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Capital controls and financial liberalization: removing the ideological bias

Abstract: To label the defense of capital controls (CC) as a left-wing proposal is a misconstruction. Such labeling uses the Borsa economist 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 (and other Post Keynesians), 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 1990s—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

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using CC, without prejudice. CC should be used whenever the benefits surpass the costs of their implementation.

**Key words:** capital controls, financial liberalization, left, right.

The idea that there is a simple and direct relationship between capital controls (CC) and the political stand of governments practicing them—the Left is more favorable to CC, whereas 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, on one hand, prolabor governments are more likely to impose a higher tax rate on capital and are thus less likely to liberalize the capital account, whereas procapital leaders are more likely to liberalize the capital account (Alesina et al., 1993). Oatley (1999) and Quinn and Inclán (1997), 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 toward a more objective evaluation of the casual opportunity of using CC. The approach used is essentially analytical and no econometrics will be used. The first section presents a brief review of the literature focusing on the institutional 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 John Maynard Keynes and developed by James Tobin, Paul Davidson (and other Post Keynesians such as Fernando Carvalho, Jan Kregel, Philip Arestis, Malcolm Sawyer, and Thomas Palley), and also by Joseph Stiglitz and Dani Rodrik. The fifth section describes the main instances of the use of more severe measures of CC after the 1990s in the light of the 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.

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 noncooperatively. 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, policymakers 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” (ibid., p. 199).

Using data for the 1967–86 period in seven Latin American countries and in the Philippines, Alesina and Tabelini 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” (ibid., p. 211).

Alesina et al. (1993) studied the institutional and political factors that might explain the decision to adopt CC in 20 Organization for Economic Cooperation and Development (OECD) countries during the years 1950–89. 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” (ibid., p. 1).
Taking the existence of CC as the dependent variable, Alesina et al. 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 1966–89 period, Grilli and Milesi-Ferretti (1995) examined the influence of an economy’s structural and political features upon the adoption of CC. Yet they 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) considered ideology among the variables, specifying the conditions under which state leaders decided to liberalize CC in 18 OECD countries during the 1967–90 period. They concluded that “the further left the state leaders are . . . the less likely a state is to liberalize capital transactions” (ibid., p. 16).

Kastner and Rector (2003) 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 (1951–98), they provide evidence in favor of the hypothesis that “[i]n capital-abundant countries, all else equal, Right and Center-Right governments enact a greater number of liberalizing changes in CC policy than other governments” (ibid., p. 5).

As a result of the acritical acceptance 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 Affonso 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 and Sicsú, 2004; 2005). This holds true especially (but not only) for developing countries, which have borne most of the costs of the 1990s crises associated with financial liberalization. As suggested by Carvalho, 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. (2005, p. 261)

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 1789–91. 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 blocs: the socialist world, representing the Left at a global level, and the capitalist world, with the United States as its hegemonic power, standing as the main obstacle to communist expansion and, thus, leading the right-wing bloc. By the end of the twentieth 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 is 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, and so on. Bobbio 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” (ibid., 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 noneconomic 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, 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 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. (ibid., p. 150)

This is crucial in order to understand why Borsa’s proposal is an example of economist reductionism—an attempt to reduce a political dichotomy (Right versus Left) to an economic dichotomy (economic liberalism versus interventionism). The first deals with objectives defined in terms of political ideals—equality (or inclusion) versus inequality (or exclusion). The second 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.

Capital controls: a synthesis

Brief background and definition

The first experiences with CC date back to the sixteenth century, when 
Spain and France restricted gold and silver exports under bullionism. 
However, after these primitive forms, only in the twentieth century did 
CC really flourish. After the Great Depression and in the 1940s, restric-
tions to the flow of capitals were adopted by the major economies—with 
few exceptions, such as the United States, Canada, and Switzerland. 
The Bretton Woods conference established the convertibility of current 
transactions but not of capital transactions. Article VI of the IMF’s Ar-
ticles of Agreement allows the adoption of controlling measures in the 
face of sustained capital outflows. In the 1970s and 1980s, restrictions 
on international capital flows were abolished in developed countries. In 
the 1990s, 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 integra-
tion 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 es-
tablishment 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, pp. 254–255).

It should be noted that during the 1990s, 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 back down, 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. . . . [T]he role of limited and temporary capital controls, especially for economies at intermediate levels of financial development, needs further study. (Rogoff, 2002)

The case for financial liberalization

Defenders of financial liberalization argue that it (1) 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; (2) helps adjust the balance of payments in economies with current account deficit; and (3) 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, because 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

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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, and so on.
resources, the free flow of capital determines an efficient allocation of capital between countries. This is the main argument used by the IMF.

The case against financial liberalization

Defenders of CC hold that they (1) give more autonomy to macroeconomic policies; (2) increase financial stability; (3) are necessary in order to avoid the overvaluation of domestic currency in times of excessive international liquidity; (4) 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 (5) may be used as instruments of industrial policy in shaping the structure of internal supply, while 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.

Some authors who defend capital controls

Among the many defenders of CC, one should note Keynes, Harry D. White, Tobin, Davidson, Rodrik, and Stiglitz. The 60-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. 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 nonconvertibility 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 U.S. leading representative, IMF bylaws 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’s 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 by the Keynes Plan. Although this section does not aim at making a thorough review of the literature on CC, it is worth mentioning that the Post Keynesians—such as Arestis and Sawyer (1997), Carvalho (2000–1; 2003; 2005), Kregel (1996; 2001; 2004a), and Palley (1998)—as a rule, highly influenced by the work of Keynes and Davidson, favor CC.2

The 1990s 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.

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 reorientation of the capitalist system. The adoption of CC, as well as the engagement in countercyclical fiscal policy, aims at ensuring the smooth functioning of capitalism. In both cases, economic interventionism should not be seen as the result of an antiliberal mind-set 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. (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 anticyclically 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’s 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. . . .

[M]y own belief is that the Americans will be wise in their own interest to accept this conception. (1980b, 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 cited in 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, 1980a, p. 297, emphasis in original). Besides, he was radically opposed to Leninism and an acerbic critic of Marx and socialism, the great icons of the Left in his time.3

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.

3 “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, 1980a, p. 258).
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 1970s 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.

Davidson casts serious doubts on the effectiveness of Tobin’s proposal, pointing out that it “is unlikely to constrain even small investors” (1997, p. 678). Moreover, Davidson 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; 1992–93; 1997; 2002) takes up Keynes’s proposal for a reform of the international monetary system, based on the recognition that

[i]nstead 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 twenty-first 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” (ibid., p. 209). This proposal is not only more modest, but especially more feasible, because 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 among its nation-members, preserving the core of the Keynes Plan.

The essence of the Keynes–Davidson proposal for international monetary system reform rests on (1) the creation of an international money

4 The effectiveness of the Tobin tax is not being discussed here. Arestis and Sawyer (1997) present a more favorable view of it.
clearing unit, held by the central banks of nations signing an international agreement upon the creation of an ICU; (2) each nation’s right to adopt CC; and (3) 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.

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 does not necessarily 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 several failures that put at risk the perfect operation of capital markets, making CC a second-best solution. Rodrik expresses his concern regarding what he calls the canonization of the financial liberalization, pointing out that unless the EMH is taken as a matter of faith, capital controls should be adopted:

The great concern I have about canonizing capital-account convertibility is that it would leave economic policy in the typical “emerging marketing” hostage to the whims and fancies of two dozens or so thirty-something country analysts in London, Frankfurt, and New York. A finance minister whose top priority is to keep foreign investors happy will pay less attention to developmental goals. We would have to have blind faith in the efficiency and rationality of international capital markets to believe that the goals of foreign investors and of economic development will regularly coincide. (ibid., p. 65)

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 on the performance of the exporting sector. Therefore, the greater its participa-
tion 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:

Since rapid capital flows into or out of a country cause large disturbances, they generate what economists call “large externalities.” . . . Such flows lead to massive disturbances to the overall economy. Government has the right, even the obligation, to take measures to address such disturbances. (ibid., p. 124)

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 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 1990s 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 specific goal: a remedy for financial market failures, as evidenced in the Asian crisis. Obviously, this cannot be genuinely labeled as a leftist proposal.

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 1990s, according to IMF’s AREAER (1990–2007).

Chile

Chile used CC during the administrations of Patricio Aylwin (1990–94) and of Eduardo Frei Ruiz-Tagle (1994–2000), both of whom belonged to the Christian Democratic Party (PDC). The PDC was borne from the Falange Nacional, a propaganda agency for the Conservative Party, from which it broke away to become a new party. After good results in the 1957

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5 For more details, see Ariyoshi et al. (2000) and Bank of Thailand (2006).
parliamentary elections, the Falange Nacional 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 1980s they became the country’s major political force.

The PDC is a centrist party and historically was the main opponent of the Socialist Party, 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 Socialist Party, and two small parties—elected Aylwin president in 1989. In the following election, PDC Chairman Eduardo Frei was elected president. Ricardo 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 1990s, 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 or to increasing the latter’s term of permanence in the country, a 20 to 30 percent 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 Lagos, the main leader of the leftist Socialist Party. 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 Lagos, an icon of the Chilean Left.

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 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, and 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 (1) access to the domestic market by foreign investors, (2) foreign investments by residents, (3) foreign loans, and (4) direct offshore investments. These measures favored long-term capital flows and FDI, which amounted to 98 percent 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 1990s, liberalized CC, which had been briefly strengthened during the Asian crisis.

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). 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 toward 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 nonalignment vis-à-vis the two superpowers of the second half of the twentieth century.

Created in 1980, the BJP 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—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 toward the liberalization of foreign capital flows, which had been historically controlled by administrative measures. The reforms resulted in (1) a slight loosening of restrictions to the inflow of capital, (2) encouragement of FDI, (3) discouragement of short-term capital inflows, and (4) the generation of future indebtedness inflows (such as deposits in foreign currency by nonresident 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 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 National Democratic Alliance as a rule maintained CC between 1999 and 2004.

**Malaysia**

Malaysia is formally a parliamentary monarchy in which the head of state is chosen among the sultans of the nine peninsular states for a five-year term and also rules on the Islamic religion. The prime minister is chosen among 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, 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, Mohamad government
was in fact authoritarian. It controlled the media and the judiciary power and used Islamic values to suppress troublesome opponents. Mohamad postured as a defender of Asian values and champion of authoritarian state capitalism, attacking the United States for its individualistic and liberal doctrine.

In 1994, Malaysia controlled the inflow of capital and, during the 1997–98 financial crises, its outflow. 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 that 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 percent 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.

**Thailand**

Ruled by kings since the thirteenth 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 among 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.

In September 2006, the country was put under the rule of a military junta that came into power in a coup. The king, as usual, endorsed the
new regime. Parliamentary elections took place after a new constitution was approved by referendum in August 2007.

In October 2006, the baht 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 U.S. dollars. As short-term speculative inflows intensified, the baht reached the most appreciated rate in seven years.

Since the appreciating trend persisted, in December 2006 the Bank of Thailand (BOT) announced the implementation of a 30 percent URR on short-term capital inflows—except for FDI—and the repatriation of investments abroad. Two days after this announcement, as the baht reverted the appreciation trend, the BOT started relaxing its control measures, exempting equity investments in the Thai stock market and other nonspeculative inflows from the requirement. The URR, however, has now been in force for almost one and a half years.6

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 pragmatic.

Conclusion

To tag the defense of CC as a left-wing proposal is a misconception. First, because such tagging is based on an economic criterion that reduces the Right versus Left dichotomy to the economic liberalism versus interventionism distinction. Second, 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: (1) during the 1930s depression and in the face of the advance of socialism, Keynes, a liberal in the broad sense, merely intended to reform capitalism; (2) by reason of the growth of speculative capital flow, Tobin aimed at preserving the autonomy of monetary policy; (3) in the face of the globalization

6 Further liberalization measures were taken in July and December 2007. See BOT (2007a; 2007b).
process, Davidson updated the Keynes Plan; and (4) 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 1990s, 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: the Left is not necessarily favorable to control and the Right is not 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.

Once the prejudice against CC is removed, the search for more conclusive empirical evidence showing that countries that use CC have a better macroeconomic performance (higher growth rates and greater financial stability) is the next step in establishing a stronger case for the adoption of CC.

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