6

Country Policies to Limit Capital Inflows

We have discussed the macroeconomic policy responses to capital inflows in Chapter 5. There is a second category of policies that seek to deal directly with the capital inflows themselves. IMF (1995, p. 12) summarises the policies of both types tried by nine different developing countries over the past several years. In this Chapter we deal with the second category of policies.

6.1 Relative Merits of Different Types of Flows

Evidently the different forms that capital inflows can take have policy implications, but only some are relevant to our concerns, and even these are often overemphasized. Foreign direct investment (FDI) can be a vehicle of technology transfer and training of local labour. More important for our purposes is the claim that it is less volatile than portfolio investment or bank lending (Agosin and Ffrench-Davis, 1996, for example, call FDI 'fairly stable' and portfolio investments 'notoriously volatile', asserting that 'it is unclear that developing countries have much to gain from this form of internationalisation of finance' – pp. 10, 28). Foreign purchase of domestic equity shares may have implications for corporate governance or foreign influence in the domestic economy. More relevant here are the dangers of stock price booms and crashes resulting from capital inflows and their reversal; and of a reduction in domestic savings (wealth effects). Foreign purchase of government bonds may help to finance budget deficits – at a cost.

There is evidence, however, that FDI is just as volatile as other capital flows (Claessens, Dooley, and Warner, 1995). Direct investors can and do hedge political risk by matching assets that cannot be moved against domestic liabilities on which they can default. Policy restrictions aiming to push foreign investors away from portfolio towards direct investment will, on this argument, simply change the accounting (see IMF, 1995, pp. 96-97). Calvo and Reinhart (1995) also obtain results suggesting that FDI flows do not behave with a significantly different volatility (or reversibility) than portfolio flows. Moreover, as discussed above, Sachs *et al.* (1996) find that the share of short-run flows (portfolio investment and bank deposits in total inflows had little or no explanatory power for vulnerability to crisis in 1995. (Frankel and Rose (1996), however, do find that a higher FDI share is associated with lower vulnerability.)

Conversely, there is also recent evidence that supports opening domestic equity markets to foreign participation (see the discussion in Dimirgüç-Kunt and Levine, 1996). In a sample of 14 'emerging market' countries during the 1980s, capital market liberalization yielded 'rapid improvements in the functioning of their stock markets' (including greater liquidity and, in the longer term, lower volatility of stock returns). Moreover, further research suggests that 'stock market development is positively correlated with the development of financial intermediaries...[and] with long-run economic growth (p.233)'. The latter relationship appears to be remarkably strong: '...if Brazil and Mexico...had had the same level of stock market development as Malaysia..., then Brazil and Mexico would have enjoyed 1.6 per cent faster capita growth each year. (p. 233)' The arguments in this section are prima facie convincing against policies that try to steer foreign investment into FDI rather than portfolio equity investment. Overall views on the desirability and effectiveness of controls

on inflows vary significantly, even in the international financial institutions – thus IMF (1995, pp13-14, 108) is continuously positive in a range of circumstances while Corbo and Hermandez (1994) are rather negative.

Finally, note also that those who thought non-FDI flows untrustworthy and dangerous and had been predicting a halt or even a reversal of 'volatile, unsustainable' capital flows – a 'hard landing' or 'crash' – were wrong. Such a view was doubtless understandable after Mexico (and shared by the international financial institutions that had favoured encouraging capital inflows) – but even then, it was wrong. It should be recalled that historically, financial/debt crises (in the 1980s, the 1930s, and the nineteenth century) were not due to the 'volatility' of the original capital flows.

6.2 Constraining the capital flows themselves

Some countries have nevertheless sought to favour FDI per se. And there are other measures that have been taken to influence the size and composition of capital inflows (see the summaries on pp.14-15 of IMF, 1995). Policy-makers may be concerned that the current account deficit corresponding to the capital inflow will be so high as to threaten confidence; or that some types of capital flow are too volatile (see Sec. 6.1); or that foreign currency borrowing, especially by commercial banks, is undesirable (it may increase the likelihood or the cost of a financial crisis). There is a general, and we believe justified concern that the pace of financial liberalisation has in some cases been too fast, and that especially with domestic financial underdevelopment and fragility, there is considerable danger in the large and rapid increases in the volume of financial intermediation that capital inflows can bring.

(i) Favouring FDI

One commonly discussed possibility is to place restrictions on the foreign issuance of securities by domestic firms. One rationle for such restrictions lies in the view that equity finance is more long-term than finance through bank lending (which may need continuing rolling over) or through the issue of bonds (which may be medium or short term and therefore, again, need rolling over). Another rationale is that holders of equities may find it more difficult to withdraw their capital – because equitiy markets are volatile (and expected to be so). As we noted in Section 6.1, neither of these arguments is watertight.

(ii) Capital Controls

There is an extensive literature on capital controls, but as the survey of Dooley (1995) shows, most of it relates to restrictions on outflows rather than inflows. Overall views on the desirability and effectiveness of controls on inflows vary significantly, even in the international financial institutions – thus IMF (1995) is cautiously positive in a range of circumstances , while Corbo and Hernandez (1994) are rather negative. On the one hand, Singapore has generally coped well with large capital inflows without controls. On the other hand, notable examples of the use of controls over inflows are Chile and Colombia in Latin America and Indonesia and Malaysia in East Asia. (Descriptions and generally favourable assessments of the Chilean and Colombian measures are given by Agosin and Ffrench-Davis, 1996, and LeFort and Budnevich (1996); Corbo and Hernandez compare four Latin American and five East Asian countries.) In these examples, different countries have used different types of controls at different times, as follows.

(a) Direct controls which involve scrutiny of all transactions. This includes dual exchange-rate systems, which, for example, have been used by Chile. (In such systems, it can be a requirement to bring capital in at a more appreciated rate than is applied to capital withdrawals.) Another example is that of Indonesia, where, since 1991 ,all state-related offshore commercial borrowing has required prior government approval (with aggregate annual ceilings).

(b) Reserve requirements. In Chile, for example, domestic foreign currency borrowing has for some years entailed a 30% non-interest bearing deposit for one year; and recently this has been extended to cover non-resident purchases of domestic securities. This tends to discourage short-run arbitrage, but it is not costly enough to deter a speculative attack on the currency when the markets expect a significant change in the parity. Colombia uses a similar reserve requirement. As IMF (1995) points out, this can be justified on prudential grounds, as a long-term policy instrument. Indeed, LeFort and Budnevich (1996) stress that a wide range of interventions to deal with capital inflows are equally helpful in strengthening prudential regulation of financial institutions.

(c) Limits on banks' foreign currency liabilities, that is on the amount which banks can borrow abroad, particularly in foreign currency. Indonesia and Thailand have implemented such policies. So has Malaysia, in the form of a prohibition on sales to foreigners of short-term money market instruments.

(iii) Elimination of Subsidies to Inward Investment

Many countries still have the remains of regimes which were designed to attract foreign investment, especially into inward looking manufacturing activities, harking back to the time when attracting investment was difficult and when inward looking manufacturing was desirable. These regimes are intrinsically undesirable – as explained at the beginning of the paper – and a time of buoyant capital inflow is a good time to abolish them.

6.3 Complementary policies

There is a further set of policies that seek either to compensate for capital inflows or to limit them indirectly. (Direct controls on the flows themselves will be discussed in the next Chapter.)

(i) Relax Controls on Capital Outflows

Several countries have thought that eliminating controls on outflows would reduce the net inflow: Chile, Colombia, Mexico, the Philippines, Sri Lanka and Thailand are among those that have taken this approach. Some have found, however, that although the relaxation may be desirable in itself, it may also raise the confidence of foreign investors and thereby stimulate even greater inflows.

(ii) Quicken the Pace of Trade Liberalisation

This is clearly a way of accommodating the capital inflows, in that it encourages the demand for imports at the expense of demand for domestic goods, and so dampens the macroeconomic boom. But, of course, if it causes a further increase in the attractiveness of investment in the country concerned, then it will give no real respite.

(iii) Encourage Higher Domestic Savings

This is also clearly a way of accommodating the capital inflows, in that it dampens the macroeconomic boom. To put the matter another way, to the extent that capital inflows are substituting for domestic saving, then an increase in the latter may tend to reduce the former.

(iv) Switch Government-Controlled Deposits from Commercial Banks to the Central Bank.

Indonesia, Malaysia, and Taiwan have all adopted such measures; by reducing deposits in the banking system they reduce the ability of the banking system to lend.

(v) External Debt Management

There is much to be said for the 'Dooley rule': that governments should only borrow long and in domestic currencies, so as not to be exposed to capital risk. Calvo and Goldstein (1996) argue that the key ratios to watch are those of short-term government debt to reserves and money to reserves.

6.4 Some further examples

Kasekende *et al.* (1996) argue there is considerable reason for concern regarding capital inflows to six countries of sub-Saharan Africa that they studied: the size of the flows is substantial; they appear likely to be unsustainable, indeed (the authors claim) reversible; they have caused significant exchange-rate appreciation and volatility in both the exchange rate and interest rates; they have been spent mainly on consumption. They do not wish to see the flow decline, however – so they are concerned mainly with composition and macro management. But their policy recommendations are constrained by limitations of the data – indeed, at the top of their list is simply 'improving recording mechanisms without driving flows back to parallel markets'. We are also sceptical of their faith in sterilised intervention (which may, as noted above, be a cause of the high real interest rates on government securities that they deplore) as well as in fiscal policy. Both assume what the data are inadequate to prove: the short-term, unsustainable character of the capital flows.