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## **CAPITAL CONTROLS IN A TIME OF CRISIS**

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### **Abstract**

The startling resuscitation of capital controls during the global crisis has substantially widened policy space in the global north and south. The paper highlights five factors that contribute to the evolving rebranding of capital controls. These include: (1) the rise of increasingly autonomous developing states, largely as a consequence of their successful response to the Asian crisis; (2) the increasing confidence and assertiveness of their policymakers in part as a consequence of their relative success in responding to the global crisis at a time when many advanced economies have and still are stumbling; (3) a pragmatic adjustment by the IMF to an altered global economy in which the geography of its influence has been severely restricted; (4) the intensification of the need for capital controls during the crisis not just by countries facing fragility or implosion, but also by those that fared “too well”; and (5) the evolution in the ideas of academic economists and IMF staff. The paper explores tensions around the rebranding of capital controls. These are exemplified by efforts to develop a hierarchy in which controls on inflows that are a last resort and are targeted, temporary, and non-discriminatory are more acceptable than those that are blunt, enduring, discriminatory, and that target outflows. In addition, tensions have increasingly focused on whether controls should be used by capital-source rather than just capital-recipient countries.

**Keywords:** Capital controls; IMF; global financial crisis; policy space for development; developing economies; policy and ideational change; financial liberalization

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## 1. INTRODUCTION

The implosion of the US' highly liberalized, liquid, and internationally integrated financial system severely damaged the case that neoclassical economists had made for several decades that the country's financial system was the ideal to which all other countries should aspire. The global crisis has posed a particularly strong challenge to true believers in the universal desirability of unrestrained international private capital flows, a central component of the financial liberalization prescription.

During the long neoliberal era, capital controls were largely discredited as a vestigial organ of wrong-headed, dirigiste economic meddling. And so it was that until the global crisis one had to look to the work of the Keynesian minority within the academic wing of the economics profession and to the world's heretical governments, central banks, and finance ministries for forceful, consistent support of the management of international capital flows. Enter the global financial crisis. Many extraordinary things happened during the crisis, one of which is that Keynesian-inflected ideas about the legitimacy and necessity of managing international capital flows began to infuse the work of a broader set of economists in academia and in the policy community. Notably, views on capital controls at the IMF evolved significantly during the crisis, though in some respects (and as I will argue below) this was a grudging evolution revealing of continuing discomfort (see Chwioroth 2014, Gallagher 2014, Grabel 2011, 2015b, Moschella 2014). The new view recognizes that capital controls are a "legitimate part of the policy toolkit" (to borrow a now oft-cited phrase from IMF research on the subject during the crisis) (e.g. Ostry et al. 2010). Greater tolerance for controls is also reflected in the pronouncements of officials associated with other multilateral institutions, important figures in the world of central banking, analysts at credit rating agencies, in reports in the financial press, and in the recent research of economists that one would not have associated with Keynesian thought.

A large group of developing and emerging economies and several countries on the European periphery implemented far-reaching, heterogeneous controls on capital inflows and outflows in response to diverse economic challenges. From a pre-crisis vantage point, the boldness, range, and creativity of the policy interventions across a significant swath of economies were unexpected. But a longer run perspective on what appears to be the "new normal" (Grabel 2011) situates the new openness and policy practice in the context of a longer-run process of legitimation that began slowly and unevenly after the East Asian crisis (Abdelal 2007, Chwioroth 2010, Moschella 2009). Hence, the global crisis has intensified a process of legitimation that predated it. The complex processes of change can most accurately be understood as "messy," uneven, contested, and evolving. That said, the degree of ideational and practical change around capital controls is far greater and more consistent than in the years following the East Asian crisis. In the language of marketing capital controls have been "rebranded" during the global crisis.

The rebranding of capital controls has occurred against a broader backdrop of uncertainty and economic, political and ideational change. This state of affairs—which I have elsewhere termed "productive incoherence"—constitutes the broader environment in which thinking and practice on capital controls are evolving (Grabel 2011). By productive incoherence I refer to the proliferation of responses to the crisis by national governments, multilateral

institutions, rating agencies and the economics profession that have not yet congealed into a consistent vision or model. Instead, and in response to diverse economic challenges, we find a proliferation of strategies that defy encapsulation in a unified narrative. I argue that incoherence is productive because it has widened the policy space to a greater and more consistent degree than in the years following the East Asian crisis (cf. Chwieroth 2015, Moschella 2014, Gallagher 2014).

How are we to account for this extraordinary evolution regarding capital controls?<sup>1</sup> In what follows I examine five factors that, in my view, must appear in any comprehensive account. These include: (1) the rise of increasingly autonomous developing states, largely as a consequence of their successful response to the Asian crisis; (2) the increasing confidence and assertiveness of their policymakers in part as a consequence of their relative success in responding to the global crisis at a time when many advanced economies have and are still stumbling; (3) a pragmatic adjustment by the IMF to an altered global economy in which the geography of its influence has been severely restricted, and in which it has become financially dependent on its former clients; (4) the intensification of the need for capital controls by countries facing a range of circumstances—not just those that confront financial fragility or implosion and those that have been buffeted by the spillover effects of policy choices in wealthy economies, but also those that fared “too well” during the first many years of the crisis; and (5) the evolution in the ideas of academic economists and IMF staff. I will also explore in passing important tensions that have emerged in conjunction with rebranding. Paramount in this regard are attempts to develop a hierarchy in which controls are more acceptable if they focus on inflows and are implemented only as a last resort, are temporary, targeted, and non-discriminatory. Less acceptable are those that target outflows and are blunt, comprehensive, lasting, and discriminatory. In addition, tensions have emerged over the question whether controls should be used by capital-source rather than just capital-recipient countries.

Others have earlier sought to rebrand controls, though these efforts did not prove sticky outside the Keynesian minority. For instance, Epstein, Grabel and Jomo KS (2004) use the term “capital management techniques” to refer to two complementary (and often overlapping) types of financial policies: capital controls and those that enforce prudential management of domestic financial institutions. Ocampo (2003, 2010) has long used the term “capital account regulations” to refer to a family of policies which includes capital controls. The IMF now refers to capital controls matter-of-factly as “capital flow management” techniques (IMF 2011b). IMF rebranding is particularly significant. The new, entirely innocuous term is suggestive of a neutral, technocratic approach to a policy instrument that had long been discredited as a vestigial organ of wrong-headed, dirigiste economic meddling in otherwise efficient markets.

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<sup>1</sup> Discussion in this paper draws heavily on though extends and updates discussion in Grabel (2011, 2015b) and parts of Grabel (2015, 2013b, 2003b, 2013c).

## **2. THE ORIGINS OF CHANGE: CAPITAL CONTROLS AND THE EAST ASIAN CRISIS**

The Asian crisis stimulated new thinking about capital flow liberalization. Key mainstream economists, such as Jagdish Bhagwati (1998) and Martin Feldstein (1998) began to be openly critical of the way in which powerful interest groups and the IMF used the Asian (and other) crises to press for capital account liberalization, and caused others to reassess the case for capital liberalization (Obstfeld 1998, Krugman 1998). IMF research staff started to change their views on capital controls, albeit subtly, unevenly, and inconsistently. In the post-Asian crisis context, the center of gravity at the Fund and in the academic wing of the economics profession shifted away from an unequivocal, fundamentalist opposition to any interference with the free flow of capital to a tentative, conditional acceptance of temporary, “market-friendly,” inflows controls (Rogoff et al. 2003). Academic literature on capital controls after the Asian crisis reflected this gradually evolving view (Chwieroth 2010, ch8, Epstein, Grabel, and KS 2004, Magud and Reinhart 2006, Kaplan and Rodrik 2001).

The new pragmatism immediately encountered push back from other leading economists (e.g., Edwards 1999, Forbes 2005), and certainly did not generate anything like a new consensus. Instead, we find halting steps away from financial liberalization orthodoxy. This unevenness is apparent in the work of the IMF during the Asian crisis, for instance, as illuminated in a 2005 study by the IMF’s Independent Evaluation Office (IEO 2005). For instance, there was disconnect between IMF research, on the one hand, and the creeping tolerance for controls by the institution’s economists when they worked with particular countries on the other, as the IEO (2005, 48) acknowledges. Moreover, policymakers from different parts of the world crafted different etiologies of the Asian crisis. Those from the US emphasized crony capitalism and over-regulated banking systems, whereas the analysis in Asia and Europe focused on radical financial liberalization (Wade 1998-9). These divergent origin stories generated conflicting interpretations of financial liberalization and contending perspectives on the need for reforms to the global financial architecture.

Despite the modest intellectual progress on capital controls that began after the Asian crisis, controls remained an exceptional and contested measure. But things begin to change during the global crisis, when circumstances coalesce so as to legitimate controls to a far greater and more consistent degree.

The evolution in thinking and practice on capital controls during the global crisis represents an important turn in the direction of post-WWII support for the measure. Capital controls were the norm in developing and wealthy countries in the decades that followed WWII (Helleiner 1994). In the first several decades of its existence, the IMF supported capital controls, a position that was consistent with and reflected the views of the economics profession (and notably, the views of John Maynard Keynes) and public figures (such as the US Treasury’s Harry Dexter White). Both Keynes and White not only saw capital controls as a central feature of postwar economic policy, but also understood that controls on both sending and receiving ends could be warranted, and that cooperation by capital source and recipient countries was essential.

### **3. REBRANDING CAPITAL CONTROLS DURING THE GLOBAL CRISIS**

Several factors have facilitated the resurrection and legitimation of capital controls during the global crisis. In the interests of clarity, I discuss these factors separately in what follows, even though I see them as fully interdependent and cumulative.

#### **Increasing State Autonomy in the Global South and East**

Dismal experiences with the IMF, especially during the Asian crisis, led policymakers in the developing world to pursue strategies that would minimize the chance of future encroachments on their policy autonomy. The chief way in which this goal was operationalized was through the self-insurance provided by the over-accumulation of currency reserves. Self-insurance strategies collectively promote resilience and even what Nassim Taleb (2012) refers to as “anti-fragility,” or the ability to thrive in periods of instability. This strategy of building anti-fragility was validated during the first many years of the global crisis.

Between 2000 and the second quarter of 2013, developing and emerging economies added about US\$6.5 trillion to their reserve holdings, with China accounting for about half of this increase (Prasad 2014a). Emerging and developing economies (with reserves of US\$7.7 trillion in 2014) accounted for 72% of the increase in global reserves between 2000 and 2014 (IMF COFER, author calculation). As with reserve holdings, the assets of developing country sovereign wealth funds grew significantly in the post-Asian crisis period.

The resources held by a group of developing countries help to create an environment wherein policymakers have the material means to enjoy increasing policy autonomy relative to the IMF. Not least, this has meant that policymakers have been able to deploy capital controls without worrying about negative reactions by the IMF or investors. The resilience and even the anti-fragility and the policy space created by these resources may prove essential if current turbulence intensifies.

#### **Increasing Assertiveness in the Developing World**

During the global crisis developing country policymakers took advantage of their increased autonomy in a variety of ways. The use of capital controls was one and perhaps the most dramatic “indicator” of increased autonomy, and we consider this matter below. But we turn now to a brief consideration of three other indicators of increasing assertiveness: the use of counter-cyclical macroeconomic policies; innovation in financial architecture; and new activism at the IMF.

##### *Counter-cyclical policies*

The developing countries that have enjoyed the ability to protect and even expand their autonomy during the global crisis used the resulting policy space to pursue a range of counter-cyclical macroeconomic policies. Ocampo et al. (2012) concludes that when we look across the developing world we find diverse, uneven counter-cyclical policy responses. This is a radical departure from the past insofar as developing country policymakers generally had no alternative but to implement strongly pro-cyclical policies, most often as per the conditions of IMF assistance. Policymakers could implement counter-cyclical and other protective policies that were previously unavailable to them precisely because of the

enabling effects of prior reserve accumulation strategies and the related growth in SWFs. Indeed, some of the resources of SWFs were used to stabilize domestic stock markets and banking systems (Park and van der Hoorn 2012).

The sheer scale of the crisis, the bold rhetoric around the need for new strategies to combat it, and the range of unorthodox policy responses pursued across the globe may have provided broader validation for the protective national policy responses pursued in the developing world. The G-20's brief "Keynesian moment" in 2008-09 opened space for capital controls and counter-cyclical responses in the developing world. Similarly, the IMF's rhetorical attention to pro-poor spending during the crisis began to legitimate counter-cyclical responses (Grabel 2013a). Expansionary monetary policies in the USA and other wealthy countries likewise helped to normalize protective responses to the crisis in the developing world. What the IMF's Lagarde termed the rise of "unconventional monetary policies" (i.e., negative interest rates) in a number of wealthy countries provided cover for other unorthodox policies, such as capital controls. Finally, the rising chorus of criticism around the cross-border spillover effects of monetary policy decisions (especially by the US) have made capital controls appear as a reasonable protective response.

#### *Architectural innovations*

As with the Asian crisis, the global crisis has promoted interest in the expansion of existing and the creation of new institutions that deliver liquidity support and long-term project finance in ways that complement the IMF and the World Bank, respectively. The initiatives have been given life by the economic and political environment in which many developing country policymakers found themselves during the global crisis.

These initiatives range from reserve pooling arrangements such as the Chiang Mai Initiative Multilateralisation among members of the Association of Southeast Asian Nations (ASEAN)+ Japan, China, and South Korea, the Latin American Reserve Fund, the Arab Monetary Fund, and the Contingent Reserve Arrangement (CRA), which involves Brazil, Russia, India, China, and South Africa (the BRICS); to development or project/infrastructure finance banks, such as the Latin American Development Bank, the New Development Bank (NDB) of the BRICS, and the China-led Asian Infrastructure Investment Bank and the Silk Road Fund/One Belt, One Road initiative; to hybrid arrangements that have both liquidity support and project finance facilities, such as the Eurasian Fund for Stabilization and Development among members of the Eurasian Economic Community.<sup>2</sup>

Collectively, these innovations indicate the extent to which developing country governments have been stimulated by the crisis to pursue architectural initiatives that express an increasing self-confidence and a desire for autonomy from the Bretton Woods institutions (BWIs). Moreover, it is conceivable that recent changes in IMF views and practice on capital controls stem partly from attempts to protect the institution's franchise from actual or potential competition from these institutional innovations.

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<sup>2</sup> See Grabel (2013a, 2015a) and Chin (2010) for an examination of these and other initiatives.

### *New lenders, renewed pressures*

The increasing assertiveness of developing countries is also given expression in the new and historically unprecedented role that they have taken on at the IMF. Developing countries were twice called upon to and did in fact commit funds to the institution (in April 2009 and June 2012). The new commitments reflect evolving power dynamics in the global economy and the IMF's evolving relationships with former clients. It is not inconsequential that most of the IMF's new lenders have been utilizing capital controls during the crisis, and more broadly have pursued various forms of dirigiste economic policy.

At the same time that developing countries took on a new role at the IMF they became more assertive in pressing the long-standing case for reform of the institution's formal governance. The 2012 contributions to the IMF by the BRICS were pointedly conditioned on governance reform, particularly implementation of the very modest governance reforms agreed to in 2010 (Giles 2012). The US Congress blocked implementation of these reforms until December 2015, and this long period of gridlock was explicitly referenced when the BRICS announced in July 2014 that they would launch the NDB and CRA.

### **The IMF's Constrained Geography of Influence**

An important consequence of the Asian crisis and subsequent changes in the global economy was the loss of purpose, standing and relevance of the IMF. Prior to the global crisis, demand for the institution's resources was at an historic low. During the crisis itself developing countries did their best to stay clear of IMF oversight. The enduring memory of prior experience and the stigma of being an IMF client are strikingly apparent in the limited demand for the institution's new (precautionary) Flexible Credit Line.

The global crisis nonetheless reestablished the IMF's central place as first responder to financial distress. The Fund was able to leverage its prior experience in responding to financial distress. Notably, the restoration of the IMF was largely due to events in and on the periphery of Europe rather than across the developing world. European institutions found themselves in need of the expertise, financial resources, and authority of the IMF (Lütz and Kranke 2014). The April 2009 G-20 meeting not only gave the IMF pride of place in crisis response efforts, but also yielded massive funding commitments to the institution.

The IMF's staff faces the challenges of protecting its restored franchise and image in an environment in which many of its former clients have pursued strategies that insulate them from the institution, are among its lenders, and have exercised increasing assertiveness in several domains. The IMF has been forced to negotiate to retain the influence that, until the East Asian crisis, it was able to take for granted. This negotiation is especially apparent in the domain of capital controls, where the IMF has often responded after the fact to unilateral decisions made by national authorities. Even where it retains substantial authority, its economists are responding to capital controls in ways that diverge from past practice.



## **Winners, Losers, Spillovers, and Capital Controls**

During 2009-14, developing and emerging countries received net capital inflows of US\$2.2 trillion (Stiglitz and Rashid 2016). The vast inflows meant that many developing countries were confronted with surges of liquidity, asset bubbles, inflationary pressures, and currency appreciations. That the market capitalization of stock exchanges in Mumbai, Johannesburg, São Paulo, and Shanghai nearly tripled in the years that followed the global crisis is just one indicator of the type of fragility induced by these inflows (Stiglitz and Rashid 2016). Expansionary monetary policies in wealthy countries fed this flood of capital to developing country markets. In a departure from the old script, capital controls were necessitated by the side effects of the relative success with which many developing countries navigated the global crisis and their own good fortune when it came to commodity prices and economic growth. This success, coupled with economic weakness and low returns on assets in wealthy countries, drove investors and speculators to developing country markets. The use of capital controls by what we might think of as “winning economies” has, in my view, contributed importantly to the legitimation of this policy instrument in the eyes of policymakers, the IMF, the international investment community, and the neoclassical core of the economics profession.

Now the tide is turning. In 2015 net capital outflows from the developing world exceeded US\$600 billion, which was more than 25% of the capital inflows that they received during the previous six years (Stiglitz and Rashid 2016). Taking previously unrecorded flows into account, the Institute for International Finance (IIF) estimates that total net capital outflows from developing and emerging economies amounted to US\$735 billion in 2015. By comparison, total net outflows from developing and emerging economies as a whole were valued at US\$111 billion in 2014 (IIF 2016), and East Asian economies experienced net capital outflows of only US\$12 billion in 1997 (Stiglitz and Rashid 2016).

In this context, some developing countries have abandoned or loosened the inflow controls that they put in place during good times, and some have begun to implement new controls, particularly on outflows. These new controls have been implemented in response to the accelerating pace of outflows and the combined effects of slowing growth, falling commodity and asset prices, weakening currencies, and reserve dis-accumulation. The excess liquidity and asset bubbles generated during good times have inevitably given way to public and private debt overhangs, which are aggravated by the locational mismatch that is made worse by the weakening of developing country currencies. In addition, these pressures have been both induced and magnified by the unsettled state of international financial markets and the spillover effects of the monetary policy environment in wealthy countries (i.e., negative interest rates, Federal Reserve tapering and tightening). In this new environment we have reason to expect familiar, vicious macroeconomic cycles in the developing world. The experience with and the widening of policy space around capital controls may well pay dividends in the coming period.

### *“Too much of a good thing”*

Policymakers in a large set of developing countries deployed capital controls to mitigate the financial fragility and vulnerabilities induced by the large capital inflows that they received during much of the global crisis. In several country settings, controls were

“dynamic” (as per Epstein, Grabel, and KS 2004) such that policymakers tightened, broadened, or layered new controls over existing measures as new sources of financial fragility and channels of evasion were identified and/or when existing measures proved too tepid to discourage undesirable financial activities. Controls were also removed as circumstances changed.

Brazil is a notable exemplar of dynamic capital controls. The country is an interesting case because the government (particularly former Finance Minister Guido Mantega) staked out a strong position on policy space for controls throughout the crisis, and because the IMF’s response to the country’s controls exemplifies the evolution and equivocation in the views of Fund staff.<sup>3</sup>

In late October 2009, Brazil began to utilize capital controls by imposing a tax on inflows of portfolio investment. They were intended to slow the appreciation of the currency in the face of significant capital inflows. Brazil imposed a 2% tax on money entering the country to invest in equities and fixed-income investments and later a 1.5% tax on certain trades involving American Depository Receipts, while leaving FDI untaxed. The IMF’s initial reaction to Brazil’s inflow controls was mildly disapproving. A senior official said: “These kinds of taxes provide some room for maneuver, but it is not very much, so governments should not be tempted to postpone other more fundamental adjustments. Second it is very complex to implement those kinds of taxes, because they have to be applied to every possible financial instrument,” adding that such taxes have proven to be “porous” over time in a number of countries. In response, John Williamson and Arvind Subramanian indicted the IMF for its doctrinaire and wrong-headed position on the Brazilian controls, taking the institution to task for squandering the opportunity to think reasonably about capital controls (Subramanian and Williamson 2009). A week later the IMF’s then Managing Director Dominique Strauss-Kahn reframed the message on Brazil’s controls. The new message was, in a word, stunning: “I have no ideology on this”; capital controls are “not something that come from hell” (cited in Guha 2009).

The Brazilian government continued to strengthen and layer new controls over existing measures during October 2010 and July 2011. These included controls that specifically targeted derivative transactions and others that closed identified loopholes as they became apparent.<sup>4</sup> For example, in October 2010 the tax charged on foreign purchases of fixed-income bonds was tripled (from 2 to 6%), the tax on margin requirements for foreign exchange derivatives was increased, and some loopholes on the tax on margin requirements for foreign investors were closed. In January 2011 Brazil introduced curbs on short selling in foreign exchange markets through the requirement that Brazilian financial institutions deposit the equivalent of 60 per cent of their short dollar positions in a non-interest bearing account at the central bank. Despite this array of ever increasing controls,

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<sup>3</sup> See Chwieroth (2015) for a related discussion of how the country successfully “counter-stigmatized” controls, and see also Gallagher (2014) and especially Fritz and Prates (2014) on the political economy of the country’s controls.

<sup>4</sup> Fritz and Prates (2014) see controls on derivatives as distinct from (though complementary to) capital controls and prudential financial regulations.

IMF economists called its use of controls “appropriate” in an August 2011 review of Brazil (Ragir 2011).<sup>5</sup>

Brazilian policymakers began to narrow some capital controls in December 2011, though at the same time continued to extend others. In December 2011 the tax on equity and fixed income portfolio inflows was lowered to zero percent, in March 2012 the hedge operations of exporters were exempted (to a limit) from the tax on inflows, and the tax on new and renewed foreign loans was extended to loans with a maturity of up to five years.

Many other developing countries implemented and adjusted controls on outflows and especially on inflows during propitious economic times. Some strengthened existing controls, while others introduced new measures. For some countries (such as Argentina, Ecuador, Venezuela, China, and Taiwan) these measures are part of broader dirigiste approaches to policy. For most other countries (e.g., Brazil, South Korea, Indonesia, Costa Rica, Uruguay, the Philippines, Peru, and Thailand), controls were part of a dynamic, multi-pronged effort to respond to the challenges of attracting too much foreign investment and carry trade.

In December 2008 Ecuador doubled the tax on currency outflows, established a monthly tax on the funds and investments that firms kept overseas, discouraged firms from transferring US dollar holdings abroad by granting tax reductions to firms that re-invest their profits domestically, and established a reserve requirement tax (Tussie 2010). In October 2010, Argentina and Venezuela implemented outflow controls. Controls in Argentina involved stricter limits on US dollar purchases; Venezuelan controls involved new restrictions on access to foreign currency and tiered exchange rates. Argentina’s controls were strengthened in October 2011. Argentina’s capital and exchange controls were lifted in December 2015 following the Presidential election of Mauricio Macri. Venezuelan capital and currency controls remain in force.

Peru began to impose inflow controls in early 2008. The country’s central bank raised the reserve requirement tax four times between June 2010 and May 2012. The May 2012 measures included a 60% reserve ratio on overseas financing of all loans with a maturity of up to three years (compared to two years previously) and curbs on the use of a particular derivative (Yuk 2012). What is particularly interesting about Peru’s measures is the way in which they were branded by the central bank. In numerous public statements the Central Bank President maintained that the country did not need capital controls even while it implemented and sustained its reserve requirement tax (Quigley 2013).

In August 2012, Uruguay imposed a reserve requirement tax of 40% on foreign investment in one type of short-term debt (Reuters 2012). Like Peru, its bilateral agreement with the US could have made this control actionable. Currency pressures also induced Costa Rica to use capital controls for the first time in twenty years. The country began to use controls in September 2011 when it imposed a 15% reserve requirement tax on short-term foreign

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<sup>5</sup> In an example of the resilience of old views, in August 2010 Canadian Prime Minister Harper used some of his time in Brazil to lecture the government about dismantling controls (Mayeda 2011).

loans received by banks and other financial institutions (LatinDADD-BWP 2011). In January 2013, the Costa Rican President began to seek Congressional approval to raise the reserve requirement tax to 25%, while also seeking authorization to increase from 8% to 38% a levy on foreign investors transferring profits from capital inflows out of the country.

In another sign of changing sentiments during the crisis, the rating agency Moody's recommended that South East Asian countries use controls to temper currency appreciation (Magtulis 2013). Indeed, numerous Asian countries deployed new or strengthened existing controls during good times.

For instance, in November 2009 Taiwan imposed new inflow restrictions that preclude foreign investors from placing funds in time deposits. At the end of 2010 controls on currency holdings were strengthened twice (Gallagher 2011). China has been pursuing what its officials term "managed convertibility," which has involved both loosening some types of capital controls while tightening others (Subacchi 2016). In 2010, China added to its existing and largely quantitative inflow and outflow controls (Gallagher 2011). In 2013 China's State Administration of Foreign Exchange (SAFE, which is the PBOC unit that manages the RMB) took new steps to control "hot money" flows in order to manage the appreciation of the currency, reduce external risks, and curb efforts to bring capital into the country via trade mis-invoicing (Monan 2013).

In June 2010, Indonesia announced what its officials termed a "quasi capital control" via a one-month holding period for central bank money market securities (raised to six months in 2011) and new limits on the sales of central bank paper by investors and on the interest rate on funds deposited at the central bank. During 2011 it reintroduced a 30% cap on short-term foreign exchange borrowing by domestic banks, and raised a reserve requirement on foreign currency deposits (Batunanggar 2013). The awkward labeling of controls in Indonesia suggested its government was still afraid of the stigma that long attached to capital controls.

Thailand introduced a 15% withholding tax on capital gains and interest payments on foreign holdings of government and state-owned company bonds in October 2010. In December 2012, the Philippines announced limits on foreign currency forward positions by banks and restrictions on foreign deposits (Aquino and Batino 2012).

As in Brazil, Korean authorities took a dynamic, layered approach to capital controls, while also targeting the particular risks of derivatives. But unlike Brazil, authorities reframed these measures as macroprudential and not as capital controls (see Chwiero 2015). In 2010 Korean regulators began to audit lenders working with foreign currency derivatives, placed a ceiling on the use of this instrument, and imposed a levy on what it termed "noncore" foreign currency liabilities held by banks. In 2011 Korea also levied a tax of up to .2% on holdings of short-term foreign debt by domestic banks, banned "naked" short selling, and reintroduced a 14% withholding tax on foreign investment in government bonds sold abroad and a 20% capital gains tax on foreign purchases of government bonds (Lee 2011, ADB 2011).

### *“Stopping the bleeding”*

Some countries have and are using capital controls during the global crisis for the more customary reason of stemming a financial or economic collapse. In these cases, the IMF has tolerated controls on capital outflows. This is notable insofar as the Fund and the neoclassical heart of the economics profession have long seen outflow controls as far worse than inflow controls.

Iceland’s policymakers put outflow controls in place to slow the implosion of the economy before signing an SBA with the IMF in October 2008. The SBA made a very strong case for the extension of these controls as means to restore stability and to protect the krona (IMF 2012a, Sigurgeirsdóttir and Wade 2015). In public statements on the matter, the IMF’s staff repeatedly said that the country’s outflow controls were crucial to prevent a collapse of the currency, that they were temporary, and that it was a priority to end all restrictions as soon as possible. The IMF’s Mission Chief in the country commented that “capital controls as part of an overall strategy worked very, very well” (Forelle 2012), and the institution’s Deputy Managing Director stated that “unconventional measures (as in Iceland) must not be shied away from when needed” (IMF 2011a). The rating agency, Fitch, praised the country’s “unorthodox crisis policies” when announcing that it had raised its credit rating to investment grade in February 2012 (Valdimarsson 2012). It should be said that neoliberals in the country did not share this enthusiasm for the unorthodox response or the IMF’s advice (Arnason and Danielson 2011).<sup>6</sup>

The IMF’s characterization of and role in strengthening Iceland’s outflow controls marked a dramatic precedent and revealed a fundamental change in thinking about capital controls. The December 2008 SBA with Latvia allowed for the maintenance of pre-existing restrictions arising from a partial deposit freeze at the largest domestic bank (IMF 2009b). Soon thereafter, a Fund report acknowledged that Iceland, Indonesia, the Russian Federation, Argentina and Ukraine all put outflow controls in place to “stop the bleeding” related to the crisis (IMF 2009a). The report neither offers details on the nature of these controls nor commentary on their ultimate efficacy, something that suggests that controls—even and most notably on outflows—are being destigmatized by the context in which they are being used, and by the Fund’s and, in the cases of Cyprus and Greece, the EU and the ECB’s measured reaction to them.<sup>7</sup> Indeed, a recent report by the IMF’s IEO (2015) takes note of the institution’s greater tolerance for outflow controls during the global financial crisis as exemplified by its support for outflow controls in Iceland, Cyprus, and Latvia.<sup>8</sup>

Cyprus was the first country in the Eurozone to implement capital controls during the global crisis. The IMF and the EU did not flinch when stringent outflow controls were implemented as the country’s economy imploded in March 2013. Cyprus’ capital controls

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<sup>6</sup> Temporary outflow controls have turned out to be rather long lived—indeed the central bank and the Finance Ministry are planning to phase out the controls during 2016.

<sup>7</sup> See Chwieroth (2015) on the process of destigmatizing capital controls.

<sup>8</sup> The IEO (2015, 13) noted that staff did not approve of outflow and exchange controls in 2008 in Ukraine (see also Saborowski et al. 2014).

evolved in the months that followed the March collapse and after it began to receive support in May 2013 under an IMF Extended Fund Facility. Capital controls began to be removed in March 2014, and the remaining controls were lifted in April 2015. Standard and Poors upgraded Cyprus' sovereign debt rating to BB- in September 2015, and in doing so cited the removal of capital controls (Zikakou 2015). Greece became the second Eurozone country to implement capital controls. These were put in place at the end of June 2015. Stringent outflow controls were put in place once Eurozone leaders announced that they would not extend Greece's then current assistance package beyond June 30 when it was scheduled to expire, and that the ECB would cap emergency liquidity assistance to the country's banks.

#### *"Taper tantrums" and the new outflow rout*

Beginning in 2013, developing countries again began to adjust, experiment, and/or create space for diverse types of capital controls against the backdrop of growing financial fragility, weakening economies, depreciating currencies, and turmoil induced by international policy spillovers. New or tightened capital controls were implemented by policymakers in the context of the growing fragility in 2015 and early 2016. Some controls that were put in place in good times were loosened or abandoned.

For example, in June 2013 Brazil eliminated some remaining capital controls that were left over from the country's heady days. It reduced the tax on overseas investments in domestic bonds from 6% to zero, and removed a 1% tax on bets against the dollar in the futures market (Leahy and Pearson 2013, Biller and Rabello 2013). In March 2014, Costa Rica put in place a framework for new capital controls aimed at giving the central bank the ability to curb speculative money flows from abroad (Reuters 2014). And, in an indication of changing sentiments in challenging times, the governor of the Bank of Mexico, Agustín Carstens, said in January 2016 that it might soon be time for central bankers in the developing world "to become unconventional" to stem the vast tide of capital outflows (Wheatley and Donnan 2016). (This is particularly notable since as recently as 2015 he had spoken strongly against capital controls; see below).

China's strategy of managed convertibility has become increasingly difficult for officials to navigate in the wake of growing national and global economic turbulence and missteps by national policymakers, particularly involving decisions to devalue the currency in August 2015 and again in late December and early January 2016. This strategy involves a complex mix of liberalizing capital controls so as to increase the convertibility of the RMB and increase its flow and use across borders, while also tightening existing and implementing new controls to protect the economy and the currency from volatile capital flows (Subacchi 2015). Liberalizing capital controls was also necessitated by policymakers' long-held goal of having the IMF agree to include the RMB in the SDR alongside other currencies that it had long designated as having "global reserve currency" status. In November 2015, China achieved this (largely symbolic) goal. Against this backdrop and in a series of announcements in 2014, the country's policymakers eased some capital controls, such as those that restricted domestic investors from investing in foreign stocks and properties, firms from selling RMB denominated shares abroad, and doubling the daily range in which

the RMB could trade (Barboza 2014, Bloomberg 2014). After the surprise decision to allow the RMB to devalue in August 2015, SAFE expended up to US\$200 billion in reserves defending the currency during the next month, increased monitoring and controls on foreign exchange transactions, imposed a 20% reserve on currency forward positions in the hopes of curbing intense speculation against the currency (Anderlini 2015). And following another round of large capital outflows in January 2016, SAFE implemented several new, ad hoc, and stringent capital controls. In a widely reported speech at the 2016 World Economic Forum in Davos, the Governor of the Bank of Japan, Haruhiko Kuroda, suggested that China use capital controls to support its currency in the face of growing pressure against the RMB and the economy.

In August 2013 India implemented capital controls on some types of outward flows. These restricted the amount that Indian-domiciled companies and residents could invest abroad (Financial Times 2013). Interestingly, then governor of the Reserve Bank of India, Duvvuri Subbarao, took pains to explain that these measures should not be labeled as capital controls (despite the obvious point). In his last speech as central bank governor he said of these measures: "I must reiterate here that it is not the policy of the Reserve Bank to resort to capital controls or reverse the direction of capital account liberalization," and he emphasized that the measures did not restrict inflows or outflows by non-residents (Reuters 2013b). Market observers nevertheless dubbed them "partial capital controls" (Ray 2013). When the new central bank governor, Raghuram Rajan took his place in September 2013, he promptly rolled back the new outflow controls (ibid).

Tajikistan deployed several types of outflow controls during 2015 and 2016 in the context of the turmoil induced by falling oil prices. These involve administrative measures that attempt to stabilize the currency, closure of private currency exchange offices, the requirement that rouble-denominated remittances be converted to the national currency, restrictions on foreign currency transactions, and termination of the direct sale of foreign currency to the population (IntelliNews 2016, UNCTAD 2015, National Bank of Tajikistan 2015). Here, too, authorities attempted to brand these measures as something other than capital controls. Indeed, First Deputy Chairman of the country's central bank, Nuraliev Kamolovich, denied that these moves amounted to capital control in an interview with the *Financial Times* (Farchy 2016).

In December 2014, the Russian government put outflow controls in place, though these are being referred to in the country's press as "informal" capital controls. The government set limits on net foreign exchange assets for state-owned exporters, required that large state exporting companies report to the central bank on a weekly basis and reduce their net foreign exchange assets to the lower level that prevailed earlier in the year, and the central bank installed supervisors at currency trading desks of top state banks (Kelly, Korsunskaya, and Fabrichnaya 2014).

Ukraine deployed several outflow controls in February 2014. These measures include a ceiling on foreign currency purchases by individuals; a ban on buying foreign exchange to invest overseas or repay foreign debt early; a five day waiting period before companies can

receive the foreign exchange that they have purchased; and limit on foreign currency withdrawals from bank deposits (to around US\$1500 per day; (Strauss 2014)).<sup>9</sup>

The case of Azerbaijan is illustrative of the continued tensions over capital controls within some countries and also of the rating agencies' new measured responses to them. In January 2016 the country's Parliament passed a bill that would impose a 20% tax on foreign currency outflows and allow repayment of dollar loans up to US\$5,000 at the exchange rate that prevailed prior to the currency's devaluation. The country's President, Ilham Aliyev, rejected the bill the next month. In doing so, the President said that "[it] was a mistake to tax foreign-currency outflows as it would scare away foreign investors...[and] cause problems for large companies like BP" (Agayev 2016). In the period between the Parliament's passage and the President's rejection, the rating agencies had a measured reaction to the prospect of outflow controls in the country. Standard and Poors lowered the country's rating, but cited low oil prices in doing so, and Fitch did not change their rating saying that "the introduction of the capital controls does not 'automatically' have consequences for the country's sovereign rating" (Eglitis 2016, Financial Times 2016).

Beginning in late 2014, Nigeria began to implement outflow controls as falling oil prices and a concomitant drop in foreign reserves destabilized its economy. In December 2014 limits on currency trading were imposed. And starting in April 2015 and continuing through the year, new outflow controls were put in place. These included limits on what Nigerians could spend on credit cards abroad; restrictions on access to hard currency and cross-border payments; limits on dollar denominated transactions using ATM cards and daily limits on foreign ATM withdrawals; foreign currency quotas and restrictions on access to dollars (Ferro 2014, Reuters 2015, Johnson 2015).<sup>10</sup> In February 2016, the IMF's Lagarde began to call publicly on the government to remove capital and exchange controls, abandon the currency peg, and borrowing from an old script--to pursue fiscal discipline and structural reform to bolster growth (Reuters 2016).

#### *Similar pressures, dissimilar responses, and legal constraints*

Not all policymakers have and are responding to the pressures induced by large inflows, outflows, and policy spillovers with capital controls. Policymakers in some countries that enjoyed high inflows during much of the global crisis, such as Turkey, Chile, Mexico, and Colombia publicly rejected inflow controls. Instead they increased their purchases of dollars and used expansionary monetary policy. These divergent responses to similar pressures reflect many factors, not least of which are differing internal political economies, the continued sway of neoliberal ideas, and the long shadow cast by the belief that central banks must signal their commitment to neoliberalism.

There is far more to the matter of resisting capital controls than the long half-life of neoliberalism, however. Some countries simply cannot introduce capital controls—either on inflows or outflows-- because of bi- or multilateral trade and investment treaties with the US (such as the North American Free Trade Agreement, NAFTA, and the Dominican

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<sup>9</sup> Some of these measures were loosened in 2015.

<sup>10</sup> Thanks to Michael Akume for research on Nigeria.



Republic-Central American Free Trade Agreement), the EU, and the OECD (Gallagher 2014, ch8, 2012, Shadlen 2005, Wade 2003). The scope of these constraints could be expanded if the pending multilateral trade agreement, the Trans-Pacific Partnership (TPP), goes into effect.<sup>11</sup>

Governments face other restrictions on controls from the obligations to liberalize financial services under the WTO (Gallagher 2012). Article 63 of the Lisbon Treaty of the EU enforces open capital accounts across the union and requires that members not restrict capital transactions with other countries. However, Cyprus and Greece are members of the EU, and they did deploy stringent outflow controls in 2013 and 2015 (respectively) when their banking systems imploded. Indeed, the EC and the ECB gave their blessing to capital controls on the grounds that controls were temporary and essential to preventing large scale exit of capital and the collapse of the banking system. Other restrictions appear in the OECD's Code of Liberalisation of Capital Movements, though since it is not a treaty the obligations are not actionable (Abdelal 2007, Gallagher 2012).

At the time when many of these agreements were negotiated, their restrictions on capital controls no doubt seemed redundant since controls were effectively blocked by the effective constraints imposed by the IMF, rating agencies and investors. Today, however, in the face of reversals by the previous enforcers of neoliberalism, the provisions are consequential. Chile's refusal to use controls during the global crisis may have as much to do with its 2004 trade agreement with the US as with neoliberal ideology. But the US-Chile free trade agreement exposes the country to lawsuits by investors who are able to demonstrate that they are harmed by controls. Mexico's situation is similar. Here neoliberal views are backed up by the strictures in NAFTA that threaten to punish any change in its policy stance.<sup>12</sup> By contrast, Brazil was free to utilize controls during the global crisis because it has not signed bilateral treaties with the US.

Reframing controls as something other than controls seems to be one viable avenue in cases where policymakers do not have the appetite to push the limits of trade/investment agreements (as with Peru and Uruguay), or where they otherwise fear the anti-free market stigma. Hence, Korea's macroprudential measures<sup>13</sup>; Indonesia's quasi-controls; Tajikistan's denial that it is using controls; India's use of partial controls, and the Central

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<sup>11</sup> A separate annex (i.e., a "carve out") to the TPP allows Chile to maintain or enact capital controls that are consistent with its own domestic laws to ensure financial stability, but such a carve out was not negotiated for other TPP signatories.

<sup>12</sup> NAFTA includes a balance of payments exception that allows capital controls when the host states "experience serious balance of payments difficulties, or the threat thereof," but use of this exception must be temporary and non-discriminatory (Gallagher 2014, 181).

<sup>13</sup> Korea's 2007 free trade agreement with the US allows temporary controls under certain circumstances. Note also that though Korea is an OECD member, it was nevertheless able to implement capital controls during the global crisis without raising the ire of other members; some of this may be explained by its successful rebranding of these controls as prudential measures. Indeed, Korea was the only OECD member to use capital controls during the global financial crisis.

Bank governor's message to foreign investors; and Azerbaijan's President blocking capital controls because of the perceived reaction by foreign investors.<sup>14</sup>

### *Revising the rule book*

Since 2008 many developing countries have implemented controls without seeking permission from the IMF. For many (but not all) countries, controls were a response to the costs of their relative economic success during much of the global crisis. It's hard to imagine that capital controls could have been rebranded as legitimate policy tools as quickly and deeply as has been the case had it not been for the divergent effects of the crisis across the globe, and the initiatives of many of the winners from the crisis to assert control over financial flows. Just as history is written by the victors, so may it be the case that the rebranding and re-legitimizing of a forbidden policy tool depends primarily on the practices and strategies of those countries whose success grants them the latitude and confidence, and the influence over other countries, not just to "cheat" in a policy domain but to revise the rule book completely. Thus, whether the IMF and the economics profession have changed fundamentally on capital controls matters less than the context in which they are being utilized.

Outflow controls have also been legitimized by widespread acknowledgement of their success in Iceland and elsewhere. Outflow controls are nevertheless still seen in a different light than inflow controls, but the crisis has catalyzed a degree of rethinking on this controversial instrument as well. It may be that outflow controls become necessary in more national contexts if present turbulence accelerates, as seems likely. This may test the limits of the policy space around this tool.

The rebranding of controls has also been facilitated by the fact that carry trade pressures caused central bankers in wealthy countries to reconsider their long-held opposition to capital controls. For example, the head of the Swiss National Bank announced that it was considering controls on foreign deposits when the currency was under pressure, though these have not been used (Ross and Simonian 2012). A top Bundesbank official signaled a softening in its traditional position in stating that "limited use of controls could sometimes be appropriate" to counter currency pressures (Reuters 2013a). Moreover, the emergence of unconventional monetary policies and the growing discussion of their spillover effects may have triggered recognition that desperate times require desperate measures. This may reflect what Benialper and Comert (2016) term a broadening of central bank practice and policy targets during the crisis.

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<sup>14</sup> In some cases, this reframing may be less instrumental than I suggest. Chwieroth (2015) argues that Korean authorities see the measures they put in place during the global crisis as prudential and consistent with their acceptance of the norm of liberalization. I should add here that the re-normalization of capital controls may involve rebranding, the focus of this paper, and/or re-framing of capital controls as something other than capital controls. The former represents a more direct assault on the pre-existing neoliberal ideology, and is expected where states have achieved substantial policy autonomy. The latter amounts to "cheating" – attempting to use a strategy that is not permitted under the neoliberal rules of the game without admitting it. We should expect this strategy in cases where states have not achieved substantial policy autonomy.

## **The Economics Profession, the IMF, and the New Pragmatism on Capital Controls**

Today IMF staff economists and leading academic economists have taken steps toward elaborating a theoretical and empirical case for capital controls.

### *Neoclassical economics and capital controls*

Two views on capital controls have predominated among academic economists who advocate neoliberalism. The first, and minority view, is associated with libertarian thought. The libertarian case against capital controls is a principled rather than a welfare consequentialist view. From the libertarian perspective, controls are a violation of investor rights. The case against them is therefore impervious to new empirical evidence or a change in economic conditions. In contrast, neoclassical welfarist critics have long held that capital controls are counter-productive.

The neoliberal case against capital controls seems to have lost some of its luster during the global crisis, though some ardent defenders have been left standing. For instance, in a discussion of inflow controls, Mexico's Central Bank Governor Carstens said: "I have only eight seconds left to talk about capital controls. But that's OK. I don't need more time than that to tell you: they don't work, I wouldn't use them, I wouldn't recommend them" (Carstens 2015). In the same speech he indicted outflow controls: "when investors come in [to a new country] they first look to see where the exit is and if it doesn't exist, they won't come in."<sup>15</sup> Some neoliberals (as we have seen earlier) have rebuked the IMF for its support of capital controls in Brazil and Iceland, and others, such as William Cline (2010), have rebuked the IMF for its new acceptance of controls. The conservative US think tank, the Heritage Foundation, has been sharply critical of the IMF's recent acceptance of capital controls) and in an issue brief highlights with horror a 2012 speech made by the IMF's Lagarde in praise of Malaysia's 1998 controls (Olson and Kim 2013).

Despite this notable camp of holdouts, we find evidence within neoclassical thought of a new pragmatism as concerns capital controls. Prior to the global crisis, neoclassical economists almost universally held that controls were costly interventions in the market because they raise the cost of capital, especially for small and medium-sized firms, and generate costly evasion strategies (Forbes 2005, Edwards 1999). Capital controls were therefore imprudent since developing countries could hardly afford to introduce new sources of inefficiency and distributional disparities.

Recent research in neoclassical economics challenges the critique by emphasizing the negative externalities associated with highly liberalized international financial flows, particularly in the absence of international coordination of monetary policies. The research has helped to legitimize capital controls, particularly targeted, temporary controls, and some of this research also offers support for international policy coordination and/or regulations on capital flows in both source and recipient countries.

There are three dimensions to the new academic research. The first strand is associated with the work of Anton Korinek, and is termed the "new welfare economics of capital

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<sup>15</sup> Recall that (as earlier noted) Carsten's spoke more catholically about controls in January 2016.

controls.” It assumes that in an environment of uncertainty, imperfect information and volatility, unstable capital flows have negative externalities on recipient economies (Korinek 2011, Aizenman 2009). In this approach liberalized short-term capital flows are recognized to induce ambient risk that can destabilize economies. Inflow controls induce borrowers to internalize the externalities of risky capital flows, and thereby promote macroeconomic stability and enhance welfare (Korinek 2011).

A second strand of research, associated with Korinek (2011, 2014) and Hélène Rey (2014, 2015), emphasizes the way in which capital controls protect developing countries from the international spillover effects of monetary policy in wealthy countries, and it explicitly takes up the absence of multilateral mechanisms to coordinate monetary, capital control, and other prudential policies. Research by Korinek and Rey provides rigorous academic support for the claims of Brazil’s Mantega and India’s Rajan (among others) regarding currency wars and spillover effects. An article in the *Economist* put the connection between these spillover effects and capital controls quite clearly: “QE has helped to make capital controls intellectually respectable again”(Economist 2013).

Korinek argues that the negative international spillover affects of expansionary monetary policy during the global crisis highlights the need for multilateral coordination (Korinek 2013). An IMF Staff Discussion Note (in which Korinek is one of the authors)(Ostry, Ghosh, and Korinek 2012) extends these themes. Citing Keynes and White, the report argues that spillovers and the absence of coordinating mechanisms justifies regulating capital flows at both ends. In this view, coordination of capital controls between source and recipient is welfare improving since the costs of controls increase at an increasing rate with the intensity of controls. Thus, a more efficient outcome is to spread the costs of controls across countries so that no one country shoulders all of the costs. In a similar vein, using data from 1995-2012, Ghosh, Qureshi, and Sugawara (2014) find that imposing capital controls on both source and recipient countries can achieve a larger decrease in the volume of flows, or the same decrease with less intrusive measures on either end. Thus, international coordination or cooperation achieves globally more efficient outcomes, and what they term costly “capital control wars” can be avoided.

Rey’s (2015) work is also motivated by the unwelcome international spillover effects of wealthy country monetary policy. These spillover effects necessitate use of targeted capital controls on inflows and outflows, particularly since she sees international coordination on monetary policy spillovers as being “out of reach.” Capital controls are necessary to protect developing countries from what she terms the “global financial cycle,” i.e., the instability triggered by large, sudden inflows associated with carry trade activity and their equally sudden exit (ibid). In a lecture at the IMF, Rey argued that the negative spillover effects of the global financial cycle are not related to the choice of exchange rate regimes in developing countries (Rey 2014). In a lecture at the IMF the next year, former Federal Reserve Chair Bernanke criticized Rey and Mantega by name for being too willing to portray policymakers in developing countries as “passive objects of the effects of Fed policy decisions” (Bernanke 2015, especially 24,30,33,36,44). Moreover, he argued that the developing countries that experienced the most turbulence already had fragile economies because of domestic economic problems. Thus, international cooperation on monetary

policy was neither necessary nor appropriate. Instead, Bernanke called for increased communication among central bankers, while also noting that a great deal of it occurs. Bernanke endorsed the use of targeted capital controls to tackle the unwelcome international spillover effects of monetary policy, though he also noted the importance of regulatory and other macroprudential measures.

Other neoclassical economists have wrestled with the international spillover effects of monetary policy and capital controls during the crisis. Nobel Laureate Michael Spence wrote of the troubling “financial protectionism” that was occasioned by expansionary monetary policy in rich countries. He (and his co-author) worried that such financial protectionism would accelerate as the era of cheap capital came to a close (Dobbs and Spence 2011). But despite characterizing controls as financial protectionism, Spence spoke favorably about their utility in developing countries during a 2010 speech at the Reserve Bank of India. There he called capital controls on such flows “essential as part of the process of maintaining control” in developing countries, and also noted that most of the high growth developing countries have had capital controls (Spence 2010).

A third strand of new neoclassical research is empirical and substantiates the theoretical claims of the welfarist approach. Ghosh and Qureshi (2016) review a large body of empirical evidence that shows that inflow controls change the composition of capital inflows and do not discourage investors. They argue that the evidence on the efficacy of outflow controls is more mixed. Even Forbes, a longstanding critic of controls, finds that Brazilian taxes on foreign purchases of fixed-income assets between 2006-11 achieved one of its key goals of reducing the purchase of Brazilian bonds (Forbes et al. 2011). Another type of empirical work involves “meta analysis” of a large volume of existing studies. Magud and Reinhart (2006) find that inflow controls enhanced monetary policy independence, altered the composition of inflows, reduced real exchange rate pressures, and did not reduce the aggregate volume of net inflows. Magud and Reinhart (2011) find the same results over a larger number of studies, including some that focus on the global crisis.<sup>16</sup>

Empirical research by economists outside the profession’s mainstream reaches beyond the tepid, conditional endorsement of capital controls that we find in the recent work of neoclassical economists (e.g., Epstein 2012, Erten and Ocampo 2013, Gallagher 2014, Grabel 2015b). Bilge Erten and José Antonio Ocampo (ibid) provide what is perhaps the most expansive support for the achievements of a range of capital controls, including those on outflows. Using data from 51 emerging and developing economies from 1995-2011, they find that capital controls that target inflows, outflows, and foreign exchange-related measures were associated with lower foreign exchange pressures, and reduced exchange rate appreciation. They also claim that outflow regulations had larger effects than inflow regulations. They also find that these three types of measures enhanced monetary policy

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<sup>16</sup> Adair Turner, former chair of the UK’s Financial Services Authority, takes note of the enduring resilience of the liberalization ideal despite empirical evidence (Turner 2014). Ghosh and Qureshi (2016) root the demonization of inflow controls in a “guilt by association” with outflow controls. They endorse the former, whereas they distance themselves from the latter, which they see as broad based and difficult to reverse.

autonomy, that increasing their restrictiveness in the run-up to the global crisis reduced the growth decline during the crisis (and thereby enhanced crisis resilience), and that countries that used these measures experienced less overheating during post-crisis recovery when a new surge in capital inflows occurred.

### *The IMF and capital controls*

The evolution in thinking on capital controls by academic economists is reflected in and reinforced by developments at three over-lapping levels of practice at the IMF: research, official statements by key officials, and policy recommendations by its staff. We find continued evidence of discomfort or tension around capital controls that is reflected in efforts to develop a hierarchy among types of capital controls and the circumstances under which they are most acceptable.

In February 2010 a team of IMF economists published a thorough survey of econometric evidence that commended inflow controls for preventing crises and ultimately reducing the risk and severity of crisis-induced recessions, and for reducing fragility by lengthening the maturity structure of countries' external liabilities and improving the composition of inflows (Ostry et al. 2010). These findings pertain to controls prior to and after the Asian crisis, as well as during the global crisis. After Ostry et al. (2010) was released, prominent IMF watchers praised the Fund for finally embracing a sensible view of controls. For example, Ronald McKinnon stated "I am delighted that the IMF has recanted" (cited in Rappeport 2010); former IMF official, Eswar Prasad states that the paper represented a "marked change" in the IMF's advice (cited in Wroughton 2010), while Dani Rodrik stated that the "the stigma on capital controls (is) gone," and that the report "is a stunning reversal – as close as an institution can come to recanting without saying, 'Sorry, we messed up'" (Rodrik 2010). Rodrik also noted that "(j)ust as John Maynard Keynes said in 1945—capital controls are now orthodox" (cited in Thomas 2010). No less telling is the sharp rebuke to Ostry et al. (2010) by Cline, which is illustrative of the discomfort that "true believers" in capital liberalization have with what they see as the Fund's troubling, wrong-headed new embrace of controls (Cline 2010).

Research on controls spilled out from various quarters of the IMF through 2011-2015. The IMF's crisis-induced research on controls culminated in a December 2012 report of the Executive Board, which the IMF terms the "Institutional View" (IMF 2012c, b). The institutional view report makes clear that inflow and outflow surges induce instability; that countries should not consider capital liberalization prematurely; that temporary, targeted, and transparent inflow and even outflow controls may be warranted during turbulence, though they should not discriminate against foreign investors; that countries retain the right under Article VI to put controls in place; and that the IMF's new, more permissive stance on controls may conflict with and be subsumed by trade and other agreements. Particularly notable is the fact that the report refrains from denigrating capital controls as a last resort measure—a theme that had recurred throughout IMF research in 2010 and 2011--and that it sanctions the deployment of outflow controls during crises.

There is clear evidence in the institutional view of the IMF's continued effort to "domesticate" the use of controls in the language around targeted, transparent, temporary,

and non-discriminatory measures. Moreover, arguments in the report continue to be guided by the view that capital liberalization is ultimately desirable, though claims to this effect are more nuanced than in the past.<sup>17</sup> Not least, the report rejects the presumption that this is the right policy for all countries at all times. Tensions over these and other matters among members of the IMF's Executive Board were given an oblique airing in a Public Information Notice released by the Fund, and more directly in press accounts, many of which focused on criticisms of the report by Paulo Nogueira Batista, then IMF Executive Director for Brazil and ten other countries (IMF 2012b). Criticism by Nogueira Batista also focused on the failure of the institutional view to consider the role of push factors from wealthy countries and the IMF's lack of evenhandedness (Prasad 2014b, 195). That said, the fact that the IMF has shifted the discussion of capital controls away from straight economics and toward the legal and institutional conditions required for their success is further evidence that the most stubborn form of resistance to controls on economic grounds has been overcome.<sup>18</sup>

The IMF continues to wrestle with the interpretation and practical implications of its own institutional view. An April 2013 "Staff Guidance Note" aimed at providing guidance as to how IMF staff should interpret the institutional view (IMF 2013). The guidance note reiterates that "staff advice should not presume that full liberalization is an appropriate goal for all countries at all times," made allowance for "a temporary re-imposition" of [capital flow measures] under certain circumstances, but reiterates that they should be "transparent, targeted, temporary, and preferably non-discriminatory." Despite the growing acknowledgement of spillover effects, the guidance note rejects the view that capital source countries should be expected to take spillover effects into account when pursuing policies in line with their "primary domestic objectives." A December 2015 report prepared for IMF staff (IMF 2015) probes what the institutional view and the 2013 guidance note mean specifically for outflow controls. In doing so, the 2015 report says that outflow controls (like inflow controls) should be transparent, temporary, lifted once the crisis conditions abate, and should seek to be non-discriminatory, though it does acknowledge that sometimes residency-based measures may be hard to avoid (IMF 2015, fn1). The report also observes that unlike capital controls on inflows, temporary controls on outflows generally need to be comprehensive and adjusted to avoid circumvention (p. 3), and that "re-imposition of [capital controls] on outflows can be appropriate and consistent with an overall strategy of capital flow liberalization...even in non-crisis-type circumstances if premature or improperly sequenced liberalization...outpaced the capacity...to safely handle the resulting flows" (p. 4).

The Talmudic process of interpreting the institutional view that has followed its release reflect not just hedging and discomfort, but also deep internal conflicts within and outside the IMF around its development. (See the IMF's IEO (2015, 9,fn15) and Gallagher (2014, ch6).) The IEO (2015) notes that it is uncertain whether implementation of this view will result in consistent IMF advice on capital controls, owing to the fragile nature of the

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<sup>17</sup> See Fritz and Prates (2014) for a critique of the institutional view on these and other grounds.

<sup>18</sup> Chwieroth (2014) argues that the greater equivocation on controls in the institutional view reflects the fact that official documents require member state approval, whereas reports such as Staff Position Notes do not.

consensus that sustains it, the resilience of internal conflict around the matter, and the constraints on controls in trade and investment agreements. Preliminary evidence suggests a basis for cautious optimism: the 2015 IEO report reviews the IMF's Article IV reports from January 2006 to August 2014, and finds that staff advice on capital controls was more discouraging in the early part of this period, and more supportive and even encouraging of such measures from 2010 on (p. 12).

Beyond the research, public statements by current and former officials at the BWIs beginning in 2009 further illustrate the normalization, lingering ambivalence, and attempt to domesticate the use of controls. For instance, former IMF First Deputy Managing Director, John Lipsky, acknowledged in a December 2009 speech that "(c)apital controls also represent an option for dealing with sudden surges in capital flows" (Lipsky 2009). In the address he makes clear that controls should be used when capital inflow surges are temporary (though we have to wonder when sudden surges would not be temporary?), and he emphasizes that controls likewise should be temporary. Despite these caveats, he argues that "(a)bove all, we should be open-minded." Public statements by the IMF's Strauss-Kahn illustrate well the grudging evolution in the IMF's views. In public statements in 2009 Strauss-Kahn emphasized the costs of capital controls, and that they tend to lose effectiveness over time (IEO 2015, Box3). But in a July 2010 speech he reframed his message: "it is just fair that these (developing) countries would try to manage the inflows" as a last resort against inflow-induced asset bubbles (Oliver 2010); and later in the year he reiterated what was by then the new mantra that capital controls are a legitimate part of the toolkit (Strauss-Kahn 2010, IEO 2015, 16). In 2010 the director of the Fund's Western Hemispheric department made a case (unsuccessfully) for the utility of controls in Colombia owing to the appreciation of its currency (Crowe 2010). The IMF's Lagarde spoke in 2012 and 2014 of the utility of temporary, targeted capital controls (IEO 2015, box3); and in March 2015 she observed that there is scope for greater cooperation in connection with monetary policy spillovers (Lagarde 2015).

Given the unevenness of the IMF's position on capital controls after the Asian crisis, the research, policy advice and statements coming from key officials during the global crisis mark by its standards a minor revolution. Change at the Fund has been uneven, to be sure, with one step back for every two steps forward. None of this should be surprising. We should expect that deeply-established ideas hang on despite their apparent disutility (Gabel 2003a). We should expect to find continuing evidence of tension and equivocation in research by academic economists and in future IMF reports and practice. But for now, at least, welfarist arguments for controls have been embraced at the top of the profession, and this is apt to continue to cast a long shadow over the IMF and beyond. More importantly, and as I have argued throughout, change at the IMF and in the economics profession is only one of a larger set of factors that have legitimated capital controls.

#### **4. CONCLUSIONS**

In the end, whether the IMF's new openness on capital controls fades with the crisis may not matter insofar as the institution has been rendered less relevant as it faces increasingly autonomous and assertive developing country members (some of which emerged as its lenders earlier in the crisis). The fact that economies that performed relatively well during



the crisis successfully utilized controls has eliminated the long-standing stigma around the instrument. That the Fund has also acknowledged the utility of outflow controls in countries in crisis also makes it harder to envision a return to pre-2008 views, something that may turn out to be quite important if the current instability continues to deepen.<sup>19</sup>

As with most rebranding exercises there is uncertainty about whether the new framing will prove sufficiently sticky, especially in the context of tensions and countervailing impulses at the IMF and elsewhere, a resilient bias within economics against state management of economic flows, and new attempts to assert outflow controls in times of distress that would run counter to the interests of powerful financial actors. For now, though, there seems to be substantial momentum propelling increasing use of and experimentation with the flexible deployment of capital controls, in some cases with IMF support and most other cases without IMF resistance. The widening of policy space and the practical experience with capital controls gained during the global crisis may prove consequential in the coming period. Even if the problems of “doing too well” fade across the developing world (as seems likely), the experiments with controls on capital inflows during better times may pay important dividends in the challenging times ahead. A critical test of recent and ongoing experiences with capital controls will occur in future crises, as states rely on and adjust fledgling practices and policies in hopes of dampening instability and otherwise managing turbulence better than they had over the course of previous crises. The coming period may test—sooner rather than later--the resilience of the new openness to controls.

In my view it is critical that efforts be made to maintain and expand the opportunity that has emerged in the crisis environment for national policymakers to experiment with capital controls and to adjust them as circumstances warrant. Hence, the pressing policy challenge today is to construct regimes that expand national policy autonomy to use capital controls while managing cross-border spillover effects. This certainly suggests abandoning (or, at the very least, renegotiating) the strictures on capital controls in existing and pending bilateral, and multilateral trade and investment agreements. It also suggests the need (ideally) to develop frameworks for burden sharing and international cooperation in the case of spillover effects. Moreover, historical and recent experience show that capital controls on inflows and outflows should be thought of not as a last resort, but rather as a permanent and dynamic part of a broader prudential, countercyclical toolkit to be deployed as internal and external conditions warrant; and that there are circumstances wherein controls may need to be blunt, comprehensive, significant, lasting, and discriminatory rather than modest, narrowly targeted and temporary (Epstein, Gabel, and KS 2004, Erten and Ocampo 2013, Fritz and Prates 2014, Gabel 2003b, 2004, Rodrik 2015).<sup>20</sup>

Any regime that seeks to develop a framework for capital controls should err on the side of generality, flexibility, and permissiveness; should involve and promote cooperation by both

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<sup>19</sup> Another possibility is that conflict over controls has decisively shifted from the economic to the legal arena of investment and trade agreements as I suggested earlier.

<sup>20</sup> Stiglitz and Rashid (2016) take what I see as a more modest view, such that current and coming turbulence in developing economies may necessitate quick action that includes targeted and time bound capital controls, especially on outflows.

capital source and recipient countries; and should embody an even-handed acknowledgement that monetary policies, like capital controls, have positive and negative global spillover effects that necessitate some type of burden sharing. It is therefore heartening that the crisis appears to have occasioned the rediscovery of the views of Keynes and White, and that these views have been given new life by the widespread use and rebranding of capital controls in many national contexts and by the related attention to currency wars and policy spillovers. Reconsideration of these matters by leading policymakers, neoclassical economists, and IMF researchers has also shifted neoclassical economists and the IMF quite far from their blanket embrace of capital liberalization prior to the Asian crisis.

The spread of capital controls and the conflict over spillovers also highlight the problems associated with the absence of global policy coordination. Brazil's former Finance Minister raised this matter on many occasions. More recently, India's Central Bank Governor Rajan in October 2015 began to be openly critical of IMF support of the easy money policies in wealthy countries, the tide of competitive and nationalist monetary easing, and the IMF's failure to flag the negative spillover effects of such measures (Times of India 2015). In this context, Rajan has proposed that the IMF (and possibly the G-20 and BIS) study this matter seriously, and develop a system for passing judgment on unconventional monetary policies and the severity of their spillovers in relation to their possible effects on growth. This might involve a panel of "eminent academics" appointed by the IMF, G-20 and/or BIS who would rate policies using a color coded (red/green/orange light system) (Krishnan 2016), or might involve the IMF passing such judgments itself (Rajan 2016).

In this environment of disruption, economic and institutional change, intellectual aperture and uncertainty we find a productive expansion of policy space for capital controls and a movement away from the reification of capital flows and other aspects of financial liberalization within neoclassical economics, something that may ultimately be seen as an important legacy of the global crisis. This change, messiness, and uncertainty exemplify what I see as the productive incoherence of the present environment.

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