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Conclusion: A New International Pact on Capital Flows

Capital controls are making a comeback. This is not necessarily bad news, because there are situations when such controls can be beneficial. However, in some cases, capital controls are more likely to be distortive than corrective. The resurgence in the use of capital controls therefore should compel the international community to more systematically coordinate their use in ways that lead to better national policy and international regulations.

Need for Symmetric Rules on the Use of Capital Controls

There are three key factors (a combination of theory and empirics) that should be addressed by any effort to develop symmetric international rules on the use of capital controls. Each of these three is analyzed in depth in this study.

First, international financial integration and openness to capital (especially debt) flows provide little if anything by way of boosting long-run growth. This is suggested in the academic literature and overwhelmingly substantiated by our research as reported in chapter 3.

Second, as argued in chapter 2, there is a good case to be made for using certain types of controls, notably prudential and countercyclical capital controls that can be effective in smoothing booms and busts in capital flows to developing and emerging-market economies. In fact, this has been the impetus for the recent implementation of such controls by a number of countries (notably Brazil, as described in chapter 1).

We find that capital controls can be part of the menu of options to be deployed in the last resort against incipient asset price bubbles, a position that the International Monetary Fund (IMF), long an opponent of the use of such controls, has recently endorsed. However, our findings go further:

Properly designed capital controls may even be effective as a regular instrument of economic policy and may be warranted in other situations that are not strictly related to capital booms and busts. One such situation would be when a country runs a structural current account deficit; maintaining capital controls can be a precautionary measure to prevent overvaluation of a currency (and thus penalize the tradable goods sector). India may be an example of this type of situation. Another situation in which capital controls may be warranted is when a country seeks to protect a fragile home banking sector from the destabilizing entry of foreign banks (or from other forms of capital inflows).

The third key factor to be addressed in any international effort to regulate the use of capital controls is raised by the recent standoff between the United States and China and the acrimonious discussions about the value of the Chinese currency, the yuan. As this demonstrates, a country can use capital controls to sustain an undervalued exchange rate as an instrument of mercantilism with beggar-thy-neighbor effects on its trading partners and hence as a tool to prevent the exchange rate adjustments that are necessary to rebalance the global economy. China has used capital account restrictions combined with exchange market intervention to maintain a persistent real exchange rate undervaluation that is economically equivalent to a tariff on imports and a subsidy for exports.

The trade effects of China's policy highlight the close connections between capital flows and trade flows and raise the question of whether these links should be considered in the design of any international rules that affect either. In reality, there is an asymmetry between the international regulation of trade in goods and trade in financial assets and capital flows. Under the World Trade Organization (WTO) and its predecessor, the General Agreement on Tariffs and Trade (GATT), international rules were promulgated to promote free trade in goods. In contrast, trade in financial assets and capital flows has been largely left to the discretion of individual countries, and this is reflected most saliently in the fact that the IMF has no jurisdiction over how its member countries manage their capital account.[1]

The challenge in designing international rules on capital controls is to design a system that permits the use of controls that are welfare-improving but prevents or restricts the use of those that are not.

1. The exceptions, of course, are flows of certain types of capital—such as foreign direct investment (FDI) in services, which is regulated under the General Agreement on Trade in Services (GATS). Also, the lacunae that we have identified relate to worldwide rules because under bilateral and multilateral agreements both goods and capital may be regulated. For example, many free trade agreements recently signed by the United States—with Chile and Singapore, for example—prohibit the imposition of capital controls even for prudential reasons. Also, the Organization for Economic Cooperation and Development (OECD) has long promoted free capital mobility.

Three Alternative Approaches to International Cooperation on Capital Flows

We consider three alternative approaches to international cooperation—in ascending order of ambition—that take account of the three key factors discussed above. We discuss the pros and cons of each option.

Maintain the Status Quo

There may not be a need for new levels of international cooperation, given the desirability of using countercyclical restrictions to address booms and busts or the benefits of maintaining other restrictions to avoid macroeconomic instability and overvaluation. After all, the status quo is permissive in providing individual countries the policy space to impose any kind of macroprudential capital account restrictions. And, indeed, this freedom has been recently exploited by a number of countries, including Brazil, that have implemented such measures. Why build a new cooperative apparatus when the status quo works well?

The case for cooperation, in our view, is twofold, stemming ironically from the fact that the status quo is not permissive enough in some ways and is too permissive in others. Because the overall international economic environment favors openness, there is a stigma attendant to any policy measures that depart from such openness. Therefore, the status quo can be considered to place de facto limits on the freedom of countries to effectively use capital controls. This is evident in the fact that, in late 2009, Brazil imposed only very weak restrictions on capital inflows in order to avoid rattling the markets and ended up incurring the stigma of being market-unfriendly without effectively addressing the inflow problem. Brazil arguably should have imposed higher taxes (as it did eventually) at the outset to stem the flood of capital. Enhanced cooperation and internationally agreed rules could sanction the use by countries of the most appropriate and effective measures.

At the same time, the lack of internationally agreed rules does, on occasion, tempt countries to impose or maintain measures that are in fact damaging. The outstanding contemporary case is China, which is breaking no international rules in using capital controls as an instrument for maintaining an undervalued currency. In fact, the status quo has been characterized by mercantilism, global imbalances, and the prospect of currency and trade wars.

Develop a Code of Conduct for Nondistortive Capital Measures

A second alternative is for the IMF to devise a code of good conduct on nondistortive capital restrictions that countries can follow if they are afflicted by problems associated with inflows. This approach would have the overarching merit of drawing out and addressing one of the central lessons from the recent financial crisis, namely that distortive capital controls can magnify the loss of welfare for individual countries and for the global economy in a crisis.

An international code of conduct might be inadequate or ineffective, however, if it were limited to blessing the use of macroprudential restrictions. The recent crisis presents a unique opportunity to revisit issues related to international capital flows, and this opportunity would be wasted if it were not used to deal also with the other major lesson from the crisis, namely that global imbalances and undervalued exchange rates are exerting a significant drag on global growth. There is an opportunity to rectify the asymmetry between the international rules for trade in goods and trade in capital, as we discuss below.

The politics involved in bargaining over new international rules may in fact be made a little less difficult by a more ambitious approach that also addresses issues related to the imbalances between countries with capital account surpluses and those with deficits. Specifically, new rules on the use of macroprudential and other nondistortive capital measures would be beneficial to developing and emerging-market economies, and in return they may be willing to give up some policy space to reach agreement on rules governing the use of capital controls to support currency undervaluation. Whether this type of bargain would be sufficient to lead to a broad agreement remains distinctly unclear, but an ambitious approach at least opens up some additional scope for negotiation between the major players.

Given these considerations, we favor a third and much more ambitious approach.

Undertake Ambitious International Oversight of Capital Controls

The asymmetry between the international rules governing capital flows and the rules governing trade in goods are problematic, especially in the current global economic environment, and can in fact threaten the global free trade regime.[2] It therefore seems natural to move toward greater symmetry in the treatment of trade in goods and trade in financial assets and capital.

We propose moving in the direction of symmetry, but remain mindful of the evidence. Since free trade in capital does not have the same long-run growth effects as free trade in goods, we propose that all countries retain a certain degree of discretion in their ability to use capital controls. Even under the GATT/WTO system, countries have always been able to implement tariffs, and so allowing a measure of capital account protection would not be particularly generous or distortive.

However, as under the rules governing trade in goods, we strongly favor transparent, price-based measures rather than quantitative measures whenever possible. This will allow the international community to more easily assess the impact of controls and limit any potential distortionary effects. Administrative controls should be allowed only if it is impossible or difficult to replace them

2. This asymmetry may have been less of an issue when exchange rates were managed collectively, as under the original Bretton Woods system, or when the world was in full employment, as before the Great Recession.

with market-based measures (for example, concerning measures to restrict the entry of foreign banks for prudential reasons). As under the rules governing trade in goods, countries would be allowed discretion in determining the magnitude of their administrative controls, but would be required to "bind" them—that is, they would not be allowed to implement administrative controls beyond those currently in place.

We also propose that any international rules allow countries to impose capital controls for prudential reasons, but that they should be required to make a plausible case for them. The IMF should develop the jurisprudence on the appropriate circumstances for the use of prudential measures, including the kind of measures that can be imposed, the types of flows that can be targeted, and the acceptable magnitude of any controls. We recognize that making such judgments may be difficult in practice, in particular because they will depend on the existing global conditions and not only on the features of the particular measures taken by individual countries. The IMF could pay particular attention to the impact of spillovers in third countries to deem whether controls should be considered distortive in particular circumstances.

Leaving this type of room for discretion would be symmetric with rules on trade in goods, which allow contingent protection measures as part of safeguard measures, countervailing duties, and antidumping actions. These contingent actions are considered safety valves that allow the underlying liberalization agenda to move forward by guaranteeing some relief against the unavoidable political pressures when conditions turn bad in a particular economy or in particular sectors. By analogy, if countries have the assurance that they can legitimately and without stigma impose prudential capital controls, they may move faster to eliminate the use of controls that are more structural.

We therefore propose the following two principles for the international oversight of capital controls. First, capital controls should be market based, and whenever feasible they should take the form of a tax on capital flows.[3] Second, administrative controls could be maintained if a prudential justification can be given, but they should otherwise be phased out over time and on an accelerated schedule for large, systemically important countries that have a greater potential to inflict negative externalities and for countries for which the evidence of exchange rate distortion is particularly strong.

What level of taxes should be permissible on capital controls? One option is to set a limit on the maximum tax, say 15 percent. As shown in chapter 2, 15 percent is the optimal level of prudential taxation found by calibrated models. Furthermore, this level would ensure that, if the controls prove distor-

3. This is important to give the international community an indication about the size of the maximum distortion induced by capital controls. Domestic prudential regulation is partly quantitative, perhaps because financial regulators cannot be sure how financial flows will respond to changes in the price of risk. Given that quantitative measures will continue to be used in domestic prudential regulation, we argue that capital controls should normally be limited to price-based instruments.

tive rather than corrective, the extent of the distortion would be relatively limited. As explained in chapter 2, the maximum impact of controls on the real exchange rate is of the same order of magnitude as the size of the tax, and so this would ensure that any distortion of real exchange rates would be limited to 15 percent or less.

How should administrative capital controls be phased out? There are several possibilities. As for trade in goods, there could be a timetable for phasing out existing controls to be set either unilaterally by some international regulatory authority or as part of negotiations. If this is considered too weak, there could be an extra requirement that the phaseout be more expeditious for larger countries that have greater capacity to inflict negative externalities on other countries or for countries that also seem to distort their real exchange rate through other policies (such as reserve accumulation).

There are pros and cons to these proposals. On the one hand, a purist view is that any rules should be uniformly applicable. But this would mean that small, economically vulnerable developing economies would be required to dismantle all administrative controls unless there are prudential reasons to justify them, which could open them to significant economic volatility. On the other hand, pragmatism dictates that the rules be more stringent for countries that are more systemically important. There is a precedent for the latter under the WTO rules, which are more stringent on the use of export subsidies by countries that trade more.

Any new rules should be embodied in an international code of good practices developed under the auspices of the IMF. In addition, the IMF could be given jurisdiction over capital account policies (a question previously debated in the 1990s, but in a very different context). Because the new rules would encompass both trade in goods and trade in financial assets, the new regime should be accompanied by a system for institutional cooperation between the IMF and the WTO, as proposed by Aaditya Mattoo and Arvind Subramanian (2008).

Any rules implemented to discourage and phase out the use of distortive capital controls can be complementary to rules directed at disciplining undervalued exchange rates, as proposed by Mattoo and Subramanian (2008). For example, there may be a situation where a country is offered the choice of either directly eliminating a currency undervaluation (for example, by refraining from intervening in foreign exchange markets or accepting supervision of its target rate) or phasing out existing restrictions on capital flows.

Fostering International Cooperation to Develop International Rules

It may be relatively easy to prescribe a set of ideal rules, but it is much more difficult to propose just how these rules can be negotiated through a cooperative international effort. In particular, what would be the incentives for those who regard themselves as potential losers—the structural undervaluers such as

China—to participate in such an agreement? There is a fairly broad menu of options—both carrots and sticks—available to induce the cooperation of individual countries because the interrelationships and symmetries between trade in goods and trade in capital allow for instruments and actions that target activity in both realms. Since China is likely to be a critical player in the success of any potential agreement, the carrots and sticks that affect it are particularly relevant.

One advantage of a collective multilateral effort to design international rules is that the wide range of affected countries can collectively bring pressure on China to participate. Recent unilateral efforts in this regard, particularly by the United States, have been largely unsuccessful. Also, an agreement on universal rules would avoid specifically targeting China (or any other country) and all countries would therefore find it more politically palatable to participate.

Some of the carrots available in the trade arena include granting China the status of a market economy under WTO rules, which would make it less vulnerable to arbitrary unilateral action—especially antidumping duties—by its trading partners (Messerlin 2004). At the moment, the restrictions on such actions are less stringent when the target is a nonmarket economy.[4]

Clear rules on sovereign wealth fund (SWF) investments could be another inducement for China to cooperate. These could take the form of securing investment opportunities for China's SWFs in an environment where Chinese investments could otherwise increasingly be subject to national regulations with a protectionist slant. China's huge stockpile of foreign reserves is not likely to be eliminated any time soon, which means that the Chinese government will be a foreign investor for some considerable time, and guaranteeing an outlet for such investment could be an important carrot for China (and also for oil-exporting countries). The nature of other potential carrots in this area is spelled out in Mattoo and Subramanian (2008).

One of the potential sticks related to trade in goods is the imposition of tariffs on countries that do not agree to bring their capital account restrictions in line with new rules. This was one aspect of legislation introduced in 2010 in the US Senate by Senators Charles Schumer and Lindsey Graham, which included the imposition of a 27.5 percent tariff on Chinese imports. More recently, the House of Representatives passed legislation that would

4. In order to establish that dumping is occurring, a firm's home and export prices are compared. This is the normal procedure for market economies, where home prices are assumed to reflect the true costs of production. If the overseas prices are below domestic prices, it is likely that they will be found to be "less than fair value," creating a presumption of dumping. In the case of China, because home prices are presumed to be distorted, investigators have the freedom to find comparable firms in third countries, say, India or Japan, to determine the "real" market costs of producing those goods. If the Chinese firm is selling its exports for less than the Indian or Japanese firms' costs, then it can be found to be selling goods for less than fair value. The key point is that antidumping investigators have such wide discretion in choosing comparable firms in other countries that it becomes easier to establish dumping and hence take action against Chinese imports.

allow undervalued exchange rates to be treated as export subsidies and hence subject to countervailing duties. Such linking of capital account policies and trade policies makes a lot of sense since, as we argue in chapter 2, it is possible to achieve with capital account restrictions exactly the same impacts on trade as through the imposition of tariffs on imports.

Sticks related to trade in assets could take the form of a broad reciprocity requirement,[5] whereby capital-importing countries limit sales of their public debt to include only official institutions from countries in which they themselves are allowed to buy and hold public debt. For example, instead of "moral suasion," the Chinese authorities would not be allowed to buy US Treasury bills or Japanese government bonds unless and until they allow foreigners to buy domestic Chinese debt.[6] A variant of this—a generalization of the proposal by Joseph Gagnon and Gary Hufbauer (2011)—is that a country could impose a tax on the holding of foreign assets by any countries that fail to sign on to the new rules (which is easily justified in terms of reciprocity). One advantage of this type of measure is that such countries would not violate existing multilateral rules, because there are none.[7]

Of course, it remains to be seen whether any of these carrots and sticks might be successful in inducing China to cooperate, but they are certainly worth a try, and cannot be worse than the status quo, which has been characterized by mercantilism, global imbalances, and the prospect of currency and trade wars.

As this study makes clear, the free international mobility of capital should not be considered the ideal toward which all countries world should aspire. There is only weak evidence that free capital mobility promotes long-run growth, but there is a strong case to be made for the use of capital controls to address short-run volatility. At the same time, it is appropriate to harmonize the regulations governing the international flow of capital in order to eliminate the asymmetry between the nonexistent rules governing trade in financial assets and the strong international regime promoting and governing trade in goods.

John Maynard Keynes, even in his most protectionist incarnation, famously tried to distinguish between the optimal degrees of insularity in the

5. See C. Fred Bergsten, "We Can Fight Fire with Fire on the Renminbi," *Financial Times,* October 4, 2010. See also Daniel Gros, "How to Avoid Trade War: A Reciprocity Requirement," VoxEU, October 8, 2010, www.voxeu.org.

6. The Chinese government debt is relatively small, and so this requirement would have to be extended to other forms of debt such as the central bank's sterilization bonds or even to private debt.

7. One obvious objection to this proposal would be that China could buy US bonds through intermediaries. But intermediaries would put themselves at considerable risk of enforcement action under existing anti-money-laundering rules. Given the sums involved, it would be hard to dissemble such operations. A more substantial objection is that the Chinese authorities could avoid the pressure by purchasing private instead of official debt.

domains of goods and capital: Let goods be home-spun as far as possible, he said, adding that "above all, let finance be primarily national" (Keynes 1933). Such a nationalistic approach has clearly been made obsolete, with trade in both goods and financial assets highly globalized, but it may still be preferable to keep trade in goods more open and unfettered than trade in capital and financial assets. Even so, there is no case at all to maintain the status quo of regulating the former and not the latter. Rules to deal jointly with trade in goods and trade in financial assets are long overdue.