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The case against capital controls: financial flows, crises, and the flip side of the free-trade argument

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The Case against Capital Controls
Financial Flows, Crises, and the Flip Side of the Free-Trade Argument

by Christopher A. Hartwell

Executive Summary

Critics of globalization view the free flow of capital as economically destabilizing and advocate capital controls for four main reasons: controls are intended to guard against volatility, prevent financial contagion, enable infant financial industries to develop in domestic markets, and be an effective measure of last resort that gives governments room in which to breathe while they pursue needed reforms.

However, the empirical record does not support the beliefs of proponents of capital controls. Protecting domestic financial markets and impeding capital flows have often exacerbated financial crises and caused contagion. Controls are invariably used for protectionist purposes rather than development and to delay reform. Most important, free capital flows, like free trade, dramatically improve a country's prospects for development.

Malaysia, the only country to resort to extensive capital controls in the midst of the Asian financial crisis in 1998, did not benefit from those drastic measures. Malaysia's restrictions were instituted more than a year after the outbreak of the Asian crisis and after the ringgit had fallen by 34 percent and the bulk of capital flight had taken place. Repealed in May 2001, the controls were used more as a shield for a corrupt government and a means of denying economic liberty than as a remedy for Malaysia's woes. Unlike other countries in crisis in the region, moreover, Malaysia has had difficulty attracting foreign direct investment.

Developing countries would be better served by addressing the real causes of financial turmoil. Specifically, countries should fix their unsound banking systems by opening their financial sectors to foreign competition, eliminate government guarantees against bank failures, create independent central banks, and move away from pegged exchange rates and toward floating or fully fixed exchange-rate regimes.

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Reliance on capital controls continues to distract attention from the causes of the problem they are supposed to address.

Introduction

The World Trade Organization ministerial meeting in Seattle in December 1999 and the protests against the International Monetary Fund and the World Bank in April and September 2000 have focused the world's attention on globalization: the increasing movement of goods and services across national boundaries and the continued integration of the world's financial markets. The riots and protests that accompanied the meetings were intended to create in developed nations a backlash against free markets. Pressure groups, such as environmentalists and labor unions, with an interest in slowing trade liberalization stepped up their attacks. The anti-globalization movement, which claims that free trade continues to impoverish developing countries, has recently been taken more seriously by the press and international organizations, as evidenced by the dialogue attempted by policymakers at the World Economic Forum in January 2001 and the "shadow" meetings in Porto Alegre, Brazil.

Coupled with the attacks on free trade are more insidious calls to reverse or stanch the free flow of capital. While the movement of goods is highly visible and provides its own constituency in favor of increasing openness, the everyday movement of capital is less evident to the public at large, becoming visible only in the event of a crash, as was the case with the Asian crisis of 1997–98. Blamed for excessive volatility, capital movements have been scapegoated by pundits and policymakers alike as the external cause of recession.[1] "Hot money" and external finance, instead of being an outstretched hand to pull nations out of poverty, suddenly became the hand that held down the developing world. Indeed, Malaysia's prime minister Mahathir bin Mohamad blamed multimillionaire businessman George Soros and an unnamed conspiracy of financiers for bringing down the ringgit in 1997 and instituted controls on capital flows into and out of his nation. Those controls were repealed in May 2001.

Although every crisis seems to spark calls for some closing of the world trading and financial system, the Asian crisis of 1997–98 afforded a chance to compare the effects different policies on capital flows across the region. Only Malaysia instituted capital controls in an attempt to reduce investment in that country. And Malaysia's seeming success in closing its capital markets, coupled with their reopening in May 2001, has sparked a revival of interest in the use of capital controls and made them credible to some international economic policymakers.[2]

The fundamental deficiencies of capital controls have not been overcome, and reliance on those measures continues to distract attention from the causes of the problems they are supposed to redress. Capital controls perpetuate inefficiencies, create vested interests in their continuance, and doom economies to second-tier status. For emerging markets, restrictions on the flow of money are especially inauspicious, for, as Alan Reynolds of the Hudson Institute has commented, it is difficult to have "capitalism without capital."[3] At heart, though, the case against capital controls goes beyond efficiency and relates directly to economic choice and individual freedom. Does a government have the right to deny citizens the ability to move their funds around as they wish? Because they deny efficiency and equity, capital controls remain a policy instrument doomed to failure.

Capital and Its Discontents

The world has enjoyed an unprecedented economic boom over the past decade: the United States, despite a recent slowdown, has enjoyed nearly 10 years of undiluted economic expansion. Trade among countries has burgeoned since the end of the Cold War: the value of trade in goods and services grew annually by 7 percent from 1990 to 1998. Regional growth has been even higher: Latin America saw the value of its trade increase by

Table 1
Net Capital Flows to All Emerging Markets (billions of dollars)

Type of Inflow	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
All emerging markets										
Total net private capital	112.6	172.1	136.3	226.9	215.9	147.6	75.1	80.5	154.1	166
Net FDI	35.4	59.4	84	92.6	113.2	138.6	143.3	149.8	128.2	130.5
Net portfolio investment	56.1	84.4	109.6	36.9	77.8	52.9	8.5	23.3	22.3	22.7
Bank loans and other	21	28.3	–57.3	97.4	24.9	–44.0	–76.7	–92.5	3.6	12.8
Africa										
Total net private capital	–4.0	–1.8	2.9	10.9	7.5	16.7	11.5	14.8	7.3	10.4
Net FDI	0.6	1.9	2.3	2.2	4.8	7.4	5.2	9.5	5.1	5.6
Net portfolio investment	1.8	1	2	1.4	1.3	3.7	4.3	4.4	1	2
Bank loans and other	–6.4	4.7	–1.4	7.3	1.4	5.6	2	0.9	1.2	2.8
Asia										
Total net private capital	20.8	57.4	63.6	104.9	104.1	–1.4	–42.6	–27.0	49.4	52
Net FDI	15.7	33.9	47.1	46.6	53.1	55.5	58.3	49.9	49.9	50
Net portfolio investment	9	21.8	11.8	14.2	12.9	3.5	–17.9	–5.6	14.9	11.6
Bank loans and other	–3.9	1.7	4.7	44.1	38.1	–60.4	–82.9	–71.3	-15.3	-9.5
Five Asian economies[a]										
Total net private capital	29	31.8	36.1	74.2	65.8	–20.4	–25.6	–24.6	-3.8	1.9
Net FDI	7.3	7.6	8.8	7.5	8.4	10.3	8.6	10.2	n/a	n/a
Net portfolio investment	6.4	17.2	9.9	17.4	20.3	12.9	–6.0	6.3	n/a	n/a
Bank loans and other	15.3	7	17.4	49.2	37.1	–43.6	–28.2	–41.1	n/a	n/a
Latin America										
Total net private capital	55.6	66.8	49.4	53.1	72.1	85.5	70	54.1	67.5	64.9
Net FDI	13.9	13.4	23.1	24.7	39.5	53.1	56.1	63.6	55.4	51.2
Net portfolio investment	30.3	44	66.7	3	41	19.2	14.7	10.6	6.3	7.8
Bank loans and other	11.4	9.4	–40.4	25.5	–8.4	13.2	–0.8	–20.1	5.8	5.9

Source: International Monetary Fund, *International Capital Markets* (Washington: IMF Press, 2000), p. 46.

Note: FDI = foreign direct investment; n/a = not available.

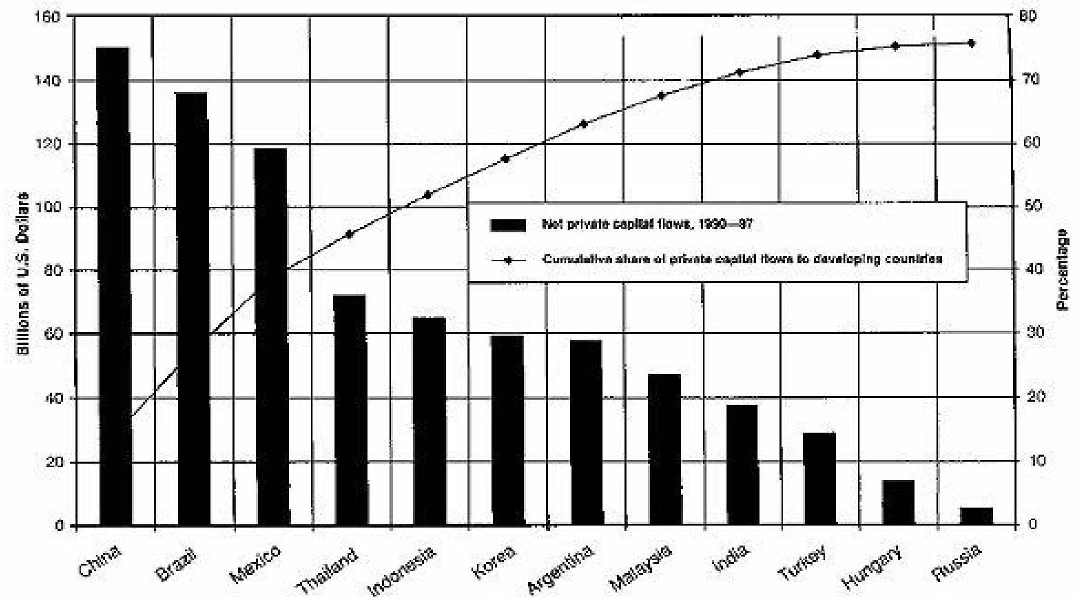
[a]South Korea, Indonesia, Malaysia, Thailand, and the Philippines.

14 percent and Central and Eastern Europe saw theirs grow by 12 percent annually over the period 1990–98.[4]

The keys to that boom are manifold and can be traced to the wave of deregulation and privatization begun in the 1980s, coupled with advances in technology. The collapse of the Soviet Union and the rush to democracy have also played a large part in the trade explosion. But the sustaining power for the boom, the underlying factor, is the increased movement of capital and the ability of financiers to cross national boundaries and take advantage of investment opportunities across the globe.[5]

Notwithstanding oscillations, the explosion of international finance and the movement of capital (Table 1) mirror the boom in trade over the past decade, and with good reason: capital investment across borders is

Figure 1
Concentration of Net Private Capital Flows, Selected Developing Countries, 1990–97



Source: Alejandro Lopez-Mejia, "Large Capital Flows: A Survey of Causes, Consequences, and Policy Responses," IMF Working Paper WP/99/17. Used with permission of Lopez-Mejia.

The free flow of capital benefits from (and follows) sound macroeconomic policy and functioning institutions.

really just a form of intertemporal trading, placing money in investments that will pay off tomorrow rather than today. Cross-border intertemporal trading, which benefits from policy and institutional differences between nations, takes advantage of the static comparative advantages of current market conditions and helps to fund the advantages of tomorrow.

The free flow of capital, as much as or more than the free flow of goods and services, benefits from (and follows) sound macroeconomic policy and functioning institutions. Developing nations enjoyed a tremendous surge in capital inflows during the 1990s, with total flows in 1997 alone equaling $295.1 billion (of which $53 billion was portfolio investment).[6] Most of the capital has been concentrated in about a dozen countries, mainly those that the markets thought had continued growth prospects (Figure 1).

However, economic fundamentals in much of the emerging world were still far from sound in the second half of the 1990s. Adherence to pegged exchange rates and unsound banking systems, coupled with rampant government corruption and a belief in government's ability to allocate resources better than the market, led directly to the Asian crisis of 1997–98 and the subsequent crises in Russia and Brazil. Institutions that were created during the Cold War and tailored to another time proved wholly unsuitable to the brisk pace of international finance, and countries with centrally mismanaged economies were left behind by the market.[7]

The lack of confidence in emerging markets manifested itself as capital flight; investors withdrew their money from East Asia (initially) and then from other shaky

economies, leading to a swing in 1997 of $105 billion in the East Asian economies alone; $77 billion of that money came from commercial bank lending and $24 billion from portfolio lending.[8]

In response to that turnaround, Malaysia took a step against financial freedom and imposed capital controls in September 1998. Malaysia's experience is instructive for the future of emerging markets because it represents an attempt by a state to wrest control from the amorphous power of "globalization"—a throwback to the days of the Cold War, when East Asia's state-directed capitalism was touted as the new paradigm of economic development.

Types of Controls

Capital controls have long been a part of the political landscape. In the rollback of the liberal international economic order that occurred after World War I, Nazi Germany was one of the first countries to use capital controls as a deliberate instrument of economic policy; a comprehensive set of exchange and capital restrictions was put in place in 1934 by Hitler's economics minister, Hjalmar Schacht, to "restrict the movement of currencies or specie across national borders."[9] The Soviet Union was also notorious for its state control of trade and finances, and an arcane array of capital controls was used to stem foreign investment (or to channel it into sectors and industries in accord with the Central Committee's plans).

Fascism and communism were not the only worldviews that regarded capital controls as a viable policy. John Maynard Keynes argued, "Flexible exchange rates and free international capital mobility are incompatible with global full employment and rapid economic growth in an era of multilateral free trade."[10] Indeed, controls were a normal part of government intervention; duties imposed by them were used to "maintain a tax base to finance wartime expenditures";[11] the founding charter of the IMF explicitly recognizes the right of countries to impose capital controls.

There is often confusion about what exactly constitutes a capital control; indeed, different countries use different policy instruments as checks on the flow of capital. For the purposes of this paper, "capital controls" refers to government attempts to limit either the composition or the size of foreign investment by controlling either price (through taxes) or quantity (through quotas) and to restrictions on citizens' or foreign investors' taking money out of a country.

While very few nations have in place the draconian controls that were in place before the fall of communism (such as an inconvertible national currency or laws against carrying foreign exchange), many developing nations still have some checks on the unfettered movement of capital. According to the IMF, by the end of 1996, 144 of a total of 186 countries had controls on direct investment, 128 countries controlled transactions in capital market securities, and 112 countries regulated trade in money market instruments.[12] Chile, often touted as the shining example of how capital controls can work (and the model for Malaysia's controls), had two different experiences with impeding capital flows in 1978–82 and 1990–98. The first set of controls was an extensive and bewildering array of restrictions that heavily penalized short-term investments. That experiment ended in the collapse of the peso in 1982; a domestic banking crisis and the concurrent failures of other Latin American currencies also contributed to the collapse.

The second set of Chilean controls, instituted in 1990, was milder, yet it still attempted to skew the composition of capital flowing into the country from short term to long term. Chile's controls used a nonremunerated reserve requirement that forced investors to deposit a proportion of their funds (between 10 and 30 percent) with the central bank—"a tax that was virtually confiscatory when applied to very short-term funds."[13] The reserve requirement was independent of the maturity of the investment. Moreover, for foreign direct investment (FDI), the central bank had a "minimum stay" requirement of one year.[14]

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Chile's second experience with capital controls used the policy instrument most often advocated by opponents of the free flow of capital, a tax on capital that will change the composition of investments flowing into a country. The prototype of that control was the "Tobin tax," named after Yale University economist and Nobel laureate James Tobin, who first suggested throwing "grains of sand" into the cogs of the financial machinery to discourage speculation and encourage long-term investment.[15] That tax, much like Chile's, would take a small percentage of the value of all foreign exchange transactions, thus reducing (or eliminating) the profit margin on very small and short-term investments. In the wake of the Asian debacle, many pundits have called for the global institution of the Tobin tax.[16] Still others claim that a Tobin tax is not large enough to deal with the growth of capital movements: boulders are needed in the cogs, not grains of sand.[17]

Although the current round of debates on capital controls has focused more on inflows than on outflows,[18] the real fear in emerging markets is that money invested in a country will suddenly be withdrawn in a frenzy of capital flight, leading to a collapse of the banking and financial systems. Malaysia's capital controls, based on Chile's, were designed to limit mobility and prevent short-term investments, but in reality they were much more oppressive. They banned transfers between domestic and foreign accounts and between foreign accounts; eliminated use of credit facilities by offshore parties; prevented repatriation of investment until September 1, 1999; and fixed the exchange rate of the ringgit at 3.8 per dollar.[19]

Why Controls?

Proponents of capital controls rely on four arguments:

1. Controls are a bulwark against volatility. Prime Minister Mahathir of Malaysia articulated that view in a particularly blunt form when he said: "I feel that we need stability for the world's economies. There is no harm in having some kind of mechanism for fixing the exchange rates, so that there is not too violent a swing in the exchange rates. It's not going to harm anybody. The only people who may not benefit from it may be a few people who deal with the currency. The rest of the world will benefit. So why are we protecting these people? Why are they so important that they are not transparent, that they are not regulated?"[20] This argument assumes that controls can prevent the dramatic reversals in capital flows that accompanied the Asian crisis of 1997–98.
2. Controls prevent contagion. (This is a sister of the volatility argument.) Capital controls can insulate an economy against financial panic in neighboring or regional economies.[21]
3. Controls protect infant financial markets. The institutional arrangements of developing nations are frequently fragile and not proficient in dealing in the hectic world of international finance. Offering shelter from speculators will allow those institutions time to mature and gain financial savvy.[22]
4. Controls are effective as a temporary last resort; they can buy governments the time needed to get their macroeconomic houses in order. A major component of this argument cites the need to keep a stable exchange rate, in the belief that runs on the currency will keep out investment in the long run and irreparably damage a country's prospects for long-term economic growth (through skyrocketing interest rates or hyperinflation).[23]

The theoretical underpinning of most of those arguments, however, flows from the old mercantilist principle that trade in goods or capital is a zero-sum game and that investment kept inside a country is a "winner," whereas investment that leaves a country causes a loss. That belief is as erroneous when applied to capital as it is when applied to goods and services.

The Problems with Controls

Volatility is often cited as the greatest threat to a fragile stock market or emerging economy, and short-term capital flows that can easily be pulled from an economy are the bogeyman of emerging markets. "Hot money" has become the derogatory term for short-term capital movements, and people who deal in those investments are derided as "speculators." Unlike FDI, which is looked upon favorably because of the tangible assets (such as factory or job creation) it provides, short-term investments are often deemed unproductive and even harmful because they are highly liquid and can be shifted rapidly.

However, various forms of investment—whether short term, long term, or in FDI form—tend to have the same generally positive effects on growth. A landmark study in 1998 examined 18 emerging markets and their experiences from the 1970s to 1994, comparing the effects of FDI and portfolio equity flows on the countries' growth.[24] While FDI had "the most pronounced positive impact" on growth, "perhaps more surprising . . . the changes in the share of portfolio equity capital inflows to GDP also have a significant positive relation to subsequent GDP growth."[25] The positive impact of all forms of investment has been constant over the past 30 years, even as direct bank lending to governments (but not bank lending to private firms in emerging markets) has declined in importance and portfolio investment and FDI have skyrocketed.

With capital bringing benefits to emerging markets, what happens when that capital is suddenly redistributed or withdrawn? Empirical research on the impact of capital flight is starting to burgeon, and recent scholarship refutes claims that investment swings are deleterious for an economy. A recent paper examined the behavior of foreign investors in Korea during the Asian crisis. The authors relied on daily data from November 1996 through the last day of trading in 1997. Korea's stock market was thoroughly pummeled by the events in the region; a dollar invested in the market on October 1, 1997, would have been worth only 35 cents at the end of the last trading day a little less than three months later.[26] But was foreign capital the destabilizing force? Did international capital and "herding" contribute to excessive volatility?

Apparently not, according to that study of the Korean stock market. It found that "the impact of domestic buying on stock returns dominates the impact of foreign selling. During the last three months of 1997, days with large foreign net selling do not have significant market-adjusted returns . . . there is therefore no convincing evidence that foreign investors play a destabilizing role."[27] The researchers even controlled for the presence of price floors in the Korean stock market (Korea's stock exchange has rules similar to those of the American Stock Exchange, trigger mechanisms that will not allow a stock's price to fall more than 8 percent in one day). It was hypothesized that any stock that fell the maximum amount in one day would continue to fall the next day, adding to a herd effect. But the nondestabilizing effect of foreign investments held even after controlling for price floors, and volatility was not exacerbated by external capital.[28]

With excessive volatility discounted as a direct result of liberalization, it is important to note the stabilizing effects that capital flows have on an economy. For an emerging nation, liberalization is its own reward. International asset-pricing models used by financiers hold that liberalizing financial markets and capital flows will reduce the liberalizing country's cost of equity capital by allowing for risk sharing by domestic and foreign agents. Domestic volatility, a factor in developing markets because of their inexperience in finance and shaky political situations, can be hedged against in foreign markets, to some extent insulating the markets from systemic risk. Recent empirical work in this area, done by Peter Henry of the Stanford Business School, confirms that stock market liberalizations raise equity index numbers in the run-up to liberalization. Furthermore, the free

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movement of capital should lead to "an increase in physical investment following . . . liberalization, because a fall in the country's cost of equity capital will transform some investment projects that had a negative net present value before liberalization into positive NPV [net present value] endeavors after liberalization."[29] In a study released in 1998, the WTO touted the stabilization benefits of liberalization, noting not only that financial gains had been reaped by liberalizing countries but also that financial stability had been greatest in countries that opened services to wide competition.[30]

Ironically, capital controls themselves are a main precipitant of increased volatility, as they favor risk-seeking investors at the expense of risk-averse ones (the exact outcome that the controls mean to reverse). Capital controls are essentially a government guarantee that investors who have taken on excessive international risk in the past (and may be affected by a global financial downturn) will have some of their risk mitigated by government fiat. Thus, controls engender what is known as moral hazard—instead of encouraging more prudent lending practices and avoiding the volatility that international flows supposedly engender, controls lend a shield that lets risk-seeking investors take on greater internal risk.

The Contagion Argument

One of the most highly touted arguments in favor of capital controls is that they supposedly impart a positive externality: by catching a financial crisis at its inception in one country, they can reduce the spread of the crisis to neighboring countries. As the IMF stated in its quarterly journal *Finance and Development,* "As the financial crises that struck . . . during the second half of 1997 . . . have amply demonstrated, financial globalization also carries very large risks, because instability in one country can now spread almost instantly to others."[31] Indeed, the wave of crises that struck in 1997–98 seemed to be the result of the feeling that emerging markets were suddenly a bad investment and it was time to switch to safer investments. Capital controls are thus supposedly a way to dampen the enthusiasm of investors and let them return to their senses.

Far from acting like sheep, however, investors often behave in a very rational manner when a currency crisis hits. The trigger mechanism for contagion is information, not too much of it but a dearth of it. Markets thrive on information, reflected in the price of resources and equity, and when those price signals are wrong because of incomplete information in emerging markets, the result is suboptional investments. However, as new information becomes available, investors adjust accordingly.[32] Without information to the contrary from other markets, new information obtained in one country is often assumed to be applicable to other countries that share the same apparent market characteristics, causing a so-called contagion effect.

Economists at the Federal Reserve Bank in New York have modeled that phenomenon. Asserting that inflows at the country level are highly volatile, they argue that "incomplete information and the subsequent process of learning . . . can generate high volatility" above and beyond any normal emerging-market jitters.[33] As information becomes readily available, however, volatility becomes "less acute over time."[34] Investors think that "events in one emerging country provide information about other countries. Thus, a very low return in one country will lead to a decline in the subjective probability [that controls will not be imposed] but it will also lead to declines in other countries."[35] The extent of this contagion will probably depend on regional factors: "For example, a regional shock in Thailand may provide more information (in the eyes of investors) about other Southeast Asian countries than a shock in Mexico."[36]

In addition, laissez faire policies can provide benefits and let adjustment mechanisms filter out contagion naturally. Singapore, blamed for some of Malaysia's troubles, seemed to be a prime target for contagion, given its small size and historical ties to Malaysia. Yet the country was only peripher-

ally hit by the Asia debacle and, as of February 2001, was posting growth rates of 9.9 percent over the previous year.[37] Singapore recovered quickly from the Asian crisis, more quickly even than Hong Kong (which uncharacteristically intervened in its stock market in 1997), traditionally a stalwart of laissez faire capitalism whose growth has been slowed by integration with China.[38] Not coincidentally, one of the reasons for Singapore's buoyancy is that the city-state was one of the most global-oriented economies in East Asia: A. T. Kearney Consulting places Singapore at the top of its "globalization index" as the most integrated economy in the world in 1998.[39] Familiar with dealing in the world's financial markets and open to the world market, Singapore was able to function as a pass-through for the contagion that swept the area and suffered very little itself.

Old-School Trade Policy

Another argument often trotted out in favor of capital controls mirrors the "infant industry" arguments that were promulgated in the 1950s and 1960s to justify protectionism on the grounds that international competition would savage fledgling domestic companies. Capital controls now supposedly have the same beneficial effect, helping financial markets in emerging economies to survive the onslaught of competition and develop into mature intermediaries. Capital controls are thus a way to erect indirect trade barriers without resorting to blanket tariffs or quotas (and thus drawing the ire of the WTO). No matter how controls are justified, however, they remain an insidious form of industrial policy that can be used to keep out foreign competition while subsidizing and protecting domestic financial services.

Industrial policy was all the rage in the 1980s in the wave of the "Asian miracle," as pundits and policymakers alike applauded the ability of the Japanese and Korean governments to "pick winners" and subsidize them appropriately.[40] Debates about "Asian values" and the importance of a tight-knit relationship between business and government filled the policy stream, and elaborate models were trotted out to justify government action as a way to overcome "coordination failures" that precluded the markets from allocating resources efficiently.[41] But, as the experience of East Asia in the 1990s shows, industrial policy cannot "pick winners" any better than an individual can pick lottery numbers. Japan's malaise over the past decade shows that "Japan needs to abandon the very elements of the old 'Japan, Inc.' system [i.e. industrial policy] that [were] singled out as its greatest strengths."[42] Favoring one industry to the detriment of another inherently distorts the economy, and no tenable argument can be made that a nation accepts that distortion in exchange for production of steel (or wool, or whatever).

Even though trade protectionism has been discredited in theory and practice, capital controls have become another way for governments to meddle in their economies to favor domestic-oriented industries over export-oriented ones. Controls favor banks that lend primarily in the domestic sector (which is more dangerous than lending internationally because of larger domestic risk, greater susceptibility to domestic policy changes, and lack of access to liquidity) over those that diversify their risks internationally and favor domestic investors (whose primary source of capital is those same fragile domestic banks that are liquidity deficient). Finally, capital controls are a major impediment to trade in goods and services, reducing exports to developing countries as well as starving exporters of needed capital.[43]

By imposing capital controls, governments are doing much more than perpetuating economic inefficiencies in their countries; they are also distorting information and preventing learning. As happened under the protectionist trade regimes of the middle of the 20th century, the protected financial markets become addicted to the protection, and their ability to function in the international marketplace in the future is impaired. It is only through functioning on their own

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and making mistakes that domestic financial markets gain institutional knowledge; sheltered from any failures, banks and stock markets will not learn to behave competitively and effectively, which makes any crash more severe. As an Organization for Economic Cooperation and Development report noted, "There is plenty of evidence to show that as markets and institutions mature, the efficiency and regulatory gains arising from the liberalization of capital movements outweigh the risks."[44]

Indeed, the repeated mistakes of financial intermediaries lead to more efficient markets. As a former World Bank economist noted, "Looking at the response of Latin America to the crises in the early 1980s and again to the Tequila crisis of 1994–95, we are of the view that countries normally draw positive lessons from crisis management."[45] Under the guise of protection, capital controls impose a learning moratorium on domestic financial intermediaries.

A Little Breathing Room

Economic systems are based on institutions, and fashioning an effective institutional structure to take advantage of the depth and breadth of international capital markets is a prerequisite to capital account liberalization. As the theory of the "second best" would predict, removing one distortion to an economy (e.g., exchange controls and capital restrictions) may actually decrease welfare if the economy is riddled with other distortions.[46] Thus, reform of financial institutions so they can handle capital flows is an important part of the process of global integration.

By imposing capital controls, governments are distorting information and preventing learning.

What happens after liberalization is effected, however, and the country in question runs into a crisis? Are controls then available to help the country weather the storm? Proponents of controls claim that they are a temporary solution, a Band-Aid that buys governments time to put their houses in order. Indeed, that has been the leading claim by Paul Krugman, the economist who single-handedly resurrected the credibility of controls.[47] Given that tackling the fundamentals is a long-term problem, capital controls would seem to be a short-term answer to an immediate fiscal crisis.

Chile and Malaysia are again presented as the new, defining cases for temporary capital controls. But listening to Mahathir makes one question the "temporary" nature of those controls:

> We keep [capital controls] there until the world's financial system is adjusted. We have said that from the very beginning. We will keep the controls on until the world makes sure that they regulate currency trading and this very rapid flow of capital, which is damaging to a lot of countries.[48]

As the investment firm CLSA Global Emerging Markets aptly noted, "The reason [the] solution of exchange controls . . . is so dangerous is that [Paul Krugman] has no conception of the capacity of some of the leaders in Asia for self-delusion."[49] Mahathir's belief that confining his economy to the second tier will bring around the world smacks terribly of cutting off his people's nose to spite his own face. Moreover, Mahathir's defiant siege mentality confirms the real reason for imposing controls: far from granting a bit of space that countries can use to carve out independent policies while they reform, controls are invariably used as a substitute for reform.

Capital markets impose rigid checks on bad policies, and controls often attempt to shield governments from those checks. In some cases, where there is little or no integration with the world, controls do, indeed, shield governments—at the cost of growth and trade. But can controls work for countries that are even moderately involved in the world's financial system?

Efficacy

Given the shortcomings of capital controls, perhaps the strongest argument against them is their basic inefficacy. Although some commentators claim that capital controls do not

produce any long-term hazards for an economy,[50] controls must be judged on their explicit goals. Among the most important is stemming perceived volatility. Here, as elsewhere, controls are less than effective. Even when controls are truly a temporary policy, once they are lifted, they create even more volatility. Capital markets tend to be conservative, and a country that has imposed controls in the past will be automatically expected to impose them again. The use of controls can thus skew the composition of capital toward the very short term, or crowd out badly needed capital altogether for a long time. As several financiers noted shortly after Malaysia's imposition of controls, those policies would turn Malaysia into "an equity black hole" and make "Malaysia virtually uninvestable."[51] Even Chile, the poster child for "temporary" capital controls, had problems. Its reserve requirement created uncertainty in capital markets, and, according to Chilean economist Salvador Valdes, "The threat that the tax might be reimposed is keeping banks and brokers from investing in stockbrokerages in Chile, because their business could be wiped out."[52]

Moreover, changing the timing of controls (i.e., instituting them in response to macroeconomic shifts rather than using them as an emergency maneuver) doesn't help to mitigate their deleterious effects on stability. "Preventive" controls, instituted before a country devalues its currency but during a balance-of-payments deficit, actually accelerate capital flight. A study done in 1993 found that 70 percent of the countries that used preventive controls experienced an increase in capital flight.[53]

Perhaps most grating to the societies that have to bear the burden of controls is the simple fact that the controls themselves are porous and offer little of the benefit that is promised. As is the case in black markets for foreign exchange, there will inevitably be evasions of the capital restrictions. As University of California at Los Angeles economist Sebastian Edwards argues: "Legal controls on capital mobility are not always translated into actual restrictions on these movements. In country after country the private sector has found ways of getting around controls."[54] The Organization for Economic Cooperation and Development has cataloged some of those means: falsification of invoices, leads and lags in paperwork, substitution of exempted flows with restricted flows, and illegal methods (such as bribery and smuggling).[55] In addition to those methods, perfectly legal instruments such as derivatives have been used to circumvent capital controls—and the longer the controls are in place, the better the private sector gets at avoiding them.[56]

To be fully effective, capital controls need to be strong enough to impose costs and distortions on an entire economy. Empirical work on capital controls has shown that, for controls to be successful "in curbing capital inflows, they need to impose very high tax rates on foreign borrowing, and therefore shoulder the burden of very high domestic real interest rates."[57] Add to that the difficulty of making controls "temporary," and countries under capital controls find "that the welfare benefit of capital inflow taxes . . . are small" and "the domestic interest rate [will] rise once the temporary shocks have disappeared, thus offsetting the benefits associated with smoothing the shock."[58]

Far from granting a bit of space that countries can use to carve out independent policies while they reform, controls are invariably used as a substitute for reform.

Case Study: Malaysia

Malaysia's experiment with capital controls provides a unique opportunity to examine the effectiveness of controls in a world that is, for the most part, liberalizing. Prime Minister Mahathir cited volatility as the prime reason for instituting controls in September 1998. Claiming that "forty years of progress should not be wrecked overnight," Mahathir moved to block capital markets' access to Malaysia and prevent withdrawal of ringgit-denominated assets.

The irony of Malaysia's worries about "hot money" is that Malaysia had historically always had a greater proportion of FDI than of portfolio equity in its economy (Table 2). Unlike Korea or other countries in Asia, Malaysia sought to liberalize its current and

Table 2
Capital Composition in Malaysia, 1983–97

Type of Capital	1983–88	1989–95	1991	1992	1993	1994	1995	1996	1997
Net private capital flows[a]	3.10	8.80	11.20	15.10	17.40	1.50	8.80	9.60	4.70
Net direct investment[a]	2.30	6.50	8.30	8.90	7.80	5.70	4.80	5.10	5.30
Net portfolio investment[a]			0.00	0.66	5.77	1.82	2.63	4.38	-0.50
Other net investment[a]	0.80	2.30	2.90	6.20	9.7	–4.2	4.10	4.50	–0.6
Net official flows[a]	0.30	—	0.40	–0.1	–0.6	0.20	–0.1	–0.1	–0.1
Change in reserves[a]	–1.8	–4.7	–2.6	–11.3	–17.7	4.30	2.00	–2.5	3.60
GDP growth (annual percentage)			8.60	7.80	8.35	9.24	9.46	8.58	7.84

Source: Christopher A. Hartwell, "Feeding the Tigers," EMP-FA Policy Study, July 2000.
Note: Negative percentages represent outflows.
[a]As percentage of GDP.

capital account in a very aggressive manner, allowing foreign investors to participate in the Kuala Lumpur Stock Exchange from its inception in 1973. Sustained economic growth in the 1990s in the region of 8–9 percent a year made Malaysia an impressive tiger and undoubtedly drove the preponderance of capital flows into the country. Private capital flows played a large role in Malaysia's economy, accounting for as much as 17.4 percent of GDP in 1993, and Malaysia became a major recipient of FDI at the end of the 1980s and beginning of the 1990s.

Indeed, because of the historical composition of capital flows to Malaysia, the country was one of the best poised to weather the Asian crisis (Malaysia also did not rely on short-term debt to the extent that its neighbors did). In fact, much of the short-term debt pouring into Malaysia came late in the game, after 1993, and the reason that Malaysia came to rely on that debt was twofold: First, the world market for semiconductors was slowing down, leaving Malaysia without a principal earner of foreign exchange. Needing capital to sustain their blistering rate of growth, many businesses turned to the short-term market. Second, and more important than the cyclical downturn, was the Malaysian insistence on "Vision 2020," Mahathir's grand plan, initiated in 1991, to turn Malaysia into an industrialized nation by 2020. That placed great emphasis on state-sponsored prestige projects, such as highways and construction projects that added little value to the economy as a whole but drained resources. Financing for those political projects was provided increasingly by shorter-term debt, which was highly sensitive to external conditions. Ironically, an economy that had weathered a banking crisis and attracted direct investment for most of its history was now relying more heavily on short-term debt—mainly because of political interference in the markets and a misguided philosophy of planning.

How has Malaysia actually fared since the imposition of controls? Facing a decline in GDP of 7.5 percent because of the crisis in 1998, Malaysia made a tentative recovery in 1999 and was projected to grow robustly into 2001 (Table 3).[59] Malaysia's recovery should be attributed to several other fortuitous circumstances and policy choices made well before the controls were instituted: the government was running a budget surplus at the time of the crisis (allowing the country to use fiscal stimuli); the savings rate in Malaysia (34 percent of GDP) provided a domestic source of financing for companies affected

Table 3
GDP Growth (percentage) and Predictions, 1998–2001

Country	1998	1999	2000	2001
Bangladesh	5	5.2	5	4.5
China	7.8	7.1	7.5	7.3
India	6.3	6.4	6.7	6.5
Indonesia	–13.0	0.3	4	5
Malaysia	–7.4	5.6	6	6
Pakistan	2.6	2.7	5.6	5.3
Philippines	–0.6	3.3	4	4.5
Thailand	–10.2	4.2	5	5
Vietnam	3.5	4.2	4.5	5.4
Hong Kong	–5.1	2.9	8	4.8
Korea	–6.7	10.7	8.8	6.5
Singapore	0.4	5.4	7.9	5.9
Taiwan	4.7	5.7	6.5	6
All of Asia	4.1	5.9	6.7	6.6

Source: International Monetary Fund, *World Economic Outlook*, October 2000.

by capital controls; and, finally, Malaysia's openness to foreign trade allowed a boom in the export sector (this development is more precarious, given that a slowdown in the American economy will greatly affect the export sector, as 20 percent of Malaysia's exports go to the United States).[60] The export boom was also due to the fact that Malaysia pegged its currency at 3.8 ringgits to the dollar, thus effectively undervaluing its currency in relation to others of the region.[61]

To take a longer-term view of the Malaysian economy, it is important to note that private consumption fueled the recovery in 1999 and 2000, with consumption increasing 8.3 percent in 2000 alone. However, little new investment in capital or equipment has occurred in Malaysia; the value of investment proposals in manufacturing, the most important sector of the economy, fell by 25.8 percent in 1999 after declining by 45 percent in 1998.[62] Coupled with the lack of investment is the simple microeconomic reality that many of the companies that were dangerously exposed in the Asian crisis are under the same management; they have not been restructured.

Thus, attributing the recovery of Malaysia to capital controls is erroneous, for they probably had little or no positive effect on Malaysia's growth after the crisis. By the time Malaysia imposed capital controls, the ringgit had already depreciated by 34 percent since the Thai baht collapsed in July 1997—fully a year and two months after the onset of the regional crisis.[63] By then, "the bulk of the portfolio outflows were already over."[64] Indeed, as *The Economist* noted, the controls "were applied so narrowly and imposed so belatedly that they have had little effect," and, "had the controls been imposed at an early stage in the crisis, Malaysia would now be struggling."[65] Instead, the recovery in the growth of GDP, the stock market, and reserves that Malaysia has experienced has also been seen in other Asian countries that did not resort to capital controls. Moreover, while other Asian countries have seen the value of their currencies rebound and FDI flows increase, Malaysia's currency remains pegged at an undervalued rate and the country has seen only weak flows of FDI. The impact of the controls on short-term debt

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Table 4
Ratio of Short-Term Debt to Reserves, 1998 and 1999
(millions of U.S. dollars)

	1998			1999		
Country	Short-Term Debt	Reserves	Ratio	Short-Term Debt	Reserves	Ratio
Korea	41,934	51,975	0.806811	46,191	73,987	0.624312
Malaysia	10,516	25,559	0.41144	9,084	30,588	0.296979
Thailand	25,679	28,825	0.890859	16,861	34,063	0.494995
Indonesia	25,919	22,713	1.141153	21,496	26,445	0.812857
China	35,231	149,188	0.236152	24,243	157,728	0.153701
Philippines	11,912	9,226	1.291134	9,320	13,230	0.70446
Pakistan	2,620	1,028	2.548638	2,843	1,511	1.881535

Source: Bank for International Settlements and author's calculations.
Note: Malaysia, China, and Pakistan had controls in place.

was also unimpressive. As Table 4 shows, short-term debt hardly declined in the Malaysian economy in absolute terms (it declined in relative terms because of Malaysia's increase in reserves), while countries that did not impose capital controls (notably Thailand, Indonesia, and the Philippines) saw their short-term debt decrease in both relative and absolute terms (Korea saw its short-term debt increase slightly but decline in relation to its reserves).[66]

If the policy course that Malaysia embarked on in 1998 was unsustainable, it would make sense to ensure that similar controls are never imposed again. However, the controls that remained on the Malaysian economy until May 2001 had the same effect on capital inflows that Malaysia's quasi-fixed exchange rate did: they guaranteed against currency volatility and encouraged capital flows that were not prohibited (which included stocks on the Kuala Lumpur exchange). Again, that created perverse incentives and actually encouraged speculative behavior in Malaysia, as long-term investment is still spooked by the threat of resumption of controls.[67] The situation will be exacerbated if changes in the Malaysian real economy do not keep pace with the capital influx. Mohamed Ariff, executive director of the Malaysian Institute of Economic Research, noted that "the real economy is improving, but it's not going by leaps and bounds to justify the kind of bull run we have in the stock market."[68] Malaysia's recovery is thus on less than solid ground. What could it have done differently?

Alternatives to Capital Controls

Capital controls tend to mask the true causes of capital crises and exacerbate the problems that developing countries face, rather than mitigate them. Malaysia's case shows this perfectly; the economy-wide distortions caused by the government before controls were instituted have actually been protected and perpetuated. As Shailenders Anjaria, director of the External Relations Department of the IMF, has said, "Given the great benefits offered by freer international capital markets, however, the best response to volatile conditions is surely to strengthen those markets' foundations (through improved accounting and disclosure rules, for example) not close them down—especially since there is little evidence that the alter-

native, stopping the flow of capital, works well or for long."[69] The best alternative to capital controls is to allow the natural adjustment mechanisms to do their job, through more openness and reform, not less.

Concentration and Competition

Capital controls often contribute to macroeconomic sources of instability in emerging markets, and restrictions on capital flows are often used to help solve structural problems, particularly in financial markets.

A major precipitant of financial crises is unsound banking systems. To prove this point, we need only look at the banks in emerging markets before the Asian crisis: of 151 banks, only 11 percent were rated C+ or better by the IMF, and none was given an A (only free-market stalwarts Singapore and Hong Kong had B or B+ banks).[70] As Rudi Dornbusch of the Massachusetts Institute of Technology has vociferously argued, sound balance sheets, not the composition of capital, are the key to avoiding financial crises. Emerging markets would do better to focus on the need "not to be exposed to unmanageable risk, not to have a single event—withdrawal cum devaluation—bring down the financial sector like a house of cards."[71]

Bank reform does not mean replication of OECD banking systems; a few policy guidelines are sufficient to help reform the financial sectors of many emerging markets:

- removal of state guarantees (such as eliminating deposit insurance),
- privatization and deregulation, and
- making the central bank independent.

Ending deposit insurance should be the first step toward severing links between business and government. Insurance for financial intermediaries only creates moral hazard, as government takes on the role of subsidizing loans to risk-seeking borrowers. Furthermore, deposit insurance and increased regulation in emerging markets could increase the level of corruption and cronyism in the financial sector. Banks, in many cases run by people with close ties to or directly involved with the government (as is the case in Indonesia), would under that scenario have a guarantee of solvency, and regulatory institutions could easily become another plum of cronyism, doled out to friends or business associates of those in power; that has indeed already been a problem in much of the region.[72]

Privatization of the banking system is thus a precondition for effective use of capital to break the stultifying control that governments of many developing countries have over their economies' financial systems. Of course, privatization will not work if there is little competition among private banks. All of the countries that have experienced financial crises in recent years, after all, had private banks. But those banks were highly protected. Unfortunately, many countries continue to have restrictions on foreign ownership of banks or have explicit rules that deny foreign banks access to domestic markets. Those rules must be lifted in order both to diversify the financial sector and to foster a climate that will make domestic banks healthier. Furthermore, introducing foreign banks into developing markets results in the transfer of technology: because international banks have been working longer at loan extension and due diligence, emerging-market banks can learn from their competitors to the benefit of domestic consumers.

Developing nations should also move toward establishing independent central banks. With independent oversight and decisions about the money supply insulated from political factors, the banking system will likely be denied government largesse, thus producing healthier books. A trio of noted economists made a similar point in 1993:

> By imposing capital controls, these governments raise more seigniorage revenue and keep interest rates artificially low. As a result, public debt accumulates at a slower rate than otherwise. This suggests that an institutional reform which makes the Central Bank more independent

A major precipitant of financial crises is unsound banking systems.

makes it more difficult for the government to finance its budget. The tightening of the fiscal constraint may force the government to adjust towards a more sound fiscal policy.[73]

In the end, nothing can preserve the banking system better than competition and strengthened private ownership of financial institutions. Policies that encourage a competitive, private financial sector and an independent central bank will help insulate against shocks.

Exchange-Rate Policy

Financial liberalization also requires a move to freely floating exchange rates. Indeed, pegged exchange rates have been a major cause of the financial crises that emerging markets have experienced since the 1990s. Developing countries have favored pegged rates because of their desire to maintain stable exchange rates. Excessive volatility in the exchange rate can discourage investment, as investors are worried about losing their money overnight. That is not a phenomenon unique to developing nations, as even industrialized nations use various mechanisms—such as sterilized intervention in the foreign exchange market, which is rarely effective—to attempt to defend their currencies or maintain exchange rates within a set range.[74] Moreover, for developing countries, large inflows can cause a real appreciation of the exchange rate, making domestic exports seem less competitive. While monetary risk can be hedged against on the international market, international investors always must assume some systemic risk, and this can be exacerbated by a volatile exchange rate.

Although both freely floating and fully fixed exchange rates are consistent with the free market, pegged rates cause distortions that can lead to currency and financial rises.

The exchange-rate regime that a nation chooses has tremendous implications for the management of capital flows and the likelihood of a crisis. Capital flows are not a priori the harbinger of volatility for a developing nation; on the contrary, when countries adopt market policies, investment in any form is beneficial.[75] But misunderstanding the economic forces that underlie pegged exchange rates can lead to a vicious cycle of bad policy decisions.

Pegged exchange rates often mask fundamental problems in an economy until those problems become so large that domestic and foreign investors respond to an impending crisis. Governments typically react to the resulting run on the currency by attempting an expensive and usually futile defense of the currency or, as was the case in Malaysia, by implementing capital controls. The most common scenario is that the market finally forces a country either off its peg or into a float (as recently happened, again, with Turkey and its float of the lira).[76] Pegged exchange rates are the source of that instability, while floating currencies rarely, if ever, need to be defended. Indeed, if the ringgit had been allowed to float, rather than defended, the normal adjustment mechanisms would have corrected the capital account surpluses that Malaysia faced.[77]

Freely floating exchange rates also have the benefit of avoiding contagion. Economist Anna Schwartz notes, "Under floating exchange rates, the economic links between one country and others are weaker," and thus "we should not expect international transmission in such an exchange-rate regime."[78] Jeffrey Sachs of Harvard University has made the point that "pegged exchange regimes are fragile in the face of adverse external shocks," and "self-fulfilling panics are much easier to handle, *or can be obviated entirely,* by floating exchange rate regimes."[79] Although both freely floating and fully fixed exchange rates are consistent with the free market, pegged rates cause distortions that can lead to currency and financial rises.[80]

Conclusion

The case against capital controls rests on sound economic reasoning. More fundamentally, attempts to restrict capital movements are an assault on individual liberty. Capital controls betray a faith in the power of government, in its ability to control supply and demand and dictate capital composition.

They also effect a "transfer of power from citizens to the state."[81] Nobel prize–winning economist F. A. Hayek put it best in his classic *The Road to Serfdom:*

> The extent of the control over all life that economic control confers is nowhere better illustrated than in the field of foreign exchanges. Nothing would at first seem to affect private life less than a state control of the dealings in foreign exchange, and most people will regard its introduction with complete indifference. Yet the experience of most Continental countries has taught thoughtful people to regard this step as the decisive advance on the path to totalitarianism and the suppression of individual liberty. It is, in fact, the complete delivery of the individual to the tyranny of the state, the final suppression of all means of escape—not merely for the rich but for everybody.[82]

As Edwards has demonstrated empirically, even when controls are in place, they are notoriously ineffective. Given the nature of controls, the proper role for government is to foster the conditions under which investment can flourish, through the protection of property rights, the enforcement of contracts, the establishment of stable money, and an exchange rate consistent with market-oriented policies. That approach is contrary to the premise of capital controls, namely that increased government intervention in financial matters is necessary for a functioning economy.

Nevertheless, increasing the role of governments and international institutions is frequently suggested as a precaution against future financial crises, a sentiment expressed by Paul Krugman. "It is hard to avoid concluding," Krugman has written, "that sooner or later we will have to turn the clock at least part of the way back. To limit capital flows for countries that are unsuitable for either currency unions or free floating; to re-regulate financial markets to some extent; and to seek low, but not too low, inflation rather than price stability. We must heed the lessons of Depression economics, lest we be forced to relearn them the hard way."[83]

Yet liberalization seems to have won the day in the world's economy, for even Malaysia's experiment in capital controls has ended. Indeed, a belief in managing capital flows is as misguided as managing industrial plans or, for that matter, the weather.[84] Krugman's calls to "turn back the clock" on capital flows, as if that were possible without sustained, all-powerful governments in most nations agreeing to limit capital flows, are not realistic. The power of international finance will not subside quietly, and a retreat from free-market economics can come about only through the suppression of civil liberties. Moreover, if developed nations were to try turning back the clock, they would be promoting policies that would keep developing nations mired in poverty.

Attempts to restrict capital movements are an assault on individual liberty.

Notes

1. Malaysian prime minister Mahathir bin Mohamad has been the most vociferous, but other commentators, such as the former chief economist of the World Bank, Joseph Stiglitz, and a bevy of economists, including Dani Rodrik at Harvard, have openly questioned the need for capital account convertibility in the first place. See Joseph Stigitz, "What I Learned at the World Economic Crisis," *New Republic,* April 17, 2000; and Dani Rodrik, "Who Needs Capital Account Convertibility?" Contribution to a symposium at Princeton University, February 1998.

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3. Alan Reynolds, "Capitalism without Capital?" *American Outlook,* Fall 1999, p. 34.

4. World Trade Organization, *International Trade Statistics* 1999 (Geneva: WTO, 2000), p. 17.

5. Jacob M. Schlesinger, "Why the Long Boom? It Owes a Big Debt to the Capital Markets," *Wall Street Journal,* February 1, 2000, p. A1.

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7. Steven Radelet and Jeffrey Sachs, "The Onset of the East Asian Financial Crisis," Harvard Institute for International Development, March 30, 1998, http://www.hiid.harvard.edu/pub/other/eaonset. pdf.

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9. Stephen Mulholland, "Legacy of Hitler's Madness: Keeping the Rand in Chains," *Sunday Business Times* (South Africa), October 20, 1996.

10. Quoted in Paul Davidson, "The Role of Financial Markets: Efficiency vs. Liquidity," Unpublished manuscript, http://econ.bus.utk. edu/davidsonextra/liqveff.html.

11. Christopher J. Neely, "An Introduction to Capital Controls," Federal Reserve Bank of St. Louis *Review,* November–December 1999, p. 13.

12. See Günther Schulze, *The Political Economy of Capital Controls* (New York: Cambridge University Press, 2000), p. 1.

13. Stephen Fidler and Andrew Balls, "Capital Controls: Feast or Famine," *Financial Times,* October 6, 1998.

14. Sebastian Edwards, "Capital Inflows into Latin America: A Stop-Go Story?" National Bureau of Economic Research Working Paper no. 6441, March 1998.

15. James Tobin, "A Proposal for International Monetary Reform," *Eastern Economic Journal* 4, nos. 3–4 (July–October 1978): 154.

16. See, for example, Heinz Stecher, "Time for a Tobin Tax? Some Practical and Political Arguments," Oxfam Great Britain Discussion Paper, May 1999, http://www.oxfam.org.uk/policy/ papers/tobintax/tobintax2.htm.

17. Paul Davidson, "Are Grains of Sand in the Wheels of International Finance Sufficient to Do the Job when Boulders Are Often Required?" *Economic Journal,* May 1997, pp. 671–86.

18. Marshall Auerback and Patrick Smith, "It's One World, Ready or Not: But Some Are Not," *International Herald Tribune,* September 9, 1998.

19. See Neely.

20 "Interview with Malaysian Prime Minister Mahathir," *Far East Economic Review,* June 24, 1999, www.feer.com/1999/9906_24/mwels1.html.

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22. Sveinbjorn Blondal and Hans Christiansen, "The Recent Experience with Capital Flows to Emerging Market Economies," OECD Working Paper ECO/WKP(99)3, February 1999, p. 9.

23. Malcolm Dowling, "The Case for an Asian Return to Fixed Exchange Rates," *International Herald Tribune,* July 2, 1998.

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26. Hyuk Choe, Bong-Chan Kho, and Rene M. Stulz, "Do Foreign Investors Destabilize Stock Markets? The Korean Experience in 1997," *Journal of Financial Economics* 54, no. 2 (1999): 227–64.

27. Ibid., p. 229.

28. Ibid., p. 262.

29. Peter B. Henry, "Stock Market Liberalization, Economic Reform, and Emerging Market Equity Prices," *Journal of Finance,* forthcoming.

30. Economic Research and Analysis Division, World Trade Organization, "Financial Services Trade, Capital Flows, and Financial Instability," Staff Working Paper ERAD 98-12, December 1998.

31. Malcolm Knight, "Developing and Transition Countries Confront Financial Globalization," *Finance and Development,* June 1999, p. 32.

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34. Ibid., p. 16.

35. Ibid., p. 19.

36. Ibid.

37. Government of Singapore Web site, http://www.mti.gov.sg/public/infocentre/article_notif_index.cfm?ID=376.

38. J.P. Morgan, *Asian Financial Markets: Second Quarter 1999* (Singapore: J.P. Morgan, 1999).

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42. Brink Lindsey and Aaron Lukas, "Revisiting the 'Revisionists': The Rise and Fall of the Japanese Economic Model," Cato Institute Trade Policy Analysis no. 3, July 31, 1998, p. 1.

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44. Pierre Poret, "Liberalizing Capital Flows: Lessons from Asia," *OECD Observer*, no. 214 (October–November 1998): 37.

45. Shahid Javed Burki, "Emerging Asia: Market Perceptions and Economic Reality," EMP Financial Advisors, LLC, Washington, March 22, 2000.

46. The theory of the second best is fleshed out most convincingly in James Meade, *The Theory of Customs Unions* (Amsterdam: North Holland, 1955).

47. Krugman, "Saving Asia."

48. "Interview with Malaysian Prime Minister Mahathir," p. 1.

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53. Sebastian Edwards and Julio Santaella, "Devaluation Controversies in the Developing Countries," in *A Retrospective on the Bretton Woods System*, ed. Michael Bordo and Barry Eichengreen (Chicago: University of Chicago Press, 1993.), pp. 405–60.

54. Sebastian Edwards, "How Effective Are Capital Controls?" *Journal of Economic Perspectives* 13, no. 4 (Fall 1999): 65–84.

55. Blondal and Christiansen.

56. P. M. Garber, "Derivatives in International Capital Flows," National Bureau of Economic Research Working Paper no. 6623, June 1998.

57. Carmen Reinhart and R. Todd Smith, "Temporary Capital Controls," Unpublished manuscript, http://www.puaf.umd.edu/papers/reinhart/tempfin.pdf.

58. Ibid.

59. According to Malaysia's Ministry of Finance, the economy grew by 7.0 percent in 2000 and was projected to grow by 4.5 percent in 2001, figures that are slightly better than those projected by the IMF. See Malaysian Ministry of Finance Web site, www.treasury.gov.my; and IMF World Economic Outlook Data Set, May 2001, www.imf.org/external/puss/ft/weo/2001/01/data/index/htm

60. "The Road Less Traveled," *The Economist*, May 1, 1999.

61. See David F. De Rosa, *In Defense of Free Capital Markets* (New York: Bloomberg, 2001), p. 185.

62. "Malaysia: The Short-Term Outlook Is Bright," Economist Intelligence Unit Country Briefing, March 13, 2000.

63. De Rosa, p. 183.

64. Ron Hood, "Malaysia Capital Controls," World Bank Working Paper no. 2536, January 2001, p. 1.

65. "The Road Less Traveled."

66. A recent paper by Ethan Kaplan and Dani Rodrik of Harvard University challenges this view of the effectiveness of Malaysia's capital controls, noting that Malaysia's policies were on an unsustainable path by September 1998 and that it was impossible for Malaysia to weather the crisis without "a sharp change in policies." This argument unfortunately gets cause and effect backwards, as the authors say that market pressure remained high in Malaysia and thus the policy configuration that prevailed was unsustainable; the precise reason that market pressure continued was the signal that Malaysia was about to make an abrupt change in policy (i.e., to institute capital flows), combined with the ongoing political turmoil between

Mahathir and Ibrahim Anwar, the former finance minister. Kaplan and Rodrik also seem to have reduced Malaysia's options to two, an IMF-type operation or capital controls. A third option—involving more supply-side policies, such as tax cuts (possible because of high budget surpluses) as a fiscal stimulus combined with swift action to accommodate the markets (such as plans for financial restructuring)—would have allowed Malaysia to weather the storm far more easily than either an IMF "austerity" package or the path that was chosen. See Ethan Kaplan and Dani Rodrik, "Did the Malaysian Capital Controls Work?" Paper prepared for National Bureau of Economic Research conference on Currency Crises, Islamorda, Florida, January 2001.

67. Thomas Fuller, "Curbs Off, Investors Rush to Malaysia," *International Herald Tribune,* January 18, 2000.

68. Quoted in ibid.

69. Shailendra J. Anjaria, "The Capital Truth: What Works for Commodities Should Work for Cash—A Commentary," *Foreign Affairs 77,* no. 6 (November–December 1998): 142–43.

70. International Monetary Fund, *International Capital Markets* (Washington: IMF Press, 1996), p. 114.

71. Rudiger Dornbusch, "Emerging Market Crises: Origins and Remedies," Unpublished manuscript, July 1999, http://web.mit.edu/rudi/www.

72. An example of the lack of legitimacy of regulatory institutions in emerging markets embroiled the Philippines at the end of 2000 and continues into 2001. Former Philippine president Joseph Estrada was accused of pressuring the Security and Exchange Commission to close its investigation of one of his friends, Perfecto Yasay (accused of insider trading on the Philippine Stock Exchange). This was one of the accusations brought against Estrada in his impeachment trial, which led to his ouster. See "Thriller in Manila," *The Economist,* March 25, 2000, p. 83.

73. A. Alesina, Vittorio Grilli, and Gian Milesi-Ferretti, "The Political Economy of Capital Controls," London School of Economics, Centre for Economic Performance Discussion Paper 169, September 1993, p. 1.

74. Kathryn Dominguez and Jeffrey Frankel, *Does Foreign Exchange Intervention Work?* (Washington: Institute for International Economics, 1996).

75. Gruben and McLeod.

76. Christopher A. Hartwell, "Turkey—Left to Baste," *EMP-FA Vision* 2 no. 3 (March 2001): 3–4.

77. "The RM Crisis: The Real Culprit at Last?" Economic Forum, November 11, 1997, http://members.tripod.com/~econforum/crisis/1.html.

78. Anna J. Schwartz, "International Financial Crises: Myths and Realities," *Cato Journal* 17, no. 3 (Spring–Summer 1997): 10.

79. Jeffrey D. Sachs, "Alternative Approaches to Financial Crises in Emerging Markets," *Revista de Economica Politica* 16, no. 2 (April–June 1996): 5–21. Emphasis added.

80. See Stanley Fischer, "Exchange Rate Regimes: Is the Bipolar View Correct?" American Economic Association and Society of Government Economists Distinguished Lecture on Economics in Government, Delivered at Meeting of the American Economic Association, New Orleans, January 6, 2001.

81. Lawrence B. Lindsey, "Control Freaks," *National Review* 50, no. 21 (November 8, 1998): 42.

82. F. A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1965), p. 92.

83. Paul Krugman, "The Return of Depression Economics," *Foreign Affairs* 78, no. 1 (January–February 1999): 78.

84. Christopher A. Hartwell, "Exchange Rate Stability," Letter to the editor, F*inance and Development* 36, no. 4 (December 1999): 40.

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