

1999

The Role of Capital Controls in Financial Crises

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The Role of Capital Controls in Financial Crises

Abstract

Lawyers need to understand the factors that contribute to financial crises because they have to be intimately involved in the drafting and implementation of measures designed to prevent, or at least ameliorate, such crises. Poor prudential regulation and poor corporate governance standards were each significant contributing causes to the Asian crisis and their upgrading will require the extensive involvement of lawyers. Likewise, a major debate has been in progress, with virtually no input from lawyers, on the role of capital controls in allowing countries the capital they want, while deterring the capital they do not want. Yet capital controls, when applied, have to be drafted, and ultimately enforced, by lawyers. This article critically assesses such capital controls and the role they can play in contributing to a more stable international financial system.

Keywords

financial crises, capital controls, international finance

THE ROLE OF CAPITAL CONTROLS IN FINANCIAL CRISES

*By Ross P Buckley**

The strengths of the law school at Bond University, and thus its research centres, have traditionally been in Dispute Resolution, Corporate and Commercial Law, and Transnational Business Law. My principal interest has been in the last field.¹ The term Transnational Business Law was chosen to reflect the fact that Bond's focus is on the study of the law that governs transactions that occur across (trans) national boundaries.² This is to be contrasted with International Business Law, which is properly the study of the law that governs business relations between (inter) nations. Bond's focus on the law of transnational commercial transactions has proven popular, particularly with foreign graduate students, and a broad range of such subjects is offered in the graduate program.³

In the past thirty years portfolio capital flows have come to prominence, far eclipsing trade flows in volume and significance.⁴ In particular,

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1 I am also a member of the Dispute Resolution Centre, and teach and write about negotiation.

2 The term was the idea of Professor Mary Hiscock, thinking with her usual precision.

3 For instance, graduate courses are offered regularly in: International Contracts, International Trade Transactions, International Investment Transactions, International Trade Law System, International Banking and Finance Law, International Business Taxation, International Commercial Arbitration, The Regulation of Emerging Capital Markets, South-East Asian Legal Systems, and Comparative Company Law.

4 In 1970 the capital that moved around the globe to support trade in goods and services far exceeded that which moved to support direct and portfolio

transnational capital flows came to prominence in our region as one of the contributing factors to the Asian economic crisis that commenced in 1997.⁵ However, as Frank Partnoy has pointed out:

lawyers and legal academics are largely absent from the debate about financial crises. The commentary is dominated by economists, many of whom unfortunately vastly oversimplify or even misunderstand the role of law in recent crises.⁶

Partnoy's complaint is a good one. We lawyers need to get involved. Lawyers need to understand the factors that contribute to financial crises because they have to be intimately involved in the drafting and implementation of measures designed to prevent, or at least ameliorate, such crises. Poor prudential regulation and poor corporate governance standards were each significant contributing causes to the Asian crisis⁷ and their upgrading will require the extensive involvement of lawyers.⁸ Likewise, a major debate has been in progress, with virtually no input from lawyers, on the role of capital controls in allowing countries the capital they want, while deterring the capital they do not want. Yet capital controls, when applied, have to be drafted, and ultimately enforced, by lawyers.

investment. Today investment capital flows outweigh trade flows by a factor of over 60 to one. Furthermore, the income ratio between the richest 20% of the world's people and the poorest 20%, 30 to 1 in 1960, had widened to 60 to 1 by 1990: Sutherland P, 'Managing the International Economy in an Age of Globalisation', The 1998 Per Jacobsson Lecture, the annual meeting of the IMF and the World Bank, October, 1998, Washington, DC. The focus of Bond's graduate offerings in transnational business law reflect this change, with a good array of investment and finance subjects to accompany the more traditional offerings in international trade law.

5 Buckley R, 'An Oft-Ignored Perspective on the Asian Economic Crisis: The Role of Creditors and Investors', forthcoming *Banking and Finance Law Review I*, Summer 2000.

6 Partnoy F, 'Why Markets Crash and What Law Can Do About It', forthcoming *University of Pittsburgh Law Review* (2000).

7 Farrar JH, 'The New Financial Architecture and Effective Corporate Governance', (1999) *The International Lawyer* 927.

8 Indeed, the crony capitalism identified by the IMF as one of the major causes of the crisis arises from the elevation of the rule of men over the rule of law.

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This article critically assesses such capital controls and the role they can play in contributing to a more stable international financial system.

In broad terms, capital controls can be either restraints on foreign exchange transactions or on capital account transactions and, if the latter, can be placed on capital inflows or capital outflows. These restraints can, in their turn, take the form of taxes or quantitative restrictions.⁹ A detailed analysis of the full gamut of available capital controls is beyond the scope of this work, and has been well done elsewhere.¹⁰ I will focus on capital account controls, and, in particular on the capital inflow controls imposed by Chile from 1991 to 1998 and the capital outflow controls imposed by Malaysia in 1998.¹¹

Chile's Controls

Chile's capital account surplus reached 10 percent of its GDP in 1990 and short-term flows represented one-third of this amount.¹² Fearing a reversal in capital flows as in 1982 Chile introduced its capital controls in 1991, modified them twice during the decade, and suspended them in 1998, as the downturn in international capital flows rendered controls unnecessary.

9 Rajan RS, 'Restraints on Capital Flows: What Are They?', The Institute of Policy Studies Working Paper No 3, Singapore, September, 1998.

10 Ibid; and Reinhart CM & Smith RT, 'Temporary Capital Controls' draft paper of August, 1997.

11 Numerous other countries have, of course, used capital controls. The experiences of Brazil (1993-97), Colombia (1993-98) and the Czech Republic are analysed in Reinhart & Smith, *ibid*; the experience of Chile with its earlier inflow controls imposed from 1978 to 1982 is analysed in Edwards S, 'How Effective Are Capital Controls?', NBER Working Paper No W7413, November 1999, at 25, available at <<http://www.nber.org/papers/w7413>>, accessed on March 20, 2000, at 11; and the experiences with inflow controls of Brazil (1993-97), Chile (1991-98), Malaysia (1994), and Thailand (1995-97) are analysed in Ariyoshi, Habermeier, et al, 'Country Experiences with the Use and Liberalization of Capital Controls', IMF Paper, January 2000, available at <<http://www.imf.org/external/pubs/ft/capcon/index.htm>>, accessed on February 29, 2000.

12 Reinhart & Smith, above n 10 at 7.

Chile's capital controls had five elements:¹³

- All portfolio flows, including foreign loans and bond issues were subject to the requirement that an amount equal to a set proportion of the flow had to be put on interest-free deposit with the Central Bank for one year irrespective of the duration of the capital inflow. The proportion was initially set at 20 percent, in May 1992 it was increased to 30 percent, and then in June, 1996 reduced to 10 percent.
- Credit lines for trade finance were subject to the same reserve requirements.
- Bonds issued abroad by local companies had to have an average minimum maturity of four years.
- Shares issuance abroad by local companies was limited to companies with relatively high credit ratings and in a minimum amount of at least US \$10 million.
- Initial investment capital (but not profits) in foreign direct investment could not be repatriated for one year.

The first four restrictions are inflow controls, the last is an outflow control. Most international attention has focused on the first restriction, the unremunerated reserve requirement. The second restriction, on trade finance credit, is undesirable in that it tends to reduce a nation's international trade, but it is necessary as otherwise the first restriction would be too readily circumvented.

The general consensus is that Chile's controls served to lengthen the average maturity of the capital it received.¹⁴ Views are more divided

13 Rajan, above n 9 at Table 3.

14 Ariyoshi, Habermeier, et al, above n 11 at para 23, Edwards, above n 11; Eichengreen B & Mussa M, *Capital Account Liberalization: Theoretical and Practical Aspects*, IMF Occasional Paper No 172, 1998, at 49-52 (and the sources there cited); Feldstein M, 'A Self-Help Guide for Emerging Markets', *Foreign Affairs*, March-April 1999, 93; Rajan, above n 9; Reinhart & Smith, above n 10 at 8; Stiglitz, 'Bleak Growth Prospects for the Developing World', *International Herald Tribune*, April 10-11, 1999, 6.

over whether they also served to reduce the volume of capital inflows.¹⁵ Certainly there was a strong initial effect: the capital account surplus fell from 10 percent of GDP in 1990 to 2.4 percent in 1991 and short-term debt inflows were virtually eliminated.¹⁶ When capital inflows surged again in 1992, the proportion of the non-remunerated reserve requirement was increased, again to good effect.¹⁷ Foreign direct investment appears to have been relatively unaffected by the controls.¹⁸

However, the controls increased the cost of credit within Chile considerably, particularly for small and medium size businesses that found evasion of the controls most difficult.¹⁹ This is a substantial price for any economy to pay. In addition, there is a wide range of factors to which the good performance of Chile's economy under these controls can be attributed. In summary, Chilean style capital controls may prove a very useful policy option for some countries, but are certainly no universal panacea nor cost free.²⁰

Malaysia's Controls

Malaysia had itself implemented inflow controls in 1994,²¹ but it is best known for its outflow controls implemented on September 1, 1998.²² In summary, these controls included:²³

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- 15 Eichengreen & Mussa, *ibid* (and the sources there cited); Reinhart & Smith, *ibid*; and Rajan, *ibid*.
 - 16 Reinhart & Smith, above n 10 at 8.
 - 17 Edwards, above n 11 at 25.
 - 18 Reinhart & Smith, above n 10 at 8.
 - 19 Edwards, above n 11 at 25.
 - 20 The conclusion of Ariyoshi, Habermeier, et al, (above n 11 at para 23) is that inflow controls were partly effective in reducing the level and increasing the maturity of inflows in Malaysia and Thailand, and in affecting the composition of the inflows in Colombia and possibly in Chile but were largely ineffective in Brazil.
 - 21 These inflow controls included, among other things, a ceiling on non-trade and non-investment external liabilities of banks and a prohibition on sales of short-term bonds to non-residents and non-trade related swaps and forward transactions on the bid side with foreigners: Rajan, above n 9.
 - 22 Spain also implemented outflow controls in 1992 and Thailand in 1997-98. The experience of these countries and Malaysia with the controls is analysed in Ariyoshi, Habermeier, et al, above n 11 at paras 28-37.

- Restriction of trading in Malaysian stocks to the Malaysian Stock Exchange.
- Foreign exchange controls prohibiting unofficial trading and import and export of the ringgit.
- Restrictions on investment abroad by Malaysian residents.
- Punitive taxes if capital was withdrawn from the country in under one year.

The controls resulted in the elimination of the offshore market in ringgit and, in effect, withdrew the ringgit from the international currency trading system as they resulted in all ringgit trading occurring through the Central Bank.²⁴

In February 1999 these controls were replaced by a graduated exit tax on capital outflows such that capital already within the country that was repatriated within seven months of its entry into Malaysia was taxed at 30%, capital repatriated between seven and nine months was taxed at 20%, between nine and twelve months at 10% and thereafter not at all. Profits on capital already in the country were free of taxes upon exit. Capital brought into Malaysia after February 1999 was free of taxes upon repatriation, but all profits therefrom were subject to a 30% tax if withdrawn within twelve months of being made and a 10% tax thereafter.²⁵

One of the common criticisms of capital controls, particularly outflow controls, is that they disrupt everyday commerce. Malaysia's experience suggests the everyday difficulties are not as large as often suggested. Furthermore, the absence of capital flight when Malaysia's controls were

23 Poon SH, 'Malaysia and the Asian Financial Crisis – A View from the Finance Perspective', *African Finance Journal*, Special Issue 1999.

24 Gengatharen R, 'Destabilising Financial Flows: Are Capital Controls the Solution?', [1999] *LAWASIA Journal* 12 at 20-21; and Wade R & Veneroso F, 'The Gathering World Slump and the Battle Over Capital Controls', 231 *New Left Review*, Sept/Oct, 1998, 13 at 21.

25 Gengatharen, id at 21-22.

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relaxed suggests outflow controls can be successfully imposed as, and held out to be, a temporary measure.²⁶

While reserving judgment on the long-term effect of Malaysia's controls, the IMF's assessment is that the controls were effective in curtailing speculative pressures on the ringgit, and were enhanced by the country's relatively good economic fundamentals, and the authorities' efforts to make the controls transparent and to strengthen Malaysia's financial sector.²⁷

It is, indeed, too early for any final assessment of the effectiveness of Malaysia's outflow controls. Certainly they have not been a major force for good or ill²⁸ and the initial vociferous criticism of them has been proven to be utterly misplaced.²⁹ On balance, it appears as if the controls have done very little harm and some real good in providing a period of stability and, in the words of the IMF study, affording 'the Malaysian authorities some breathing space to address the macroeconomic imbalances and implement banking system reforms'.³⁰

26 Krugman P, 'Analytical Afterthoughts on the Asian Crisis', available at <<http://web.mit.edu/krugman/www/minicris>> (accessed on February 29, 2000).

27 Ariyoshi, Habermeier, et al, above n 11 at para 36.

28 Edwards, above n 11 at 8-9.

29 Wade & Veneroso, above n 24 at 23.

30 Ariyoshi, Habermeier, et al, above n 11 at para 37. See also, to the same general effect: Edwards, above n 11 at 23; and Gengatharen, above n 24 at 12-13.

The Uses of Inflow Controls

Developing nations are better served by direct investment than portfolio investment and by long-term debt rather than short-term debt.³¹ Capital inflow controls, used sensibly, can go some small way to achieving those goals.

The potential need for some regulation of inflows can be seen from the experience of the five Asian economies most affected by the 1997 crisis: Indonesia, Malaysia, the Philippines, South Korea and Thailand. They received \$93 billion of private capital inflows in 1996 which changed to \$12 billion in private capital outflows in 1997. The reversal in one year of \$105 billion represented some 11 percent of their combined GDP and was comprised of a \$77 billion turnaround in commercial bank lending, a \$24 billion turnaround in portfolio equity and a \$5 billion reversal in non-bank lending. Foreign direct investment remained constant at about \$7 billion.³²

The clearest lesson from the crises in Mexico, Asia and Russia was the danger of excessive short-term indebtedness and other forms of short-term capital inflows. There is strong evidence that the ratio of short-term debt to foreign currency reserves is a powerful predictor of financial crises, and that higher short-term debt levels are associated with more severe crises.³³ Short-term financing is simply not suitable, in the main, for the needs of developing countries. There is accordingly a

31 Eichengreen & Mussa, above n 14 at 22.

32 Norton JJ, 'Are Latin America and East Asia an Ocean Apart?' *The Connecting Currents of Asian Financial Crises*, 4 *NAFTA Law and Business Review of the Americas* 93. See also 'The perils of global capital', *The Economist*, Aug 22, 1998, US ed, 52. Foreign capital inflows into equity portfolios and commercial bank loans have been put at \$12.1 billion and \$55.5 billion respectively in 1996 and at -\$11.6 and -\$21.3 billion in 1997 – which also gives a reversal of about \$100 billion: Poon, above n 23. See also figures in East Asia Analytical Unit, *Asia's Financial Markets: Capitalising on Reform*, (Canberra: EAAU, Dept of Foreign Affairs and Trade, Commonwealth of Australia, 1999) at 13 & 29.

33 Rodrik D & Velasco A, 'Short-term Capital Flows', NBER Working Paper No W7364, September 1999.

strong argument for capital controls along Chilean lines that fall most heavily on short-term inflows.³⁴

Interestingly, there is quite a strong case that capital controls might best be imposed by developed countries.³⁵ The net effect of international financial flows is to transfer capital from high-saving to low-saving countries. For the past two decades, this has largely meant from poorer countries to the US and, to a much lesser extent, the UK and some other European countries. Capital inflow controls in developed countries would, paradoxically, result in more capital, and capital in the most appropriate currency, where it is needed, in developing countries.

The Uses of Outflow Controls

Capital outflow controls may well be required to provide a fence behind which emerging markets nations can build strong monetary and financial systems and sophisticated and well-resourced prudential regulators. Capital markets impose different disciplines upon the US, on the one hand, and emerging markets nations, on the other. The US government can stimulate its economy through deficit spending without prompting a retreat of international investors for these investors trust the US Federal Reserve to keep a tight rein on the money supply and thus on inflation. However, the same deficit spending approach by an emerging market nation would prompt a hasty withdrawal of capital for fear of inflation and currency depreciation. Given this is how markets work, capital controls may well be necessary to erect a fence behind which an emerging market

34 Eichengreen B, 'Bailing in the Private Sector: Burden Sharing in International Financial Crisis Management', 23 *The Fletcher Forum of World Affairs*, Winter-Spring 1999, 57 at 60.

35 Recent fascinating research suggests that barriers to the free movement of capital into developed countries can increase capital stocks, and GDP, in both developed and developing nations. Like much economics, the proof of this relies on so many assumptions that it is not at all clear whether it can serve as a policy guideline for the real world. However, in a world in which so much capital flows from developing to developed countries, it makes intuitive sense. See Espinosa-Vega MA, Smith BD & Yip CK, *Barriers to International Capital Flows: Who Should Erect Them and How Big Should They Be?*, Federal Reserve Bank of Atlanta Working Paper 99-6, July 1999.

government can reflate its economy after a crisis.³⁶ It is bad policy to toss out 'the single greatest discovery of the Keynesian revolution, namely the importance of fiscal stabilizers'.³⁷ Even the IMF has all but admitted that its initial policy prescription of fiscal contraction served only to deepen the Asian crisis; and the nations of the region have made a tremendous recovery from the crisis once they pursued expansionist fiscal policies. Outflow controls may well be necessary if policies of fiscal expansion are to be pursued.

Inflow and Outflow Controls Compared

The empirical research suggests that inflow controls are more effective than outflow controls.³⁸ Outflow controls are best used as a temporary counter-crisis measure.³⁹ Outflow controls lose their effectiveness more quickly and completely over time than do inflow controls.⁴⁰ The incentive to avoid outflow controls is much stronger than for inflow controls and much easier: under-invoicing or over-invoicing is easy to effect and extremely difficult to police.⁴¹ Nonetheless, the effectiveness of inflow controls also declines over time as markets exploit the potential to channel restricted flows through exempted channels.⁴² For this reason,

36 Block F, 'Controlling Global Finance', *World Policy Journal*, Fall 1996, 24 at 30.

37 Eichengreen B, 'Capital Controls: Capital Idea or Capital Folly?', November 1998 available at <<http://emlab.berkeley.edu/pub/users/eichengr/capcontrols.pdf>> (accessed on March 17, 2000).

38 Mathieson D & Rojas-Suarez L, 'Liberalization of the Capital Account: Experiences and Issues', IMF Occasional Paper No 103, March 1993; and Reinhart & Smith, above n 10.

39 Sutherland, above n 4 at 12.

40 Cuddington J, 'Capital Flight, Estimates, Issues and Explanations', Princeton Essays in International Finance no 58; Edwards, above n 11 at 7, Edwards S, *Real Exchange Rates, Devaluation and Adjustment* (Cambridge: The MIT Press, 1989); and Viscio I, 'The recent experience with capital flows to emerging market economies', 65 *OECD Economic Outlook*, June 1, 1998, 177.

41 Wade & Veneroso, above n 24 at 30. See also Eichengreen & Mussa, above n 14 at 11.

42 Ariyoshi, Habermeier, et al, above n 11 at para 26; and Eichengreen & Mussa, above n 14 at 11.

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enduring inflow controls need to be particularly comprehensive in coverage and rigorously enforced.⁴³

Inflow controls by their nature are up-front and transparent. Foreign investors know of them upon investing.⁴⁴ The risk of outflow controls being unilaterally imposed part way through an investment's life may well be a significant disincentive to investment and this is a potential cost of such controls that Malaysia may be yet to experience. The critical thing with all controls is that they be administered and enforced cleanly and transparently, which may be a challenge for some countries.⁴⁵

Overview of Capital Controls

Four things must be kept in mind, and are often overlooked, in discussions of capital controls.

First, free capital mobility is a relatively recent phenomenon. Capital controls were only abandoned by most developed nations in the early 1980s having previously been in place throughout the Bretton Woods era since World War II.⁴⁶ Indeed, global economic growth has been lower since the general abandonment of capital controls by developed nations than it was during the Bretton Woods era. While there are many potential explanations for this, it makes it difficult to argue that capital controls unduly restrain economic growth.⁴⁷

Secondly, the US developed its productive capacity behind heavy trade barriers in the 19th century. At the time the United Kingdom sung the praises of free trade, as such a policy enhanced its strong position and suited its interests. There were few free marketeers in the then

43 Ariyoshi, Habermeier, et al, above n 11 at para 26.

44 Edwards, above n 11 at 25.

45 Edwards, above n 11 at 26.

46 The US and Canada had traditionally operated fairly liberal capita accounts. The UK removed its controls in 1979, Japan in 1980, Germany in 1981, Australia in 1983 and New Zealand in 1984: Eichengreen & Mussa, above n 14 at 35-36; and Block, above n 36 at 30.

47 Wade R, 'The coming fight over capital controls', 113 *Foreign Affairs*, Dec 22, 1998, 41.

emerging market known as the United States.⁴⁸ Of course this all changed as the 20th century, and US economic strength, progressed. Capital has replaced goods in significance in the movement of resources between nations. The interests of many emerging economies may best be served by barriers to the free movement of capital, just as the interests of the US were perhaps best served in the 19th century by barriers to the free movement of goods.

Thirdly, free trade served Britain's interests last century when it was the largest producer of manufactured goods. The US requires access to foreign savings to finance its high-consuming, low-saving way of life and its high levels of investment.⁴⁹ The hard line Washington consensus in favour of unfettered international capital mobility reflects US strategic interests. Asian nations, in the main, enjoy high savings rates and can finance much of their economic development internally. Indeed, if the citizens of these countries could be forced to keep their savings at home, the nations would have little need for foreign capital.⁵⁰ For instance, Asian investors outside Japan held almost US\$ 165 billion in US Treasury securities at the end of 1997 – this is almost the entire combined GDP of Malaysia and the Philippines.⁵¹ The US, on the other hand, has a low savings rate and needs access to foreign capital to sustain its living standards. Free capital mobility meets this interest of the US

Fourthly, capital controls, in conjunction with some of the other policies recommended here, can give countries a real measure of control over their economy. In the aftermath of the Asian crisis, it was critical that China maintain the value of its currency as the increase in the competitiveness of China's exports in the wake of a devaluation would have devastated other teetering economies in the region. As Peter Fisher, Executive Vice President of the Federal Reserve Bank of New

48 Galbraith JK, *The Culture of Contentment* (Boston: Houghton Mifflin, 1992) at 46.

49 Wade & Veneroso, above n 24 at 41. The US and UK have the lowest savings rates among OECD countries and the US household savings rate is the lowest of any major industrial economy since WWII: id at 17–18.

50 Such a restriction is, of course, extremely difficult, if not impossible, to implement. See consideration of outflow controls in text accompanying n 40 above.

51 East Asia Analytical Unit, above n 32 at 103. The combined GDP of Malaysia and the Philippines in 1997 were some US\$180 billion.

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York, said, 'I sleep sounder knowing the People's Republic of China has capital controls and they are working to improve them. I think that's a plus for the world economy'.⁵² Capital controls, and China's massive foreign exchange reserves, enabled it to hold the line tightly on its currency.⁵³

Viewed from the vantage point provided by these four factors, capital controls appear a sensible policy option for developing countries – just as they were for all countries between 1945 and 1979.

However, Dr Mahathir's imposition of controls over outflows of capital from Malaysia in September 1998 attracted widespread condemnation from the international financial community. This is unsurprising as the conventional presumption in economics is that markets are the most efficient resource allocation mechanisms and should be left alone to do what they do best. What is surprising is the subsequent speed with which conventional opinion shifted on this issue.

In the months leading up to this decision, some economic heavyweights had challenged the conventional wisdom and suggested that restrictions on capital flows were no bad thing. Paul Krugman of MIT had argued in September, 1998, that outflow controls may well be necessary to retain capital in an economy while its government implemented the policies of fiscal expansion that he, and many others, saw as necessary in Asia.⁵⁴ Without such controls, upon the implementation of such policies capital would typically flee an emerging market. Dani Rodrik, of Harvard, took an even bigger bite arguing there was little evidence linking capital market liberalisation to higher economic growth and positive proof of the risks of such liberalisation. The Washington consensus on free market economics had been promoted and pursued with a remarkable consistency ever since it was seriously challenged in the wake of the

52 IMF Economic Forum, 'Financial Markets: Coping with Turbulence', Washington DC, December 1, 1998; available at <<http://www.imf.org/external/np/tr/1998/TR981201.HTM>>; accessed on October 5, 1999.

53 One suspects, without evidence, that the US Treasury may have called upon the PRC government to cooperate in this regard, and that China's accession to the WTO, in spite of its human rights record, may in part represent the calling in of that favour.

54 Krugman P, 'Saving Asia: it's time to get Radical', *Fortune*, September 7, 1998, 75.

debt crisis in the 1980s. Fascinatingly, however, for the first time in over fifteen years the consensus began to disintegrate quite quickly on the issue of the desirability of the unfettered movement of capital. By December 1, 1998, at a seminar organised by the IMF, the three of the four participants who spoke of capital controls were supportive of Chilean-style inflow controls (which we will consider shortly).⁵⁵ The participants were speaking in their personal capacities but were senior employees of the IMF, the Federal Reserve Bank of New York and Salomon Smith Barney, the large investment bank: and so reflect a quite remarkable turnaround in sentiment. Furthermore, 'Country Experiences with the Use and Liberalization of Capital Controls',⁵⁶ an IMF study published in January 2000, found that outflow controls in Malaysia had done virtually no harm and some good.

Financial Liberalisation

The clearest lesson from the Asian economic crisis, the one upon which there is almost unanimous agreement, is the need for the proper regulation of a financial system to precede its liberalisation.⁵⁷ Recent empirical research suggests that open capital accounts and being the recipient of large capital flows make a country more likely to enter a recession and that capital controls reduce this likelihood.⁵⁸

In opening the capital account, a nation is changing the rules of its financial game quite significantly. By permitting banks to borrow heavily in foreign currency, a nation limits the role of its central bank as lender

55 IMF Economic Forum, above n 52.

56 Ariyoshi, Habermeier, et al, op cit n 11.

57 Ariyoshi, Habermeier, above n 11 at para 57; Buckley, 'Six Lessons for Banking Regulators from the Asian Economic Crisis', Weerasooria (ed), *Perspectives on Banking, Finance & Credit Law* (Sydney: Prospect Media, 1999) 51; East Asia Analytical Unit, above n 32 at 48; Edwards, above n 11 at 25-26; Edwards S, 'On Crisis Prevention: Lessons from Mexico and East Asia', NBER Working Paper No 7233, July 1999 at 23; Eichengreen & Mussa, above n 14 at 45; Meyer LH, 'Lessons from the Asian Crisis: A Central Banker's Perspective', Levy Economics Institute Working Paper No. 276, August 1999; Sutherland, above n 4 at 11; and Viscio, above n 40.

58 Easterly W, Islam R & Stiglitz J, 'Shaken and Stirred: Volatility and Macroeconomic Paradigms for Rich and Poor Countries'. XII World Congress of the IEA, Buenos Aires, August, 1999.

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of last resort. A central bank can only print local currency to discharge lender of last resort functions.⁵⁹ A nation is limited to its foreign currency reserves to perform a similar role, however they are limited and rarely up to the task in the contemporary world.

Completely open capital accounts are best seen as a long-term goal for developing countries. After all, there was considerable economic development between 1945 and 1979 when capital controls were in place in virtually all nations. Ultimately the strongest financial systems will be those tested by international competition. However, as experience in Mexico and Asia has demonstrated, it is vital that the systems, when tested, are not found wanting. Accordingly, it is sensible for emerging markets to hasten slowly in opening their capital accounts⁶⁰ and to first ensure high standards of regulation domestically. The transition from the crony capitalism, poor transparency, and ineffective regulation for which the Asian nations were roundly criticised by the IMF in late 1997, to modern autonomous, transparent and well-regulated financial systems, will likely be a long journey.

Conclusion

For as long as a developing nation has a thin financial market, unsophisticated private sector risk management techniques and an unsophisticated and under-resourced capital market regulator, there are good arguments for controls on capital in-flows.⁶¹ This is particularly so in Asia, where high local savings rates diminish significantly the need for completely open capital markets. As an economy's own capital markets deepen, and its regulatory systems mature, then it can safely move towards liberalising its capital account.

59 Meyer, above n 57.

60 'Keeping the hot money out', *The Economist*, January, 1998.

61 Bustelo P, Garcia C & Olivie I, 'Global and Domestic Factors of Financial Crises in Emerging Economies: Lessons from the East Asian Episodes (1997-1999)', ICEI Working Paper No 16, Instituto Complutense De Estudios Internacionales, Madrid, November, 1999, 78. This was also a recommendation of the Council on Foreign Relations in the US, see 'The Future of the International Financial Architecture; A Council on Foreign Relations Task Force', *Foreign Affairs*, Nov/Dec 1999, 169.

In the interim, of course, capital controls do have costs. Controls restrict access to foreign capital for investment, increase real interest rates, require expensive public administration and may reduce the pressure for domestic policy reform.⁶² In particular, capital controls require considerable administration, and just as with trade barriers, capital controls can reduce the pressure for, and thus delay, needed policy adjustments.⁶³ Policy reform and the development of efficient regulatory institutions must be continued apace by developing nations even when controls are in place.

Nations need to realise though that controls will only buy them a limited window of opportunity. Controls lose their effectiveness over time. Accordingly it is critical that the nations use this time wisely: to reflate their economy if that is their goal, or to implement structural and regulatory reforms of their economies and financial sectors.⁶⁴ Unless it opts for a permanently closed capital account, a nation cannot shelter behind capital controls indefinitely – contemporary capital is too fluid.

62 'The perils of global capital', *The Economist*, Aug 22, 1998, US ed, 52. And, of course, capital flows are not the only mechanism for the transmission of contagion. Even a completely closed capital account will not insulate an economy from trade-related contagion as Taiwan experienced in the wake of the Asian crisis. See 'Emerging-market measles', *The Economist*, Aug 22, 1998, US ed, 56; and Wade & Veneroso, above n 24 at 40.

63 Ariyoshi, Habermeier et al, above n 11 at para 26.

64 Sutherland, above n 4 at 12; Rubin R, 'Treasury Secretary Robert E Rubin Remarks on Reform of the International Financial Architecture to the School of Advanced International Studies, Johns Hopkins University', April 21, 1999.