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Can short-term capital controls promote capital inflows?☆

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Abstract

In an economy à la Diamond and Dybvig (J. Polit. Econ. 91 (3) (1983) 401), we present an example in which foreign lenders find it profitable to invest in an emerging market if, and only if, the emerging market government imposes taxes on short-term capital inflows. This implies that capital controls that are effective in reducing the vulnerability of emerging markets to financial crises may increase the volume of capital inflows.

JEL classification: F32; G14; G24

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1. Introduction

The financial crisis in Southeast Asia alerted the international community to the possible destabilizing effects of capital flows, and weakened the case for an early and complete liberalization of capital transactions. Policy makers are anxiously trying to find a solution to the dilemma of how to "maximise the benefits of capital flows to developing countries while minimizing both the number of panics and the damage they do".[1]

The view that short-term capital flows may increase the vulnerability of emerging countries to financial crises, and, for this reason, they should be regulated, is becom-

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[1] "Regulation and capital flows," *Financial Times*, March 25, 1998.

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ing increasingly popular. For example, Stiglitz suggested that emerging markets should follow the Chilean example, and impose controls on short-term speculative capital flows.[2] In fact, according to the then chief economist of the World Bank, "Even critics of the Chilean system acknowledge that the reserve requirement has significantly lengthened the maturity composition of capital inflows to Chile. This […] may be the reason that Chile has been relatively unaffected by recent financial crises."[3]

Those who oppose capital controls stress that "the *effectiveness* of Chile's capital controls is mixed. While the composition of capital inflows has been altered in favor of longer term flows, the goal of reducing the total volume of funds entering the country has not been achieved. Once the costs of distorting financial transactions are added to *the scheme ineffectiveness*, the case for Chile's capital controls is considerably weakened" (Edwards, 1998, emphasis added). But is this argument correct? Should we really expect that (short-term) capital controls that reduce the vulnerability of an emerging market to financial crises reduce the total volume of funds entering the country?

In this paper, we will attempt to answer this question with the help of a simple model à la Diamond and Dybvig (1983) in which foreign investors facing uncertainty about their liquidity needs have to decide whether to invest in an emerging market. We show that a tax on short-term capital inflows can prevent bank runs, and through this channel, it can increase the expected returns of investing in emerging markets. This in turn implies that there is no reason to measure the *effectiveness* of (short-term) capital controls according to their ability to reduce the volume of foreign investments.[4] In fact, capital controls that are successful in reducing the vulnerability of an emerging market to financial crises can indeed increase the volume of capital inflows. Accordingly, the empirical findings suggesting the ineffectiveness of capital controls in reducing the total volume of capital flows in emerging markets[5] do not refute, and may instead corroborate, the view that short-term capital controls can be effective instruments in reducing the vulnerability of such markets to financial crises.

2. The example

Assuming there are three periods, 0, 1, and 2, we borrow from Postlewaite and Vives (1987) the following constant return to scale technology: for each unit invested

[2] Since 1991, the Chilian law required that a fixed percentage of all non-direct foreign investment entering the country be deposited in an unremunerated account at the central bank for 1 year. The percentage was originally fixed at 20%, increased to 30% in 1992, reduced to 10% in June 1998, and set to zero since September 1998. This system is equivalent to the imposition of a tax on capital inflows inversely proportional to the length of stay of the inflow.

[3] Stiglitz (1998).

[4] Of course, this statement is only valid when (as in this paper) we do not consider situations in which capital controls are imposed to limit the volume of capital inflows and thus to avoid an excessive appreciation of the exchange rate.

[5] See for instance Valdés and Soto (1996) and Cardoso and Laurens (1998) in the case of Chile, and Cardoso and Goldfajn (1998) for a discussion of the more controversial case of Brazil.