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The Case for Capital Controls

James Crotty

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10th floor Thompson Hall
University of Massachusetts
Amherst, MA, 01003-7510
Telephone: (413) 545-6355
Facsimile: (413) 545-2921
Email: peri@econs.umass.edu
Website:
<http://www.umass.edu/peri/>



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The Case for Capital Controls

**James Crotty
University of Massachusetts, Amherst
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James Crotty is Professor of Economics, Research Fellow in the Political Economy Research Institute, and member of the Center for Popular Economics at the University of Massachusetts, Amherst campus. He is grateful to the Ford Foundation and the Political Economy Research Institute at the University of Massachusetts for their research support.

I. Introduction

A central lesson drawn from the experience of the decades between the World Wars was that the economic and political fate of the world could not be safely entrusted to unregulated, free market national and global economic systems. History warned that this was a path to economic instability, global depression and political chaos. In the aftermath of World War II, national economies, even those in which markets played a powerful role, would be placed under the ultimate control of governments, while international economic relations would be consciously managed by the International Monetary Fund (IMF) and World Bank. Trade was expected to rise in importance, but it was thought at the time that the degree of global financial integration would remain modest, with cross border money flows under tight government control. The global prosperity that characterized the quarter century following the war – the “Golden Age” of modern capitalism – reinforced belief in the wisdom of social regulation of economic affairs.

The economic instability that erupted in the 1970s has led us back to the future. The troubles of that decade created a powerful movement, led by business and financial interests, to roll back the economic regulatory power of the state, replacing conscious societal control with the “invisible hand” of unregulated markets – just as in the prewar period. Though governments still play a large role in most economies, they have ceded an enormous proportion of their economic power to global markets. The economic theory used to guide and justify this transformation is known as Neoliberalism. Neoliberal enthusiasts promised that this new *laissez-faire* era would dramatically improve economic performance in both developed and developing countries. Unfortunately, these promises have not been kept. In the Neoliberal era, global growth has slowed,

unemployment has risen, financial crises are common, and inequality has increased almost everywhere. The recent Asian crisis is just the latest signal that the basic structures of the new global marketplace are dangerous to the economic interests of the majority of the world's people.

What can be done to improve global economic performance? We focus on three related problems of the current era. First, excessive financial market liberalization has created serious speculative boom-bust cycles damaging to economic growth. The financial collapse that originated in Thailand in 1997, spread to most of the nations of the Pacific region, and moved on to ensnare Russia and Brazil, is but one example of the dangers of today's liberalized capital markets. Second, the weakening of state regulation of cross border capital mobility in recent decades, and the subsequent leap in the magnitude and speed of capital movement across national boundaries, have caused governments around the world to shy away from expansionary budget and interest rates policies because they displease global investors. Governments that reduce interest rates or use budget deficits to stimulate growth and lower unemployment are often punished by capital flight, which raises interest rates and can trigger exchange rate crises. Third, the ongoing liberalization movement has substantially reduced the economic power of developing country governments. Since all the development success stories of the Post World War II era occurred in countries where the government exercised substantial influence over economic activity, it is not surprising that average growth rates in Latin America, Africa, and, recently, much of Asia have sharply declined.

We argue that the reimposition of government control over cross border capital movements by both developed and developing economies, though certainly not a panacea for the troubles of the era, can help in the resolution of all three of these problems. But first, we discuss

the evolution of global liberalization and document the deterioration of global economic performance in the past two decades.

II. From the Golden Age to the Neoliberal Era

As Western nations faced the transition from war to peace in the late 1940s, powerful political forces developed in support of a “Great Transformation” from control of economic life through the blind forces of free markets to social or state responsibility for economic performance. In the West, returning soldiers and an invigorated labor movement demanded that governments guarantee full employment and rising wages. Even business became a reluctant supporter of the new economic transformation because it feared the political and social consequences that would follow if a return to the prewar system led once again to depression. Meanwhile, experience with running war-time planned economies and new developments in the theory of government economic policy associated with the Keynesian “revolution” provided the guidelines government officials required to create and operate a state regulated peacetime economic system. A general political consensus thus developed committing Western governments to the promotion high employment and strong growth, and the use of tax and spending policy to contain inequality and poverty and provide essential social services to all citizens, no matter what their income.

Government power to regulate national economic activity depended crucially on the modest extent of global economic integration and on control of cross border economic activity. Cross border mobility gives industrial and financial capital the power to frustrate government policy. When money is free to flee the country in search of higher returns if the government tries to lower interest rates in pursuit of growth, low interest rates may be impossible to sustain. If

inflation picks up even moderately at full employment, capital flight can boost interest rates, triggering a recession.

For much of the Golden Age, however, governments did not have to confront this problem. Outside the US, all governments tightly regulated the movement of money across their borders. This allowed them to keep average interest rates low, which helped sustain strong growth in investment and income. Moreover, trade was a relatively small percent of GDP and was subject to government control; even the largest corporations produced and sold almost all their goods at home. When governments used tax cuts and higher spending in pursuit of growth, their efforts were not undercut by an excessive rise in imports.

Limited global economic integration and government control of cross border economic transactions also gave governments an important degree of political autonomy from the business sector.¹ By eliminating the run-away option available to financial and industrial capital, regulation of capital flows and trade in the Golden Age gave governments the ability to choose, and the power to achieve, policy objectives that did not have enthusiastic business support.

The Bretton Woods international financial system, created by the US in concert with Britain at War's end, was designed to reinforce the ability of governments to regulate their national economies in pursuit of growth and full employment. The top negotiators for the US and Britain – Harry Dexter White and John Maynard Keynes, respectively – supported the expansion of trade. But they believed that the growth of trade could not be sustained in the long run if money was allowed to freely cross national borders, creating unstable exchange rates in the process. As national economies became more trade dependent, exchange rate volatility would create ever

increasing real sector instability. To prevent this, the Bretton Woods system was based on fixed exchange rates, which can only be maintained if governments limit cross border money flows. Moreover, Keynes and White knew that governments would not be able to achieve sustained full employment if financial capital was free to cross borders in search of higher interest rates or lower inflation. To make the maintenance of both full employment and exchange rate stability possible, the Bretton Woods Agreement authorized governments to regulate all cross border financial transactions other than those needed to finance trade. “I share the view,” Keynes wrote in the early 1940s, “that central control of capital movements, both outward and inward, should be a permanent feature of the post-war system.”²

The general trend in the developing world was also toward state-led development, based on industrial policy (through which the state directs resources toward sectors of the economy seen as crucial to the development process), manipulation of interest rates, taxes and government spending in pursuit of high growth, and government regulation of trade and cross border flows of real and financial capital. This was obviously the case in Asia, where the spectacularly successful “East Asian Model” relied heavily on state economic intervention, but it was true as well of much of Latin America. Some of these governments were authoritarian, some were corrupt, and some did a poor job of economic management; state power to regulate economic affairs is clearly no guarantee of successful economic performance. However, on average, good growth rates were widely achieved. In the words of Harvard economist Dani Rodrick:

The postwar period up until 1973 was the golden age for economic growth. Scores of developing countries experienced rates of economic expansion that were virtually unprecedented in the history of the world economy.³

In the late 1960s, rising inter-nation competition, moderate inflation, international payments imbalances and declining profitability began to weaken Golden Age institutions and policies. The breakdown of the Bretton Woods fixed exchange rate system and the burst of inflation triggered by the first OPEC oil price tripling in the early 1970s caused further damage. The second OPEC price hike in 1979-80 accelerated inflation yet again, creating exchange rate instability and financial market chaos.

The 1970s proved to be a disastrous decade for US business and financial interests, leading them to demand a drastic change in economic arrangements. In response, the US under President Reagan and Federal Reserve Chairman Volcker, and the United Kingdom under Prime Minister Thatcher, launched a second Great Transformation – from the state managed Golden Age institutions toward a market controlled system often referred to as the global Neoliberalism. Other advanced industrial nations followed the lead of the US and UK, though not as quickly and decisively.⁴ Nations were pressed to deregulate, liberalize and privatize, and shrink the social safety net. Government policy shifted focus from promoting growth and employment to minimizing inflation. Governments also began to give up control over not just trade, but direct foreign investment and cross-border financial flows as well. Global markets thus became increasingly integrated.

These policies were, to a considerable extent, imposed on the developing nations of the world by external agents – the US and other G7 nations, the IMF and World Bank, and multinational corporations and banks – though domestic businessmen were often allies in this project. The Third World debt crisis of the early-mid 1980s gave these agents considerable

leverage. Given the large foreign debt buildup that took place in the developing world in the 1970s, the high interest rates and rising oil import bills of the early 1980s, along with the collapse of export markets brought on by the global recession of the period, pushed many developing nations to the verge of default.

The response of the “first world” was to impose a policy package on the debtor nations that came to be known as the “Washington Consensus.” In return for loans, indebted countries had to implement recession-inducing interest rate and budget policies which generated trade surpluses by slashing imports, but created rising unemployment and falling wages as well. Debtor nations were also pressured to minimize their regulation of trade and capital flows. These changes eliminated key policy tools that developing country governments had used to guide their national economies in the Golden Age. By the end of the 1980s, the only important area of resistance to Neoliberal institutions and policies was East and Southeast Asia.

III. Neoliberalism: Promise and Performance

Proponents of liberalization argued that once the distortions created by government interference were removed from global markets and the benefits of the new information based technical revolution were free to flow everywhere, high growth, accelerated productivity gains, and declining unemployment would follow. Financial liberalization would lead to lower interest rates and higher global investment. Unconstrained by capital controls, credit and technology would move from the capital and knowledge rich advanced nations to the opportunity rich poorer ones. Free-market enthusiasts argued not only that maintenance of the status quo could only bring continued instability, but also that market liberalization was the *only* economically and politically

alternative to current economic structures and practices. This proposition came to be known by the acronym TINA – There Is No Alternative to Neoliberalism.

Opponents of Neoliberalism argued that unregulated market systems, like the US in the prewar years, suffer from cyclical instability, the maldistribution of income and wealth, and, on occasion, depression. Unregulated global financial markets are especially unstable, generating irregular patterns of bubbles, panics and crashes. Globalization, financial liberalization, the roll back of the welfare state, and the rejection of activist government policy to regulate growth were therefore seen as a recipe for sluggish and unstable economic growth, rising inequality and perhaps, at some point, another global depression. They agreed that the status quo was unviable, but insisted that any program of institutional and policy reform would have to contain an effective regulatory role for the state in order to be successful.

The market liberalization revolution is now more than two decades old. On the basis of economic performance to date, it is hard to make a convincing case that Neoliberal policies have generated the results their supporters predicted for them.

Liberalization has proceeded at an impressive pace in recent decades. For example, financial capital has become extraordinarily mobile. In 1977, in the midst of petrodollar recycling, about \$18 billion of currency trades took place daily; in 1983 the figure was \$83 billion. In 1989, it was \$590 billion. By 1998, \$1.5 trillion moved across borders every day. Not surprisingly, such hyperactive capital flows have been accompanied by frequent bouts of domestic and international financial instability as well as increased volatility of exchange rates. John Eatwell reported that on average, “the monthly volatility of G7 exchange rates has tripled, with far larger increases in

volatility being experienced by [developing] countries.”⁵

But has such freedom of capital flows brought lower real (or inflation adjusted) interest rates as promised? On the contrary, the current era has seen the highest real interest rates of modern times. For the G7 nations, real long term interest rates averaged about 2.6% from 1959-70, 0.4% from 1971-82, but jumped to 4.9% in the 1983-94 period.⁶ High interest rates are one reason why inequality has risen in recent decades; ever larger shares of national income are being transferred from workers and other income claimants to owners of financial assets, who are the richest group in society. With interest rates and exchange volatility risk so high, it is not surprising that most studies report a slowdown in capital investment.

Most important, economic growth has slowed significantly. The most widely cited data on global growth rates was compiled in 1995 by Angus Maddison for the Organization for Economic Cooperation. He reports that while annual real GDP growth in the world economy averaged 4.9% in the Golden Age years from 1950 to 1973, it slowed to 3.0% in 1973-92. Western European growth rates fell from 4.7% in the early period to 2.2% in the latter. Latin America’s growth averaged 5.3% from 1950-73, but only 2.8% from 1973-92. Africa grew at a 4.4% pace in the first period, but at a 2.8% rate in the second one. Asia, the last bastion of state led development, was also the only major area not to experience a significant post Golden Age slowdown, maintaining growth between 5% and 6% for the entire era.⁷

We get the same results if we focus on the 1990s. World GDP growth averaged but 2.2% from 1990-98, the slowest growth of the post war era. Developed nations had an average GDP growth rate of only 2.1% from 1991-98.⁸ Latin America growth averaged 3.2% from 1990-97,

better than in the “lost decade” of the 1980s, but much lower than in the Golden Age. Desperate Africa showed GDP growth of only 1% a year from 1990-97. By way of contrast, the state led economies of Asia grew by 6.5% from 1990-96, prior to the outbreak of financial crisis in that region.⁹ Other crucial performance indicators, such as average unemployment and productivity growth rates, show the same pattern.

It has been argued that at least the US, as the master of the new information technologies and the pioneer of corporate restructuring, has prospered in the current era. But the concept of US exceptionalism is not supported by the data. US GDP growth averaged 4.2% a year from 1959-73, but only 2.6% in the Neoliberal years from 1980-98. From 1990-98, growth was only 2.5% per year. Annual growth in labor productivity fell from 3.2% from 1959-73, to under 1.3% from 1980-98; it was 1.4% in the nineties. And the average US unemployment rate, which was 4.8% from 1950-1973, rose to 6.6% in 1980-98.¹⁰ The US has also run the largest trade deficits in the world in the past twenty years. It is true that some aspects of US performance has improved in the past three years (though the current account deficit will likely hit \$300 billion for 1999), but whether this is the start of a marvelous “new era” or just a typical end of business cycle performance remains to be seen. [revisions from Dymski-Isenberg, 17-18?]

If we look below national economic performance and examine the situation confronting ordinary American workers and their families, things look even worse. Following an era of impressive growth from the War’s end through 1973, the median real wage of all full time workers fell by 5.5% between 1979 and 1997, while the male median wage declined by 15% in the same period. The drop in male wages affected all but the highest paid workers. The real wage of male

college graduates was lower in 1997 than in 1973. Median real family income rose by 2.9% a year from 1947-73, but by just 0.2% per year from 1979-97.¹¹ Even that small gain was achieved only by a substantial increase in hours worked per family each year. In addition, both wage and family income inequality rose substantially, and the poverty rate rose moderately over the past two decades.

In 1997 the United Nations Conference on Trade and Development evaluated global economic performance in the Neoliberal era. Their report drew the following conclusions.

- Taken as a whole, the world economy is growing too slowly to generate sufficient employment with adequate pay or to alleviate poverty;
- This has accentuated longstanding tendencies for divergence between developed and developing countries;
- Finance has gained the upper hand over industry, and rentiers over [business] investors;
- Capital has gained in comparison with labour, and profit shares have risen in developed and developing countries alike;
- Growing wage inequality between skilled and unskilled labour is becoming a global problem;
- The hollowing out of the middle class has become a prominent feature of income distribution in many countries;
- There is almost everywhere increased job and income insecurity.¹²

It is often asserted that while subgroups like the unskilled and uneducated have suffered, liberalization has been good on average, for most people, and for most countries. But the available evidence is inconsistent with this proposition. Economic performance has deteriorated – on average and for majorities – virtually everywhere but in pre-crisis Asia.

IV. What is to be Done? The Contribution of Capital Controls to the Restoration of Global Prosperity¹³

The evidence presented in the previous section indicates that there are many serious economic problems in today's global economy. Here we focus on but one key question: what can

be done to reverse the global growth slowdown?

Widespread liberalization of domestic financial markets and cross border capital flows has slowed developing country growth in two important ways.¹⁴ First, liberalization has created serious, recurrent speculative boom-bust financial cycles that have constrained average growth rates.

Second, by weakening or eliminating capital controls and state regulation of credit allocation, financial liberalization has made it difficult to adopt and impossible to maintain the state guided development models that were in large part responsible for the high Third World growth rates experienced in the Golden Age and the decades-long East Asian “miracle.” The most effective of these models relied on capital controls to help stabilize financial markets and limit speculation, facilitate government control of interest rates, reinforce state control over the allocation of credit flows (an important tool of industrial policy), and prevent the disruption of sustained economic expansion by capital flight.¹⁵

Turning first to the issue of financial instability, it is clear that financial liberalization has dramatically increased turbulence in global financial markets. “Financial crises seem now to happen with almost monotonous regularity,” The Economist recently observed.¹⁶ Moreover, every serious developing country financial crisis of the past two decades was preceded by financial liberalization. A recent United Nations report states that “financial deregulation and capital account liberalization appear to be the best predictors of crisis in developing countries.”¹⁷

It is now widely acknowledged that liberalization of domestic financial markets and cross border capital flows was a key cause of the recent Asian crisis.¹⁸ According to Joseph Stiglitz, the World Bank’s chief economist, “it is unlikely that the [Asian] crisis could have occurred without the

*liberalization of capital accounts.*¹⁹ Problems began with the acceleration of financial liberalization in the 1990s. Foreign investors were anxious to take advantage of the opportunity to profit from the “miracle” economies of Asia that such liberalization offered. When Asian markets opened to them, they poured money in. In 1996 alone, there was a net inflow of \$93 billion in private foreign capital into the five countries most affected by the crisis. Most of the capital was short term, and most of the short term capital was bank loans, not portfolio investment. Korea alone doubled its foreign debt from \$60 billion in 1994 to \$120 billion in 1996; two thirds of this debt was short term.

Much of the foreign money was used, either directly or via intermediation through local financial institutions, to help fuel speculative investment booms. Between 1986-90 and 1991-95, investment as a percentage of GDP rose from less than 32% to almost 38% in Korea, from 23% to 39% in Malaysia, and from 33% to over 41% in Thailand.²⁰ In Thailand, residential and commercial real estate were the primary targets of speculation, though stocks were also important. Loans from domestic and foreign financial institutions to Thai property developers almost tripled between 1993 and mid 1996, eventually creating a rising excess supply of housing and office space that triggered a price collapse in 1996. Foreign capital inflows also helped push Thai stock prices up by 150% between 1991 and 1994, then helped sustain them at an inflated level until the market burst in 1996. In Korea, short term foreign capital flowed primarily into capacity expansion in basic industry. The problem here was that much of this capital was invested in industries, such as autos and semiconductors, in which Korea already produced far more than it could consume domestically – two thirds of auto production was targeted for export – and export prospects were

poor because of large global excess capacity. For example, over-supply drove the price of semiconductors, Korea's major export earner, down by almost 80% in 1996.²¹

We should not be surprised that a good deal of the capital flowing into Asia turned out to be invested imprudently. At any point in time, there is a limit to the number of investment projects, private and public, that offer an attractive rate of return. Domestic saving in East Asia, at 30 to 40 percent of GDP, was large enough to finance almost all profitable projects. There may have been unusually large public infrastructural projects and key foreign technologies that require foreign financing (which should have been done on a long term basis), but with this important exception, the additional Asian investment projects funded with foreign money were likely to be only marginally profitable. As Furman and Stiglitz noted:

In the case of East Asia, where the saving rate was very high, the benefit to the extra capital accumulation that followed liberalization may have been relatively low.²²

In sum, local firms and banks had used short term foreign loans to finance long term, risky, domestic investment. This meant that any number of not unlikely events could trigger a repayment crisis – a rise in foreign or domestic interest rates, a fall in the exchange rate (which would make repayment through domestic earnings harder), a rise in the exchange rate (which would lower the export earnings of domestic firms), an increase in the trade deficit, the end of an asset bubble, or a fall in domestic profit rates. Over-reliance on short term *domestic* loans to finance long term investment is unwise; over-reliance on short term *foreign* loans to do so is grossly irresponsible.

By 1996 it was becoming clear to informed observers that the speculative real estate and stock markets booms in Thailand were ending, as all such booms must. Domestic and foreign

investors began to shift money out of the country, which caused a collapse of domestic asset prices, and put downward pressure on the bhat. The government had maintained a fixed bhat\dollar exchange rate for many years to attract foreign investors by eliminating fear of exchange rate loss. They continued to defend the bhat in 1997, but the rising swell of money leaving the country forced them to let it float in July. It proceeded to sink like a stone. Panic eventually spread to other markets in the area. The huge capital inflow of 1996 was followed by a net capital outflow of \$12 billion in 1997. This one year turn around of \$105 billion was about 11% of the pre-crisis GDP of the five affected countries.

No financial system in the world, no matter how modern or well regulated, could have withstood such drastic capital flow volatility without experiencing economic trauma. In the US, for example, a proportionate year to year capital flow swing would be almost one trillion dollars, enough to create financial chaos. Foreign banks pulled \$36 billion out of the area in 1997. Since their loans had financed long term investments, repayment of principal out of profits was not possible, while the forced sale of assets purchased with the loans only worsened the collapse in their prices. Naturally, Asian currencies plunged, interest rates spiked, domestic banks either became insolvent or stopped making loans out of fear of insolvency, large numbers of local firms went bankrupt, and the whole area sunk into recession.

Korea, Thailand and Indonesia were forced to sign agreements with the IMF to avoid debt default. Governments were ordered to raise interest rates dramatically and to run budget surpluses in order to induce recessions, thereby generating the trade surpluses needed to pay back the debt. The IMF even demanded the removal of all remaining controls over short term capital flows, in

spite of the fact that most observers believed that the relaxation of previously tight controls helped cause the crisis in the first place. Most important, the US dominated IMF took advantage of the weak bargaining position the crisis had put these countries in by making its loans contingent on a commitment to adopt lasting Neoliberal reforms.

By contributing to the outbreak of severe financial crisis, the irresponsible deregulation of domestic financial markets and the weakening of controls over international capital flows across Asia helped bring the fastest growth area on earth to its knees. Korea's economy shrank by 5.8% in 1998 after growing at a 7.1 % rate in 1996; Indonesia's GDP fell by 13.1% last year after rising by 8% in 1996; Thailand's economy suffered a 7.6% contraction in 1998 compared with 5.5% growth in 1996; Malaysian GDP fell by 6.7% last year as opposed to an 8.6% growth in 1996; and the Phillipines' economy dropped 0.5% in 1998 after growing 5.7% in 1996. The shift from high growth to stagnation in Asia lowered global growth to about two percent a year in 1998 and 1999.

In my view, however, the greatest threat to developing country growth prospects in the longer run in the current era may come not from the effects of recurrent short term financial instability per se, but rather from the pervasive pressure in this period to eliminate state led development models. As noted, not all efforts at state led development have been successful, but, contrary to current conventional wisdom, all successful development experiences to date have relied on substantial state economic regulation. It is hard to think of a single example of high growth sustained over a long period in a developing country, in either the prewar or post war era, in which the government did not consistently violate key tenets of Neoliberalism and deliberately interfere in important ways with market processes.

Until the crisis, Asia was living proof that TINA was an ideological slogan rather than a scientific law. Though the precise economic role played by the government varied from country to country, for three to four decades most of Asia relied heavily on state economic intervention, including the widespread use of capital controls, to maintain the highest growth rate in the world. East and Southeast Asia accounts for only about 25% of global production, but it generated about half of global growth from 1990 through 1996. If the current IMF-driven liberalization of Asia results in the replacement of East Asian development models with Neoliberal structures (an outcome which, though uncertain, is the stated intention of the liberalizers), it will likely signal the end of above average growth rates in the area, and thus perhaps a permanent decline in global growth rates.

But, in my opinion, the damage done by free capital mobility is not limited to less developed nations. Unregulated capital movement also prevents developed country governments from consistently creating enough growth to generate rising wages and low unemployment. Fast growth and sustained low unemployment may at times be accompanied by rising inflation, a deterioration of the trade balance, and a falling exchange rate. Inflation and falling exchange rates in turn induce financial capital flight because they erode the return on domestic relative to overseas investment. Meanwhile, the wage increases that often accompany low unemployment may motivate industrialists to shift production abroad. In the absence of capital controls, the mere anticipation that these events will follow the implementation of expansionary policy can trigger a rapid money capital outflow, which itself will kick interest rates up, put downward pressure on stock and bond prices, depress the exchange rate, and increase inflation. With capital now able to

flee *en masse* at the first premonition of trouble, problems that expansionary policy might have generated only slowly and in concert with its benefits in previous decades are now magnified by capital mobility and appear *before* the benefits of the policy have a chance to develop. Capital mobility thus destroys the economic viability of expansionary government policy even in developed countries because it simultaneously raises its costs and lowers its expected benefits.

Most economists do not doubt that capital flows can be controlled if the government is determined to control them. Debate concerns the costs and benefits of controls. Opponents of controls believe that unregulated markets operate with impressive efficiency. Since controls interfere with market processes, it is assumed that they must have serious costs, yet because the efficiency of markets is taken for granted, their potential benefits are seen as modest at best. Supporters of capital controls agree that they can have costs, especially if poorly implemented. Controls can be used to protect domestic monopolies, reduce the efficiency of the price mechanism, and create incentives for corruption. History contains many examples of the misuse of controls. But it also reminds us that in the Golden Age and even beyond, almost all advanced countries used controls on both inward and outward capital flows to help generate sustained high growth. So did most developing nations. The creation of the economic “miracles” in Japan, Korea, Singapore, Taiwan and later China would have been impossible without strict regulation of capital movement.

The financial panic that raced across the globe following the Asian crisis has put the debate on capital controls back on the political agenda. And the fact that those Asian countries that maintained strong capital controls, such as Taiwan, China, India and Vietnam, did not suffer the

direct effects of the crisis, has strengthened the position of those who support controls. The Financial Times ran an article titled ‘Japan: Government ponders capital controls.’²³ The Wall Street Journal reported that German Chancellor-Elect Gerhard Schroeder “gave his strongest endorsement yet of placing greater controls on international capital flows and restructuring the global financial system”; it noted that the French government shared his view.²⁴ Business Week expressed concern over “the anarchy of markets that globalization has unleashed,” adding that “the idea of limited capital controls is picking up support from top economists as well.” It quotes the World Bank’s Joseph Stiglitz as arguing “that it’s time to consider some form of taxes, regulations, or restraints on international capital flows.”²⁵ The New York Times observed that there is “a growing number of economists calling for new steps to control these capital flows or at least soften their impact.” The article points out that “it is the holdouts with respect to capital controls, like China and India, that have weathered the crisis much better than the others, because they were not vulnerable to a sudden exodus of capital.”²⁶ Respected Financial Times columnist Martin Wolf argued that

it is impossible to pretend that the traditional case for capital market liberalization remains unscathed. ... After the crisis, the question can no longer be whether these flows should be regulated in some way. It can only be how.²⁷

Finally, the Asian crisis led influential Harvard economist Jeffrey Sachs to conclude that governments must control short term capital flows, limiting inflows to the amount needed to finance trade, while prohibiting their use in financing long term investment. “One could approach such limits through taxation...or through outright supervisory limits,” he argued, adding that the thesis that “short-term flows essentially cannot be controlled is not convincing.”²⁸

Policies to control cross border capital movements could be implemented at the international and/or domestic levels. A system of international controls on capital flight could be negotiated that required countries to return capital that entered their markets in violation of the laws of the nation of origin. Both Keynes and White supported such international cooperation, which would be especially helpful to the efforts of smaller, poorer countries to enforce their controls. International cooperation in monitoring and controlling the movement of funds is already occurring, as countries look for more effective ways to restrict the laundering of drug money and minimize the extent of tax evasion by their multinational corporations.

The Tobin Tax a small percentage tax on all foreign exchange transactions, is another globally coordinated measure which has received wide support among academics and some international organizations.²⁹ It is designed to discourage excessive short term speculation – 80 percent of all currency transactions are reversed within one week – without impeding longer-term capital flows. Tobin points out that such a tax would have to be levied globally, or at least in all major financial centers, otherwise foreign exchange transactions would simply move to an untaxed locale. Of course, if the US and Britain simply announced that no country that failed to enforce the Tobin tax would be allowed to use Anglo-American financial markets, the rest of the world would immediately agree to enforce it.

However, there are serious limitations to the Tobin Tax as a mechanism for dealing with very large speculative flows of short-term capital such as those associated with the recent Asian crisis. Such controls are, in the present political environment, most likely to be implemented at the national or regional levels, where they are more feasible politically. Progressive cross border labor

and citizen alliances are developing, but are not yet at the point where they can have a serious impact on global economic policy. As Manfred Bienefeld explained: "The focus on nation states derives primarily from a pragmatism born of a total inability to conceive, let alone construct, a meaningful political process at the global level."³⁰

A paper I published with Gerald Epstein³¹ and the United Nations Trade and Development Report 1998 are two of many available sources that discuss in detail the great variety of capital controls that have been used successfully by a large number of nations in the post war period. There have been a dazzling array of quantitative or size restrictions on the flow of capital used by different countries at different times. For example, in 1975, 17 industrial countries and 85 developing countries had some types of quantitative restrictions on international capital transactions on the books. By 1990, 11 industrial countries and 109 developing countries still had legislation that enabled their use. Other powerful and widely used forms of control over financial capital include restrictions on bank lending to non-residents, dual exchange rates to reduce the impact of capital movements on the costs of imports and exports, and strict rules on importing and exporting foreign currencies.

However, I would argue that the easiest and most efficient way to reduce destructive capital mobility is to use a well developed, politically accepted institution which all industrial countries rely on – the tax system. The great advantage of using the tax system is that it involves no new bureaucracy and, at least in the advanced countries, is reasonably cost effective. Consider first the imposition of a tax on the sale of financial assets, which could be limited to the sale of assets held for less than some target length of time if desired. Such a tax is sometimes referred to as a “Keynes

tax” because in *The General Theory* Keynes argued for the “the introduction of a substantial government transfer tax on all transactions” in the stock market in order to minimize speculative trading.³² The Keynes tax is a natural complement to the Tobin tax because before a large sum of money can flee a country, it must first be accumulated by a speculator through the sale of domestic assets or by borrowing. Taxing the sale of the asset and taxing the foreign exchange transaction should have the same qualitative effect on the profitability of flight. Most important, a Keynes tax can be applied unilaterally.

Similar results could be obtained through changes in the provisions of the capital gains tax: penalty rates (relative to ordinary income) applied to the sale of assets held for less than some target period could be very effective. Tax systems have also been used to change the relative returns on foreign versus domestic financial assets. Institutions such as pension funds and insurance companies hold large and rapidly rising shares of advanced country domestic financial wealth, and they are trading securities across national borders at an increasing rate. By taxing the gains from cross border investments at a penalty rate and by discriminating against the deductibility of cross border losses, governments could substantially reduce the propensity of money to move into and out of the country.

A major advantage of using the tax system to regulate capital movement is that it is easy to change the rate of taxation from time to time; the government can thus encourage, as well as discourage, capital flows when it seems advisable to do so. Chile has used a tax-like mechanism to successfully regulate short term capital flows. Chileans who take out foreign loans with a maturity of less than one year must deposit a percentage of the loan in a non-interest bearing account at the

Central Bank. By varying that percentage, the government has exercised substantial control over the volume of short term foreign borrowing.

Enforcing international capital controls need be no harder (but, of course, also no easier) than imposing taxes. Taxes, like capital controls, are, to some degree, evaded. It costs money and takes effort to collect taxes, as it does to control capital mobility. But where there is a will to collect taxes, they are collected. Changes in the tax law would simply extend this mechanism to the regulation of international capital mobility.

It is often argued that any attempt to implement capital controls is self-defeating because capital will flee the country as soon as the enforcement legislation is given serious political attention, before the controls can be implemented. There is some validity to this argument, but it applies as well to any serious policy proposal (such as low interest rates, higher taxes on the rich or tighter financial market regulation) perceived to be against the interests of the wealthy.

Careful consideration suggests that this impediment to the effective use of controls is manageable. If capital controls are part of a sensible general plan to raise the rate of economic growth and reduce economic uncertainty over the longer run, some holders of longer term real and financial assets might not see flight as their most profitable option. Keep in mind that fast-growth East Asian countries had no trouble raising foreign capital even when their capital controls were extremely tight. More important, the sequence in which various controls are introduced can limit the severity of capital flight. Suppose relatively moderate Keynes and Tobin taxes are introduced first. If more powerful controls are contemplated thereafter, they can be preceded by a substantial rise in the magnitude of these taxes –the cost of flight can be raised just as the incentive

to flee goes up. In the same vein, taxes on some transactions involved in the flight of capital can be applied retroactively, again limiting the gain from flight. And it is possible to enact standby controls in conditions where there is no immediate plan for their implementation. At some future time when more comprehensive controls are needed, the standby controls can be used without prior notice to prevent anticipatory capital flight.

According to a recent study of financial crises by the United Nations Conference on Trade and Development:

Use of capital controls has been a pervasive feature of the last few decades. In early postwar years capital controls for macroeconomic reasons were generally imposed on outflows as part of policies for dealing with balance-of-payments difficulties and for avoiding, or reducing, the size of devaluations. Moreover, there was widespread use by both developed and developing countries of controls on capital inflows for...longer-term development or structural reasons... With the return to freer capital movements from the 1960s onward, large capital flows caused problems for the governments of certain industrial countries such as Germany, the Netherlands and Switzerland, which responded with various controls... More recently, a number of developing countries experiencing similar macroeconomic problems as a result of large capital inflows have resorted to capital controls as part of their policy response.

The continued outbreak of “financial crises and the frequent recourse by countries to controls to contain the effects of swings in capital flows,” the study concludes, strongly points to the need for governments to continue to regulate capital mobility.³³ It is clear that there are no serious technical or economic – as opposed to political – impediments to the use of capital controls.

V. Conclusion

Enough evidence has accumulated to make a strong case that relatively unregulated, globally integrated markets generate slow growth, high unemployment, financial instability and rising inequality in the current era, just as they did before the Golden Age. If economic

performance is to improve significantly, governments will have to reverse course and rebuild their capacity to intelligently regulate market processes in the national interest.

Two immediate challenges are posed by the issues considered in the last section. The first is political. Globalization has greatly increased business control of domestic political priorities. A way must be found to replace the demands of business, finance, and the wealthy with the interests of the majority as the main concern of government economic policy. The second is economic. Conditions must be created that make expansionary macroeconomic policy more effective everywhere, and once again permit developing country governments to adopt state led growth models. Both tasks would be facilitated by the widespread reimposition of capital controls. That controls are feasible is not in dispute even on the right: as The Economist put it, those "who demand that the trend of global integration be halted and reversed, are frightening precisely because, given the will, governments could do it."³⁴

Capital controls can help with the political challenge by regulating and reducing capital mobility, thereby eliminating one of the main channels through which business and financial interests dominate the political process. As Dani Rodrik put it, under current conditions, "it is global markets that dictate policy, not domestic priorities" (99, 15); controls can help reverse this political imbalance. Controls would also help meet the economic challenge because they make expansionary macroeconomic policy more effective by substantially reducing its costs and raising its benefits. They also give developing country governments an essential tool for the guidance of national economic growth.

Endnotes

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1. Integration per se is not the problem; lack of state control over international transactions is. But given free mobility, capital's power to frustrate state policy is proportional to the extent of global integration.
 2. John Maynard Keynes, The Collected Writings of John Maynard Keynes. Volume 25. Activities 1940-1944: Shaping the Postwar World. (London: Macmillan, 1980), p.52.
 3. Dani Rodrick, The New Global Economy and Developing Countries: Making Openness Work. (Washington, D.C.: Johns Hopkins University, 1999), p.68.
 4. For contrasting explanations of the breakdown of Golden Age and the rise of Neoliberalism, see Samuel Bowles, David Gordon, and Thomas Weisskopf, After the Wasteland (Armonk, New York: Sharpe, 1990), and Robert Brenner, "The Economics of Global Turbulence," New Left Review 229, pp. 1-264.
 5. John Eatwell, International Financial Liberalization: The impact on World Development. (New York: United Nations Development Programme, Office of Development Studies, 1996), p. 38.
 6. Reported in David Felix, "Asia and the Crisis of Financial Globalization," in Dean Baker, Gerald Epstein, and Robert Pollin, eds., Globalization and Progressive Economic Policy (Cambridge: Cambridge University, 1998), p. 184.
 7. Angus Maddison, Monitoring the World Economy 1820-1992 (Paris: OECD, 1995), p. 60.
 8. In World Development Indicators 1999 (Washington, DC: World Bank, 1999), p. 4.
 9. Data from United Nations Conference on Trade and Development, Trade and Development Report (New York: United Nations), various issues.
 10. Data is taken from the Council of Economic Advisers, Economic Report of the President (Washington: United States Government Printing Office, 1999).
 11. Data in this paragraph is from Lawrence Mishel, Jared Bernstein and John Schmitt, The State of Working America 1998-99 (Ithaca, New York: Cornell University, 1998), pp. 51, 131, 132, and 157.
 12. United Nations Conference on Trade and Development, Trade and Development Report 1997 (New York: United Nations, 1997), pp. 65-66.

13. Some of the arguments in this section are taken from James Crotty and Gerald Epstein, "In Defense of Capital Controls," The Socialist Register 1996, pp. 118-49.

14. The argument in this section focuses on financial capital mobility. The benefits and costs of foreign direct investment to developing countries are analyzed in James Crotty, Gerald Epstein and Patricia Kelly, "Multinational Corporations in the Neoliberal Regime," in Dean Baker, Gerald Epstein and Robert Pollin, eds., Globalization and Progressive Economic Policy (Cambridge: Cambridge University, 1998), pp. 117-43.

15. The economic functions exercised by the state in Korea and Taiwan are clearly explained in Alice Amsden, Asia's Next Giant (New York: Oxford University, 1989) and in Robert Wade, Governing the Market, (Princeton: Princeton University, 1990).

16. The Economist, June 12, 1999, p.65.

17. United Nations Conference on Trade and Development, Trade and Development Report 1998 (New York: United Nations, 1998), p. 55.

18. For an extensive analysis of the Asian crisis, see James Crotty and Gary Dymiski, "Can the Neoliberal Regime Survive Victory in Asia? The Political Economy of the Asian Crisis," International Papers in Political Economy, no. 2. 1999.

19. Joseph Stiglitz, "Sound Finance and Sustainable Development in Asia," Keynote address to the Asia Development Forum, March 12, 1998, emphasis in original.
[Http://www.worldbank.org/html/extdr/extme/jssp031298/htm](http://www.worldbank.org/html/extdr/extme/jssp031298/htm).

20. United Nations Conference on Trade and Development, Trade and Development Report 1998 (New York: United Nations, 1998), p. 61.

21. An excellent discussion of the Korean crisis can be found in Ha-Joon Chang, Hong-Jae Park, and Chul-Gyne Yoo, "Interpreting the Korean Crisis: Financial Liberalization, Industrial Policy, and Corporate Governance," Cambridge Journal of Economics, 22. no. 6. November 1998, pp. 735-46.

22. Jason Furman and Joseph Stiglitz, "Economic Crises: Evidence and Insights from East Asia," Brookings Papers on Economic Activity, no. 2, 1998, pp.1-114.

23. Financial Times, September 30, 1998.

24. Wall Street Journal, October 9, 1998.

25. Business Week, November 12, 1998, pp. 113-14.

26. New York Times, September 20, 1998.

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27. Quoted on page 1550 in Robert Wade, "The Asian Debt-and-development Crisis of 1997-?: Causes and Consequences," World Development, 26, no. 8, 1998, pp. 1535-1553.
28. Page 71 in Steven Radelet and Jeffrey Sachs, "The East Asian Financial Crisis: Diagnosis, Remedies, Prospects," Brookings Papers on Economic Activity, no. 1, 1998, pp. 1-74.
29. The Tobin Tax is explained and defended in David Felix, "Financial Globalization vs. Free Trade: The Case for the Tobin Tax," UNCTAD Review (New York: United Nations, 1996).
30. On page 122 of Manfred Bienefeld, "Capitalism and the Nation State in the Dog Days of the Twentieth Century," The Socialist Register 1996, pp. 94-129.
31. James Crotty and Gerald Epstein, "In Defense of Capital Controls," The Socialist Register 1996, pp. 118-49.
32. John Maynard Keynes, The Collected Writings of John Maynard Keynes. Volume VII. The General Theory of Employment, Interest and Money (London: Macmillan, 1973), p. 160.
33. United Nations Conference on Trade and Development, Trade and Development Report 1998 (New York: United Nations, 1998), pp. 103, 105.
34. The Economist, October 7, 1995, p. 16.