Economics

Capital Controls Are Becoming Disturbingly Popular

There are reasons for countries to worry about too much foreign investment, but regulation could be a cure that's worse than the disease.

By Noah Smith
January 7, 2020, 7:00 AM EST

Let it roam free? Photographer: Safin Hamed/AFP/Getty Images

In the late 20th century, economists generally accepted the notion that financial capital should be allowed to flow freely between countries. But economists are beginning to question this consensus. That could lead to less open financial and currency policies around the world, or herald the coming of a new global monetary order.
There are a number of reasons that free capital movement became a popular policy prescription. Economists believed that international investment made countries' domestic financial systems more efficient and sophisticated, transferring ideas from abroad and subjecting local banks and markets to competitive pressures. These improved financial systems would do a better job of allocating capital to where it needed to go – and, in the process, improving productivity, investment efficiency and growth rates.

But by the late 1990s, that emerging orthodoxy was already starting to show cracks. A series of financial and economic crises in Asia in 1997 showed that sudden capital outflows could devastate an emerging market even if its fundamentals were sound. A new view of international investment dollars as a destabilizing force began to emerge. When times are good, this theory goes, foreign capital flows into a country, pushing up asset prices and igniting speculative bubbles. But small changes in conditions can send capital stampeding out of the country, devastating the local financial system and leading to an economic slowdown. Even some diehard defenders of free trade, like Columbia University professor Jagdish Bhagwati, began to argue that capital mobility was a special case in which unfettered trade could cause more harm than good.

This new skeptical view of capital liberalization was only strengthened by the Great Recession, which saw some countries grappling with housing bubbles seemingly inflated by inflows of international investment dollars. Meanwhile, a huge capital outflow from China in 2015-16 was stemmed only by draconian restrictions on moving money out of the country.

Evidence continues to emerge about the macroeconomic dangers of capital flowing freely between countries. Economists Barry Eichengreen, Poonam Gupta and Oliver Masetti find that capital outflows from emerging markets have become more volatile over time. Foreign direct
investment, where investors actually buy a factory or other real asset in a country, is less fickle, but even it has become more volatile in recent years – now instead of just selling stocks and bonds, global investors are likely to actually pack up and move their factories and offices out of a country.

There might also be longer-term reasons for countries to block influxes of foreign money. Economists Dani Rodrik and Arvind Subramanian argue that capital inflows can cause a country’s exchange rate to appreciate, hurting the country’s export industries, which in turn hurts productivity growth. Economists Gianluca Benigno, Nathan Converse and Luca Fornarò find evidence that capital inflows hurt manufacturing, likening capital inflows to the so-called resource curse that plagues oil-dependent economies. Economists Bilge Erten, Anton Korinek and José Antonio Ocampo find strong evidence that capital movement can hurt countries by reducing aggregate demand.

Not everyone is worried. Economists Geert Bekaert, Campbell Harvey and Christian Lundblad wrote a 2009 paper arguing that the opening of capital accounts was associated with higher productivity growth and investment efficiency. They argue that the benefit of financial liberalization outweighs the costs – at least, for countries with good rule of law, low corruption and strong bureaucracies.

But Erten et al. argue that the downside risks, especially for countries with weak institutions, are just too great. The best solution, they suggest, is a flexible policy that restrains financial inflows in booms and restricts outflows during busts.

So capital controls might make a global comeback. But this could cause trouble. First, as economist Milton Friedman pointed out, people who want to move their money around the globe tend to find ways around capital controls. Technology like cryptocurrency could make this easier than ever. Global systems of capital controls could result in an eternal game of cat-and-mouse between investors and regulators.

Also, it’s not easy to separate the free movement of money from the free movement of goods. Since capital flows affect exchange rates – money coming into a country tends to make its currency pricier – a global regime of capital controls will be easy to use for trade wars. It’s possible that given the tools to do so, more countries would try to limit inflows in order to keep their exchange rates cheap, leading to global currency competition and resentment in those countries that still allow inflows.
In such an environment, it would be hard for a country to play the stabilizing role that the U.S. has played in the global economy over the past few decades. If other countries implement capital controls and the U.S. doesn't, it could result in the dollar getting much stronger and U.S. exports becoming even less competitive. That could cause a protectionist reaction in the U.S. – or even its own system of capital controls. Global trade would suffer, and a lot of people would be worse off.

So as they contemplate the return of capital controls, economists shouldn't only think about the problem from the perspective of individual countries. The question of what a fair and stable global financial system would look like without the free movement of capital remains unanswered.

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