Introduction

The original intent of this study was to revisit the question of how developing and emerging-market economies should best integrate into global financial markets by taking stock of the literature and these economies' experience with international capital flows since the 1990s.

One important question, of course, is, What are the lessons and implications of the global financial crisis for capital account policies in developing and emerging-market economies? As the crisis unfolded and the Great Recession took hold, however, it became clear that the crisis was deeply affecting the process of financial globalization itself and that our original question therefore had to be framed not only from the perspective of developing and emerging-market economies but also by looking at the system as a whole.

The globalization of financial markets during the past 20 years did not occur by design. Free trade in financial assets has not been directed or supported by the type of international rules and institutions that the World Trade Organization (WTO) provides for the liberalization of trade in goods.[1] Developing and emerging-market economies integrated into global financial markets in part because they expected to receive some dividends in terms of growth, but perhaps more fundamentally because of a particular understanding of how the world economy is ordered and how financial globalization is aligned with the direction of history.

The fundamental principle supporting financial globalization is that econ-

1. There are some exceptions, such as the prerequisite of capital mobility for EU membership and the fact that certain types of capital—such as foreign direct investment in services—are regulated under the General Agreement on Trade in Services (GATS). The difference between free trade in goods and free trade in assets was emphasized by Bhagwati (1998).

omic development sooner or later requires that a country accept free capital mobility.[2] In the cosmology of global finance as it came to be viewed in the 1990s, the core of the system comprised a few international financial centers located in the countries that were the most financially liberalized, both domestically and externally. The second concentric circle in the system comprised advanced economies that did not have international financial centers, and the third circle comprised the emerging-market economies, which attempted to play by the same rules as the core countries and sought to attract global investors to their financial markets. In this worldview, full membership in the "advanced country club" required an acceptance of free capital mobility, and capital controls were seen as a vestige of economic backwardness.

Is this worldview being challenged by the global financial crisis? The crisis certainly reinforced the arguments of those who emphasize the dangers of financial liberalization, and the pendulum has begun to swing back toward more regulation of financial markets. In particular, the potential role of prudential capital controls in helping to deal with booms and busts in capital flows is now better understood by economists, and their use has become more acceptable in official circles.[3] In this context, the International Monetary Fund (IMF) was asked by its shareholders to address the question of whether there is a need for globally agreed "rules of the road" for managing capital flows (Strauss-Kahn 2011).

Against this backdrop, the view developed in this book can be summarized as follows. (1) The question of capital controls is a technical, not an ideological, one: Some controls may be appropriate under certain circumstances, whereas others may be harmful. (2) It is desirable to negotiate an international agreement about which controls are appropriate and which are not. (3) Such an agreement should become the basis for an international regime that legitimizes the use of controls that are appropriate ("good controls") and discourages the use of those that are not ("bad controls").

The basic difference between "good" and "bad" controls is that the former correct distortions that arise under laissez-faire whereas the latter create distortions. The former include prudential measures to address boom and bust cycles in asset prices induced by capital flows.[4] They also include precautionary measures to prevent a country from running large current account

2. This association does not presume causality from capital account openness to growth—which, as explained in chapter 3, remains quite elusive in the data. The Washington Consensus is quite consistent with the view that opening the capital account prematurely or in the wrong way can be detrimental to growth and that appropriate sequencing is important (Williamson 1990).

3. Prudential controls have been endorsed (subject to caveats) by the IMF and by the Group of Twenty systemically important economies (G-20) at its November 2010 Seoul summit. They were also an important theme of the French G-20 presidency during 2011.

4. The case for such prudential controls is reviewed in chapter 2. In this book, the terms "prudential" or "macroprudential" refer to measures aimed at reducing the risks of financial instability.

deficits that could jeopardize macroeconomic stability or to prevent overvaluation of a currency that would excessively weaken the tradable goods sector.

Bad controls distort capital flows in harmful ways. The most onerous capital account restrictions, both before and after the start of the global financial crisis, are those used by countries such as China to competitively prevent the appreciation of their currencies, thus distorting international trade and capital flows. The role of capital account restrictions in distorting the real exchange rate is broadly understood, but its central importance is not. As we argue in this book, accumulating international reserves would be much less effective in preventing real currency appreciation in the medium to long run if such accumulation were not supplemented by severe restrictions on capital inflows. In the case of China, the government induces "forced saving" in the domestic private sector in order to finance the current account surplus, which in turn contributes to prolonging global imbalances and lowering employment in the rest of the world.

The second main conclusion of this book is that it would be desirable for a code of good practices concerning capital account policies to be developed under the auspices of the IMF.

The first reason for such a code is that, under some circumstances, unconstrained national actions can be collectively damaging.[5] A second reason is that such a code would reduce the stigma associated with capital controls: The current lack of rules stigmatizes countries for not following whatever happens to be the conventional wisdom at the time, which in recent years has favored free capital mobility. As a result, countries that have recently imposed capital controls have often done so apologetically and with less-than-optimal vigor. Finally, a code would help define a set of best practices that countries can aim for in implementing capital controls.

But we also argue that the "rules of the road" for managing capital flows should go even further. Any set of rules will fail to address the biggest challenge posed by capital controls if it is limited to blessing the controls that are deemed to be appropriate but fails to discourage the use of restrictions that are harmful. Any code of good practices for capital controls that is developed should also be used to define by exclusion controls that are presumed to be distortive and should not be used.

Looking forward, the presence of distortive capital controls raises an issue of deep concern: the asymmetry between the existence of a strong multilateral framework for international trade in goods and the absence of rules for trade in assets. The WTO and its predecessor, the General Agreement on Tariffs and Trade (GATT), promulgated strong rules to promote free trade in goods. In contrast, trade in assets has been left largely to the discretion of individual countries, reflected most saliently in the fact that the IMF has no jurisdiction

5. For example, if all countries held their capital at home with no change in the ultimate pattern of investment, investors would be deprived of the benefits that attend the lower risk exposure of holding more diversified portfolios.

over its members' capital account policies. This asymmetry makes no sense because, as outlined in this book, capital account policies (including the accumulation of reserves) can be used to achieve exactly the same trade effects as tariffs on imports and subsidies for exports. Thus, any conflict about international trade has a natural tendency to spill over to capital flows, and vice versa.[6]

This asymmetry between trade in goods and trade in assets will become increasingly problematic for the global economic system. It was not a fundamental problem under the Bretton Woods system (when capital account restrictions were widespread) because global trade integration was much less advanced than it is today and exchange rates were managed multilaterally. Nor was it a serious issue when global trade integration involved primarily advanced economies, because these economies were simultaneously opening themselves to international capital flows. Finally, it was not perceived to be a pressing problem before the Great Recession, when the global economy was close to full employment (even though growth was being achieved at the cost of large imbalances that were already becoming a concern). But looking forward, several factors—including especially a persistent global demand deficit and the rising share of China in world trade—will lay bare the inconsistency of having multilateral rules and institutions for trade in goods and no multilateral framework for trade in assets.

What should be covered in a code of good practices for capital account policies? This is not an easy question: The difference between "good" and "bad" capital controls resists easy definition. There are many species of capital controls. Capital controls can cover inflows or outflows. They can be administrative or market based.[7] They can be prudential—aimed at reducing the risk of financial instability—or used for other objectives, such as limiting the appreciation of the domestic currency.[8] They can be implemented anticycli-

6. For example, consider the proposal that the United States respond to China's accumulation of dollar reserves by "countervailing interventions" (C. Fred Bergsten, "We Can Fight Fire with Fire on the Renminbi," *Financial Times,* October 4, 2010). This strategy is motivated by the desire to address a trade imbalance, but it is difficult, if not impossible, to implement in practice because of the heavy restrictions on the Chinese assets that US authorities could buy. There is no treaty or framework by which the international community can compel China to sell more of its domestic assets to nonresidents.

7. Akira et al. (2000, 7) define administrative (or direct) capital controls as controls that "restrict capital transactions…through outright prohibitions, explicit quantitative limits, or an approval procedure," whereas market-based (or indirect) controls "discourage capital movements and the associated transactions by making them more costly to undertake." Another (related but not identical) distinction is between price-based and quantity-based controls. Price-based controls take the form of a tax on capital flows and are also market based. We would also classify quantity-based controls as market based if they take the form of tradable quotas. The important criterion in determining whether a control is market based is whether the induced price distortion is observable in a market.

8. In some cases, limiting the appreciation of the currency may itself have a prudential motivation (as discussed in chapter 2).

cally to counter booms and busts in capital flows, or they can be structural. This book makes the case for one type of capital control that we consider to be important—price-based, prudential, and anticyclical controls on inflows—but this does not mean that all appropriate controls must have those features. For example, a country may want to protect a fragile banking system with administrative structural controls, at least for a while.

Establishing international criteria to distinguish the good varieties and uses of capital controls from the bad ones is a difficult but not an impossible task, and the stakes justify that it be tried. What should be the basic principles? We discuss in the conclusion to this book various options that presume different degrees of international coordination and multilateralism. Our most ambitious proposal can be summarized as follows:

- The international community should not seek to promote totally free trade in assets—even over the long run—because (as we show in this book) free capital mobility seems to have little benefit in terms of long-run growth and because there is a good case to be made for prudential and other nondistortive capital controls. But, as for trade in goods, if there are controls, we would be strongly in favor of having transparent, price-based measures. We recognize that the judgment call about what level of controls is appropriate in a given circumstance may be difficult in practice and propose that the effective tax implied by market-based capital controls should not exceed 15 percent (a level consistent with the recent literature on the optimal taxation of capital flows).
- Administrative (non-market-based) controls may be justified in some cases, but the primary justification for them should be prudential—that is, to promote or preserve financial stability. The IMF should develop the jurisprudence to define the appropriate circumstances and measures.
- The new rules could be embodied in an international code of good practices developed under the auspices of the IMF. Because the framework of international trade rules would then encompass both goods and 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).

The interdependence of international trade in goods and international trade in assets underlies the argument for increased international oversight of capital account policies. In particular, one impetus for the 15 percent threshold is to limit real exchange rate distortions and thus to help maintain a level playing field for international trade.[9] From this point of view, our proposal is comparable to others put forward to limit exchange rate misalignments. Some of these other proposals target norms for such variables as exchange rates or

9. Under some conditions, the impact of capital controls on the real exchange rate is of the same magnitude as a tax on capital flows (see chapter 2).

current account balances, but the economic justification for such norms is often debatable.[10] Other proposals focus instead on the policy instruments that underlie the distortions (such as foreign exchange intervention or, as we do here, capital account policies), which has the advantage of avoiding the need for strictly defining the desirable outcomes.

The global financial crisis generated a multilateral response, but the impetus for global cooperation created by the crisis has weakened, and that may leave little hope of achieving international agreement on far-reaching, global financial reforms. In particular, what would be the incentives for those who regard themselves as potential losers, such as China, to participate in such an agreement? There is a menu of options—including both carrots and sticks—available to induce cooperation, as discussed in the conclusion. Using the example of China, the carrots could take the form, in the area of trade in goods, of granting China the status of a market economy, and in the area of trade in assets, of securing investment opportunities for its sovereign wealth funds. The sticks could take the form of restrictions on exports, restrictions on foreign asset holdings, or taxation of the yield on foreign assets of countries that fail to abide by the new rules (Gagnon and Hufbauer 2011).

The book is structured as follows. Chapter 1 reviews the experience of developing and emerging-market economies with capital flow volatility during the global financial crisis and discusses the resurgence of controls on capital inflows, with special emphasis on Brazil. Chapter 2 presents the case for prudential capital controls, but then argues that existing controls are often not prudential in nature and instead appear aimed at maintaining a persistent currency undervaluation. Chapter 3 revisits the question of whether capital account liberalization has a significant impact on growth using a "meta-regression" approach that measures the robustness of the results across a large number of empirical specifications. Chapter 4 looks at the same question but focuses on certain types of capital flows (equity, foreign direct investment, and bank flows) and their likely microeconomic consequences. Finally, the last chapter takes stock of the analysis and presents our main policy conclusions.

10. In particular, they require making an implicit judgment about the appropriate saving and investment rates for given countries.