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Review

Capital Controls in the 21st Century[☆]



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ABSTRACT

Governments have rarely imposed or removed capital controls in response to short-term fluctuations in output, the terms of trade, or financial-stability considerations. We show empirically that controls on the international flow of financial capital are highly durable, often remaining in place for decades; their duration is striking compared with related phenomena such as exchange rate regimes. This represents a challenge to any proposed use of capital controls as an instrument of macroeconomic and macro-prudential management, since we have little experience in using capital controls at high- or medium frequencies. Any new policy initiative mandating frequent shifts in controls will be based on theory rather than data-driven experience.

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1. Introduction

Capital controls are back. The International Monetary Fund has softened its earlier opposition to their use (see [IMF, 2012](#)). Some emerging markets, Brazil for example, have made renewed use of controls since the global financial crisis of 2008–9 ([Forbes et al., 2012](#); [Jinjarak et al., 2013](#)).

A growing number of academic commentators have lent at least indirect support to this movement by suggesting tightening and loosening controls in response to a range of economic and financial issues and problems. While the rationales for these recommendations vary, they tend to have in common the assumption that first-best policies are unavailable, and that capital controls can be thought of as a second-best form of intervention. One set of studies considers a setting in which output fluctuates because nominal wages are rigid and monetary policy is not available to manipulate the price level. Thus, [Schmitt-Grohe and Uribe \(2012a, b\)](#) analyze a country with rigid nominal wages and a fixed exchange rate.⁴ They show that, absent the ability to implement policies that address the nominal wage distortion or that change the exchange rate and price level directly, controls should be tightened temporarily in periods of large capital inflows to prevent wages from rising to levels from which they are then unable to fall when the capital inflows dry up, resulting in unemployment. [Farhi and Werning \(2012\)](#) show that the argument for temporary controls that are adjusted counter-cyclically (i.e., that are imposed or tightened in response to inflow surges or declines in the world interest rate, and then loosened when the surge subsides or world interest rates recover) carry over to the cases of imperfectly flexible wages and exchange rates.⁵

A second, closely related strand of literature characterizes capital controls as a device for optimally manipulating the international terms of trade. In some periods countries may benefit from higher export prices (stronger terms of trade) as a way of increasing domestic purchasing power vis-à-vis the rest of the world, insofar as the countries in question possess market power. In other periods they may instead prefer higher import prices (weaker terms of trade) as a way of shifting demand toward domestic goods and encouraging their production, insofar as other distortions result in a suboptimal level of output. [De Paoli and Lipinska \(2013\)](#) describe a model in which import and export taxes and subsidies (which might be used to manipulate the terms of trade directly) are unavailable, and capital controls are instead tightened and loosened as these competing concerns gain and lose importance over the business cycle.⁶

A final strand of literature argues for the flexible use of capital controls to buttress financial stability. [Ostry et al. \(2012\)](#) and [Forbes et al. \(2013\)](#) recommend tightening capital controls to limit capital-inflow surges that create financial risks, and then loosening them when such risks subside. The argument is analogous to that made for flexible capital and liquidity requirements to limit the pro-cyclical movement of money and credit aggregates that results from the failure of agents to internalize the impact of their collective actions on asset prices (and therefore on the collateral constraints on which lending depends). First-best policy in this case would directly address the distortion with which the ready availability of foreign funding interacts. If that distortion arises from the failure of agents to internalize the effect of their actions on collateral constraints, then the first-best response is to raise loan-to-value regulation and other collateral-oriented regulatory policies, to prevent an excessive surge of lending when the value of collateral rises. If the risk is a sudden outflow of foreign funds from domestic banks that threatens a liquidity crisis, then the first best response is to hold those banks to higher liquidity standards, or otherwise insure against this risk. If the problem is that banks receiving foreign funding extend riskier loans as they expand their balance sheets, then the first-best solution is to strengthen supervision and regulation so as to limit the balance-sheet expansion and prevent the deterioration in asset quality. But if these first-best policies are not available, there may then be an argument for tightening controls on capital inflows as a second-best response. Such are the conclusions of [Korinek \(2010\)](#), [Jeanne and Korinek \(2010\)](#), [Bianchi \(2011\)](#), [Bianchi and Mendoza \(2013\)](#), [Benigno et al. \(2013\)](#) and [Korinek \(2013\)](#).

⁴ Equivalently, a country that is a member of a monetary union.

⁵ [Davis and Presno \(2014\)](#) combine the sticky-wage rationale for controls discussed in this paragraph with the financial-stability rationale discussed below.

⁶ The models of [Costinot et al. \(2011\)](#) and [Cordero and Montacino \(2010\)](#) are closely related.

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