Introduction and Overview

Christine P. Ries

Until recently, capital controls were considered by many policymakers to be among the more arcane and technical instruments of economic policy. National governments frequently imposed controls in support of balance of payments and monetary policy objectives when international capital flows threatened to overwhelm domestic policy priorities. The appropriateness of their application in these conditions, or the extension of their use to other situations, was little discussed. In the last decade, however, the power of market-based economics has swept through formerly socialist and communist countries, leading to economic and political reform in many of these states. With these changes, debates over the use of capital controls have gained new prominence since capital controls have frequently been used to sequence and fine tune liberalization policies in the emerging market economies.

The essays in this book should convince the reader that debates about the role and impact of capital controls can no longer be relegated to the offices of “policy wonks” and economists who specialize in international monetary policy. Rather, as political and economic institutions are transformed within a global setting, decisions to divert or distort the flow of global capital have pervasive and long lasting impacts on the basic structures of national economies. Capital controls are not tangential but fundamental elements of economic policy and management.

Capital controls, far from being an arcane tool for fine tuning economic policy and macroeconomic balance of payments management, are shown to be of central relevance in determining patterns of international ownership and the character of national private investment. They can also have a significant effect on patterns of population migration and the development of national comparative advantage. They affect industrial organization at the deepest levels and so should be of concern to corporate strategists, investment portfolio managers and equity traders, and anyone concerned with such broad issues of public policy as development and growth, education, and infrastructure planning.
In the following chapters several noted economists present their thoughts about the use of capital controls in the reforming economies of the formerly communist countries. In addition, the collection of analytical approaches presented here offers important insights about the formation of basic institutions and the essentials of public policy analysis in dynamic political and economic settings.

One important lesson learned from the study of capital controls in emerging market economies is that controls can have pervasive, lasting impact on an economy and society if the restrictions are in place while basic institutions and infrastructure are developing. While much of the literature on this subject deals with the speed and sequencing of liberalization, this book extends our understanding of the permanent impact of even temporary controls.

We also learn several important lessons about the study of public policy in situations where not only economic, but also political and social institutions are in a state of flux. In the dynamic and complex environments of emerging markets, our work must demonstrate the effects of any policy choices on the individual decisions that determine patterns of investment, ownership, employment and economic development. In order to understand and predict these relationships we must explicitly describe the transmission of macroeconomic variations into the microeconomics of decision making. This allows us to describe the relationship between financial variables and real economic, social, and political outcomes. Finally, in order to address this range of issues and interactions, we must draw upon several traditionally distinct literatures and develop analytical approaches that incorporate the most useful features of each.

1. General Lessons for Policy Analysis in Dynamic and Restructuring Economies

Perhaps the greatest change in the global economic system since 1945 has been the explosive growth in capital flows and capital mobility between nations. Our traditional approaches to questions of capital control evolved from a time when trade flows dominated the public attention and public policy was focused on the relative status and well being of producers and consumers at home and abroad.

Today, it is much more widely understood that global capital flows can drive both instability and economic growth. Investment funding is generally seen as the basis for the development of infrastructure and national produc-
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tive capacity. It is also clear that access to global financial markets is a necessity given the magnitude of investment required for economic development. Finally, international investment flows and trade in ownership claims carry with them information, transfers of technology, intellectual capital, and managerial talent.

As capital flows have come to dominate international trade flows, and to carry with them so many intangibles such as issues of ownership and transfers of technology, so must our intellectual orientation expand as we propose and assess public policy. From the literature written for corporate financial managers and the financial services industries we learn that the forces of global arbitrage and the emergence of new financial markets and services exert a strong influence on the allocation of investment funds. This work allows us to understand the channels by which arbitrage is conducted and to elucidate the linkages between economic development projects and individual investors. We can understand and predict how global investors will assess those differences in risk and return that are inherent in a particular national social and economic setting.

The reality of global arbitrage also confronts us with a powerful fact: Nations and governments that pursue economic development and prosperity are in direct competition with other nations and even large corporations for the funding that supports such growth.

From this perspective we are better able to model and measure the transmission of changes in aggregate variables such as interest rates or foreign exchange rates into the individual investment and operating decisions that ultimately determine aggregate growth and prosperity. That is, taking the perspective of global financial arbitrage and financial market structures, we are able to assess the linkages between micro- and macroeconomics and between the real and financial sectors. Our work in emerging markets and the essays presented in this book demonstrate that an understanding of these linkages is central to the formation of effective economic policy.

The literature on capital markets and corporate finance has also yielded a perspective on economic and organizational restructuring and revitalization that is highly relevant to emerging market activity. Cross-border investment flows carry not only funding for development projects, but also components of ownership and control. Issues of ownership and control pull us beyond the issues of nationalism and mercantilism to concerns about decision making, incentives, and productivity.

The exploration of these economic insights together with unavoidable political challenges suggests new formats and new perspectives for policy
analysis. In this book we present analytical models and analysis that account for the public and private, the real and financial sectors, nationalism and productivity against a background of democratic political systems.

Finally, taken together the approaches presented in the chapters that follow enable us to better predict the effects of particular economic policies in complex and multifaceted settings and where individual agents or decision makers adapt their behavior in response to policy. By focusing on the particular setting of emerging economies, we were forced to account for the adaptability that comes as decision makers gain freedom of choice and access to information.

In addition, because the countries we studied were small and their political systems nascent, all of the interactions and decisions are more complex than for large, well-established countries. Clearly, the approaches developed here for addressing capital controls in rapidly changing and complex environments have many lessons for sophisticated policy analysis of other dynamic and complex settings.

2. Implications for Parliamentary Structure and Control of Public Policy

The lessons of this book may also be extended to consider the process by which public policy is formed, assessed and adopted. One implication of our work is that the imposition of capital controls, and perhaps the parliamentary and institutional procedures by which they are imposed, should be discussed with the broadest possible range of representatives from the impacted sectors and other interested parties.¹ Not only the direct, but the indirect and long-term consequences must be fully and explicitly explored. The details of our analysis can also be used to develop a list of individuals and groups that may be convened as political constituencies in support of various policies.

The analysis also raises important concerns for environments that are changing rapidly. In such markets, basic institutions are still unformed or malleable and changing patterns of social and political affiliation create a dynamic environment. Patterns of trade, channels of marketing and distribution, and the ownership and control of productive assets evolve rapidly.

In such settings, public policies are potentially more powerful than where existing institutional arrangements constrain decision makers on all sides. When policy decisions can influence the very foundations of institutional arrangements, they can be expected to have a much more enduring impact than is usually the case, for good or ill. The natural balances and corrective
mechanisms inherent in well-developed institutional arrangements may not be present in emerging market countries.

These natural balances existing in the more mature democracies—and absent in the emerging market economies—mitigate the effects of changes in both political and economic spheres. In the emerging market economies, long-established interest groups or constituencies with an interest in preserving past privileges may dominate policy discussions, and groups with a greater stake in the future may not be adequately represented. In addition, the former may use their position to cement themselves in power as new institutions are formed.

On the economic side, shallow markets for credit and other risk management instruments mean that any given change in a macroeconomic variable will have a more substantial effect on the real sector of the economy. For example, changes in interest rates will have a greater impact on the availability of credit to small and growing enterprises in economies where a broader range of security offerings is not open to the borrower.

These aspects of the emerging market situation present special challenges to analysts of economic policy. We are dealing with settings that are dynamic and fluid. The transmission of changes in macroeconomic variables has greater and longer lasting effects on microeconomic or individual behavior. Decision makers are more heavily influenced by a few basic aggregate variables than is the case where fully developed markets and institutions offer a range of alternative solutions for investment and operating problems.

3. Liberalizing Markets: An Overview

Liberalizing countries face the issue of “sequencing” as they determine the order of markets to be opened to international competition. At one extreme is the “big bang” approach where product and financial markets are liberalized domestically and at the same time opened to foreign competition. In practice, many successful liberalization experiences have eschewed this approach for a more gradual process of liberalization. Most often, market pricing, profits, and private ownership are first accepted in internal markets with allowance for imports and international competition to follow. At some point, financial markets are opened domestically and internationally, but national banking and financial services are usually protected well into the liberalization process. In addition, restrictions on the inflow and outflow of capital owned by foreigners are usually lifted before the elimination of restrictions on domestic residents’ ability to invest capital abroad.
In “Orthodoxy is Right: Liberalize the Capital Account Last,” John Williamson supports the sequence of liberalization outlined above. A key reason for delay in liberalizing foreign capital flows is the possibility that massive inflows and outflows might destabilize financial markets and thus disrupt product markets before reforms are fully established and firms have become strong enough to endure financial shocks. In particular, large capital outflows may drive domestic interest rates so high that credit is largely unobtainable for most firms, and these firms, which are likely to have weak balance sheets in the early stages of liberalization, are unlikely to survive. Or, massive capital inflows may lead to such strong exchange rate appreciation that domestic firms cannot sell profitably in international markets or compete against imports. Reducing the possibilities of such disruptions justifies delay in capital account liberalization until producers are strong enough to face capital account shocks. Of course, restrictions on foreign capital flows are likely to reduce overall investment in the liberalizing country, and thus restrictions should be progressively relaxed as product-market liberalization becomes more strongly entrenched. Similarly, restrictions on domestic residents’ outflows to reduce the possibilities of destabilizing capital flows can be relaxed as product-market liberalization is strengthened.

In “Reality and the Logic of Capital Flow Liberalization,” Manuel Guitián argues that this sequencing strategy is misconceived. While interventions that restrict the international flow of capital are currently accepted as tools of international policy, Guitián argues that the acceptability of capital controls is an artifact of the past. As we approach the twenty-first century, capital controls are far more likely to disrupt than to facilitate effective and efficient global economic integration and expansion. In today’s environment, trade flows are relatively well established and capital flows are increasingly important to the effective functioning of the global economy.

A simplifying and powerful perspective is presented in Guitián’s argument for parallel treatment of current account or trade transactions and capital transactions. He reviews the strong and generally accepted reasons for promotion of current account convertibility or free trade in goods. These same arguments should also be applied, he argues, to trade in capital—trade in financial securities. In parallel with free trade, freedom of capital movements will enhance economic efficiency, promote growth, and increase wealth.

Another persuasive argument for the removal of restrictions on capital flows is related to the underlying health of the domestic economy. Capital controls are imposed in order to insulate the domestic economy from external
economic shocks or in order to preserve domestic economic distortions, including "prevailing sources of imbalance and of inappropriate policies." Capital controls mask the effects of these distortions and can actually cause the distortions to become institutionalized. The distortions prevail, often with widespread, negative, and unintended effect.

One implication of Guitián's argument is that public policy analysis in this arena should be shifted from a preoccupation with the effects of exchange rate changes on the balance of trade to focus on the effects of capital flows on domestic investment growth and performance. This approach would also argue for attention to policies that promote flexibility and responsiveness rather than those that reward inflexibility.

Finally, as a byproduct of the argument for capital mobility, we are offered an informed view of economic history that not only explains the international acceptance of capital controls, but offers interesting insights into the makings of international monetary institutions and international agreements.

"Preconditions for Liberalization of Capital Flows—A Review and Interpretation," by Claus Wihlborg and Kalman Deszeri provides a review of the scholarly background to which the other chapters implicitly speak. Their survey describes widespread agreement that both developing and industrialized countries should support full capital mobility, though limits to convertibility and sequencing may still depend on some preconditions in the economy for effective implementation. Much of the more current literature discusses these preconditions and the underlying causes of conditions that would prevent full convertibility. Wihlborg and Deszeri suggest that the limits to full liberalization may come from either market failures or policy limitations or both, and their comprehensive review of the literature shows how each argument depends on a basic assumption about market and policy failures. They argue that some criteria for liberalization, such as sufficient revitalization of privatized industries, may delay capital account liberalization for an excessive and perhaps indefinite period. Like Guitián, they relate the discussion to an analysis of failures in commercial or trade policy that shows why authorities may apply a "second best" policy because of implementation limitations.

Finally, their chapter leads us into the broader perspective that is addressed in succeeding chapters. In recognizing the financial underpinnings for capital flows, they suggest that analysis that fails to account for investor expectations and risk will lead to biased and erroneous prescriptions.

"The Information Costs of Capital Controls" by Richard Sweeney
introduces the second section of this book. While the chapters in the first section provided background and framework, those in the second section introduce and develop new perspectives. Sweeney’s paper leads off by assessing one of the other roles of the financial system: to provide information for a broad range of business and investment decisions. Sweeney concludes that this role is sufficiently important to push the sequencing argument strongly in favor of early liberalization for capital transactions.

By pricing financial securities, the capital markets perform many functions in the economy. One of the most important is to provide information about the size and costs of various risks. When functioning capital markets are fully open, managers and investors can use the information contained in the patterns of security prices to assess the risks inherent in particular assets. Without this information, each assessment and each decision conceivably requires very extensive data collection, analysis and calculation. Since, in reality, these calculations cannot be effectively made, the quality of the resulting decisions is greatly compromised.

When, however, local and national economies are fully integrated into the global economy, capital markets are free to assess information and security pricing is fair, the information assessment burden is manageable. Rather than starting from scratch, each decision maker can simply observe market prices and make incremental adjustments for differences in the project under consideration. This chapter presents the conceptual and mathematical arguments and shows the magnitude of the estimation costs that must be borne by decisions makers in countries where markets are isolated from global pricing.

Within the scheme of this book this chapter makes an important transition. An essential assumption for the mathematical development is that international financial arbitrage is a force to be reckoned with. Sweeney shows us how our policy analysis must be reoriented when arbitrage forces are dominant, as they have certainly become in recent decades.

Working further into the analysis of information and risk, Sweeney considers the importance of government credibility in this process. He shows that lack of credibility undermines the entire pricing process and significantly reduces the value to be gained by more immediate liberalization. He demonstrates that credibility is damaged when controls are retained for domestic investors even though investment transactions for foreigners are freed. With this discussion, the chapter introduces issues of credibility that are later addressed and extended in the chapters by Dickinson and Mullineux, and Wihlborg and Willett.
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In “Currency Convertibility, Policy Credibility, and Capital Flight in Poland and Czech and Slovak Federal Republic” David Dickinson and Andrew Mullineux connect the discussion of capital controls to a broad range of other macroeconomic policies. They discuss various types of convertibility and show how these represent attempts to manage both exchange rates and capital flows. By addressing the specific arrangements by which convertibility is controlled and the range of possible responses, their essay places the issue of capital controls firmly at the center of a complex global economic and political system.

Their discussion of the specific ways that convertibility policies interact with this complex, global system shows that today’s economic agents have almost unlimited opportunity to pursue global arbitrage opportunities. That is, “effective” capital outflow may occur even if convertibility is lifted and controls are tight. For example, capital controls often stimulate the “dollarization” of the economy. Though not traditionally thought of as capital outflow, “dollarization” has identical effects. The strength and magnitude of this effective outflow is directly related to the appropriateness of the level of the exchange rate.

Dickinson and Mullineux broaden the discussion further as they recognize that capital may flow in both directions as economic adjustment and liberalization proceed and that each direction may be problematic. In acknowledging that overshooting may occur, these authors provide the macroeconomic perspective underlying the issues of risk as addressed in the previous chapter by Richard Sweeney. The essay also anticipates the discussion of the effects of risk on capital investment decisions that is presented in Christine Ries’s following essay.

Dickinson and Mullineux augment our consideration of the conceptual issues relating to sequencing and capital flows by examining evidence on capital flight in the early stages of economic liberalization in Poland, the Czech Republic and Slovakia. They develop measures of capital flight and trace these in relationship to macroeconomic problems and government credibility in these cases. Their conclusion is that investor uncertainty over political possibilities causes capital flows that exceed what might be expected due to normal investor reshuffling of portfolios.

With this last analysis and discussion, Dickinson and Mullineux’s essay moves us to the next stage. Their work anticipates a new policy perspective regarding the control of capital flows. When international arbitrage forces are strong, governments may best be advised to abandon defensive postures in favor of positive and accommodating positions. Even if capital can be
effectively restrained, the costs are large. As Sweeney shows, the detrimental and pervasive effect on information flows and analysis alone are sufficient to argue for more immediate capital account liberalization. Dickinson and Mullineux’s work strongly suggests that governments are better advised to recognize that global capital resources will flow toward attractive investment opportunities. Rather than attempt to constrain capital flows, governments might more effectively achieve investment and growth targets by attending to their attractiveness as hosts for investment and operations.

In “Capital Controls and Corporate Investment Behavior” Christine Ries pushes this argument more fully to the level of specific decision making and examines the microeconomic implications. Using the theory of corporate finance, she assesses the effects of tight capital controls on the structure of ownership and industrial development. When such controls have the effect of raising the returns required by investors, they reduce the total amount of capital investment in the country. Further, if domestic investors are especially penalized by being denied opportunities to diversify their risks through investment in foreign markets, the risk that they effectively bear for any given project is higher than the risk borne by foreign investors.

When this bias against domestic investors is sufficiently large, foreigners gain the advantage in bidding for projects that have lower risk and greater long-term growth prospects. They accept higher up-front costs and are initially willing to commit larger amounts of capital and to postpone their gains over a longer period.

These patterns of investment have important implications for the future corporate and asset ownership patterns within the country. Foreigners are likely to be charged with “buying up” the country both because of their large initial investments and because the value of the investments will grow more over time. Depending on the degree of bias, one will see domestic ownership concentrated in industries that quickly become “mature” while foreign ownership will dominate in industries that constitute the growth sector. The same bias affects all operating and internal investment decisions and places domestic owners and investors at an increasing disadvantage in terms of employee training and recruitment, investment in new technology, and expansion of employment opportunities. The analysis can be extended even to address issues of population migration with implications for the types of employment opportunities and immigration the capital control policies will encourage.

The chapter demonstrates the many ways that capital controls change investment and operating decisions and shows that a country that adopts these
controls may be buying significant social and political problems in the future.

"Capital Account Liberalization and Policy Incentives: An Endogenous Policy View" contributes insights from the fields of public choice and rational choice economics. This perspective emphasizes the endogenous roles of policymakers: policies influence markets and markets influence policies. Clas Wihlborg and Thomas Willett emphasize that a complete analysis requires recognition of this endogenous component. One implication is that policies may be more credible if the institutional context imposes high costs on government actions that violate trust or exceed the bounds of good judgment. For example, domestic monetary authorities may be effectively constrained by fear of negative market reactions to monetary growth rates that are perceived as excessive.

Similarly, conclusions about the impetus for and effects of speculative crises depend on whether capital flows are seen as the triggers for crisis or whether the flow of capital is seen as a symptomatic response to more basic policy initiatives. Does an exogenous reorientation of investment flows cause an economic crisis, or does the cause reside in some deeper flaw in basic public policy? The policy prescription in times of crisis or as prophylactic policy must depend on the answer to this question.

If significant capital outflow represents flight from poor policies, the prescription is to change the underlying policy. However, if capital outflow is exogenous and unwarranted, it may be appropriate to institute capital controls or other policies to slow or stop that outflow.

Michael Dooley's chapter, "A Payments Mechanism for the Independent States of the Former Soviet Union," addresses a fundamental aspect of international capital flows—the payments mechanism for international transactions. This case study, however, focuses directly on the agents most strongly affected by the economic and social transformation. It considers the development of payments mechanisms between states that are newly independent but were formerly part of the USSR. In essence, this is trade that was formerly interstate, but is now international.

Dooley raises considerations of both economics and politics. His objective is design a payments mechanisms that shifts trade patterns as little as possible from the most efficient outcome. "The basic idea is that...the payments mechanism should get in the way as little as possible." Dooley provides details regarding the direction of trade between republics and discusses the mechanics required to finance this trade. He then considers the various political arrangements required to bring about the appropriate policies and institutions.
As a final chapter, this essay takes us into the specifics of one area where capital liberalization directly affects trading transactions and economic well being. Dooley draws explicitly the connection between the financial market structure and the facility of trade in goods. He shows the roles that national governments must play in effecting orderly and efficient transitions. Finally, this piece demonstrates again the range of issues and considerations that must come into play as policy analysts debate controls on the flows of capital and other capital market interventions in an era of dynamic transformation and complex change.

Notes

1. Here we implicitly assume that those in control of public policy seek policies to benefit the whole country, rather than to benefit select individuals and groups at the expense of the whole. Further, this discussion assumes that the range of representatives to a discussion are sufficiently focused to support the development of a consensus.