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Cosying up to capital controls now

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"EVERY single member of the G-20, without exception, has signed on to that action plan (on suspected terrorist funding)," Canadian Finance Minister Paul Martin said during the recent G-20 Finance Ministers meeting in Ottawa.

The need for controls on funds has been brought into sharper focus since the attacks of Sept 11. Even the US Treasury and the multilateral organisations, including the International Monetary Fund (IMF) and the World Bank, are now in favour of controls.

Yet during the Asian financial crisis when Malaysia called for controls on "speculative and destructive capital flows" it was criticised for turning against the trend of globalisation.

Now the Bretton Woods institutions together with the G-20 have "bowed to the post 9-11 state of global affairs". They agreed to "establishing new controls on capital flows - usually anathema to the US Treasury and the IFIs (International Financial Institutions) - but only for suspected terrorist networks, not for the nagging problem of speculative capital flows".

According to Martin the G-20 nations agreed to move as quickly as possible on the anti-terrorism plan, which calls for making public lists of terrorists with frozen assets and maintaining financial intelligence units in each country to track terrorist financing.

Even though the IMF and the US Treasury opposed any talk of capital controls during the 1997 financial crisis IMF's Article VI authorises member countries "to exercise such controls as are necessary to regulate international capital movements" and empowers the IMF to request tighter controls.

But it has been argued that greater capital mobility allowed markets to price assets efficiently and optimally. "Interventionist policies that distort the markets - and not the markets themselves - are deemed the root causes of financial disorder".

But according to David Felix of Washington University in St Louis "lifting capital controls has opened the gates to an accelerating volume of international financial flows... These have been accompanied in most of the developing and industrialised world by slackened growth of investment, savings, output, trade volume and productivity".

Writing for the US think tank Foreign Policy In Focus, Felix argues that increased capital mobility has caused global growth to slacken for two main reasons. First, heightened volatility of both nominal and exchange rates, and second, much higher real interest rates generated by the explosive growth of cross-currency financial flows.

Higher volatility raises the risks of investing long term, while higher interest rates raise the cost of capital. Combined they have tilted private investment after the 1960s towards projects with quicker payoffs. These have contributed less to productivity growth than did the long term investment characterised by the less volatile period.

During the financial crisis and the Asian contagion in 1997, Malaysia had called for curbs on "hot money". Prime Minister Datuk Seri Dr Mahathir Mohamad who made the call was told that he did not understand economics.

However, the thinking now even in the west and in major financial capitals is changing in favour of capital controls and indeed on the need to curb flows of hot money and capital.

"Curbing hot money flows is essential for reducing exchange rate volatility and contagious currency crises," according to Felix. He adds that "controlling short terms flows is also essential for allowing countries more scope to implement monetary and fiscal policies and to initiate environmental and other programmes that complement their socio-economic structures and social welfare objectives".

In fact discussions are now under way among the G-7 and at the IMF to curb exchange rate volatility and contagious currency crises. But unfortunately moves to "reforming the global financial architecture" still target government policies, not market failures, as the root cause of financial disorders.

They stress greater "transparency" from governments, urging them to provide more timely and comprehensive information to financial markets on domestic conditions and impending regulatory and policy changes.

"Proposed reforms aim to further reassure foreign investors by pressing developing and `transitional' economies to model their banking and capital market institutions and bankruptcy laws on those of the advanced economies".

The agenda for reform of the financial architecture is "short on proposals to deal with market failure". Felix says the official agenda is dangerously one-sided in demanding that developing countries reform to accommodate the needs of the financial markets of the creditor countries, while devoting little attention to the volatility of these markets.

Thus there is no assurance that the push for "transparency" will prevent recurrence of the sudden reversal of financial flows that afflicted the European Union in 1992, Latin America in 1982 and 1995 and East Asia in 1997 and Turkey and Argentina in 2001.