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Capital Management Techniques in Seven Developing Countries During The 1990s: Lessons For Policymakers[*]

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Introduction

Following the Asian crisis of the late 1990's, there has been a renewed interest in the role of capital controls in developing countries within both policy and academic circles. The reasons for this interest are not hard to find. Even strong proponents of capital account liberalization have acknowledged that many countries that avoided the worst effects of recent financial crises were also those that used capital controls, including China, India, Malaysia and Chile. Consequently, prominent mainstream economists and even the IMF have relaxed their insistence that immediate capital account liberalization is the best policy for all countries in all circumstances (IMF 2000, Fischer 2002) Adding momentum to the discussion over the last several years, a number of highly respected economists have actively argued in favor of capital controls (e.g. Bhagwati 1998, Stiglitz 2002, Krugman 1998, Rodrik 1998), adding their voices to the many heterodox economists who have argued for controls for many years (e.g. Crotty and Epstein 1996, Pollin 1998, Felix 2001, Grabel 2002).

Despite this apparent increase in the tolerance for capital controls, most mainstream academic and policy economists remain quite skeptical about the viability and desirability of controls, at least in two specific senses. Whatever increased tolerance for capital controls exists applies to controls on inflows, not on outflows. Moreover, controls on inflows are generally seen

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as a “temporary evil,” useful *only* until all of the institutional pre-requisites for full financial and capital account liberalization are in place.

Regardless of economists' misgivings, many countries nevertheless employ capital controls of various kinds to achieve important policy goals. Our study presents intensive case studies of seven developing countries that maintained a variety of controls over capital inflows and outflows during the 1990s (Epstein, Grabel, Jomo 2003).

Capital Management Techniques

Departing from common practice in this literature, we found it useful to broaden the study of "capital controls" beyond its normal limits. More specifically, we investigated what we term *capital management techniques*, referring to two complementary (and often overlapping) types of financial policies: policies that govern international private capital flows and those that enforce prudential management of domestic financial institutions. We argue that certain types of prudential financial regulations actually function as a type of capital control; moreover, capital controls themselves can function as or *complement* prudential financial regulations. Our research demonstrates that there is often a great deal of synergy between prudential financial regulations and traditional capital controls. We also find that it can be difficult (and sometimes impossible) to draw a firm line between prudential domestic financial regulation and capital controls. For instance, domestic financial regulations that curtail the extent of maturity or locational mismatches may have the effect of influencing the composition of international capital flows to a country, even if those types of regulations are commonly classified as prudential domestic financial regulations and not as capital controls. Hence, for the IMF and others to argue that prudential management is “good” and capital controls are “bad” is to draw a distinction for ideological, rather than sound policy purposes.

The Case Studies

We undertook seven case studies of the diverse capital management techniques employed in Chile, Colombia, Taiwan Province of China, India, China, Singapore and Malaysia during the 1990s. Regimes of capital management take diverse forms and are multi-faceted. Importantly, capital management techniques can be static or dynamic. Static management techniques are those that authorities do not modify in response to changes in circumstances. Capital management techniques can also be dynamic, meaning that they can be activated or adjusted as circumstances warrant. Tables 1 and 2 summarize the main results from our case studies.

Table 1
Types and Objectives of Capital Management Techniques Employed During the 1990's

Country	Types of Capital Management Techniques	Objectives of Capital Management Techniques
Chile	**Inflows** - FDI and PI: One year Residence Requirement - 30% URR - Tax on foreign loans: 1.2% per year **Outflows:** No significant restrictions **Domestic financial Regulations:** - strong regulatory measures	- lengthen maturity structures and stabilize inflows - help manage exchange rates to maintain export competitiveness - protect economy from financial instability
Colombia	**Similar to Chile**	**Similar to Chile**
Taiwan POC	**Inflows** *non-residents* - bank accounts can only be used for domestic spending, not financial speculation - foreign participation in stock market regulated - FDI tightly regulated *residents* - regulation of foreign borrowing **Outflows** - Exchange controls **Domestic Financial Regulations** - restrictions on lending for real estate and other speculative purposes	- promote industrialization - help manage exchange for export competitiveness - maintain financial stability and insulate from foreign financial crises
Singapore	**"Non-Internationalization" of Singapore $ inflows** **outflows** *non-residents* - financial institutions can't extend S$ credit to non-residents if they are likely to use for speculation - non-residents: if they borrow for use abroad, must swap first into foreign currency **Domestic Financial Regulations** - restrictions on creation of swaps, and other derivatives that could be used for speculation against S$	- to prevent speculation against Singapore $ - to support "soft peg" of S$ - to help maintain export competitiveness - to help insulate Singapore from foreign financial crises
Malaysia (1998)	**Inflows** - restrictions on foreign borrowing **Outflows** *non-residents* - 12 month repatriation waiting period - graduated exit levies - inversely proportional to length of stay *residents* - exchange controls **domestic financial regulations** *non-residents* - restrict access to ringgit *residents* - encourage to borrow domestically and invest	- to maintain political and economic sovereignty - kill the offshore ringgit market - shut down offshore share market - to help reflate the economy - to help create financial stability and insulate the economy from contagion

Table 1, cont.

Country	Types of Capital Management Techniques	Objectives of Capital Management Techniques
India	**Inflows** *non-residents* - Strict Regulation of FDI and PI **Outflows** *non-residents* - none *residents* - exchange controls **Domestic Financial Regulations** - strict limitations on development of domestic financial markets	- support industrial policy - pursue capital account liberalization in an incremental and controlled fashion - insulate domestic economy from financial contagion - preserve domestic savings and forex reserves - help stabilize exchange rate
China	**Inflows** *non-residents* - strict regulation on sectoral FDI investment - regulation of equity investments: segmented stock market **Outflows** *non-residents* - no restrictions on repatriation of funds - strict limitations on borrowing Chinese Renminbi for speculative purposes *residents* - exchange controls **Domestic Financial Regulations** - strict limitations on *residents* and *non-residents*	- support industrial policy - pursue capital account liberalization in incremental and controlled fashion - insulate domestic economy from financial contagion - increase political sovereignty - preserve domestic savings and foreign exchange reserves - help keep exchange rates at competitive levels

Sources: See Epstein, Grabel and Jomo (2003).

What general policy lessons of these seven experiences? The most important of these are:

1. Capital management techniques can enhance overall financial and currency stability, buttress the autonomy of macro and micro-economic policy, and bias investment toward the long-term.

2. The efficacy of capital management techniques is highest in the presence of strong macroeconomic fundamentals, though management techniques can also improve fundamentals.

3. The nimble, dynamic application of capital management techniques is an important component of policy success.

4. Controls over international capital flows and prudential domestic financial regulation often function as complementary policy tools, and these tools can be useful to policymakers over the long run.

5. State and administrative capacity play important roles in the success of capital management techniques.

6. Evidence suggests that the macroeconomic benefits of capital management techniques probably outweigh their microeconomic costs.

7. Capital management techniques work best when they are coherent and consistent with a national development vision.

8. There is no single type of capital management technique that works best for all developing countries. Indeed our cases, demonstrate a rather large array of effective techniques.

Lessons for Policymakers

The most important lesson of our study is that during the last decade policymakers in diverse developing countries have successfully used a variety of capital management techniques to achieve important economic objectives. Global financial integration has not frustrated these policies, and the countries that maintained them never became pariahs in international capital markets. Policymakers in other developing countries would do well to build upon the lessons of these recent successful experiences.

Table 2
Assessment of the Capital Management Techniques Employed During the 1990s

Country	Achievements	Supporting Factors	Costs
Chile	-altered composition and maturity of inflows -currency stability -reduced vulnerability to contagion	-well-designed policies and sound fundamentals -neoliberal economic policy in many domains -offered foreign investors good returns -state and administrative capacity -dynamic capital management	-limited evidence of higher capital costs for SMEs
Colombia	-similar to Chile, but less successful in several respects	-less state and administrative capacity than in Chile meant that blunter policies were employed -economic reforms in the direction of neoliberalism	no evidence available

Table 2, cont.

Country	Achievements	Supporting Factors	Costs
Taiwan POC	-debt burdens and financial fragility are insignificant -competitive exchange rate and stable currency -insulated from financial crises -enhanced economic sovereignty	-high levels of state and administrative capacity --policy independence of the CBC -dynamic capital management	-limited evidence of concentration of lending to large firms, conservatism of banks, inadequate auditing and risk and project assessment capabilities -large informal financial sector -limited evidence of inadequate liquidity in financial system
Singapore	-insulated from disruptive speculation -protection of soft peg -financial stability	-strong state capacity and ability to use moral suasion -strong economic fundamentals	-possibly undermined financial sector development -loss of seignorage
Malaysia 1998	-facilitated macroeconomic reflation -helped to maintain domestic economic sovereignty	-public support for policies -strong state and administrative capacity -dynamic capital management	-possibly contributed to cronyism and corruption
India	-facilitated incremental liberalization -insulated from financial contagion - helped preserve domestic saving -helped maintain economic sovereignty	-strong state and administrative capacity -stong public support for policies -experience with state governance of the economy -success of broader economic policy regime -gradual economic liberalization	-possibly hindered development of financial sector -possibly facilitated corruption
China	-facilitated industrial policy -insulated economy from financial contagion -helped preserve savings -helped manage exchange rate and facilitate export-led growth -helped maintain expansionary macro-policy -helped maintain economic sovereignty	-strong state and administrative capacity -strong economic fundamentals -experience with state governance of the economy -gradual economic liberalization -dynamic capital management	-possibly constrained the development of the financial sector -possibly encouraged non-performing loans -possibily facilitated corruption

Sources: See Epstein, Grabel and Jomo (2003).

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