and elsewhere, all these risks converged, making the policy response more complicated.

Under the rubric of "heterodox financial policies," the paper discusses a number of alternative policies that the Washington Consensus eschewed.¹ These heterodox policies are: 1) transaction taxes on purchases of securities and foreign exchange (Tobin tax, for example), 2) "the "Chilean model" of exchange rate and capital flows management. 3) restrictions on currency convertibility, and 4) a fairly recent proposal for a publicly managed international closed-end mutual fund for emerging markets.

The paper assumes that the orthodox policies to manage flows (e.g., sterilization) are insufficient or ineffective. Indeed, many studies are available (and a number of these presented or published even before the Asian crisis struck in 1997) that demonstrate the limits and weaknesses of conventional approaches. Nevertheless, if the paper could be expanded,² the inclusion of a section on a critique of conventional (or neoliberal) policies vis-à-vis capital flows management would have provided firmer support to why heterodox policies are needed.

Allow me to comment on a couple of policy options in Grabel's menu.

Chilean Model

On the Chilean model, what has been established by numerous studies, and which Grabel upholds, is that the soft control (e.g., high and non-interest bearing reserve requirement on financial flows) changed the composition and maturity of the capital flows. In other words, the Chilean type of control provided the incentive for investors to shift to longer-term credits and foreign direct investments. The preference for foreign direct investments and longer-term maturity thus discouraged excessive short-term flows that could have been the source of volatility in the financial system. From here, we are reminded of one significant lesson--long-term and foreign direct investments are preferable to short-term and portfolio investments.

But as the saying goes, capital is capital. Heavy inflows of capital, even if such flows are mainly made up of foreign direct investments or have longer-term maturities, create other problems. The increase in the supply of foreign currencies, holding other factors constant, appreciates the domestic currency and can lead to overvaluation. Overvaluation makes imports cheaper and

¹ I use the past tense to give the Bretton Woods Institutions the benefit of the doubt. Especially in the disastrous aftermath of the 1997 East Asian Crisis, the Bretton Woods Institutions have, at least at the rhetorical level, acknowledged the need for caution in fully opening up the capital account. The International Monetary Fund (IMF), for example, is now open to "soft controls" such as the Chilean type of controlling capital inflows.

² Take note that this paper is an abridged version of Grabel's "Averting Crisis."

exports more expensive, which could translate into a serious current account deficit. In fact, overvaluation threatens the whole real sector of the economy, not only the export sector, for the cheap imports undermine the import-substituting industries. (In the Philippine case, the gainers from an overvalued currency were the nontradables, especially the financial and real estate sectors.)

Here, we pick up a couple of lessons. First, too much capital, even of the foreign direct investment variety, can also undermine the economy. In East Asia (e.g., Korea), productive investment opportunities because of overcapacity or non-expanding markets, dried up. Would-be foreign direct investments had to be diverted to shorter-term equities and treasury bills.

Second, there is no single bullet, and as Grabel emphasizes, complementary policies have to be put in place for crisis prevention. In the Chilean example, the currency still appreciated despite the control on inflow. The Chilean government also had to depreciate the currency (through a crawling peg) to supplement the control on short-term capital flows. To be sure, the Chilean currency would have been much stronger if not for the control.

We can derive two important policies from the above lessons.

- A policy option, the feasibility of which is also determined by the institutional setting, is to develop the state's capacity not only to monitor movement of foreign capital but also "direct" the allocation of private capital. This is nothing new. Recall how the states in the pioneer NICs (newly industrializing countries) in East Asia allocated credit to "winners," particularly to export-oriented firms.
- Investments to sustain growth should rely primarily on domestic savings. A key feature of the East Asian miracle is precisely the generation of high domestic savings. Regrettably, countries like Korea later on avoided what in the short-run would have been painful measures. They became lazy and took what at first seemed to be the easy path of opening up the capital account to gain fresh investments.

Transaction Taxes

On the transaction taxes, Grabel notes their limits. A very high tax rate in normal times would have perverse consequences. The optimal rate would be low (as the proponents themselves state), but a low rate would not by itself discourage capital from the buying of securities and foreign exchange. The tax would be treated as a one-off transaction with an inconsequential effect on the cost of capital. And so long as the rate of return on investing in one emerging market economy is greater than the sum of 1) the rate of return in the capital's residence, 2) the anticipated future change in the rate of exchange, and 3) the risk premium, expect foreign capital to continue to flow into the emerging market, notwithstanding the transaction tax.

With regard to the securities tax, we must be aware of a tradeoff--it could be an obstacle to the deepening of the local equity markets in developing countries.

This does not suggest that transaction taxes such as the Tobin tax (tax on purchase of foreign currency) are undesirable. In Grabel's words, transaction taxes can "modestly reduce some of the risks." The point of Grabel is that while we emphasize the benefits of the transaction tax, we also have to recognize what it cannot do.

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A benefit of the Tobin tax is a foil to "day trading" in the currency market. The tax dampens transactions in which one-off profit is extracted from a low rate (more or less equal to the tax rate) involving a huge-volume transaction.

A variation of the original Tobin proposal is to have a variable rate or a two-tiered rate--a low rate during normal times and a high rate in times of volatility. As earlier said, the low rate in times of normalcy would not significantly curb short-term inflows. Having a high but non-interest bearing reserve requirement is a better approach. The higher tax rate is imposed once a spike occurs or once the band in which the exchange rate is allowed to move is breached. The higher tax rate is therefore applied *ex post*; this thus takes the form of a control on outflow. But Grabel and many other economists advocating capital control believe that a tax on inflow is preferred to a tax on outflow.

The effectiveness of the Tobin tax is its application at the global level (notwithstanding the limits that Grabel has raised). We can even refine this by saying that it can be made effective at, say, the regional level so long as the region's main financial centers are covered. To illustrate, East Asian economies can implement a Tobin tax if it could be enforced in the region's financial hubs, namely Tokyo, Hong Kong and Singapore.

The most obvious benefit from the Tobin tax is the vast amount of revenues that even a low tax rate can generate. These revenues can be used for various development purposes. Worth exploring is using a portion of the revenues to be part of an international reserve fund that can be used to fight speculative attacks and reduce investors' panic. The huge amount of reserves is already a deterrent to speculative attacks.

In this context should we appreciate the debate on the principal objective of the Tobin tax--whether it is to curb capital volatility and speculation or to raise revenues? Clearly, the two objectives are not exclusive. The generation of revenues, as illustrated above, can serve the objective of fighting volatility and speculation. The question though is what objective can better withstand rigorous scrutiny and better muster political and popular support.

Conclusion

Grabel has provided us with options that are the alternative to neoliberal approaches to managing capital flows. These alternatives are arguably better equipped to prevent or mitigate the different risks in the financial system. Indeed, in relation to neoliberalism, the options Grabel presented are "illiberal," for they entail significant degree of control or state intervention.

But if we accept the D. Rodrik proposition that we make a distinction between neoliberalism and neoclassical economics and that we make neoclassical economics an ally in some instances in fighting neoliberalism, then we can contend that some illiberal policies that Grabel has expounded are not that radical at all.

It is neoliberalism that attempts to suppress the interventionist or illiberal aspects found in neoclassic economics. From one perspective of neoclassical economics, capital control is no big deal. At the theoretical level, we recall, for example, the Mundell-Fleming model, which states that one cannot simultaneously have a fixed exchange rate, monetary policy independence, and full capital mobility. One can have two of the three features. It thus suggests that capital control is permissible in a regime of independent monetary policy and a fixed exchange rate (the East Asian countries that were hit by the 1997 financial crisis had a *de facto* fixed exchange rate). In practice, we cite Chile, one of the most liberal economies in the world, for successfully adopting capital

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controls during the 1990s. Chile's capital control was a necessary condition in Chile's economic growth and that the control was an integral part of what was trumpeted as a strategy of economic liberalization.

And if linked to the international trading of goods, full capital mobility can become a serious obstacle to freer trade. We have made a short explanation on how capital account liberalization adversely affects tradables via the channel of the exchange rate. It is not surprising that free traders, so to speak, like J. Bhagwati are critical of accelerated capital account liberalization in developing countries.

Moving away from neoclassical economics to Keynesian thinking, we note an important point in Grabel's paper--that getting more information through prudential regulation and surveillance is insufficient to prevent crises. In the financial system, information is an intrinsic problem. The different capital control measures can be seen as temporary in the sense that they can be introduced and withdrawn depending on specific contexts. But in the era of deeper economic integration, in which financial crises have become more frequent and more virulent, expect capital control in varying degrees and forms to become a fixture.