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Revisiting Price-based Controls on Capital Inflows in a "Sophisticated" Emerging Market

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Summary. — Large and volatile capital flows pose serious challenges for macroeconomic management in developing countries. In this paper, we examine the price-based capital controls adopted by Brazil during the 1990s with the objective of facing some of those difficulties. We use data on capital account transactions at a monthly frequency in order to evaluate the effects of those policies on net fixed-income capital flows and on total portfolio flows using GMM techniques. Our results suggest that the controls could have been effective in reducing both types of flows.
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Key words — international capital flows, capital controls, Latin America, Brazil

1. INTRODUCTION

The excessive liquidity in international capital markets during the 1990s posed several challenges to policy makers in emerging economies. Among numerous issues, the links between financial volatility and short-term capital flows, even if the direction of causality between the two is not always clear-cut, were a particular source of concern. In addition, problems associated with moral hazard, fragility in financial intermediaries' and corporate balance sheets, asset price bubbles, consumption booms, and real exchange rate overvaluation were intimately connected to the boom–bust cycle in capital flows to developing countries following the financial liberalization process.

In this context, it became evident that full capital account openness can be associated with increased macroeconomic volatility and limitations in degrees of freedom for domestic policy makers, which prompted a certain number of countries to (re)-adopt capital account regulations. In fact, the experience of developing economies with the adoption of capital controls (on inflows, outflows or both) in the last 15 years is diverse and encompasses countries such as Brazil, Chile, China, Colombia, India, Malaysia, Taiwan, Singapore among others (see Ariyoshi *et al.*, 2000; Epstein, Grabel, & Jomo, 2003).

Our interest at present lays on examining the imposition of price-based capital account management polices in Brazil since the early 1990s. The aims of those regulations included reducing the costs of sterilization policies and the appreciation of the real exchange rate associated with large capital inflows and increasing the autonomy of domestic monetary policy. This paper intends to evaluate the effectiveness of those regulations in attaining some of these goals.

In particular, we will analyze monthly data compiled by the Brazilian Central Bank on capital account transactions in fixed-income securities and more generally on portfolio flows. To our knowledge this specific dataset has not been used previously to evaluate the Brazilian experience. Firstly, we will present a description of the macroeconomic environment in Brazil during the 1990s and the capital account regulations adopted. Subsequently, we will proceed to a brief critical review of the current literature on capital controls in Brazil. Finally, we will analyse the effects of the price-based capital account policies on net fixed-income inflows and

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on total net portfolio flows using GMM techniques.

2. BACKGROUND AND CAPITAL ACCOUNT POLICIES

Brazil undertook the first significant measures toward the liberalization of its capital account in 1987 with the creation of investment channels that gave foreigners exemptions from domestic income tax on capital gains (the so-called Annexes I–III). In May 1991, an important resolution concerning the regulation of portfolio inflows to the country was implemented (the so-called Annex 4 legislation), profits relating to those investments were free of tax and income remitted abroad only had to pay 15% of income tax. Throughout the 1990s, the process of deregulation of both capital inflows and outflows took momentum, deposits in foreign currency, international issues of commercial papers, profit remittances related to FDI, ADRs and IDRs, issues of certificates of deposits by Brazilian banks in foreign currency among others financial transactions were liberalized.

In the late 1980s, Brazil was cut-off from international financial markets and faced a period of high exchange rate volatility (particularly after the default on external debt). After a large devaluation in September 1991, the Central Bank chose to adjust the nominal exchange rate following a PPP rule, therefore reducing exchange rate instability and opening up a positive interest rate differential with industrialized countries; hence stimulating capital inflows. In fact, as shown in Figure 1, in the first quarter of 1992 Brazil was already experiencing large capital flows, even in a period of instability associated with high inflation. As far as the composition of those flows is concerned, one should note the predominance of portfolio inflows until 1997 (see Figure 2). FDI only started to become important from 1996 onward (essentially associated with the privatization of public utilities) and showed resilience during the international financial crises of the late 1990s, contrary to the other categories of capital flows. Finally, it is notable that the residual category ''other'' experienced a significant decrease in 1994, arguably linked to the difficulties experienced by the Brazilian banking sector in that year, which culminated in a government bail out program.

It is of crucial importance to emphasize that the return of capital flows to Brazil was accompanied by an effort by Central Bank authorities to sterilize those inflows, which contributed to an increase in public debt. As shown by Palma (2004), sterilization policies were responsible for a significant part of the rapid increase in domestic public debt verified in the 1990s. In fact, the second half of the 1990s was marked

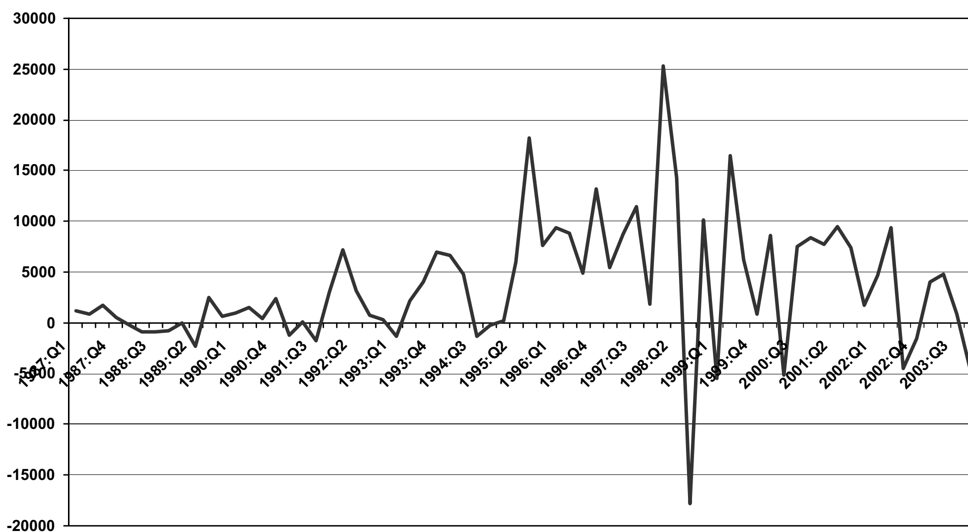

Figure 1. *Brazilian capital account 1987–2003 (in Millions of US Dollars of 2000). Source: Brazilian Central Bank.*

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