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Freeing Greece from capital controls: Were the restrictions enforced in time?

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ABSTRACT

Recent developments in Greece have caused for the implementation of banking capital controls on the outflow of funds, a policy decision not uncommon, especially in emerging markets. However, the issues of the Greek economy, which seem to stem from the public sector but have been passed on to the banking sector, pose a unique challenge to researchers. In this paper, we employ VBanking, an object-oriented model for banking simulations to examine whether capital controls in Greece were enforced at the appropriate time. Additionally, we propose that the banking sector will not purge this regulation soon. Finally, we demonstrate the destructive effects of capital controls both on the financial system and on the real economy. We present the empirical results of our work, which suggest that the Greek authorities' response to the deterioration of the banking sector was lagged.

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1. Introduction

The globalisation of the modern economic system has resulted in increased capital flows, across international border and locally as well. Authorities often attempt to tweak the efficiency of monetary policy tools by implementing restrictions on capital flows (both outgoing and incoming), which are generally referred to as capital controls. In this paper, we present a particular set of capital controls, which limit the circulation of cash inside the borders of the economy, an issue currently at hand in Greece. We employ an object-oriented simulation model, VBanking (Virtual Banking), to examine whether these restrictions were implemented in a timely manner in the Greek banking sector and to attempt a forecast as to the persistence of these measures, based on the relevant literature and using data on the capital requirements of Greek banks in the days preceding the crisis.

Capital controls have been used historically as a response to financial crises. The first well known use dates as far back as World War I. More modern instances of capital controls can be found in Malaysia, Iceland, Cyprus and, more recently, Greece. What is particular to the Greek case is that in the first three economies, the causal crisis was the financial crisis. On the contrary, in Greece the financial crisis that called for the implementation of capital controls was subsequent to a lasting fiscal and political crisis, which has driven the economy into a recessionary slump and has thus put further strain on the banking sector. Capital controls, in various forms, have also been used to limit capital inflows, which may impede the use

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of monetary policy and may also cause currency appreciation, over the short term. A notorious form of regulation against capital inflows was the Chilean *encaje*, a short-term, interest-free, mandatory deposit with the country's Central Bank, which was required for foreign investors.

Our work contributes to three aspects of the existing literature. First, we propose an empirical implementation of the theory on cash capital controls, where research appears to be limited since a significant portion of the relevant literature focuses on restrictions imposed on the inflow of capital, a common solution in developing and emerging markets. Second, we propose the optimal point (in terms of the financial and output costs) during a bank run where controls should be enforced. Lastly, we use the aforementioned findings to examine the timeliness of the implementation of capital controls in the Greek banking sector in the end of June 2015.

The structure of this paper is as follows. Section 2 discusses the relevant literature. Section 3 briefly presents the economic environment under which the Greek banks operate. Section 4 contains the methodological approach we have implemented. We describe the introduction of capital controls in the VBanking economy, showing how existing literature supports the new features, and we present the formal model definition. In Section 5, we discuss the empirical findings of our simulations and show how these apply to the current situation in Greece. Section 6 includes our concluding remarks.

2. Literature review

Despite their relatively infrequent use, capital controls have been the subject of academic research due to the fact that they are usually the foremost solution to a banking system that is in a critical state of cash haemorrhaging, even though they are considered detrimental to the efficiency of the financial system. Additionally, existing literature seems to reach contradicting conclusions as to the efficiency and adequacy of capital controls, particularly when used in the context of a recessionary economy. Furthermore, as Magud et al. (2011) point out, researchers have failed to agree upon a unified framework for examining capital controls. Finally, each country which has implemented restrictions in capital flows seems to be a unique case to such an extent that existing studies cannot even agree on a single measure of what a successful implementation entails. Eichengreen and Rose (2014) present a thorough discussion on capital controls in modern economies. They show that capital controls are persistent, staying in place for long periods of time, exhibiting similar behaviour to international trade policy regulations. Their use is linked with limited financial depth, weak political institutions and lower quality of financial regulation.

One of the most prominent supporters of capital controls is Krugman (1998), who has argued in favour of capital controls, as a short-term tool to limit capital outflows that would prevent the economy from bouncing back to a positive path. Johnson and Mitton (2003) suggest that imposing restrictions on capital flows may also limit cronyism, due to the similar extent that capital resources would be limited to politically connected and non-connected firms alike. Both Bhagwati (1998) and Rodrik (2000) argue in favour of capital controls in particular cases and especially over the short term. They also point out that capital market liberalisation may make the financial system more vulnerable to speculative attacks, which have been an issue in many smaller economies, such as Greece. Finally, Montiel and Reinhart (1999) examine regulation enforced on capital inflows in the Asian economies during the 1997 crisis and show that they were mostly effective in limiting the volume of capital, while in some instances they affected the composition of capital, which shifted away from long-term investments towards short-term capital.

On the other hand, some researchers remain unconvinced by the above arguments. Goodman and Pauly (1993) argued that capital controls had become obsolete as early as the start of the 90s, due to the globalisation of the financial markets and the abundance of evasion strategies from firms. Mitchener and Wandschneider (2015) show that capital controls enforced in the 1930s US economy limited the effectiveness of monetary policy instruments and slowed down economic recovery. Danielsson (2008) supports the same argument, but in reference to the Icelandic economy and points out that the opportunity cost in terms of corporate investment exceeds the benefits of long lasting capital controls. Edwards (1999) and Schmidt (2001) examine the effectiveness of regulation on both inflow and outflow of capital and show that such policy measures carry a significant administrative cost and are often ineffective and prone to corruption. Edwards however points out the partial effectiveness of policy measures in Chile in increasing the maturity of foreign debt. Both introduce the idea of a Tobin (1969) tax on capital flows, which seems to be a more effective tool. Both also agree that policy measures that aim at improving banking supervision and decreasing moral hazard in the banking sector should be regarded as first-best policies.

Eichengreen and Rose (2014) argue against capital controls also, suggesting that such measures should be used as a last resort, after first-best policies have been exhausted. Forbes et al. (2011, 2012) show that the use of capital controls raises negative externality issues to neighbouring economies and that this effect should be taken into account in policy decisions. It should be noted that the decision to implement policies that limit capital inflows or outflows is a rather difficult one, since these flows tend to be unpredictably volatile, challenging policy makers even more (Broto et al., 2011). Alesina et al. (1993) argue that limiting capital outflows permits the local economy to run under increased inflation, since individuals can no longer hold capital in foreign funds and assets. In general, they show that controls favour distortions in domestic policy, but allow greater independence of government policies, with respect to financial trade neighbours. Finally, Fernández et al. (2013) argue that capital controls are irrelevant when dealing with real economic crises and show that output and exchange rate fluctuations cannot be dealt with using capital controls.

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