CONTROLS ON CAPITAL MOVEMENTS

Petriş Sorina
University of Oradea
Faculty of Economics

Until recently, capital mobility was encouraged across national borders, because it was considered that such capital can seek the highest rate of return. However, recent global financial developments have shown that, due to contagion, the mobility of capital flows can cause severe financial imbalances.
In the context of globalization, liberalization or maintaining controls on capital flows is a current topic, more debated by economists.
This topic is very important, due to the impact of liberalization decision or maintaining controls on capital flows has on the overall macroeconomic framework. The paper analyzes the relationship between capital flows' control and the income per capita, the degree of central bank independence, democracy country, the foreign exchange regime. Also, it analyzes the effectiveness in time of capital controls, taking account of financial system development and potential risks of instability. Over time, it was observed that a period in which they have imposed restrictions on capital movements was followed by a removal of such restrictions, and vice versa. Cyclic change of capital movements regime corresponds to the cyclic evolution of the global economy.
Full capital account liberalization led to the emergence of currency and financial crises, so that the idea of maintaining controls on capital is not rejected by economists. After a full liberalization of capital flows, there is a change in the mentality of an increasing number of economists, who support the maintenance of controls, in a gradual liberalization.

Keywords: capital flows, controls. liberalization, crisis,benefits.
JEL Classification: F21, F32, F43.

I.Introduction

Liberalization of capital flows is one of the four single market freedoms: free movement of persons, goods, services and capital. Liberalization of capital flows has been undertaken in many countries around the world, the methods used being different.
Periods of restrictions on capital movements were followed by periods of removal of these restrictions, and vice versa.
Thus, the nineteenth-century liberalism was followed by the imposition of severe restrictions on international movement of capital and foreign trade in the interwar period. The post-war period has four distinct phases:
-phase immediately following the end of the war, when they were taken several measures to liberalize capital movements;
-late '60s, when this trend is reversed, and a large number of countries impose new restrictions on capital flows;
-'80s, when orientation changes again to liberalization;
-in 2011, when after the global financial crisis, it was observed that the large capital flows caused severe financial imbalances, thus it seems that the trend is changing, again, to the contrary.
The cyclical change in capital movements regime corresponds to the cyclic evolution of the global economy.
Currency and financial crises arising from full liberalization of capital account have led economists not to reject anymore the possibility of maintaining controls on capital. Thus, the stage of complete liberalization of capital flows is now followed by a phase of maintenance of controls, in a gradual liberalization.

II. The results of the research

Lipschitz, Lane and Mourmouras (2002) believes that "although capital controls can distort inter-temporal allocation of resources and can be used as an excuse to relax macroeconomic discipline, they can provide temporary protection for emerging economies to volatile capital flows, like interbank loans and portfolio investment". Barry Johnston (1998) said that "the full liberalization of capital transactions and transfers does not mean abandoning all rules and regulations related to foreign transactions".

Capital controls are seen as tools used by governments, in order to earn income. Controls limit the residents' ability to direct their funds residents to foreign investment, in order to avoid financial balance domestic inflation (Alesina and Tabellini, 1989). Authorities may raise reserve requirements on domestic financial institutions, thereby reducing the flow of services costs without eroding the rate of inflation. This perspective suggests that most likely controls are used where the domestic financial system is well regulated and reserve requirements can be used to require financial institutions to control public sector obligations. Epstein and Schora (1992), Alesina, Grilli and Milesi - Ferretti (1994), Quinn, Inclan and Toyoda (2001), Milesi - Ferretti and Razin (1998), Bai and Wei (2000), all considered it unlikely to maintain controls in countries where central banks have a high degree of independence.

Most studies show a negative association between controls maintenance and income per capita. Mean, the more developed is the country, the more likely to be removed restrictions on capital flows. In the current period is noted that all countries with high income have already removed controls on capital movement.

Another area of literature examines the association of the controls with the exchange rate regime. Largely, it is recognized that capital mobility increases the difficulty of operating a stable currency. For countries with fixed exchange rates, is unlikely to have an open capital account (Leblang, 1997; Milesi - Ferretti, 1998, Leblang, 1999, Garrett, Guisinger, and Sorens, 2000).

Many economists believe that democracy is positively associated with capital account liberalization (Quinn, 2000; Garrett, Guisinger, and Sorens, 2000). Thus, democracy is seen as a mechanism used to resolve social conflicts, resorting to forced financial repression and inflation. Democracy provides an impetus for recognition of rights, including international economic rights of residents, who have a greater ability to support the removal of restrictions on their investment options (Dailami, 2000).

According to IMF (1999), in the period 1993-1997 were 106 cases that have introduced new controls on capital, the majority of them restricting their most open positions of banks in transactions with non-residents and credit expansion. The reasons are different, or maintain monetary policy autonomy in a fixed rate regime, or limit the volatility of financial markets within a variable course.

Various studies have shown that the effectiveness of controls on capital is limited in time, because there are ways to avoid them (Johnston, 1998). The more developed financial system, the financial intermediaries are easier to avoid some sort of control.

Peter Garber (1998) highlights the risks to avoid prudential controls over capital. He argues that whether a uniform tax on all gross capital inflows, the gross transactions will move offshore and students will eventually apply only net inflows.

Also, if you require different controls that allow investments in shares, but limited short-term investments with fixed interest, then capital flows will enter the path of the least closed. Often, developing countries have preferred a fixed exchange rate regime to control inflation, considering the exchange rate as a nominal anchor for prices. This policy option has its risks, which can be mitigated through controls on capital. In the specific context of fixed exchange rates, capital controls aim is or to improve the effectiveness of monetary policy, or to prevent speculative attacks.

In the mundellian traditional model, the capital controls allow the central bank to hold authority over monetary policy under a fixed exchange rate (Johnston, 1998, Edison and Reinhart, 2001). The cost of capital movement between the host country and the world requires a difference between interest rates in the country and abroad. In particular, a type of aggregate demand crisis, if requires a tax on capital outflows, the central bank may maintain, at least for a time, an interest rate below the international level. Conversely, if the central bank wants to limit capital inflows in an overheated economy, will enter a kind of tax on capital inflows, targeting an interest rate higher than that which would satisfy the interest rate parity condition.

Another issue refers to the controls that want to prevent speculative attacks on exchange rate parity. Incentives for a speculative attack are high: if the attack fails and the central bank manages to defend the parity, the speculator loses only interest for the period, but if the attack succeeds, causing the local currency depreciation, gains can be very large.

To deal with speculative attacks, governments may set ceilings for short-term loans granted by non-resident banks, and limit their interventions term market, they can also limit foreign currency outflows. Offshore markets for its currency, which generally escapes supervision of the central bank, should be closed. These are emergency measures, compared with prudential measures that are used in normal times (Edison and Reinhart, 2001). During the Asian crisis, Malaysia has introduced such emergency measures.

In the context of flexible exchange rates, capital controls motivations differ. Currency fluctuations are usually associated with loss. By imposing a cost on capital inflows and outflows in the short term in a flexible exchange rate regime, can achieve greater stability in capital flows. However, there are risks that cannot be neglected in the fact that reduced volatility of flows can cause high volatility of asset prices (stocks, exchange). Perhaps, controls on capital transfers adjustment costs from quantity to prices (Calvo and Rodriguez, 1979).

If monetary policy is exclusively dedicated to maintaining price stability, the country can only rely on fiscal policy to counter a negative demand shock. However, according to traditional mundelliane analysis, assuming perfect capital mobility, fiscal policy in a small open economy is completely ineffective in a flexible currency regime: any increase in public spending increases the interest rate, rate is estimated and the net exports fall. At the end of adjustment, additional deficit induces a current account deficit further, without real impact. In this context, a tax on capital inflows will limit their volume, will moderate the appreciation and could support a counter-cyclical fiscal policy effectively (Dăianu ed., 2002).

Regardless of the currency regime, capital inflows cause real appreciation of national currency. Net capital inflows have counterbalance the trade deficit. If the trade deficit is used to finance value investment projects, should not be any cause for concern. However, if foreign saving serves financing the budgetary deficit, consumption of imported goods or speculative real estate investments, things can be different. How the two destinations cannot be separated (and even if they could, financial intermediaries would find ways to avoid), it is very difficult to achieve selective controls to prevent speculative flows, but to support good investments (Dăianu ed., 2002).

In general, economists that have conducted empirical research tend to agree that, the controls that are intended to reduce the aggregate capital inflows were not very effective, but have contributed to changing the structure of foreign flows for long-term financing (Montiel and Reinhart, 1999).

Recent financial crises and financial instability reveals major risks that may be associated with short-term capital investments. Economic policy measures, which seek to limit this type of investment seem attractive lately.

One of these measures is the introduction of the Tobin tax. James Tobin, Nobel laureate for economics, suggested that any international transfer of capital would be subject to a small ad valorem taxes and the fees to be inversely proportional to the duration of the investment. For example, a fee of 1% (which means 2% for the round-trip of a particular capital) is equivalent to

an annualized 27% tax, if the funds are only one month in the country, than a fee of 0.2% annualized, if funds are 10 years. Tobin viewed this measure as a means of limiting the mobility of capital, which would allow the central bank to regain a degree of control over monetary policy, in a fixed exchange regime. Note that this tax penalizes both inflows and outflows of capital. Therefore, it may be helpful in reducing the aggregate flows, but not necessarily net flows. However, for a developing country, with little capital outflows, a Tobin tax would reduce the net volume flow.

Another measure of short-term investment is the establishment of the unpaid discriminatory reserve requirements. This measure affects only the capital inflows, not the capital outflows. It is generally imposing different reserve requirements for banks lending to nonresidents, and can be extended to any type of capital. Usually, the regulations define these reserves as a percentage of borrowed capital and impose a minimum interval of time for these deposits. So, stocks are not necessarily the same duration as the loan of which have been established. Reservations are unpaid, so involves an opportunity cost. This can serve to reduce capital inflows, on the whole, or to change the structure of capital inflows, if the distinction between different maturities of financing. Introducing this form of capital control implies an increase in domestic interest rate and a decrease in the forward premium, which could arise from a sharp depreciation of the exchange rate.

If you want to remove all capital inflows, this measure will be applied indiscriminately. If you want to discourage short-term inflows, it may be a short period of deposits in reserve (about one year). Thus, with higher external loan maturity, with the lower cost that the measure it induces the debtor.

As noted, the Tobin tax and deposit formation unpaid, for a year, for any investment, may discourage short-term funding. If short-term loans become more expensive, other forms of financing, such as foreign direct investment (FDI) become more attractive. Do not forget, however, that foreign investors may demand a higher risk premium for long-term loans. In this case, debtors could assume short-term financing risks, than to face a lack of funding at an interest rate that seems reasonable to them (Rogoff, 1999).

III. Conclusions

- Inverse relationship between maintenance checks and income per capita. Mean, how the country is more developed, the more likely to be removed restrictions on capital flows.
- Unlikely to maintain control in countries where central banks have a high degree of independence.
- Democracy is positively associated with capital account liberalization.
- Effectiveness of capital controls is limited in time, because there are ways to avoid them. The more developed financial system, the financial intermediaries are easier to avoid some sort of control.
- Existence of risks, in the case of avoiding prudential controls over capital.
- Regardless of the currency regime, capital inflows cause real appreciation of national currency.
- Overall, controls that intended to reduce the aggregate capital inflows were not very effective, but have contributed to changing the structure of foreign flows in favor for long-term funding.
- Recent financial crises and currency instability reveals major risks that may be associated to short-term capital investments. Measures to limit this type of investment: Tobin tax, unpaid discriminatory to hold minimum reserves.
- After a full liberalization of capital flows, there is a change in the mentality of an increasing number of economists, who support the maintenance of controls, in a gradual liberalization.

IV. Bibliography

1. Alesina, Alberto Tabellini, 1989, *Political Instability and Economic Growth*; Paper available at: http://ideas.repec.org/a/kap/jecgro/v1y11996i2p189-211.html.
2. Alesina, Alberto; Grilli, V. şi Milesi-Ferretti, G., 1994, ―The Political Economy of Capital Controls□, în Leiderman L. şi Razin A., (eds.), *Capital Mobility: The Impact on Consumption, Investment and Growth*, Cambridge University Press, pp. 289-321.
3. Bai, Chong-En şi Wei, Shang-Jin, 2000, *Quality of Bureaucracy and Open-Economy Macro Policies*, NBER Working Papers 7766.
4. Calvo, Guillermo şi Rodriguez, C.A., 1979, *A Model of Exchange Rate Determination Under Currency Substitution and Rational Expectations*, Journal of Political Economy, 85, pp. 617-625.
5. Dailami, Mansoor, 2000, ―Managing Risks of Global Financial Market Integration□, în Adams, C.; Litan, R.E.; Pomerleano, M., eds., *Managing Financial and Corporate Distress: Lessons from Asia*, Washington D.C., Brookings Institution.
6. Dăianu, Daniel (coord.), 2002, Opening the Capital Account in Romania*:* How Much and How Fast*?*, SSRN Working Paper.
7. Edison, Hali J. şi Reinhart, Carmen M., 2001, *Stopping Hot Money*, Journal of Development Economics*,* Vol. 66 (Decembrie), pp. 533–553.
8. Epstein, Gerald şi Schor, Juliet, 1992, ―Structural Determinants and Economic Effects of Capital Controls in OECD Countries, în Tariq, Banuri şi Juliet, Schor, *Financial Openness and National Autonomy*, Clarendon Press, pp. 136-161, Oxford.
9. Garber, Peter M., 1998, *Derivatives in International Capital Flow*, NBER Working Paper 6623, Iunie.
10. Garrett, Geoffrey; Guisinger, Alexandra şi Sorens, Jason P., 2000, *The Political Economy of Capital Account Liberalization*.
11. Johnston, Barry, 1998*, Sequencing Capital Account Liberalization,* Finance&Development, Vol. 35, Nr. 4; Paper available at:
http://www.aseansec.org/carh/Helmi%27s%20Web/Papers/johnston.pdf.
12. Leblang, David, 1997, *Domestic and Systemic Determinants of Capital Controls*, International Studies Quarterly, Nr. 41, pp. 435-454.
13. Leblang, David, 1999, *Domestic Political Institutions and Exchange Rate Commitments in the Developing World*, International Studies Quarterly, Nr. 43.
14. Lipschitz, Leslie; Lane, Timothy şi Mourmouras, Alex, 2002, *Capital Flows to Transition Economies: Master or Servant*, FMI Working Paper, Vol. 02, Nr. 11.
15. Milesi-Ferretti, Gian Maria şi Razin, Assaf, 1998, *Current Account Reversals and Currency Crises: Empirical Regularities*, NBER Working Paper Series.
Montiel, Peter şi Reinhart, Carmen M., 1999*, Do Capital Controls and Macroeconomic Policies Influence the Volume and Composition of Capital Flows*?, Journal of International Money and Finance Vol. 18, pp. 619–635; Paper available at:
http://people.ucsc.edu/~hutch/241B/Ec%20241b%20SYLLABUS%20Winter%202010_files/Montiel_Reinhart_JIMF1999.pdf.
16. Rogoff, Kenneth, 1999, *International Institutions for Reducing Global Financial Instability,* Journal of Economic Perspectives, Vol. 13, pp. 21-42.
17. Quinn, Dennis, 2000, *Democracy and International Financial Liberalization.*
18. Quinn, Dennis P.; Inclan, C. şi Toyoda, A.M., 2001, *How and Where Capital Account Liberalization Leads to Economic Growth*, 2001 Annual APSA Convention, San Francisco, California.
19 *** International Monetary Fund, 1999, *Exchange Rate Arrangements and Currency Convertibility*, Washington.