Gene Frieda - Capital Controls in Crisis Prevention

Countries need to feel secure in indebting themselves. Capital controls tend to materialize when countries start to become insecure about this process. The tendency has been for controls to come as a function of an accelerated size and speed of capital inflows, or in periods when past inflows threaten to reverse course in sudden, sharp fashion. My plan today is to talk to you briefly about why capital controls increasingly make sense, but also why they are increasingly doomed to failure.

In December, Thailand announced a 30% non-interest bearing reserve requirement on all portfolio inflows held under one year. The measure was a surprise to the market, particularly because Thailand had not been a major recipient of foreign capital to its debt market and because inflows to the equity market have generally been encouraged as a form of longer-term investment.

Thailand's main “stated” concern related to excessive exchange rate appreciation and its potential adverse impact on exporters, but I can make a strong argument as to why the measures were more a result of the interim government's efforts to bolster its legitimacy with key domestic political constituencies. In this sense, I would not hold Thailand up as an example of where the world is headed, either in terms of military coups or with capital controls! And just because Thailand botched its controls doesn't mean that controls are a bad idea.

21st Century Trilemma - A country cannot have have it all: free capital mobility, a fixed exchange rate and a monetary policy oriented toward domestic needs. This is the famous trilemma. The move in the late 1990s toward floating exchange rates was a necessary choice for countries seeking to tap into the strong growth in global capital flows. Monetary policy was accordingly left for use as a tool to achieve internal balance, while exchange rates were left to adjust as required to achieve some semblance of external balance.

As the growth cycle in capital inflows has extended, countries have begun to show discomfort with the extent of the resulting appreciation pressure on currencies. This was less of a problem between 2002 and 2005 when many emerging market exchange rates were still considered undervalued and output gaps were negative in many countries. Loose monetary policies were appropriate. measurters,

- To prevent crisis by altering composition of capital inflows or slowing inflows, on the basis that some capital inflows can be welfare-reducing, especially when driven by speculation and/or implicit guarantees on banks' external liabilities.

There are variations on the theme, but there are two main options for control regimes: price and quantity

- Taxes and unremunerated reserve requirements (URRs) increase the price of undertaking a given investment and leave it to the market participant to decide whether the transaction is

Is private equity investment a direct investment, a portfolio equity investment or a debt liability?

Is the problem due to locals or foreigners? In most cases, foreigners tend to get the blame for excessive capital inflows, but in many of the past currency crises and indeed within Central and Eastern Europe presently, the culprits look more like overborrowing locals than foreigners.

Which forms of capital controls are preferable?

regime to segment markets in a way that sought to achieve specific policy objectives.