A Return to Capital Controls?

Arvind Subramanian says Brazil's latest move to tax certain kinds of foreign investments was sensible and should force a reevaluation of the orthodoxy that opposes all capital controls.

Recorded October 27, 2009.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Arvind Subramanian, senior fellow at the Institute, is here to talk about the state of play on capital flows especially to the developing economies after the financial crisis. Thanks for joining us, Arvind. It's always a pleasure to have you.

Arvind Subramanian: Thanks, Steve.

Steve Weisman: You and John Williamson have written a paper taking note of a very interesting action by Brazil imposing a tax on certain kinds of foreign inflows. What actually happened and why did they do that?

Arvind Subramanian: The Brazilian authorities used to have a small tax on inflows into the Brazilian bond market. Recently, they've imposed a bigger tax on a wider range of flows coming into the country. The reason that they said they were doing this was because their currency was under pressure from too much capital coming in, and they wanted to slow down the rise of the Brazilian real because that was hurting exports and obviously going to affect activity in the Brazilian economy.

Steve Weisman: How does capital inflow cause the local currency to appreciate?

Arvind Subramanian: Essentially what capital inflow means is that outsiders are bringing in dollars and they are demanding domestic currency and they're demanding domestic currency in different forms. They want to invest in various kinds of different domestic Brazilian assets. It could be equities. It could be bonds. It could be in the banking system. So, essentially it means that the demand for Brazilian currency starts rising very sharply and that means that there's upward pressure on the currency.

Steve Weisman: Isn't that a healthy thing?

Arvind Subramanian: It really depends, Steve. I think one has to distinguish two aspects of this whole thing. When currency goes up in line with the productivity gains domestically, then that currency appreciation is not a bad thing because it reflects something underlying going on. But if a currency surge is unrelated to domestic productivity development, that means that the country starts losing competitiveness. So that means that Brazilian products will be more expensive on world markets and they would start losing out.

Steve Weisman: But the investors think that Brazil was a good investment and is competitive so that causes them to buy the currency in the first place.

Arvind Subramanian: Yes, but you can have too much of a good thing. So, the very act of doing precisely what you said they're doing actually aggravates competitiveness. Now, Steve, I think you have to keep two things in mind. One is steady inflows versus surge inflows; and I think these are two different things altogether.

Steve Weisman: And this was a surge?

Arvind Subramanian: Yeah, this was a surge.

Steve Weisman: Why did it happen?

Arvind Subramanian: I think part of the reason is that—remember, when the crisis took place there was a flight to safety to dollars, right? And then once I think that phenomenon subsided, when the world economy and the financial systems started stabilizing, investors start looking around and saying, "Hey, which countries survived the crisis the best?" And it turns out that emerging market countries have done reasonably well …

Steve Weisman: Especially Brazil.

Arvind Subramanian: Especially China, India, and Brazil have done very well. So, naturally investors say, "Where is the best return for the money? Where are the growth prospects best?" And that's why capital has started surging into these emerging market economies.

Steve Weisman: Arvind, you were at the IMF and the IMF conventional wisdom preaches that these kinds of controls through this tax are a no-no. So did Brazil anger the International Monetary Fund or anyone else when it took this action?

Arvind Subramanian: When Brazil took this action, the IMF responded in very moderate terms, saying, "This is an action they've taken. We can understand it but there are better ways of addressing the problem. Moreover, these things don't work because these taxes can be easily evaded."

There's actually nothing wrong with what the IMF said. But the problem as we wrote in this Financial Times piece yesterday was that it represented very much business as usual at the IMF. And what is business as usual? I think there was an unmistakable ideological bias in favor of free capital flows.

Steve Weisman: Does that bias flow from the influence that capital owners have at the IMF?

Arvind Subramanian: It's a combination of things, Steve. I think it partly comes from a belief in markets. I mean, this is the counterpart of what happened domestically, the view that markets can't go wrong and finance was generally a good thing. We had that ideology, which was partly responsible for the domestic part of the crisis in the United States. Leading market share leaders saying, "Markets know how to price assets, so we shouldn't really come in the way of markets."

The foreign counterpart of that was the same. Foreign capital knows what it's doing and it's pricing currencies like it prices assets domestically and we should buy lots of trust in markets. The problem, of course, is that we know that these markets are subject to herd behavior, sudden stops, when the capital comes in and flows out, and this can be very unsettling and be costly.

So, the question really is what is the best way of dealing with this? Now, the immediate response of the IMF is not to control them per se but to try to do other things to address the problem. And what we are saying is that in the armory of weapons to be deployed against these flows, one should also consider reasonable ways of restricting these flows. And I think the bigger point that we make is the following, Steve, which is very important to underline. When we had this foreign finance fetish—you know I like alliteration, countries being enamored of foreign finance—that meant that countries that wanted to deal with this by taking measures like what Brazil is doing, they risked being seen as somehow imprudent and market unfriendly in their behavior because the intellectual either or ideology was to shun this implicitly.

So, what we're making a pitch for is to be a little bit more pragmatic about these things and to recognize that in some situations—I mean, putting a tax on capital inflows may be a reasonable thing to do in the short run. Many countries pay the cost in not being able to take such actions. What is really interesting is that even this Brazilian action suffered from real defensiveness because of the same fear that they were going to antagonize markets and risk being seen as market unfriendly.

Steve Weisman: Did they antagonize markets? Did they criticize?

Arvind Subramanian: I think markets think that this measure is not going to stay because this cannot be sustained and so on. In fact, if Brazil is actually serious about this action, it may really need to ramp it up and actually have it in for a much longer time than they're currently contemplating.

Steve Weisman: But isn't there a danger if too many countries slap these kinds of controls on capital?

Arvind Subramanian: Yes, I certainly think that if everyone starts doing it, there is a certain risk. And it's a little bit the counterpart of the global imbalance problem, Steve, right? Because essentially this placing restrictions on capital is trying to get a more competitive exchange rate. And that means these countries will start running current account surpluses and then we have the global imbalance problem at the international level.

Clearly what you identified is, again, a conflict between what is good nationally but what may not be good collectively for the international system. That is why I think we need better, stronger, multilateral rules on exchange rates.

Steve Weisman: Are there any other countries that are going to now mimic Brazil's action, such as China or India or any of the other sort of major developing countries?

Arvind Subramanian: Well, Steve, that's a very good question but remember that China and India are relatively closed to capital. I said relatively, they don't allow all forms of capital to come in at any point for whatever. Brazil is relatively open, that's why it felt it had to take some measures to kind of moderate the flow. China and India have controls already but a lot will ride, I think, on how this Brazilian action pans out. If other countries feel that it's working, then there may be a danger of imitation here.

Steve Weisman: Brazil is one of the most admired economies in the world so what it does is going to be carefully watched in lots of places, right?

Arvind Subramanian: Absolutely, especially in Latin America, Steve, where Brazil is the kind of original leader as it were and as you said, it's been seen to have done well in terms of economic management. So you're absolutely right.

Steve Weisman: Do you think the IMF or other international financial institutions and organizations are going to look at this a little bit more realistically in the future given the advice that you and John Williamson are offering and perhaps others are?

Arvind Subramanian: Well, I think there's no doubt about the fact that I think there is going to be a reevaluation of all these kinds of measures. I mean, in part because the global financial crisis has really exploded the myth that somehow markets know how to price assets and that more finance, always and everywhere, is a good thing.

So, part of that denting of that myth as it were is going to lead to reevaluation of some of these actions, I'm sure. And I just hope it leads to a really pragmatic assessment and a lot more research. When the IMF officials said, "Oh, this can be evaded and they're not very effective," I mean, my response is that, "Hey, all taxes are evaded. Does that mean you don't impose taxes at all? You just look for better ways of implementing taxes." Designing taxes and implementing them, that's exactly what I think needs to happen in this case as well.

Steve Weisman: When will we know whether Brazil's action produces the results that they desired?

Arvind Subramanian: I think we will see what Brazil itself does in the future. If for example it feels that it needs to take more—if the currency, for example, doesn't stop appreciating, they may do other things. That's when we'll have to see whether these things are working or not and also how long they would keep this in place.

Steve Weisman: And is it appreciating now or have they stabilized the situation?

Arvind Subramanian: It's too early to tell, Steve. Let's see what happens over the next few weeks.

Steve Weisman: On that note, not only let's see what happens but let's talk about it again.

Arvind Subramanian: Thank you, Steve.

Steve Weisman: Thanks.