Curbing Hot Capital Flows to Protect the Real Economy

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Developing countries are once again the destination for speculative capital flows with inflows reaching pre-crisis levels, leading to currency appreciation and asset bubbles. Many of these nations are deploying prudential capital regulations to stem these flows. However, this may only be a partial remedy to the problem – such measures should be coupled with action by the developed countries in order to fully steer capital to productive use and to avoid future crises.

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As nations across Asia and Latin America still have a long way to go in terms of economic growth, foreign investment is quite welcome. The problem is that the sheer volume and composition of these flows implies that a large part does not go into productive investment. Mass inflows of short-term capital are causing asset bubbles and currency appreciation in developing countries, which make macroeconomic policy difficult and raise the risk of future crises. Short-term inflows are flocking to the developing world largely through the mechanism of the carry trade.

Another Crisis in the Making?

Since the global financial crisis began, interest rates have been very low in the United States (US) and in other industrialised nations. Increased US liquidity can trigger investors to pull dollars out of the US and invest them in nations with higher interest rates for rapid return, often using derivatives. Known as the carry trade, such speculative short-term flows push up the value of emerging market currencies and create asset bubbles. It is for this reason that the US was criticised at the 2010 G-20 summit in Seoul. For example, Brazil, with interest rates over 10%, has seen an appreciation of over 30% due in part to the carry trade; and was most vocal in Seoul. This is a problem in many emerging and even poor developing countries, like Uganda, with excessive short-term inflows.

Figures 1 and 2 (p 13) exhibit capital inflows into emerging Asia and Latin America since the financial crisis. Immediately after the crisis there was a massive and destabilising retreat of capital from the developing countries to the "safety" of the industrialised world. However, as both these figures show, emerging markets are again a fruitful destination for speculative capital.

In Figure 1, inflows (non-foreign direct investment or non-FDI) of capital into emerging Asia are juxtaposed with the appreciation of the South Korean won. In Figure 2, capital flows to Latin America are followed by appreciation of the Brazilian real. These two currencies have appreciated more than 30% since the onset of the crisis.

Responding to Excessive Inflows

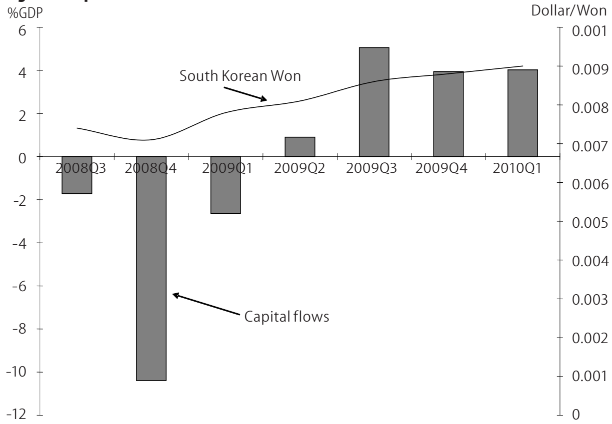
Emerging and developing economies are following a set of options to stem the tide, one of which is to engage in prudential capital account management by taxing or putting unremunerated reserve requirements on capital inflows. While this is not a panacea, it does help to provide greater monetary policy autonomy to these countries. This is essential as their growth rates are high at present, and it is crucial for them to not only avoid inflation in goods and services, but also asset price bubbles and overvalued exchange rates.

Many nations such as Brazil, China, Argentina, Taiwan, Thailand, South Korea, Peru and Indonesia have put in place various forms of capital account regulations to limit excessive inflows. Such controls have been recently sanctioned by the International Monetary Fund (IMF) – a landmark shift.

These measures follow a mountain of economic evidence in academia and by the international financial institutions, most notably the National Bureau of Economic Research in the US, the IMF, the United Nations, and the Asian Development Bank. In February 2010, the IMF economists published a staff position note empirically showing that capital controls not only work but "were associated with avoiding some of the worst growth outcomes" of the current economic crisis. The paper concluded 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" (Ostry et al 2010: 5).

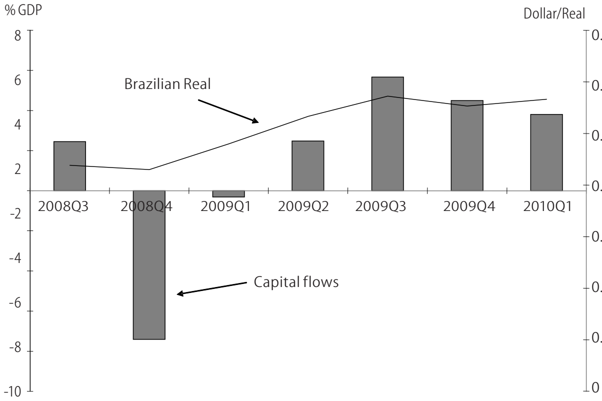
This IMF note singles out measures such as taxes on short-term debt (like those put in place by Brazil) or requirements whereby inflows of short-term debt need to be accompanied by a deposit to be placed in the central bank for a certain period of time (as practised by nations such as Chile, Colombia and Thailand). The goal of these measures

Figure 1: Capital Flows and Currencies in Asia



Asia includes South Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
Source: IMF (2010).

Figure 2: Capital Flows and Currencies in Latin America



Source: IMF (2010).

– which are often turned on when capital flows become excessive and turned off when things cool down – is to prevent massive inflows of hot money that can appreciate the exchange rate and threaten the macroeconomic stability of a nation.

The IMF's findings could not have come at a better time. Following the latest round of quantitative easing (QE2) by the US Federal Reserve, the carry trade is again bringing speculative capital to developing countries that could disrupt their recovery from the crisis. As pointed out by Ocampo (2010), "...monetary expansion may be largely ineffective in the country that undertakes it, but can generate large negative externalities on others."

Barriers to Effective Controls

To make the proper deployment of capital controls effective, however, at least three obstacles need to be overcome. First, after a time, investors often evade prudential capital management through derivatives and other instruments. Second, US trade and investment agreements make capital controls difficult to implement. Third, speculative capital can still wreak havoc because hot money passes by countries that successfully deploy controls and flows into nations that do not.

Brazil started imposing a tax on hot money inflows in October 2009 and has been fine-tuning them ever since, in part because of the volume of flows; but also because the regulation was being evaded. Some investors have avoided controls by disguising short-term capital as FDI through currency swaps and other derivatives and by purchasing American depositary receipts (ADRs). ADRs are issued by US banks and allow investors to buy shares of firms outside the US – enabling investors to purchase Brazilian shares in New York and thereby avoiding controls in Brazil. In a step in the right direction Brazil moved to levy a 1.5% tax on ADRs to stem speculation around the earlier controls. Now a Brazilian bank or investor that deposits shares with foreign banks will be charged the tax.

Since 2003, US trade and investment treaties have made prudential management of capital accounts by developing country trading partners difficult, if not impossible. The treaties have mandated the free flow of capital to and from countries – for instance, in trade deals with Chile, Peru and Singapore. In the case of Singapore and Chile, the countries resisted these measures, but ultimately agreed to the treaties. Pending deals with Colombia and South Korea would also ban prudential capital controls. Other higher income countries and trade partners – such as Canada and Japan – grant countries the right to use the macroeconomic tool or at least grant exemptions to prevent or mitigate crises.

The third problem, which may be the most difficult, is that capital will simply flow by those nations that successfully deploy controls to nations that do not. Some economists, such as former IMF economist Arvind Subramanian, proposes full-fledged coordinated capital controls among all emerging market economies to circumvent the problem. This is a justifiable solution to the coordination problem but of course not all emerging markets will agree to coordinate. We propose attacking the problem at its source.

Regulating the Carry Trade

Actions taken by developing countries on their capital accounts may not be enough as the wall of money presently coming towards them is so large and potentially volatile. Therefore it may be desirable to complement these measures with action by the countries where the capital is coming from, especially from the US – due to QE2 and the general ease of US monetary policy. Given that majority of the carry trade will in the near future come from the US, it could start regulating the outflow of capital from the carry trade.

The US could introduce measures to discourage the carry trade flows to the rest of the world, and especially to developing countries. This could be done by taxing such flows. Also, foreign exchange derivatives that mimic such transactions could have high margin requirements to discourage them.

Such a measure would benefit the US economy as the purpose of QE2 is to encourage increased bank lending and lower interest rates in the US and not for funds to be channelled abroad. It would also benefit emerging countries, whose economies are being harmed by excessive short-term inflows that could cause future crises. It would be a big win-win for the world economy.

The results of the recent US elections make it very difficult for the US to currently pursue the first best policy to keep its economy recovering – further fiscal expansion. As Keynes showed, and we have seen during numerous crises, private investment and consumption will not recover on their own – due to both over-leveraging and lack of confidence – without the stimulus of aggregate demand, which only governments can give in these circumstances. Once the recovery is on track, fiscal policy needs to contract to avoid both overheating and excessive public debt.

The Fed has already brought the short-term interest rate to zero, so Bernanke, to his credit, has ventured into the emergency toolkit. The Fed chairman should be applauded for his willingness to think past convention. As one of the last policymakers in developed countries with significant economic power, he is now almost the sole voice for an expansionary economic policy.

However, on its own, QE2 may not be enough to restore the US economy to growth. It will contribute to further overheating of asset prices in the emerging economies, which could complicate macroeconomic management for them now and also increase the risk of future crises.

To ensure QE2 helps the US economy to grow, mechanisms need to be found to channel the additional liquidity created by the Fed as credit *to the real economy*. The key is to expand credit to small and medium-sized enterprises, starved of funds at present, and to finance large investments in infrastructure, including that required to generate clean energy. Institutional innovations may be necessary to achieve this, such as the creation of an infrastructure fund.

Internationally, if the US dug into the emergency toolbox again, it could place prudent capital regulations on the outflow of speculative capital via the carry trade. This might help avoid future crises in the destination countries, which would harm not only them, but also the US and the world economy.

Controls on short-term outflows would facilitate the liquidity created by the Fed to stay in the US and have a better chance of going towards productive investment. Such investment could help developing countries via trade rather than causing speculative capital to flow to emerging markets and wreak havoc with their financial systems and economies.

Road to the G-20

Reorienting capital flows for productive development should be a priority as world leaders prepare for the next G-20 meeting in Paris. Prudential capital account regulations, deployed in both the industrialised and the developing world, should be examined as a partial remedy to the problem. It is promising that the French Finance Minister Christine Lagarde said in early December, "Capital controls should only be done…in case of a surge of capital flows and in a coordinated fashion. There needs to be a referee." Her emphasis on coordinated capital controls is significant as France heads the G-20 for 2011.

To rectify some of the problems related to capital flows, industrialised nations (especially the US) should consider regulating the carry trade and providing safeguards in their trade treaties to allow developing nations to deploy prudential regulation. Developing countries should also put in place prudential regulations. The Financial Stability Board, as well as national regulatory authorities should oversee them and take measures to limit avoidance.

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