Capital controls in emerging markets: A good idea?

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A few years ago the IMF produced some (cautious) comments and studies arguing that currency management and capital controls were OK in some circumstances. Many emerging market countries took this as an endorsement of their approach to policy which has not been limited to temporary crisis measures. The Figure below shows the national investment-saving correlations for the OECD countries over 1982-2010 and for a group of emerging countries (China, Brazil, India, South Africa, Mexico and South Korea) in the manner of Martin Feldstein and Charles Horioka.

In a 1980 paper, Feldstein and Horioka looked at two views of the relation between domestic saving and the degree of mobility of world capital. If capital is perfectly mobile, you would expect there to be little or no relation between the domestic investment in a country and the amount of savings generated in that country, since capital would flow freely to wherever the returns were highest. On the other hand, if the flow of long-term capital among countries is impeded by regulations or for other reasons, investors will be more likely to keep their money in their own country and increases in domestic saving will be reflected primarily in additional domestic investment. Feldstein and Horioka's analysis supported the second view more than the first.

Three decades later, the OECD economies have more-or-less achieved an open economy without capital controls (led in large part by Europe). But the emerging markets have a high correlation of national savings to investment (0.7), indicating a prolonged lack of openness.

The growing gap between the correlations for the OECD (highly open) and the emerging economies (impeded) is pointing to a fundamental imbalance in the world economy. Does it matter? The IMF study mentioned above showed that countries with stronger capital controls had a lesser fall in GDP in the post-crisis period. While the original authors were cautious in interpreting their results, this was not so for the users of those findings. This is all the more worrying given that the OECD exactly reproduced the IMF study and found that the results were not robust to a simple stability test. In other words, the OECD tests show that these results certainly should not be used as a basis for claiming some form of general support for long-term use of capital controls.

The OECD also ran a simpler study using the IMF's own measures of capital controls, with both the IMF's original sample period and updating it. The OECD study found significant and contradictory results, which were much more consistent with an exchange rate targeting and "impossible trinity" interpretation of outcomes.

In the good years prior to the crisis, capital controls are indeed good supporters of growth. This is likely because combined with exchange rate management there is a foreign trade benefit, companies are not constrained for finance, and containing inflows reduces the build-up of money and credit following from exchange market intervention (and associated asset bubbles).

However, in the post-crisis period the exact opposite is found and the results are highly significant. Capital controls are negatively correlated with growth. The pressure on the exchange rate is down, not up, as foreign capital retreats, and international reserves are used up defending against a currency crisis (contracting money and credit). Companies are more constrained by cash flow and external finance considerations. Just at the time when foreign capital is needed, countries with the most controls suffer the greatest retreat of foreign funding. Investment and GDP growth suffer.

The full sample period (data from both before and after the crisis) shows significant negative effects of capital controls. That is, the overall net benefit appears negative compared to less capital controls.

These results have an intuitive appeal, consistent with economic theory. While it is early days, and some caution is required, the findings suggest that in the long-run dealing with the global investment-savings imbalances could be of benefit not only to developed countries, but also to the developing world itself.

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Original article: Adrian Blundell-Wignall, Director, OECD Directorate for Financial and Enterprise Affairs, Special Advisor to the Secretary-General on Financial Markets, "Capital Controls in Emerging Markets: A good idea?", OECD Insights blog, *http://wp.me/p2v6oD-1Cz*.

Blundell-Wignall, A. and C. Roulet (2014), "Capital controls on inflows, the global financial crisis and economic growth: Evidence for emerging economies", *OECD Journal: Financial Market Trends,* Vol. 2013/2, *http://dx.doi.org/10.1787/fmt-2013-5jzb2rhkgthc*.

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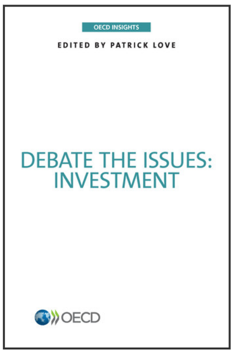
OECD work on institutional investors and long-term investment, *www.oecd.org/pensions/private-pensions/institutionalinvestorsandlong-terminvestment.htm*.



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