TEXTO PARA DISCUSSÃO N° 1311a

CAPITAL CONTROLS AND FINANCIAL LIBERALIZATION: REMOVING THE IDEOLOGICAL BIAS IN LIGHT OF THE CONTRIBUTION OF KEYNES AND OTHERS AND THE RECENT EXPERIENCE

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SINOPSE

Rotular o controle de capitais como uma proposta da esquerda é um duplo equívoco. Tal rotulação tem como base critério economicista à Borsa, que reduz a dicotomia entre direita e esquerda à distinção liberalismo econômico *versus* intervencionismo. Além disso, o intervencionismo econômico subjacente à defesa do controle de capitais por parte dos autores analisados (Keynes, Tobin, Davidson, Stiglitz e Rodrik) não é fruto de convicção ideológica em prol de ampla e indiscriminada interferência do Estado na economia. Para eles, controles são instrumentos de utilização tópica, justificada pragmaticamente, ou seja, de acordo com circunstâncias econômicas específicas. Taxar o controle de capitais como prática de governos de esquerda também é incorreto. Dos cinco principais países que usaram controle de capitais a partir da década de 1990 – Chile, China, Índia, Malásia e Tailândia –, só o governo chinês pode ser considerado de esquerda. O panorama político dos demais países é muito mais complexo do que supõem os que acreditam haver uma relação simples e direta entre o controle de capitais e o posicionamento ideológico dos governos que o praticam. Reconhecer isso é um importante passo na direção de uma avaliação mais objetiva da eventual oportunidade de se adotar controle de capitais, sem preconceito. Controles devem ser usados sempre que os benefícios de sua adoção suplantem os custos.

ABSTRACT

To label the defense of capital controls (CC) as a left-wing proposal is a misconstruction. Such labeling uses the Borsa economicist criterion, which reduces the dichotomy between right and left to a distinction between liberalism and interventionism. Yet, under this criterion, the use of CC cannot be labeled as a leftist proposal. The interventionism underlying the defense of CC, as pioneered by Keynes and developed by Tobin, Davidson, Stiglitz and Rodrik, is not the fruit of an ideological conviction favoring widespread and indiscriminate State intervention. For them, CC are instruments to be used under specific economic circumstances. To call CC a practice typical of left-wing governments is also a misinterpretation. Among the countries using strict forms of CC since the 1990's–Chile, China, India, Malaysia and Thailand–only China's government may be called leftist. The other countries' political panorama is more complex than may suppose those who believe in a simple and direct relationship between CC and political ideology. The discussion should be stripped of the prevalent ideological bias: CC are not inherent to the political leanings of the governments that adopt them but are an expedient used under a pragmatic justification. Recognizing this is an important step toward a more objective analysis of the incidental opportunity of using CC, without prejudice. CC should be used whenever the benefits surpass the costs of their implementation.

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1 INTRODUCTION

The idea that there is a simple and direct relationship between capital controls (henceforward CC) and the political stand of governments practicing them–the left is more favorable to CC, while the right is more favorable to financial liberalization–is widespread. This statement, in turn, is based on a hypothesis commonly assumed by economists and political scientists, according to which, in the one hand, pro-labor governments are more likely to impose a higher tax rate on capital and are thus less likely to liberalize the capital account; whereas pro-capital leaders are more likely to liberalize the capital account (ALESINA; GRILLI; MILESI-FERRETI, 1993). Quinn and Inclán (1997) and Oatley (1999), among others, share a similar view.

This idea was pioneered by Alesina and Tabelini (1989), who presented a model according to which left-wing governments are more favorable to CC than right-wing governments. Kastner and Rector (2003) found evidence supporting the hypothesis that the further to the right a government, the more it favors the liberalization of the capital account. Li and Smith (2003) present evidence that the further to the left a government, the more it favors CC.

This paper does not intend to be a critical review of the methodology used in the above-mentioned works–although a lot could be done in this direction. Rather, it aims at examining to what extent CC may be seen as a leftist proposition–or, conversely, to what extent the liberalization of the capital account may be seen as a right-wing proposal. The removal of this ideological bias is an important step towards a more objective evaluation of the casual opportunity of using CC. The approach used is essentially analytical and no econometrics will be used. The second section presents a brief review of the literature focusing on the institutional and/or political determinants of CC. The two subsequent sections examine the concepts of right and left and of capital-control mechanisms. Following this, we will show the core motivations of the main defenders of CC, as pioneered by Keynes and developed by Tobin, Davidson, Stiglitz and Rodrik. The sixth section describes the main instances of the use of more severe measures of CC after the 1990's in the light of International Monetary Fund's (IMF) *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), namely, Chile, China, India, Malaysia and Thailand. Our conclusion is that CC have been wrongly labeled as a left-wing policy and that the prime reason for their adoption is not ideological but pragmatical. They should be used whenever the benefits surpass the costs of their implementation.

2 THE IDEOLOGICAL BIAS AGAINST CAPITAL CONTROLS: A BRIEF REVIEW OF LITERATURE

The idea of the utilization of CC as a left-wing policy can be traced back to Alesina and Tabelini (1989) who developed a model aimed at relating the political instability of developing countries to certain economic variables such as public external indebtedness, capital flight and restrictions on capital outflows. The model represents an economy in which two groups of agents–workers and capitalists–behave non-cooperatively. There are two types of government: one is left-wing and represents the interests of the workers; the other is right-wing and defends the interests of businessmen. In each case, policy-makers look forward to maximizing the economic welfare of their own constituency or social group. Uncertainty concerning the economic policies of the next government creates political risk, and therefore influences the current decisions of the two social groups and of the ruling government. The model explains that capital flight and large external debt are more likely to occur in politically unstable countries. More specifically, "the model also predicts that left-wing governments are more inclined to restrict capital outflows than right-wing governments" (p. 199).

Using data for the 1967-1986 period in seven Latin America countries and in the Philippines, they concluded that their model's findings were "roughly consistent with the empirical evidence". However, they acknowledged that this evidence "is merely suggestive; more empirical research on this topic is called for" (p. 211).

Alesina, Grilli and Milesi-Ferreti (1993) studied the institutional and political factors that might explain the decision to adopt CC in 20 Organisation for Economic Co-operation and Development (OECD) countries in the years 1950-1989. Instead of using a formal model, they focused on finding empirical support for available theories. Their paper intends to find out whether the decision to impose CC may be related to certain institutional and political variables. Its main motivation is the recognition that "capital controls have not been examined from this political-institutional perspective" (p. 1).

Taking the existence of CC as the dependent variable, they regressed it on the following variables: the government's political leanings (right or left-wing); the nature of the ruling executive power (one-party government with parliamentary majority; minority or coalition government); government durability; the Central Bank's degree of independence; and the exchange rate regime. They found that CC are more likely to be in place in stable political systems–meaning majority and long-standing government. Nevertheless, they failed to gather evidence for the existence of a significant relationship between CC and the ideological orientation of those governments practicing them. The findings of Alesina and Tabelini (1989) were therefore not confirmed by the results from the experience of the OECD countries.

Using data for 61 countries in the 1966-1989 period, Grilli and Milesi-Ferretti (1995) examined the influence of an economy's structural and political features upon the adoption of CC. Yet, they have ruled out government ideological orientation as a possible determinant of CC. Their conclusion is that controls are more likely to occur in lower-income economies, where governments play a greater role in economic activity, the central bank has limited independence and the exchange rate is managed.

One should note two papers presenting empirical evidence supporting the idea that using CC is more likely to be a leftist initiative. Li and Smith (2003) have considered ideology among the variables, specifying the conditions under which state leaders decided to liberalize CC in 18 OECD countries during the 1967-1990 period. They concluded that "the further left the state leaders are (…) the less likely a state is to liberalize capital transactions" (p. 16).

Kastner and Rector (2003) have studied the relative importance, on a country's CC policies, of the domestic political decision-making system vis-à-vis the international environment. Using a sample of 19 OECD countries over 47 years (1951-1989), they provide evidence in favor of the hypothesis that "In capital-abundant countries, all else equal, Right and Center-Right governments enact a greater number of liberalizing changes in CC policy than other governments" (p. 5).

As a result of the acritical acceptance and/or superficial interpretation of this literature, many believe that CC are an exclusively leftist initiative and that liberalization of the capital account is a rightist proposal. Consequently, CC are often dismissed as a left-wing option–a tag obviously intended for disparagement, as can be clearly seen in the words of Pastore, a former president of the Central Bank of Brazil:

> Defenders of capital controls are mostly left-wing (...) I have been an opponent of heterodoxy for more than 40 years and am therefore perfectly justified in calling for an IOF [tax on financial operations] for capital inflows (…) without being accused of leaping onto the bandwagon of the stupid leftist point of view which says that the control of capital flows leads to a more efficient monetary policy (PASTORE, 2005).

The above quotation is an example of the ideological bias against CC. Widespread belief in this bias is one of the reasons for the condemnation of CC adoption. Conversely, the defense of financial liberalization seems to be grounded on ideological convictions rather than on empirical evidence (CARVALHO; SICSÚ, 2004; 2005). This holds true specially (but not only) for developing countries, which have borne most of the costs of the 1990's crises associated to financial liberalization. As suggested by Carvalho (2005), there are other reasons besides the economic rationale for the unconditional preference for financial liberalization:

> The greatest mystery to be addressed by a research on capital controls, although, might be on the political economy field. (…). The continuity of the liberalization is not explained by economic reasons. (…). The most likely reason for the governments' reluctance to consider the alternative to reactivate capital controls belongs to the political economy field. This holds both domestically, by the examination of the game of interests formed and crystallized around the capital account liberalization, and internationally, including the influence of institutions as the IMF (CARVALHO, 2005, p. 261).

3 THE DICHOTOMY BETWEEN RIGHT AND LEFT

The right *versus* left dichotomy goes back to the French Revolution and appeared first in the Constitutional Assembly of 1789-1791. Since then, the historical permanence of this dichotomy saw its terms modified in their meaning as a result of changes in the ideological and political fields. The Russian Revolution (1917) led to the creation of a confederation of socialist countries, the Union of Soviet Socialist Republics (USSR). After World War II, the USSR imposed its brand of socialism to Eastern Europe, which had come under its political and economic hegemony. The world was divided into two politically and economically antagonistic blocks: the socialist world, representing the left at a global level; and the capitalist world, with the United States of America as its hegemonic power, standing as the main obstacle to communist expansion and, thus, leading the right-wing block. By the end of the 20th century, with the fall of the *Berlin wall* and the globalization process, this dichotomy was intensely questioned.

Nevertheless, it did not lose its descriptive usefulness. Bobbio (2001) retrieves the essence of the dichotomy's meaning by proposing a criterion to distinguish right from left, based on the political ideal of equality: for the left, equality is the rule, and inequality, the exception; and, for the right, the opposite is true. Eventually he set forth a new version of his criterion, with the purpose of accounting for new demands from groups who identify themselves as *excluded*–for reasons of ethnicity, gender etc. He reaffirmed his criterion by choosing as reference the political ideal of *inclusion*.

The right *versus* left dichotomy is not limited to the opposition between liberals and interventionists, as proposed by Borsa (1998). For him, the dichotomy becomes meaningless under the globalization process, and all that is left to distinguish its two elements is "the way capitalist development is managed. According to the Right, the State should not interfere with the market. The Left claims that the State should guide and rule the market" (BORSA, 1998, p. 618). Bobbio refuses Borsa's classification, arguing that there is a sphere of human action ruled not by the market, but by other institutions and by non-economic criteria such as those of a political nature:

> (...) the distinction is not dead and buried, but is alive and kicking. Only those who believe in the market's permeability and expect from it the solution to all the problems resulting from civic coexistence can believe that there is only one road to globalization, that of the total mercantilization of human relations. The wider the market, the greater the problems it generates or cannot solve (BOBBIO, 2001, p. 15).

The right *versus* left dichotomy is defined in terms of *objectives*. That is to say, equality (or inclusion) is what the left strives for, regardless of the *means* used to achieve these objectives. The search for equality (or inclusion) did not fall with the *Berlin wall*. Conversely, the disruption of the socialist system does not imply in the end of the left:

> Following the collapse of the Communist system, which was seen as the historical fact most in tune with the ends upheld by Leftist ideals, some would suggest that what disappeared for good was the Left, and that 'the end of History' might be rightly represented as the final triumph of those ideals until then considered as characteristic of the Right (BOBBIO, 2001, p. 150).

This is crucial in order to understand why Borsa's proposal is an example of *economicist reductionism*–an attempt to reduce a political dichotomy (right *versus* left) to an economic dichotomy (economic liberalism *versus* interventionism). The first one deals with objectives defined in terms of political ideals–equality (or inclusion) *versus* inequality (or exclusion). The second one refers to the means that can be used to achieve a given economic goal. One distinction does not encompass the other. Both can coexist and be combined to create new categories of a double political and economic nature. There can be right-wing or left-wing liberalism, as well as right-wing or left-wing interventionism. In short, the right *versus* left dichotomy retains its explanatory efficacy and should not be confused with the distinction between liberalism and interventionism.

4 CAPITAL CONTROLS: A SYNTHESIS

4.1 BRIEF BACKGROUND AND DEFINITION

The first experiences with CC date back to the 16th century, when Spain and France restricted gold and silver exports under *bullionism*. However, after these primitive forms, only in the 20th century did CC really flourish. After the Great Depression and in the forties, restrictions to the flow of capitals were adopted by the major economies–with few exceptions, such as the United States of America, Canada and Switzerland. The Bretton Woods Conference established the convertibility of current transactions but not of capital transactions. Article VI of the IMF's *Articles of Agreement* allows the adoption of controlling measures in the face of sustained capital outflows. In the seventies and eighties, restrictions on international capital flows were abolished in developed countries. In the 1990's, financial liberalization reached developing economies.

CC is a phrase used to describe any instrument that to any degree limits the free flow of capital between a country and the rest of the world. One may apply them to all the items of the capital-account or only to certain types of financial operations. It may be effected through administrative measures that exert a direct rule upon capital flows; or through incentive mechanisms implemented via the market. From the operational standpoint, controls may be created upon the inflow or the outflow of capital.

As regards the framework within which they are adopted, CC may be permanent or temporary. In the first case, the costs of financial integration are considered to exceed the benefits thereof. Therefore, the capital-account must be controlled. In the second case, financial liberalization is seen as desirable and controls must therefore exist only until the establishment of the necessary prior conditions that will allow the country to fully benefit from the liberalization of its capital-account. As soon as the economy is ready to benefit from financial integration, controls must be removed.

In both cases, CC are conceived as an instrument not to be adopted on a political basis. Those who neglect the efficient market hypothesis (EMH) propose that controls must be permanent. Those who assume the EMH consider that CC are undesirable. In this case controls must be, at best, temporary. The rationale behind the use of CC is purely economic:

> (...) its possible adoption does not rely only on the existence of failures that would demand an intervention (...) but also on evaluation of the costs and benefits that would result from its implementation through a set of specific instruments" (CARVALHO, 2005, p. 254-255).

It should be noted that during the 1990's the IMF became the main champion of financial liberalization. The climax of the great pressure put on by the IMF for the removal of CC was the revision of article VI of its *Agreement*, taken into account at its annual meeting in 1997. Ironically, in the face of the devastating impact of the Asian crisis, the IMF was forced to backdown, leaving this objective aside and paradigmatically adopting a more favorable stand as regards temporary controls:

> Admittedly, in its routine surveillance missions, prior to the Asian crisis, the IMF may have sometimes tilted too far towards benign neglect as countries prematurely liberalized markets for short-term capital movements, before the internal regulatory structure was in place to handle them. Now, the IMF's advice is more nuanced. (...) the role of limited and temporary capital controls, especially for economies at intermediate levels of financial development, needs further study" (ROGOFF, 2002).

4.2 THE CASE FOR FINANCIAL LIBERALIZATION

Defenders of financial liberalization argue that it: *a*) promotes efficient capital allocation, to the special benefit of developing countries that, due to scarcity of capital, would receive a positive capital flow in the quest for larger returns; *b*) helps adjust the balance-of-payments in economies with current-account deficit; and *c*) imposes greater discipline on governments, for capital will only flow to countries with solid macroeconomic fundamentals. It is furthermore argued that CC limit individual liberty and work against the ideal of a free society; and are inefficient and therefore innocuous, since economic agents will always find legal loopholes in order to escape their influence.[1]

As a rule, proponents of financial liberalization stress the allocative efficiency improvements allegedly resulting from the removal of CC. This argument is similar to the one used to defend commercial liberalization: just as free trade promotes optimum global allocation of productive resources, the free flow of capital determines an efficient allocation of capital between countries. This is the main argument used by the IMF.

4.3 THE CASE AGAINST FINANCIAL LIBERALIZATION

Defenders of CC hold that they: *a*) give more autonomy to macroeconomic policies; *b*) increase financial stability; *c*) are necessary in order to avoid the overvaluation of domestic currency in times of excessive international liquidity; *d*) allow taxation of capital revenues, thus making possible a redistributive tax policy by barring domestic agents from transferring funds to countries with lower taxation; and *e*) may be used as instruments of industrial policy in shaping the structure of internal supply, whilst encouraging the inflow of Foreign Direct Investment (FDI) for specific sectors.

As a rule, defenders of CC note that they increase the autonomy of monetary policy by allowing the existence of a domestic and foreign interest rates differential.

5 SOME AUTHORS WHO DEFEND CAPITAL CONTROLS

Amongst the many defenders of CC, one should note Keynes, White, Tobin, Davidson, Rodrik and Stiglitz. The sixty-year period in which these authors developed their contributions may be broken down into three paradigmatic moments. The contextualization of those moments is important to understand why CC are an instrument the adoption of which is justified on a pragmatic basis.

[1] As suggested by Carvalho (2003), this last argument is incompatible with the others: if controls were innocuous, they would be unable to restrict individual liberty, to jeopardize economic efficiency etc.

Conversely, these authors propose CC as an expedient to be used under specific economic circumstances.

Keynes broke new ground when he criticized financial liberalization in Bretton Woods, defending the non-convertibility of the capital-account. Although his proposal for the restructuring of the international monetary system–essentially based on the creation of a supranational central bank that would issue an international currency and play the role of an international clearing union (ICU)–was put aside in favor of the White Plan, named after the United States of America leading representative, IMF by-laws envisage only the convertibility of the current-account and grant members the right to adopt CC when there is a threat of sustained capital outflows.

After the collapse of the Bretton Woods system, in the early 1970s, and the resulting adoption of floating exchange rates by major industrialized economies, Tobin took up Keynes' arguments for CC, pointing out the loss of monetary policy autonomy resulting from intensified short-term capital flows. Two decades later, Davidson criticized the effectiveness of the Tobin tax and proposed a reform of the international monetary system, inspired on the Keynes Plan.

The nineties were marked by the financial globalization process, typified by the drastic intensification of international capital flows. The belief that the free flow of capital would result in greater efficiency in capital allocation and thus greatly benefit developing countries did not materialize. On the contrary, what we saw was a succession of financial crises, precisely in those developing countries that would supposedly benefit the most from financial liberalization: Mexico, Southwest Asia, Russia, Brazil and Argentina. It is in this context that we should consider the contributions made by Stiglitz and Rodrik, who argue that the existence of market failures justifies the adoption of CC.

5.1 KEYNES

Keynes (1930) warned that, in the gold-standard system, capital-account liberalization would jeopardize monetary policy autonomy. He was a reformer, and never suggested there should be a profound or radical re-orientation of the capitalist system. The adoption of CC, as well as the engagement in counter-cyclical fiscal policy, aims at ensuring the smooth functioning of capitalism. In both cases, economic interventionism should not be seen as the result of an anti-liberal mindset which, of course, Keynes never shared. They are pragmatic measures adopted for the attainment of a specific result that the market cannot spontaneously achieve.

The increase in public spending was to be justified as a solution to chronic unemployment, which, as it spread during the Great Depression, threatened capitalism by furthering the advance of socialism. Because he feared seeing the Marxist prophecy come true, Keynes justified the setting aside of orthodox liberalism:

> Whilst (...) the enlargement of the functions of government (...) would seem (...) to be a terrific encroachment on individualism, I defend it, on the contrary, both as the only practicable means of avoiding the destruction of existing economic forms in their entirety and as the condition of the successful functioning of individual initiative (KEYNES, 1973, p. 380).

CC are necessary in order to guarantee autonomy in the setting of interest rates, one of the main instruments of macroeconomic policy. In its absence, monetary policy could not be used anti-cyclically and, thus, policymakers would be waiving an important tool in the war against unemployment, the main threat to the capitalist system at that time. This was the guiding principle of Keynes' proposal in Bretton Woods:

> (...) the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without references to the rates prevailing elsewhere in the world. Capital control is a corollary to this. (...) my own belief is that the Americans will be wise in their own interest to accept this conception (KEYNES, !980, CW, v. XXV p. 149).

Indeed, Americans recognized that there was a need for controlling capital flows–or else they might become an additional source of disturbance, jeopardizing foreign trade. At this point, the Keynes-White dispute was superseded by a convergence of interests:

> It would seem to be an important step in the direction of world stability if a member government could obtain the full cooperation of other member governments in the control of capital flows (WHITE *apud* BOUGHTON, 1998, p. 40).

It is worth noting that although the political profile of the precursor of CC, in its modern form, is complex enough, Keynes cannot be categorically labeled as a leftist. He was opposed to Labour, England's most important left-wing party. Moreover, Sir John, created a lord for his services to the British Empire, openly sided with the intellectual and political elite of the bourgeoisie: "Ought I, then, to join the Labour Party? (...) To begin with, it is a class party, and the class is not my class (...) the *class* war will find me on the side of educated *bourgeoisie*" (KEYNES, 1980, CW, v. IX, p. 297). Besides, he was radically opposed to Leninism and an acerbic critic of Marx and Socialism, the great icons of the left in his time.[2]

For Keynes, CC were a measure that allowed capitalism to "hand over the rings in order to save the hand", justifiable as a need, and not as a decision resulting from political or ideological convictions. They were an expedient to assure the smooth functioning of capitalism.

5.2 DAVIDSON *VERSUS* TOBIN

Tobin (1978) proposed a very small tax on spot conversions of currencies, with a view to discouraging the speculative flow of short-term capital. Early in seventies he warned that the intensity and volatility of these flows could seriously jeopardize a country's macroeconomic performance–even with a floating exchange rate–especially by reducing the autonomy of monetary policy. From the microeconomic viewpoint, he also pointed out the negative impact of exchange rate volatility: oscillations in the exchange rate unbalance relative prices and affect the competitiveness of the import and export sectors.

[2] "How can I accept a doctrine which sets up as its bible (...) an obsolete economic textbook [Marx's Das Kapital] (...) not only scientifically erroneous but without interest or application for the modern world? How can I adopt a creed which, preferring the mud to the fish, exalts the boorish proletariat above the bourgeoisie and the intelligentsia who, with whatever faults, are the quality in life and surely carry the seeds of all human advancement?" (KEYNES, CW, v. IX, p. 258).

Davidson (1997) casts serious doubts on the effectiveness of Tobin's proposal, pointing out that it "is unlikely to constrain even small investors" (p. 678).[3] Moreover, he warns that besides being ineffective in reducing speculative capital flows, (marginally) increasing the transaction cost for foreign exchange may also jeopardize international trade. Davidson (2002) also provides evidence showing that the Tobin tax would increase rather than decrease exchange rate volatility.

Davidson (1982; 1992; 1997; 2002) takes up Keynes' proposal for a reform of the international monetary system, based on the recognition that:

> Instead of producing the utopian promises of greater stability, more rapid economic growth and full employment claimed by classical economists, liberalization of capital-flow regulations has been associated with exchange rate instability, slower global economic growth and higher unemployment (DAVIDSON, 2002, p. 220).

More than simply reviving the Keynes Plan, Davidson updates Keynes's proposal to meet the economic and political circumstances of the 21st century, based on the recognition that at the current stage of "economic development and global economic integration (…) a supranational central bank is not politically feasible" (DAVIDSON, 2002, p. 209). This proposal is not only more modest, but specially more feasible, since it does not require that national control of both local banking system and macroeconomic domestic policies be surrendered. The creation of the ICU would require *only* an international agreement amongst its nation-members, preserving the core of the Keynes Plan.

The essence of the Keynes-Davidson proposal for international monetary system reform rests on: *a*) the creation of an international money clearing unit, held by the central banks of nations signing an international agreement upon the creation of an ICU; *b*) each nation's right to adopt CC; and *c*) a trigger mechanism that would encourage surplus nations to spend their credits, thus creating a bias toward the expansion of foreign trade.

Tobin, in short, wants to preserve the autonomy of monetary policy, whereas Davidson, like Keynes, wants to reform the capitalist system. These objectives, of course, are not an appanage of the left.

5.3 STIGLITZ AND RODRIK

Stiglitz and Rodrik emphasize the existence of financial market failures and reject the EMH. The incompleteness of markets and asymmetric information jeopardize the existence and stability of competitive equilibrium. In this situation, the free operation of the market doesn't necessary lead to a Pareto efficient equilibrium. CC aim at correcting market failures that invalidate the main argument for financial liberalization–the promotion of efficient capital allocation.

Rodrik (1998) pointed out the inadequacy of the parallel drawn between the goods and services market and the financial market, used in arguing that financial liberalization, similarly to trade liberalization, improves efficiency. He identifies

[3] The effectiveness of the Tobin tax is not being discussed here. Arestis and Sawyer (1997) present a more favorable view of it.

several failures that put at risk the perfect operation of capital markets, making CC a second-best solution.

Stiglitz (2002) observed that the high volatility of capital flows generates negative externalities that place economic performance at risk. Large capital outflows, which devaluate domestic currency, worsen the solvency of companies indebted in foreign currency. On the other hand, massive capital inflows, overvaluing the domestic currency, hamper the competitiveness of domestic production. This has a negative effect upon the performance of the exporting sector. Therefore, the greater its participation in the Gross National Product (GNP), the lower the economic growth rates. In this case, exporters are penalized by decisions made not by them but by investors, thus creating a negative externality. To minimize the effects of its high volatility, Stiglitz defends CC.

Stiglitz became one of the most vocal critics of the accelerated and intense financial liberalization wave sponsored by the IMF in the 1990s. In his opinion, this was the main specific cause of the Asian crisis. He went on to conclude that the good economic performance of China and India (countries that did not succumb to the nineties crises) are to be explained also by their having practiced CC.

Stiglitz's and Rodrik's stand for CC is no gratuitous and indiscriminate aggression against the free operation of the market, and should be understood in context. They defend CC as an instrument aimed at a very specific goal: a remedy for financial market failures, as evidenced in the Asian crisis. Obviously, this cannot be genuinely labeled as a leftist proposal.

6 RECENT EXPERIENCES IN CAPITAL CONTROLS

In the opposite direction as regards the capital-account liberalization, Chile and Malaysia adopted CC in the 1990s and Thailand did the same at the end of 2006. China and India did not bend to the pressure–mainly from the IMF–in favor of a greater mobility of capital. They still set considerable restrictions upon the capital account, although some liberalizing measures have been taken recently. Those are the main instances of the use of stricter CC measures after the 1990's, according to IMF's AREAER.[4]

6.1 CHILE

Chile used CC during the administration of Mr. Aylwin (1990-1994) and of Mr. Ruiz-Tagle (1994-2000), both of whom belonged to the Christian Democratic Party–Partido Demócrata Cristiano (PDC). The PDC was born from the Falange Nacional (FN), a propaganda agency for the Conservative Party, from which it broke away to become a new party. After good results in the 1957 parliamentary elections, the FN merged with other forces also identified with the social thought of the catholic church and opposing both economic liberalism and fascist and communist totalitarianism, to create the PDC. Their program was for reform and social change, and in the eighties they became the country's major political force.

[4] For more details see Aryoshi et al. (2000) and BOT (2006).

The PDC is a centrist party and historically was the main opponent of the Socialist Party (PS), one of the most important leftist parties in Latin America. In 1973, a coup shut down political parties, which only returned to the scene in 1988, when a plebiscite resulted in dictator Pinochet being voted out of the presidency. Rid of the ultra-rightist dictatorship, the Coalition of Parties for Democracy–formed by the PDC, the PS and two small parties–elected Mr. Aylwin President in 1989. In the following election, PDC Chairman Eduardo Frei was elected President. Mr. Lagos attained the presidency in 2000 by defeating Joaquín Lavín, the candidate of the Independent Democratic Union (UDI), Chile's major right-wing party.

In the early nineties, facing a surge in capital inflows, Chile adopted controls–mainly upon the inflow of short-term capital and based on an incentive mechanism. The purpose was to give policymakers greater autonomy, so that they could conciliate a tight monetary policy aimed at reducing inflation with the preservation of domestic production competitiveness, threatened by the predictable appreciation of the domestic currency resulting from the massive capital inflow.

With a view to reducing the inflow of volatile short-term capital and/or to increasing its term of permanence in the country, a 20%-30% compulsory unremunerated reserve requirement (URR) on foreign loans–except for trade credits–and on fixed-income securities, was instituted in 1991. With the retraction of the international capital flow following the Asian crisis, the URR was extinguished in 1998.

The imposition of CC was therefore the act of a coalition government led by the centrist PDC. Capital-account liberalization, begun under the Frei administration, was continued under the presidency of Mr. Lagos, the main leader of the leftist PS. The Chilean experience categorically refutes the thesis that CC are exclusively a leftist initiative: they were practiced by a government led by a centrist party, and financial liberalization was furthered even more during the administration of Mr. Lagos, an icon of the Chilean left.

6.2 CHINA

The People's Republic of China was created in 1949 as a socialist state. Imposed by a revolution, the Chinese regime reproduced the USSR's model. The constitution relied on socialism and democratic centralism as its mainstays, with the Communist Party as the sole authorized party and one of the holders of state power. The regime was only formally democratic. In fact, it was authoritarian: government officials and Communist Party members were indistinguishable. The new regime isolated the country: no political alliances were made, and the closing-up of the economy was also partly the result of the blockade by the United States of America and their allies, suspended only in 1971.

In the 1990s, a process of reform and economic opening was initiated, with a view to building a socialism with Chinese characteristics. This process integrated state planning and the market, social and private property, protectionism and foreign opening, regulation and deregulation. In spite of this drawn-out reform process, China still controls its capital-account, especially by means of administrative requirements and quantitative restrictions to capital flows. In 1996, the country adopted the convertibility of current transactions, but capital flows underwent only limited liberalization, maintaining restrictions regarding: *a*) access to the domestic market by foreign investors; *b*) foreign investments by residents; *c*) foreign loans; and *d*) direct offshore investments. These measures favored long-term capital flows and FDI, which amounted to 98% of the capital-account between 1990 and 1996.

In order to avoid the devaluation of the *yuan* during the Asian crisis, CC were strengthened by stricter administrative measures, aimed mostly at holding down the illegal outflow of capital disguised as current transaction payments.

China is the best example of CC adopted by a leftist (authoritarian) regime. Yet, through a complex process of political, economic and social transformation, the country has since the nineties liberalized CC, which had been briefly strengthened during the Asian crisis.

6.3 INDIA

India is a "democratic, secular, socialist and autonomous republic" which, following its independence (1947) and until 1997 was ruled by a majority government from the Indian National Congress (INC) party. In 2004 the INC returned to power by means of a center-left coalition also supported by two communist parties, thus forming a solid political and parliamentary base. Nationalist in its origin and sympathetic towards socialism, the INC is nowadays characterized by a social-democratic ideology with populist nuances. It holds a center-left position, with the communist and socialist parties on its left and its great rival, the Bharatiya Janata Party (BJP), on its right. CC are a historical item in the INC program, which supported a foreign policy of non-alignment vis-à-vis the two superpowers of the second half of the 20th century.

Created in 1980, the BJB is the champion of the country's Hindu majority and defends market economy and conservative social policies. It came to power in 1997 and lost it a few months later. For two years, the country was governed by unstable party coalitions. In 1999, the BJP, leading a newly created coalition–the National Democratic Alliance (NDA)–won the elections, bringing political instability to an end and consolidating a period of political-party maturity for Indian democracy. In 2004, the INC achieved an historic victory, taking its situationist opponents by surprise.

Since 1991, India has been promoting economic reforms of a liberalizing nature. A gradual process was started towards the liberalization of foreign capital flows, which had been historically controlled by administrative measures. The reforms resulted in: *a*) a slight loosening of restrictions to the inflow of capital; *b*) encouragement of FDI; *c*) discouragement of short-term capital inflows; and *d*) the generation of future indebtedness inflows (such as deposits in foreign currency by non-resident Indians). Remaining under administrative control were the outflow of capital and the inflow and outflow of short-term capital. The beginning of the present decade saw the liberalization of debt-generating operations, with a limited loosening of restrictions on capital outflows.

India is thus, on the one hand, an exemplary historical experience in the adoption of CC by a democratic center-left government. On the other hand, it paradigmatically contradicts the viewpoint that right-wing governments necessarily adopt financial liberalization policies: the government led by the right-wing NDA as a rule maintained CC between 1999 and 2004.

6.4 MALAYSIA

Malaysia is formally a parliamentary monarchy in which the head of state is chosen amongst the sultans of the nine peninsular states for a five-year term and also rules on the Islamic religion. The Prime Minister is chosen amongst the representatives of the party holding a majority of House of Representatives seats. Islamic law is on an equal status with the Constitution, and is applied by the states to Muslims. The dominant political party is the United Malays National Organization (UMNO), which, since the country's independence (1957) rules in coalition with other parties, mainly the Chinese-Malaysian Association and the Indian Malaysian Congress.

From 1981 to 2003 there was just one Prime Minister, Mahatir Mohamad. Although the regime was formally democratic, Mr. Mahatir's government was in fact authoritarian. It controlled the media and the Judiciary Power and used Islamic values to suppress troublesome opponents. Mr. Mahatir postured as a defender of Asian values and champion of authoritarian state capitalism, attacking the United States of America for its individualistic and liberal doctrine.

In 1994, Malaysia controlled the inflow of capital and, during the 1997-1998 financial crises, its outflow. First, excessive international liquidity led to the adoption of mainly administrative controls to contain the inflow of short-term capital–attracted by the difference between domestic and foreign interest rates–and the appreciation of the *ringgit*. The main measure was the elimination of remuneration on foreign-bank investments in domestic assets. Furthermore, bank indebtedness abroad was limited.

During the Asian crisis, a varied arsenal of controlling measures was used to stop the devaluation of the *ringgit*, under pressure from sustained capital outflows. Discarding policies recommended by the IMF, the country faced the crisis by also taking measures which would not jeopardize its economic-growth momentum, and which contemplated: the lowering of interest rates; the broadening of credit; the increase of public spending; and a fixed exchange rate after a 50% devaluation.

Malaysia, only formally a constitutional parliamentary monarchy, is a case of CC under a right-wing authoritarian regime. Controls were first used in the context of excessive international liquidity and later as a reaction to the sustained capital outflow resulting from the Asian crisis. This is one of the most evident examples showing that practical, as opposed to ideological reasons, can justify CC.

6.5 THAILAND

Ruled by kings since the 13th century, Thailand officially became a parliamentary constitutional monarchy in 1932. According to the 1997 People's Constitution, although the king has limited power as chief of State, he is the sacred protector of Thai Buddhism and a symbol of national identity and of political unity. The ruling king has been occupying the throne since 1946. The government is headed by a prime minister appointed by the king from amongst the members of the House of

Representatives, who are elected by popular vote. The prime minister is usually the leader of the main party in charge of composing a coalition government. In practice, the government is dominated by the military and bureaucratic elites.

Since September 2006 the country has been ruled by a military junta that came into power in a coup. The king, as usual, endorsed the new regime. Parliamentary elections are likely to take place in December 2007, supposedly after a new constitution comes into effect.

In October 2006, the *bath* began to appreciate as a result of massive capital inflow, mainly for investment in the stock market and government bonds. In addition, foreign funds started to sell considerable amounts of US dollars. As short term speculative inflows intensified, the *bath* reached the most appreciated rate in seven years.

Since the appreciating trend persisted, in December the Bank of Thailand (BOT) announced the implementation of a 30% URR on short term capital inflows–except for FDI–and the repatriation of investments abroad. Two days after this announcement, as the *bath* reverted the appreciation trend, the BOT started relaxing its control measures, exempting equity investments in the Thai stock market and other non-speculative inflows from the requirement. The URR, however, has been in force for almost 1 year now.

Thailand is another example of the adoption of CC by a right-wing, authoritarian regime. As in Chile, controls were utilized to prevent overvaluation of the domestic currency. This is a further case showing that CC have been wrongly labeled as a left-wing policy and that the prime reason for their adoption is not ideological but pragmatical.

7 CONCLUSION

To tag the defense of CC as a left-wing proposal is a misconstruction. First because such tagging is based on an economicist criterion that reduces the right *versus* left dichotomy to the economic liberalism *versus* interventionism distinction. Secondly, even under the Borsa criterion, the use of CC cannot be labeled as a leftist proposal. The economic interventionism underlying the recommendation of CC is not the fruit of an ideological conviction favoring widespread and indiscriminate State intervention. The argument of the main authors proposing CC is that they are an instrument to be used under specific economic circumstances: *a*) during the thirties' Depression and in face of the advance of socialism, Keynes, a liberal in the broad sense, merely intended to reform capitalism; *b*) by reason of the growth of speculative capital flow, Tobin aimed at preserving the autonomy of monetary policy; *c*) in face of the globalization process, Davidson updates the Keynes Plan; and *d*) Stiglitz and Rodrik wished to remedy financial market failures, the consequences of which were specially dramatic during the Asian crisis. These have never been the proper objectives of the left.

To label CC as a practice typical of left-wing governments is also incorrect. Among the five main countries using more severe CC after the nineties, only the Chinese government may be called left-wing. The political panorama in the other countries is much more complex than may suppose those who believe there is a simple and direct relationship between CC and the political stand of governments practicing them. There is no relationship between political ideology and CC: neither the left is necessarily favorable to control, nor the right is necessarily favorable to financial liberalization. Recent experience shows that developing countries adopt CC in order to reduce the unstable effects of financial globalization on their domestic economies through a pragmatic attitude–disregarding the political orientation of their governments.

The discussion should be stripped of its ideological bias: CC are an expedient used under a pragmatic justification and are not inherent to the political leanings of the governments utilizing them. Tagging CC as a leftist proposal is a prejudice that has become an ideological argument backing the unconditional preference for financial liberalization. Removing this bias is an important step toward a more objective analysis of the incidental opportunity of using CC. Their adoption (or removal) should be based solely on an economic rationale. In brief, CC should be adopted if their benefits exceed their costs; conversely, they should be removed if the opposite is true.

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