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Capital Controls: A Practical Guide

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1. The case for capital controls

Capital controls have been largely rejected by mainstream theory for several decades. [1] Even critical economists have treated them with skepticism. [2] Things began to change toward the end of the last decade; note that the IMF has published staff papers stating that capital controls ought to be considered in the case of deep financial crises. [3]

The resurgence of interest in capital controls owes much to the inability empirically to defend the theory of Optimal Currency Areas. In practice, freely floating exchange rates do not lead to autonomy in monetary policy, especially for small open economies, and the main reason is free capital flows. In the presence of free capital flows, exchange rates tend systematically to over- and undershoot the fair - or equilibrium - values, as these would be determined by purchasing power parity or uncovered interest parity. Market-determined exchange rates can even move in the wrong direction for extended periods of time. [4] The reason is currency speculation sustained by free capital flows. Countries with relatively high rates of inflation and thus relatively high interest rates tend to be swamped by inflows of short-term funds that drive up the exchange rate of their currencies in real terms. This destroys absolute and comparative advantages in international trade and distorts the production structure between tradable and non-tradable goods.

Formal monetary autonomy for relatively small open economies is thus an empty shell. Monetary authorities are obliged to react to the vagaries of the currency market and the formal freedom of a central bank (no obligation to intervene) has no material basis. This practical reality has meant that, for countries wishing to participate actively in the world market, it has been necessary to deploy various techniques and institutional methods to deal with free capital flows and the ensuing exchange rate instability.

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[1] See, for instance, Grenville, S. (2004) “The IMF and the Indonesian Crisis” Bulletin of Indonesian Economic Studies, Taylor and Francis Journals, Vol. 40 (1), pg. 77-94; Fischer, S. (2001) “Exchange rate regimes: Is the bipolar view correct?” Distinguished lecture in economics and government, delivered at the meeting of the American Economic Association. 6th of January. New Orleans, Lousiana.

[2] Krugman, P. (1999) "Capital Control Freaks--How Malaysia got away with economic heresy" Slate, posted Sept. 27, 1999, http://www.slate.com/authors.paul_krugman.htm; Jomo, K.S. (2001) "Capital Controls," in Jomo, ed., Malaysian Eclipse: Economic Crisis and Recovery, Zed Books, London 2001.

[3] International Monetary Fund (2012) “The Liberalization and Management of Capital Flows: An Institutional View”, Washington, IMF.

[4] See UNCTAD (2010) “Trade and Development Report 2010: Employment, globalization and development”, Chapter 1, pg. 24.

Some countries that have not been willing to leave the determination of the exchange rate to the market have been encouraged to cooperate with other countries to achieve greater exchange-rate stability. Note that, in the absence of cooperation, conflict is unavoidable as a change in one country's exchange rate always affects another country. For *n* countries in the world as a whole there are *n-1* exchange rates. Consequently, the necessity for international monetary cooperation has been apparent, and has led to the creation of zones of relatively fixed exchange rates. The largest of these is the European Monetary Union which has eliminated exchange rates altogether, while also encouraging free capital flows.

Other countries, particularly in the developing world, that have sought to keep exchange rates stable as a matter of macroeconomic and trade policy have inevitably been attracted to capital controls. The most prominent example is China, which deploys an extensive battery of capital controls to keep the exchange rate of its currency under control, deeming it vital to its trade policy. China has been remarkably successful in controlling the value of its currency, but the price it has paid has been the accumulation of vast foreign exchange reserves, denominated mostly in dollars. Thus, the unstable foreign exchange markets have meant that China has been providing a huge subsidy to the US economy, since the dollars are kept as US government bonds.

Still other developing countries that wish to participate in the world market but also maintain relatively free capital flows, such as Brazil, Mexico, or South Korea, have been obliged to prevent violent fluctuations of the exchange rate by adopting long-term counter inflationary strategies based on relatively high interest rates. The result has been sustained overvaluation of the exchange rate with negative effects for the domestic economy. This policy has similarly led to the accumulation of huge foreign exchange reserves, mostly denominated in dollars. In effect, developing countries have allowed foreign capital inflows – thus increasing their external indebtedness – by keeping huge dollar reserves - thus exporting capital to developed countries (primarily the USA) on a net basis. At the same time, the sterilisation of capital inflows by central banks has resulted in the creation of highly liquid assets held by domestic banks, thus facilitating domestic financial expansion and domestic debt. Moreover, the effectiveness of the reserves as a barrier against the sudden withdrawal of capital flows has not been tested.

Finally, for still other countries, the adoption of capital controls has been an attractive and often necessary option in times of crisis. The rapid introduction of capital controls has been a vital method in stabilising exchange rates and preventing banking collapse in times of crisis. For countries facing the threat of rapid capital outflows there is, in reality, no practical option other than imposing a degree of capital controls. During the last four years – following the global crisis of 2007-9 – capital flows to developing countries have once again been substantial, partly because of easy monetary policies in the USA, the UK and elsewhere. Since the end of 2013, however, the possibility of tighter monetary policy and higher interest rates in mature countries has become more realistic, thus raising the prospect of capital outflows from developing countries. In that context, the policy option of capital controls has acquired added urgency. Furthermore, the Eurozone crisis that broke out in 2009-2010 has also raised the prospect of severe banking crises that could lead to individual countries exiting the monetary union. In that context too, the option (indeed, the necessity) of capital controls to staunch capital flight has also acquired urgency, as was sharply demonstrated in the case of Cyprus in 2013.

In short, free capital flows have meant significant risks and costs for developing countries, while the benefits have been highly debatable. Consequently, capital controls are a realistic policy option that needs to be carefully considered. This Policy Paper engages in a brief overview of capital controls and the actual practices deployed by several countries across the world. The focus is on the effectiveness of controls. A variety of measures have been deployed in practice, typically pivoting on controls over bank payments and withdrawal of bank deposits. Listing some of the methods commonly used could offers a short practical guide.

2. Successful deployment of capital controls: Three prominent instances

Contrary to conventional wisdom, capital controls have been widely used around the world, particularly when a crisis has erupted, or was about to erupt. A recent study by the IMF showed that for the period 1995-2005, 75 countries out of a sample of 91 countries have used some form of capital controls. [5] The study indicates that controls have been deployed

[5] Schindler, M. (2009) "Measuring Financial Integration: A New Data Set" by Martin Schindler IMF Staff Papers, Vol. 56, No. 1, 2009, pp. 222-238. The paper reflects the author's interpretation and codification of information provided in the IMF's Annual Report on Exchange Rate Arrangements and Restrictions (AREAER) and should not be viewed as an official national or IMF view.

on both capital inflows and outflows. In particular, countries experiencing exchange rate crises have used capital controls extensively in order to stabilize markets. Examples include Argentina (2002-2005), Brazil (2000-2001), Indonesia (1996-1997), Malaysia (1995-2005) and Mexico (1995). Other countries have deployed capital controls as a basic tool of macroeconomic policy, such as China.

In this light, consider below a brief summary of successful introduction of capital controls in three cases, namely Chile, Malaysia and Iceland.

Chile was one of the first countries to introduce capital controls early in spite of the prevalent mainstream approach favoring free capital flows. Chile restricted capital inflows in June 1991 in the context of national currency appreciation caused by deflationary policies and loss of monetary control. The chief method used was the imposition of costly reserve requirements on inflows, and controls were largely successful : [6]

Changes in the Unremunerated Reserve Requirements (URR) in the period of capital controls in Chile

Jun-91	20% URR introduced for all new credit
	Holding period (months) = to credit maturity with a minimum period of 3 and a maximum period of 12 months
	Holding currency: same as credit
	Investors can waive the URR by paying a fixed fee (through a repo agreement at discount in favor of the central bank)
	Repo discount rate = USD libor
Jan-92	20% URR extended to foreign currency deposits with proportional holding period
May-92	Holding period (months) = 12
	URR increased to 30% for bank credit lines
Aug-92:	URR increased to 30%
	Repo discount = USD libor + 2.5%
Oct-92	Repo discount = USD libor + 4.0%
Jan-95	Holding currency: USD only
Jul-95	URR extended to Secondary Agreements at Discount Rate (ADR)

[6] The information presented here derives from De Gregorio, J., Edwards, S., Valdes, R., (2000) "Controls on Capital Inflows: Do They Work?" NBER Working Paper No. w7645; Le Fort, G., and Sanhueza, G., (1997) "Flujo de Capitales y Encaje en la Experiencia Chilena de los 90", Central Bank of Chile; Laurens, B., and Cardoso, J., (1998) "Managing Capital Flows: Lessons from the experience of Chile", IMF Working Paper No. 98/168.

Sep-95	Period to liquidate USD from Secondary ADR tightened
Dec-95	Foreign borrowing to be used externally is exempt of URR
Oct-96	Foreign Direct Investment committee considers for approval productive projects only
Dec-96	Foreign borrowing < USD 200,000 (500,000 in a year) exempt of URR
Mar-97	Foreign borrowing < USD 100,000 (100,000 in a year) exempt of URR
Jun-98	URR set to 10%
Sep-98	URR set to zero

A further example of effective capital controls is Malaysia, which used controls to react to the Asian crisis at the end of the 1990s. Malaysia had a fairly modest ratio of short-term debt to GDP but, instead of requesting assistance from the IMF, it deployed a set of capital controls. The focus of controls were administrative measures to prevent the export of capital. Controls could not be evaded on a large scale and were successful in eliminating offshore ringgit markets and stopping speculation despite the easing of domestic monetary and fiscal policies. Controls were also effective in lowering interest rates and stabilizing exchange rates. [7] Malaysia's strategy proved superior to the IMF programmes adopted by its Asian neighbors since its GDP, consumption, investment, employment and wages recovered much faster. The stock market also recovered faster, interest rates dropped more, and inflation was also lower than in the neighboring countries. [8] The measures deployed in the case of Malaysia included: [9]

Controls on Capital and Exchange Controls, September 1998

1. Malaysia fixed the exchange rate at Malaysian Ringgit (RM) 3.80 per $US
2. Prior approval was required for nonresidents to be able to buy or sell ringgit forward.
3. All sales of ringgit assets were required to be transacted through approved domestic intermediaries. This effectively shut down the operation of the offshore ringgit market.
4. Nonresidents were required to obtain the approval of then central bank to convert ringgit held in external accounts into foreign currency, except for the purchase of ringgit assets in Malaysia or for the purposes of conversion and repatriation of sale proceeds of investment made by foreign direct investors.
5. Settlements of imports and exports were required to be settled in foreign currency. However, free

[7] See Kochhar, K., Johnston, B., Moore, M., Otker-Rober, I., Roger, S., and Tzanninis, D., (1999) "Malaysia: Selected Issues", International Monetary Fund Staff Country Report 99/86; Ariyoshi, A., (1999) "Country Experiences with the Use and Liberalization of Capital Controls," International Monetary Fund, Washington, DC.
[8] See Kaplan, E., and Rodrik, D., (2001) "Did the Malaysian Capital Controls Work?", NBER Working Paper No. 8142.
[9] Ibid.

exchange was maintained for all current account transactions in addition to supply of trade credit to non-resident exporters of Malaysian goods.

6. Credits to External Accounts were limited to sales of foreign currency, ringgit instruments, securities or other assets in Malaysia; salaries, wages, rentals commissions, interest, profits, or dividends.
7. Debits to External Accounts were restricted to settlement for purchases of ringgit assets and placement of deposits; payment of administrative and statutory expenses in Malaysia; payment of goods and services for use in Malaysia; and granting of loans and advances to staff in Malaysia.
8. Domestic nationals were forbidden to export more than RM 10,000 during any travels abroad. Foreign nationals were forbidden to export more than RM 1,000 upon leaving Malaysia.
9. After September 1, 1998, nonresident sellers of Malaysian securities were required to hold on to their ringgit proceeds for at least 12 months before repatriation was to be allowed.
10. Ban on the provision of domestic credit to non-resident correspondent banks and stockbroking companies.

Changes in Controls, 1999

1. As of February 15, 1999, the year-long moratorium on repatriation of investments was replaced with a graduated tax. All capital that had entered Malaysia before February 15, 1999 was subject to the following levies on the capital being removed: (a.) 30% if repatriated within the first 7 months after entering Malaysia, (b.) 20% if repatriated between 7 and 9 months after entry, (c.) 10% if repatriated between 9 and 12 months of entering, and (d.) no levy if repatriated after one year of entry.
2. For funds entering Malaysia after February 15, 1999, capital was free to enter and leave without taxation; however, profits were taxed at the rate of 30% if repatriated within one of entry and 10% if repatriated after one year of entry.

More recently, in 2008 Iceland faced a collapse of its banking system that caused a deep recession in 2009-2010. For several years in the 2000s, Iceland had attracted large inflows of short-term capital since its interest rate spreads were very large compared to the Swiss franc and the Japanese yen. [10] In the late 2000s Icelandic banks became very weak and international investors started to exit the krona, which meant a depreciation of 25% in the period just preceding the banking collapse, and even further depreciation afterwards. Capital controls were introduced to prevent large capital outflows that could have caused general economic collapse. Introduction of controls breached the European Economic Area (EEA)

[10] See Plantin, G., and Shin, HS. (2011) “Carry trades, monetary policy and speculative dynamics” CEPR Discussion Paper DP8224.

agreement, which stipulates free movement of capital between EEA countries. The European Free Trade Association (EFTA) Court, however, ruled that, in the case of Iceland, controls were compatible with the EEA agreement. [11] Note that, although controls were imposed on capital flows, movements on current account were left free. Payments of wages, interest and dividends to non-residents were also allowed.

3. Successfully applying capital controls within the EMU: Cyprus

Capital controls, finally, were imposed in Cyprus in 2013. This was a remarkable development partly because of the severity of controls, and partly because they went counter to the established policies of the European Monetary Union (EMU). The crisis in Cyprus had considerable similarities with that in Iceland insofar as the cause of the collapse in both cases was a deep banking crisis. Both islands had developed as financial centers in the preceding period, allowing their financial systems to become at least eight times as large as GDP before collapse. However, unlike Iceland which has its own currency, Cyprus is a member of the EMU. Thus, while the banking crisis was followed by severe restrictions on capital flows in both countries, in Cyprus controls were imposed by the EU ostensibly to prevent the collapse of the Cypriot banking system, while keeping the country in the monetary union. Iceland, in contrast, allowed its banks to go bankrupt while also defaulting on its debts. The outcomes in terms of growth, employment and income have been very different, with Iceland performing much better in the aftermath of the imposition of controls.

The measures applied in the case of Cyprus directly contravened Articles 63-66 of the Lisbon Treaty of the EU regarding free capital flows. The Cypriot government had already been forced to impose haircuts on bank deposits over €100,000 after abandoning a plan that threatened to impose losses on smaller deposits across the board. Capital controls were, thus, introduced to prevent a massive run on the banks in Cyprus rather than to a currency crisis. Furthermore, the EU also found it necessary to impose stringent restrictions on domestic financial transactions as well as cross-border flows to safeguard financial stability. The measures were successful in stopping an incipient bank run and preventing banking meltdown, although it took some time before staunching the growing outflow, in part because of the ability of banks to transfer funds to their own branches abroad. However, the

[11] See EFTA (2011) Court Case E-3/11 “Palmi Sigmarsson v the Central Bank of Iceland”

imposition of capital controls has not facilitated a recovery of the Cypriot economy because the country remains trapped in the EMU. Capital controls were accompanied by a severe austerity policy rather than currency devaluation, while Cypriot banking remains effectively bankrupt and continues steadily to lose deposits at the rate imposed by the controls. Cyprus thus remains in deep recession. The measures applied to Cyprus include: [12]

The restrictions applied in March 2013:

a) The cashing of cheques is prohibited.

b) The following are permitted:
   (i) cashless payment or transfer of deposits/funds to accounts held in other credit institutions within the Republic up to €50.000 per month per natural person in each credit institution regardless of the purpose.
   (ii) cashless payment or transfer of deposits/funds to accounts held in other credit institutions within the Republic up to €200.000 per month per legal person in each credit institution regardless of the purpose.
   (iii) cashless payment or transfer of deposits/funds to accounts held in other credit institutions within the Republic for the purchase of goods and or services regardless of the amount :
   Provided that the cashless payment from one credit institution to another, for a person's own account is not permitted:
   Provided further that the credit institution may request justifying documents if it is deemed necessary.

c) Cashless payment and or transfer of deposits/funds to accounts held abroad are prohibited, with the exception of:
   (i) transaction that falls within the normal business activity of the customer upon presentation of justifying documents as follows:
      (aa) payment and or transfer of deposits/funds of up to €1.000.000 per transaction, is not subject to the Committee's approval:
      Provided that each credit institution shall ensure that the justifying documents presented in each case, justify the execution of the payment and or of the transfer of deposits/funds.
      (bb) payment and or transfer of deposits/funds above €1.000.000 per transaction, is subject to the Committee's approval. The relevant credit institution shall submit to the Committee a request for each such payment and or transfer of deposits/funds as well as the necessary justifying documents. The relevant payment institution may submit to the Committee a request for each such payment and or transfer of deposits/funds and the necessary justifying documents and the name of the credit institution involved. The Committee in taking its decision takes into account the justifying documents and the liquidity buffer situation of the credit institution. The Committee's decision is communicated to the credit institution in every case and to any relevant payment institution.
      Provided that the Committee may request information for payment and or transfer falling within the category of section (bb).
   (ii) payments for salaries of employees upon presentation of supporting documents.

[12] Central Bank of Cyprus (2013) "The Enforcement of Restrictive Measures on Transactions in case of Emergency Law of 2013", Press Release (Unofficial Translation).

(iii) living expenses up to €5.000 per quarter as well as tuition fees, of a person who is studying abroad and is a first degree relative of a Cyprus resident, on the basis of supporting documents:
Provided that payment and or transfer for living expenses shall be allowed only upon submission to the relevant credit institution of documents establishing that the person receiving the payment and or transfer of deposits/funds is studying abroad and is a first degree relative of a Cyprus resident:
Provided further that tuition fees shall be paid only to the beneficiary educational institution, upon submission of the relevant justifying documents:
Provided still further that the credit institution maintains a catalogue in which it records and monitors all payments:
Provided still still further that the Committee may require the submission, to its attention, of the catalogue mentioned in the above proviso and or information on any payment and or transfer which falls under case (iii).

(iv) transfers of deposits/funds outside the Republic up to €5.000 per month, per person for each credit institution and or payment institution regardless of the purpose.

d) Sums transferred from a fixed term deposit to a sight/current account shall be subject to the restrictive measures applicable to sight/current accounts.

e) Exports of euro notes and/or foreign currency notes are prohibited in excess of €3.000, or the equivalent in foreign currency, per natural person per journey abroad.
The Director of Customs and Excise Department shall ensure the implementation of this measure.

f) Every financial transaction, payment and or transfer which has not been completed prior to the entry into force of the Enforcement of Temporary Restrictive Measures on Transactions in case of Emergency First Decree, of 2013 shall be subject to the restrictive measures provided in this Decree:
Provided that any financial transaction, payment and or transfer, which has not been processed by the credit institution prior to the entry into force of the Enforcement of Temporary Restrictive Measures on Transactions in case of Emergency First Decree,
of 2013 shall be cancelled and will have to be submitted anew.

g) Credit institutions shall not facilitate the circumvention of the restrictive measures.

h) The restrictive measures apply to all accounts, payments and transfers regardless of the currency denomination.

i) It is prohibited to transfer euro notes and/or foreign currency notes, in areas of the Republic, where the Republic does not exercise effective control, in excess of the amount of –

(i) €300 daily or its equivalent in foreign currency, per natural person who has its permanent residence in the Republic:
Provided that, in the case a natural person resides in areas of the Republic where the Republic does not exercise effective control, the transfer of euro notes in excess of €300 is permitted, if the euro notes originate from a salary payment, in the areas where the Republic exercises effective control, upon presentation of justifying documents,

(ii) €500 daily or its equivalent in foreign currency, per natural person who has its permanent residence abroad.
The Director of Customs and Excise Department shall ensure the implementation of this measure.

j) The opening of a new account for any person who is not an existing customer of a credit institution on the date of entry into force of the Enforcement of Temporary Restrictive Measures on Transactions in case of Emergency Sixth Decree of 2013, is prohibited unless-

(i) the account will only be credited with funds transferred from abroad to the Republic, or
(ii) the prior approval of the Committee is obtained or.
(iii) The account is a new fixed term deposit created with funds from cash provided that :
  (aa) the amount to be deposited exceeds €5.000 and
  (bb) the new fixed term deposit cannot be terminated prior to its maturity.
  Provided that upon the first maturity of the fixed term deposit the funds from the fixed term deposit will not be subject to the restrictive measures imposed by sub-paragraph (b) of the Decree:
  Provided further that the opening of a current account for the beneficiary/beneficiaries of the fixed term deposit is prohibited, or
(iv) The account relates to a new loan granted after the entry into force of the Enforcement of Temporary Restrictive Measures on Transactions in case of Emergency Nineteenth Decree of 2013:
Provided that the opening of a current/sight account related to the new loan is permitted and the funds in the current/sight account can only be used for the servicing of the loan and for the regular activity of the customer and not for depositing purposes:
Provided further that the credit balance of the current/sight account, cannot at any time exceed the amount of the loan balance:
Provided even further that the loan proceeds must be disbursed into a current/sight account, within the same credit institution, within the Republic and shall be subject to the prevailing restrictive measures. The funds in the current/sight account can be deposited in cash or be transferred from an account abroad or from other accounts within the Republic, subject to the prevailing restrictive measures.

k) It is prohibited to add new beneficiaries in a current/sight account unless the prior approval of the Committee is obtained.

Exceptions:

A. All money transferred from abroad to the Republic.
B. Withdrawal of cash using credit and or debit and or prepaid card issued by foreign institutions on accounts abroad.
C. The cashing of cheques issued on accounts held with foreign institutions abroad.
D. Cash withdrawals from accounts of credit institutions with the Central Bank.
E. Payments and receipts of the Republic.
F. Payments and receipts of the Central Bank.
G. The foreign diplomatic missions and the UN missions in the Republic based on the exemptions specified in the Vienna Convention for Diplomatic Relations and the Agreements between the Republic and the United Nations and other international Agreements which have precedence over national legislations.
H. The payments via a debit and or credit and or prepaid card.
I. Transactions or payments that have been authorised by the Committee.