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Capital Flows and Controls in Middle-Income Countries:
policy responses and development implications

Intervention by Bhumika Muchhala, Third World Network

Developing and emerging economy countries have been experiencing a surge of capital inflows from the advanced economies, which are threatening their macroeconomic and trade growth and stability. These capital flows, which are primarily speculative and short-term in nature, are transmitting destabilizing effects through their impact on exchange rates and asset, credit and commodity markets. The trigger for these flows is found in the continued monetary policy expansion in the US and other advanced economies, which involves injecting considerable sums of liquidity into the economy (e.g. quantitative easing) and close-to-zero interest rates.

The Federal Reserve's creation of \$600 billion in liquidity in early November 2010 stimulated the dollar carry trade, where investors borrow cheaply in the US and invest in higher-yielding currencies and assets in emerging market economies. A key problem of asymmetry is seen in how the quantitative easing pursued in the US is unable to establish stable and rigorous growth, demand and jobs nationally, and yet has critical structural impacts in developing countries across the world.

The destabilizing impacts of capital inflows in middle-income countries

There are three key adverse impacts that the surge in capital inflows has on developing countries. First, capital inflows affect trade and financial stability through currency appreciations and in some cases, widening current account deficits. Currency appreciation disrupts export competitiveness, increases the price of imports (particularly at a time when food prices are reaching record highs), and affects employment in export manufacturing and industrial sectors that form the backbone of many middle-income economies. In countries such as Brazil, South Africa, India and Turkey, current account imbalances exacerbate the rate and extent of currency appreciation.

Second, the excess liquidity in middle-income countries is increasing the pressure on consumer prices and fuelling credit and asset bubbles through sharp price rises in real estate and the stock market. However, sooner or later, bubbles always burst, resulting, as the world has seen in the last few years, in a lot of damage. Third, any surge in capital inflows can lead to a reciprocal surge in outflows from middle-income countries back to the advanced economies. This scenario can potentially occur when the US and other advanced economies eventually carry out fiscal and monetary policy tightening and put an end to the credit expansion and historically low interest rates which have marked their crisis response. High-volumes of capital outflows in a concentrated period of time may cause economic disorder through currency devaluations, loan servicing problems, and balance of payments difficulties, as seen in the Asian financial crisis of 1997-98.

Capital controls and the role of the IMF

In order to manage the various risks associated with the surge in inflows, middle-income countries across Asia, Latin America, and the Arab region have employed some form of capital account regulation, or capital controls. The last one year has presented landmark shifts in the international consensus on capital controls, as demonstrated by the new acceptance of 'macro-prudential regulations' by the International Monetary Fund (IMF) and the Group of 20 (G20) at its Seoul Summit in November 2010.

The IMF, which has historically been opposed to capital controls, significantly revised its ideological framework with a February 2010 study titled, *“Capital inflows: The role of controls.”* This study stated that “capital controls are a legitimate part of the toolkit to manage capital inflows in certain circumstances,” and that the use of capital controls by governments during the threat of financial crisis “was associated with avoiding some of the worst growth outcomes associated with financial fragility.” However, the Fund has specifically endorsed controls only on inflows. This proves insufficient when sudden capital flight occurs and controls are required on outflows. Some academics have also highlighted the important role and need for rich countries, in particular the US, to regulate their capital outflows to deter destabilizing dollar carry trade flows from the US to the rest of the world.

The IMF staff and board are currently discussing the institution’s role in managing cross-border capital flows. IMF executive directors agree, as noted in a summary of their board discussion on capital flows, that the Fund’s role in capital flows needs to be strengthened by developing a coherent Fund view that informs policy guidance to member states. The possibility of the IMF having jurisdiction over capital account regulations can be dangerous. Efforts to harmonize the complex array of policies included in capital controls is not appropriate in a world where countries are in very diverse stages of development and need national policy space to design specific capital control measures that fit unique country circumstances, and which ensure support for domestic financial systems, vital productive sectors and domestic firms. Financial systems in developed countries are systemically different from the financial systems in middle-income countries or least developed countries, and this underscores the need for special differential treatment for developing countries, where full autonomy and choice should be exercised in selecting and shaping the best policy mix for the objective of domestic financial and economic health.

Capital controls and the constraints posed by Free Trade Agreements (FTAs)

The most serious constraint to the ability of developing countries to apply capital controls is found in free trade agreements with developed countries. In particular, US trade and investment treaties restrict capital controls by mandating the free flow of capital to and from countries, for instance, in trade agreements the US has with Chile, Peru and Singapore. In the case of Singapore and Chile, the countries resisted these measures at first, but ultimately agreed to the treaties. According to academic researchers, the pending trade deals the US has with Colombia and South Korea may also ban prudential capital controls. Meanwhile, other developed countries, such as Canada and Japan, grant countries the right to use capital account regulations as a macroeconomic tool, or at least grant exemptions to prevent or mitigate crises.

Earlier this year, over 250 economists signed a petition letter addressed to the US Treasury, Trade Representative and Secretary of State, urging the US government to re-think provisions in US FTAs and bilateral investment treaties that strictly limit the ability of other countries to deploy capital controls, in light of the altered international consensus that capital account regulations are an important policy tool for protecting the economic and financial stability of countries. The economists state that given the severity of the global financial crisis and its aftermath, nations need all the possible tools at their disposal to prevent and mitigate financial crises.