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A Capital-Controlled Future?

What are the chances that, in the next five to ten years, large parts of the world economy move to some form of capital controls in the management of exchange rates? What are the implications of this more mercantilist approach? Could, for example, U.S., Canadian, and Mexican policymakers feel the need to tighten up their collective trade pact in light of this potential fundamental change in global exchange rate management?

Fourteen global experts rate the probability.

Three out of ten that capital controls are widely used.

MANSOOR DAILAMI
Manager, Emerging Global Trends Team, World Bank Group

The fundamental question is how global financial governance will adapt to the greater influence of emerging market economies.

It is a testimony of how times have changed that we are discussing the issue of capital controls in managing exchange rate regimes over the next five to ten years. Prior to the 2008–2009 crisis, the international agenda supported continued liberalization of the capital accounts of major emerging economies in pace with their local capital market development and capacity to institute the necessary operating framework for managing floating exchange rate regimes. But recent years have seen a resurgence of support for capital controls in academic and official circles, with the International Monetary Fund now endorsing their use as part of countries' policy tools for managing large-scale capital flows. Capital controls have also been used in practice. Brazil, for example, imposed formal mechanisms to curb large capital inflows in 2009. Perhaps more unexpected was the Swiss National Bank's commitment to maintaining an exchange rate floor of 1.20 Swiss francs per euro as of September 2011, a notable move given that it put a currency of considerable international status under control.

A key challenge facing the international economic policy community—certainly one that is greater during turbulent times—is to deliver well-coordinated policies in response to current conditions while keeping sight of long-term developments and underlying structural shifts. Over the long term, the interest of the world economy, including developing countries, is best served by policies that encourage open and prudentially regulated markets. The current incarnation of capital controls thus should be viewed as transitory responses rather than a fixture of the global financial landscape. But the landscape is undergoing a transformative change. The progress of a growing number of emerging market economies in improving their domestic institutions and finances over the past two decades has allowed them better access to international financial markets, and these countries have a growing stake in the safety and stability of the global financial system. At the same time, advanced economies are increasingly dependent on capital from emerging market economies for public sector financing given their anemic growth prospects and rising health care and pension costs. Once the instability associated with the current macroeconomic policy imbalances is properly addressed, the broad incentive is for more liberalized international capital. This is the crux of the issue. Capital flows are a symptom, not a cause, of financial instability. It is the combination of zero interest rate policy in countries with mature financial centers and heightened risk aversion due to the euro area sovereign debt crisis that is behind the yield-seeking and safe haven motivations we see driving speculative capital to the United States, core Europe, and major emerging economies.

When gross global capital flows peaked at $22 trillion in 2007, almost 87 percent of that amount was movement of capital among advanced countries. That share will decline in the future, tilting increasingly toward emerging economies. For those countries, the best way forward is to renegotiate the terms of global financial governance to better reflect the long-term development agenda and with a mind toward reducing the negative risks involved with protectionism and currency wars. I would put the overall chances of widespread use of capital controls at three out of ten.

The views expressed here are those of the author. They do not necessarily represent the views of the World Bank and its affiliated organizations.

There is a clear increase in the probability such tools will be used.

MIROSLAV SINGER
Governor, Czech National Bank

Most developed economies are experiencing economic slowdown or outright recession. Growth is slowing even in many emerging economies. The source of this situation is deleveraging in previously overextended financial sectors in the majority of developed economies. We can therefore conclude that the recovery in the years ahead will be shallow. It will take time to rectify many of the imbalances. Since the most common monetary policy tool—the interest rate—has almost exhausted its potential in most developed economies, other macroeconomic policy tools are being and will be tried. Capital controls have been used by some emerging economies. Exchange rate interventions have been employed by developed economies. And some economies have used trade restrictions in the area of commodity trading—for example, China with regard to scarce metals. So there is a clear increase in the probability of such tools being used. Even the likelihood of tools more directly related to control of international trade has increased.

Let me offer some more general comments. The world is becoming more fundamentally uncertain. As a result, alignment and coordination of macroeconomic policy tools and policies can only take us so far. There is no guarantee that rules and harmonization will produce the right outcome, that the new rules will be significantly better than previous ones, or that the "right" set of rules exists at all. Therefore, it is surprising to me that we are so obsessed—at least in Europe—with limiting the space for diversification of rules. Diversification is a tried and tested strategy for dealing with fundamental uncertainties. The push for harmonization at the expense of space for diversification is leading individual sovereigns to take a different approach, namely, that of insulation and buffering. This is no bad thing. We should take a lesson from the maritime world, where ships are constructed with watertight compartments to contain flooding if the hull is breached. The rules of shipbuilding are fundamentally more clear and effective than the current rules of global macroeconomic management.

The marginal benefits of focusing more on space for diversification of approaches and on rules for the proper use of macroeconomic tools other than pure fiscal and interest rate policies are perhaps currently greater than the benefits of further policy alignment. The latter benefits may be positive, but they are diminishing significantly.

I do not think the U.S.-Canada-Mexico bloc will follow Europe as far down the road of harmonization. I doubt that it needs to do so very urgently, as its component parts are doing relatively well following a rather different set of policies stemming from different strategic priorities.

Eight or nine out of ten.

BERNARD CONNOLLY
CEO, Connolly Insight, LP

The probability of widespread capital controls in the world in the next five years is very high—eight or nine out of ten. The underlying problem in the world is one of dynamic inefficiency, which, as scholars Maurice Obstfeld and Kenneth Rogoff put it in 1996, "wreaks havoc with our intuition about the laws of economics." The result is intertemporal disequilibrium, in which interest rates are too high and too low at the same time: too high to produce a mature-economy recovery without a new credit bubble; too low to avoid aggravating imbalances. In other words, the world as a whole cannot get off the conveyor belt towards an ultimate depression and financial collapse without some very improbable (however desirable) re-emergence of Thatcher-Reagan-Douglas policies (and such policies would probably need to be accompanied by the temporary nationalization and complete restructuring of the whole financial system).

In such circumstances, with the first best unavailable, policymakers will seek the second best—and probably come up with something close to the worst. Countries will no doubt attempt to keep on increasing the size of credit bubbles, such as that represented by monetary union in Europe. They will need capital flows and maintained or increased risk appetite to do that, so forms of financial repression other than capital controls will come, and indeed have already started coming, first. But in the next big "risk-off" crisis, flows of capital seeking safe havens are likely to overwhelm foreign exchange intervention, central bank swap lines, and attempts at "coordination." Capital controls will then be very probable. They will represent a big step along the road to serfdom already made all too likely by three things: former Fed Chairman Alan Greenspan's mistakes in the second half of the 1990s; the malignant, freedom-destroying lunacy of monetary union in Europe; and the growth model in China dictated by that country's Communist legacy.

The October euro-area summit made it clear that capital controls there, at least, are inevitable. If the area were significantly downsized (probably the least-bad, though horrible, outcome), re-denomination would have to be accompanied by draconian, if hopefully temporary, capital controls within the area, while an accompanying global "risk-off" crisis might have the effects suggested above. But keeping the area together would require a fiscal union. If that were not to become a transfer union—rightly unacceptable to a democratic and legitimate German polity—it would have to involve targets not just for budget deficits but also limits on current account balances. By definition, limits on current account deficits imply limits on capital account surpluses. Imposing such limits would necessarily involve capital controls, whether implicit (through attempts to enforce budget surpluses to offset private sector deficits) or explicit, in support of domestic credit controls and a command economy. Either way, the notions of a single market for goods and services and of free movement of capital would be sacrificed in the pseudo-religious worship of the single currency.

Capital controls are a blunt measure and only have temporary effects.

KLAAS KNOT
President, De Nederlandsche Bank

In the last three decades, the global economy has been defined by the forward march of financial globalization. Most of this is positive. It has accompanied tremendous growth in global trade. There has been a massive technology transfer through persistent foreign direct investment from advanced to emerging and developing countries. Countries like the Netherlands have benefited in particular from greater trade and financial investment. Yet the financial crises of the past decades have showed us that financial globalization can have a dark side if improperly managed. This was already clear from various emerging markets crises in the 1990s, but the 2008 global financial crisis revealed that advanced economies are vulnerable as well. While each of these crises involved sudden currency movements, exchange rates are not the key issue. On the contrary, the real problem is financial stability. We have learned that some forms of cross-border debt flows, especially when combined with complex financial products and lax supervision, can feed the build-up of domestic credit bubbles in rich and poor countries alike. And when these bubbles burst, the shock waves are felt all the more strongly in our interconnected world. The financial crisis therefore forces us to rethink our approach to financial globalization. How can its dark side be avoided and its benefits be maintained?

In this context, the traditional case for capital controls has recently resurfaced—particularly in emerging markets which experience the most difficulties from large and volatile capital flows. With the financial crisis, subsequent unconventional policies, and recently renewed global financial stresses, many countries have seen a rollercoaster trend in their capital account. Some emerging market economies, with shallow financial systems and limited supervisory capacity, may choose to reinstate capital controls when other policy options are exhausted. Yet they should be aware that capital controls are a blunt measure and only have temporary effects. The first best solution remains sound policy, by improving fundamentals, implementing structural and institutional reforms, and introducing macro prudential policy frameworks. This prescription applies both for emerging and advanced economies.

As we manage the fallout of the financial crisis, and the subsequent crises of fiscal sustainability, it is more important than ever to cooperate on global capital flows. A roadmap of international financial reform—Basel III, Solvency II, the regulation of the shadow banking sector—is seeking to manage financial sector risks, including those related to cross-border flows, such as short-term wholesale funding, wild divergence of loans and deposits, or foreign exchange lending. It is vital that these reforms and new macroprudential policies are implemented consistently across borders so as to prevent regulatory arbitrage. For advanced economies such as the United States or the Netherlands, many measures can limit the drawbacks of financial integration without reducing integration itself. Countries should actively pursue policies to reduce the risks and the mismatches on their external balance sheets, for instance via reducing leverage in the banking system and ensuring that capital flows are not distorted by an over-reliance on debt. These financial reforms will help to mitigate external risks. Capital controls are clearly off the table for our countries.

In the longer run, an ideal global economy would have fully open capital accounts, developed financial sectors, and strong macroprudential supervision to manage risks. These conditions would help support global growth in both rich and poor countries. Whether we can get there will depend entirely on whether the policymakers of this world can work together toward cooperative solutions. If we can, then financial globalization will allow us to share not just shocks, but also prosperity.

The relevant issue: reconciling capital flows with financial stability.

BARRY EICHENGREEN
Professor of Economics and Political Science, University of California, Berkeley

"Large parts" of the world economy and "some form" of capital controls offer the respondent lots of wiggle room, propelling him almost irresistibly to an answer of five on a scale of one to ten. Some form of smart restrictions on capital flows at the national level will be consistent with increased emphasis on macro-prudential regulation if effective global coordination of macro-prudential policies proves impossible. In my view, reconciling capital flows with banking and financial system stability—not with exchange rate stability, as in the question posed—is the relevant issue. Will regions like North America then respond with deeper financial integration? If the time frame is five to ten years, then I doubt it. Deep financial integration at the regional level requires building strong regional institutions to govern and regulate capital flows. Europe, where the pressure to do so is greatest, is finding the task exceedingly difficult. If and only if the United States shows a willingness to pool real regulatory authority with Canada and Mexico would I be prepared to change my tune.

Unlikely, but the pressure will be overwhelming.

PEDRO-PABLO KUCZYNSKI
Former Prime Minister and Minister of Economy and Finance, Peru

While pressure to create capital controls rates an eight (high), the likelihood is only a two (very low).

Why? As we all know, more and more capital is looking for a landing spot as a result of quantitative easing and actions by the Bank of England, European Central Bank, and so forth which exacerbate existing imbalances (point one above) but are so large that they will defeat most barriers to control capital inflows (point two above). Controls to stem the outflows of capital have never worked. Witness why Geneva and Luxembourg are on the edge of France, and Lugano a few kilometers from Italy? Sure, outflow capital controls work in North Korea (there is little capital to go out), but they hardly work in countries as diverse as Argentina or China. Capital controls are a really bad idea but an appealing illusion when one can think of nothing else.

We live in abnormal times. Certainly, printing money saved the U.S. and the world economies from collapse in 2008–2009. But now with extremely low interest rates (in fact negative after inflation) in the erstwhile "first world," the printed money is sitting in banks and corporations that are waiting to see what happens next. Until the United States picks up—sooner rather than later—and Europe—later rather than sooner, this tide of money will be looking for a home. The tide, like a tsunami, is unstoppable until the big actors in the world economy begin to recover.

I am writing from Peru, amazingly an "investment grade" economy where the outside money floods in. Our international reserves are one-third of GNP. They would be even higher if we did not have protests against mining. So the central bank is in a bind: Should it keep interest rates high against inflation (about 3 percent because of imported oil and corn) or lower them in order to stem the flood of money from outside and risk inflation, something Peruvians dread because of the hyperinflation of 1989–1990. It is a dilemma that would make Hamlet proud.

Only as a temporary tool.

RODRIGO VERGARA
Governor, Central Bank of Chile

As growth remains weak in advanced economies, monetary policy has been ultra-expansionary. The historically low levels of interest rates in these economies, coupled with the reasonably good performance of emerging market economies, have resulted in the latter receiving large capital flows from the former. This situation, reinforced by the several waves of quantitative easing, is expected to persist for many years as central banks of advanced economies have signaled their willingness to maintain their interest rates at very low levels into the foreseeable future.

This situation has led to broad consideration of the options and policy tools available to countries and international institutions. These options include letting the exchange rate fluctuate, adjusting the policy rate to avoid pulling in more capital, tightening fiscal policy to allow space for monetary easing, using macro-prudential tools to moderate credit growth and reduce the imbalances and mismatches that may be associated with fast credit expansion, purchasing foreign exchange reserves, and temporarily reducing the degree of financial integration by using some form of capital controls.

In this context, how likely it is that the world economy will move toward a more capital-controlled future? The answer to this question depends on the time frame. In the short run, some countries balancing their policy options in the face of excessive capital inflows, overvalued real exchange rates, high housing prices, and signs of overheating in the domestic front may consider that some degree of capital controls is a useful way to deal with these pressures.

However, most policymakers recognize that capital controls are a second-best policy tool and, if applied, should be transitory and based on the exceptional situation that some economies (particularly small emerging market economies) are currently enduring. Capital inflows are unlikely to be harmful in the absence of frictions from resource reallocations or other externalities. While the time frame required for addressing these frictions may favor controls as a useful temporary tool, medium- to long-term trends will not be efficiently addressed with capital controls. Furthermore, the evidence shows that controls are not effective in taming the volume of capital flows in the medium term, especially when there are fundamental causes, such as medium-term growth differentials, behind them.

Thus, I believe that in the medium term, the trend toward a more capital-integrated world would most likely remain, as there is broad recognition that from a longer-term perspective capital integration is welfare-improving.

One in ten chance because the competition will be between money and hard assets.

TADASHI NAKAMAE
President, Nakamae International Economic Research

The chance of a large part of the world economy moving to some form of capital controls in the management of exchange rates in the next five to ten years: one in ten.

The global economy will be too swamped by enormous problems in the next five to ten years for capital controls to work as any sort of solution. These include the European debt crisis, China's surplus of capacity, and the developed world's reckless ride into seemingly never-ending rounds of quantitative easing.

As can be seen from Japan's unsuccessful attempts to get out from its quantitative-easing policy for the past dozen years, this is not a policy from which a central bank can easily exit. This is because quantitative easing fails to stimulate economic growth and inflation. A vicious cycle emerges as money is printed faster than the nominal economy grows. This money, rather than helping to develop small domestic businesses, flows into emerging economies, thus raising their exchange rates. This capital inflow to emerging economies will continue as long as they are robust enough to adapt to their stronger exchange rates—another big issue for the coming years.

The result of quantitative easing on individual countries' economic growth and inflation is dreadful. In the four years between the second quarter of 2008 (just before the Lehman event) and the second quarter of 2012, the Federal Reserve expanded its balance sheet by 34 percent per year. Yet the United States' nominal GDP and GDP deflator rose by 2 percent and 1.5 percent respectively in the same period. Thus, real GDP grew by only 0.5 percent.

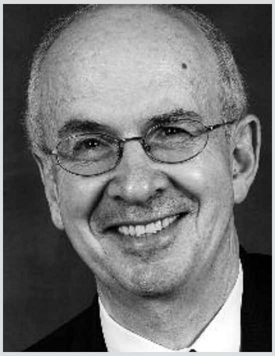
In the same period, central banks in Great Britain, Europe, and Japan were also printing money as fast as they could. The Bank of England inflated its balance sheet by 40 percent, the European Central Bank by 20 percent, and the Bank of Japan by 9 percent. Meanwhile, Britain's nominal GDP rose 1.5 percent, Europe's by 0.6 percent, while Japan's fell 1.5 percent. Britain's GDP deflator increased by 2.4 percent, Europe's by 1.1 percent, and Japan's deceased by 1.4 percent. This led Britain's real GDP to fall by 0.9 percent, Europe's by 0.5 percent, and Japan's by 0.1 percent.

By comparison, Japan's results, while bad, are not dire. This contradicts claims made by Ben Bernanke, chairman of the Federal Reserve, who said his "aggressive" approach to quantitative easing would be far more effective in the short- to mid-term than the Bank of Japan's "timid" approach. However, as the above numbers show, this is not the case. Rather, the opposite is true.

During the above period, the Japanese yen appreciated against the U.S. dollar, while the sterling and euro depreciated against the dollar. In dollar terms, Japan's growth rate of 5 percent far exceeded that of the United States, which was 2 percent (Great Britain's was -3.8 percent and Europe's was -4.2 percent).

Quantitative easing has failed. Yet no one can exit because this means higher interest rates (too dangerous for banks which own huge amounts of government bonds, and too dangerous politically). The sizes of the balance sheets of the Federal Reserve, the Bank of England, the European Central Bank, and the Bank of Japan are already 18 percent, 23 percent, 32 percent, and 30 percent of GDP respectively (before they picked up the unfortunate habit of easing at the first sign of trouble, balance sheets used to be below 10 percent of GDP). As these get bigger, the quality of the assets they own rapidly deteriorates, leading to a decline in the central banks' credibility. As this starts to happen, the money they print will be rejected in favor of assets such as precious metals and real estate.

Thus, competition will not be between currencies but between money and these sorts of assets. Capital controls for large parts of the global economy will hardly be an issue.



Yes, there will be an increasing reliance on capital controls.

DESMOND LACHMAN
Resident Fellow, American Enterprise Institute

Historic experience suggests that bad economic times all too often spawn beggar-my-neighbor policies. Sadly, the global economy is already facing difficult economic times. And there is every reason to expect that those bad economic times will get materially worse in the years that lie immediately ahead.

The European economic periphery is presently in a deflationary spiral as a result of excessively pro-cyclical fiscal policies within a euro straitjacket. This spiral is fueling a widespread anti-austerity political backlash in Europe, which raises the very real risk of a disorderly unraveling of the euro. Meanwhile, U.S. public finances are on a clearly unsustainable path, Japan is facing a ticking demographic time bomb that will highly complicate the financing of its government, and incipient political instability in China could place that country on a very much slower growth path than it has enjoyed over the past decade.

As Guido Mantega, the Brazilian finance minister, does not tire of reminding us, the industrial economies are already engaged in a global currency war in response to their sluggish domestic economies. The United States, the United Kingdom, and Japan are all resorting to aggressive quantitative monetary policy easing that has the effect of artificially cheapening their currencies. At the same time, the European Central Bank has vowed to do whatever it takes to save the euro, and China continues to manipulate its currency with a view to keeping it artificially undervalued. These trends have already forced emerging market countries such as Brazil that are faced with massive capital inflows to resort to inward capital controls. Even the International Monetary Fund now concedes that there are circumstances where inward capital controls are justified.

The odds would appear to be high that the global economy is now entering into a prolonged period of weak economic growth and persistently high unemployment. In such circumstances one must expect an increasing reliance on capital controls, especially were one to get a disorderly unraveling of a major currency bloc as is the euro.

Probability: A three on a scale of one to ten.

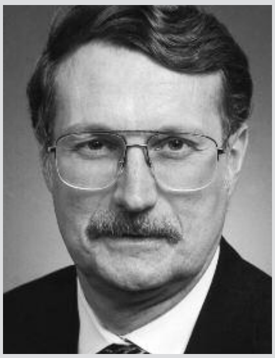
SEBASTIAN DULLIEN
Professor for International Economics, HTW Berlin-University of Applied Sciences, and Senior Policy Fellow, European Council on Foreign Relations

When it comes to capital controls, a remarkable rethinking has taken place over the past few years. While these instruments were frowned upon by leading economists and international organizations in the 1990s and early 2000s, now even the International Monetary Fund is recommending capital controls in situations of volatile and destabilizing capital inflows. Even before the IMF's change of mind, a number of emerging markets have used different taxes, restrictions, and prohibitions to protect their economies from volatile international capital markets. From China to India to Brazil, many countries have used capital controls in combination with foreign exchange interventions to prevent an excessive appreciation of their national currencies.

Nevertheless, it is not very likely that this will lead to a widespread introduction of capital controls for the larger part of the world economy. In fact, on a scale of one to ten, I would judge the probability for such a development only as a three.

The reasons are simple. The largest part of the world economy (measured in GDP in current prices) is still made up of the three big industrialized regions: the United States, the European Union, and Japan. For the foreseeable future, these regions will not need capital controls and exchange rate management. The problem for most OECD countries and of the United States, European Union, and Japan in particular at the moment is a sustained weakness of aggregate demand, coupled with very low nominal interest rates and a sustained reluctance of commercial banks to lend and private companies to invest. At the same time, inflationary pressure is weak and there is even talk of deflationary risks. Central banks in these countries will thus try to jump-start their economies with ultra-lax monetary policies and unorthodox monetary policy instruments such as quantitative easing. Creating gross capital outflows and hence a depreciation of their own currencies is a welcome side effect as this creates inflation through rising import prices and hence further lowers real interest rates. However, to reach this outcome, no capital controls are necessary.

In contrast, emerging markets and developing countries will have to deal with the fallout from the developed world's policies. Capital flows will pour into the less developed countries. This will force down interest rates below what is sustainable with stable macroeconomic development and will force up exchange rates to a level where the manufacturing sector is hurt. It will be these middle-income countries which will increasingly resort to capital controls as a tool to provide shelter from the negative externalities of the rich world's monetary policies. We will thus have significantly more capital controls, but this trend will stop most likely at the borders of the rich world.



Odds are only 1.5 in ten.

GEORGE HOGUET
Global Investment Strategist, State Street Global Advisors

Absent another downturn as profound as the global financial crisis and great recession of 2007–2009, it is unlikely that large parts of the world economy will move to significant permanent capital controls in the next ten years. Therefore I put the odds at only 1.5 out of ten. Relentless advances in internet technology will continue to facilitate global trade and cross-border investment, as will the desire by global investors to diversify their portfolios.

However, at times governments may be tempted to adopt transaction taxes (for example Brazil's tax on financial transactions), and pursue forms of financial repression. Furthermore, negative interest rates (as in Switzerland and Denmark currently) may persist for some time. And the one-off imposition of controls on capital outflows in periods of extreme economic duress (Malaysia 1998) will always remain in the policy arsenal. In addition of course, governments will continue to restrict investment in sensitive technologies. Yet the underlying technological drivers of globalization remain intact.

The current financial fragmentation in the eurozone and the perverse interaction between the eurozone's banking and sovereign crises highlights yet again the ability of markets to create a negative feedback loop. However, one of the successes of the frenetic, eclectic, and unorthodox policymaking put in place at the height of the global financial crisis was the avoidance of multiple sovereign defaults and the widespread use of capital controls. The adjustment in Europe will take several years, but the eurozone will survive with the free movement of capital a continuing, defining element.

In terms of emerging markets, global imbalances are gradually falling, with China's 2012 current account surplus forecast at roughly 2.5 percent of GDP versus roughly 10 percent in 2007. Note that China and India (which together represent roughly 12 percent of the world economy) and Saudi Arabia continue to slowly and cautiously liberalize foreign access to their markets. Thus, despite the greatest shock to the international financial system since the 1930s, policymakers in these countries have not removed capital account liberalization from the agenda. Evidently they believe the benefits of phased capital account liberalization outweigh the costs.

The home bias maintained by investors in the developed world is persistent (particularly in Japan). In light of low nominal return expectations and longevity risk in the developed world, flows into emerging assets of all kind are likely to accelerate. Given the history of political instability in many emerging markets, investors in these countries are increasingly likely to reduce their home bias. Thus, important constituencies in both developed and emerging markets will continue to advocate open capital markets.

What could go wrong? A lot—such as debt crisis in Japan, or a repeat of the 2007–2009 experience, which might lead citizens to conclude that governments and corporate managements are incapable of understanding and managing the increasingly complex and interconnected global economy. Under such circumstances, and with a less energetic and skillful global policy response than recently witnessed, large-scale capital controls might be back on the table. But internet technologies are still in the early phases of development, and will continue to drive globalization.

Possible, but not likely.

ANDREAS DOMBRET
Member of the Executive Board, Deutsche Bundesbank

The probability of a broad-based scenario of capital controls is—in my view—still relatively low. I would put it somewhere between two and three out of ten. In fact, I believe the opening of economies to cross-border capital flows will continue. Countries following this path can expect to benefit from deeper financial integration, for example, through greater ease of financing or increases in the productivity of their financial sectors. Yet financial integration is admittedly challenging, and countries have—for very different reasons—taken measures to influence cross-border capital flows. History has shown repeatedly that large and volatile capital inflows, as well as sudden stops and subsequent outflows, can breed distortions in the real economy and the financial sector and may lead to volatile exchange rates. In response, some countries have at times chosen to stabilize capital flows and exchange rates by active capital flow management. However, other countries are seen as applying capital controls for more mercantilist motives, such as to manipulate exchange rates and achieve unfair advantages for export industries.

Despite such measures, I do not believe that we are heading toward an environment with significantly more capital controls than those seen in the recent past. Nor do I subscribe to the view that there is a tangible threat of emerging currency wars. First and foremost, policymakers are well aware that mutual beggar-thy-neighbor policies can undermine domestic economic stability and prosperity. Second, it is difficult to design capital controls so as to guarantee their medium-term effectiveness. Empirical evidence shows that countries are better able to alter the composition than the size of capital flows. Furthermore, a high degree of international cooperation and the possibility of discussing these matters in international fora—such as the International Monetary Fund—will help to discourage non-cooperative policies. Lastly, introducing capital controls seems quite challenging given the high requirements for appropriate design and timing. Communication is also an issue—the idea is not to send false signals to the international community. Altogether, it is likely that countries will remain aware of the huge benefits of free trade and integrated global capital markets.

A three out of ten.

RICHARD JERRAM
Chief Economist, Bank of Singapore

I would put the chance at a three out of ten. A view on the probability of capital controls needs to be based on two distinct factors: ideology and economic conditions. The latter will be the more powerful factor in pushing for capital controls. Admittedly, we have seen a slight shift in ideology in recent years, with even the International Monetary Fund recognizing that the optimal configuration of the Trilemma not necessarily being open capital flows, flexible exchange rates, and independent monetary policy. Nevertheless, the developed world needs growth and despite the criticism of the excesses of the past decade, this is more likely to be achieved by a liberal, free-market model rather than any competing ideology. More generally, the lack of trade protectionism also supports the idea that we are not seeing a big ideological shift.

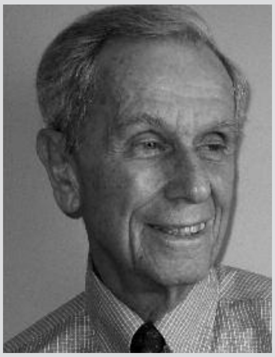
Capital controls could take three forms: on outflows, inflows, or transactions. The potential for regulatory arbitrage means that without agreement of all major economies—which looks unlikely—a transactions tax on foreign exchange would be ineffective. Controls on outflows or inflows by individual countries are more practical.

If you believe that widespread financial repression in the developed world is ultimately the only way out of the current crisis, then capital controls will be a necessary component. After all, you cannot artificially depress domestic returns if the capital is free to escape to repression-free jurisdictions. More likely is that we see a continuation of the current ultra-low interest rate environment for much of this decade, which encourages capital outflows in order to weaken the exchange rate and accelerate the adjustment process.

This naturally raises the question of whether the recipients of these flows will increase capital controls, or other market-distorting macro-prudential measures, in order to limit the impact of unconventional monetary policy in much of the developed world. This has already been happening and seems likely to intensify because these flows are potentially destabilizing either through the impact on domestic monetary conditions or due to the risk of dislocation if they reverse rapidly. As such, we should expect to see individual countries, mainly emerging economies, introducing more measures to limit capital flows. Of course, the irony is that this will reduce the stimulative impact of central bank balance sheet expansion in the developed world and thus delay recovery and prolong the period of ultra-loose monetary policy.

It is hard to envisage the circumstances where economic conditions in the developed world would create pressure for capital controls on inflows. Even if another global financial crisis produces a temporary safe-haven rush into the U.S. dollar, then the response is more likely to be negative nominal interest rates rather than outright capital controls.

So I am left with the conclusion that capital controls in the developed world are unlikely, although they are likely to intensify in individual developing economies.



There will be a fundamental change in exchange management over the next decade.

STEPHEN AXILROD
***Author,* The Federal Reserve: What Everyone Needs to Know**
(Oxford University Press, forthcoming)

With the exception of the potential for increased transitional use of capital controls by countries that might possibly exit the euro, I would not see more active use in the period ahead of capital controls more generally. I believe there will indeed be a fundamental change in exchange management over the next decade or longer (the chance rating about an eight out of ten), but it would more likely reflect behavior consistent with the formation of additional trading blocs, either formal or informal, competitive with the dollar and the euro—all as part of an effort to make a more level playing field for international economic and financial negotiations.

As the present comparatively depressed period in the world economy proves to be a passing phase, underlying trends toward more open societies and more widespread and rapid communication of evolving technical and economic knowledge will reassert themselves and continue to have their equalizing impact on the capacity for economic growth (to the extent local political authorities and elites do not effectively resist). The distribution of income, output, and wealth among countries should continue to become less centered in the U.S. and euro economies as a group. Exchange rate policies and other international economic and financial negotiations will be made, as time goes on, in fluid market conditions as relative economic power slowly shifts, and without so dominating an anchor or port in the storm as the dollar once was and still mostly is.

In that context, smaller countries may take shelter in trading blocs around emerging economic powers such as China, perhaps India, perhaps Brazil, and perhaps Russia—with the roles and place of such as Australia, Japan, and Indonesia uncertain. Whether the currency of any of these countries can compete with the dollar or euro as a true multinational and internationally acceptable currency will depend not merely on the strength and size of their economies but also on the presence of a legal system that is objective and reliable, financial markets that are well and fairly regulated, and a welcoming civil society. Nonetheless, while more widespread currency unions may not prove politically possible, it seems likely that exchange rates within a trading bloc could be tied more or less closely to the dominant country

Such an institutional evolution would mean that international negotiations on payments imbalances would involve, and is already evolving, broader multi-country negotiations involving the United States, the euro bloc (such as it becomes), and other blocs or countries recognized as equally major. And of course the International Monetary Fund obviously will have to be restructured in any event to reflect the inevitable shifts in the distribution of economic and financial power. I would not think that capital controls would, in such a world, become any more prevalent than they have been and probably should become less so.