# Capital Control Reconsidered: Financialization and Economic Policy

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**Abstract**

*First, we examine the nature of capital controls and their impact on selected countries. We provide a critique of IMF policy and an examination of its results in practice. We then show how the warning signs of the 1970s were ignored and the consequences became apparent during the ensuing period of neoliberal hegemony. We present a summary of the neo-classical arguments concerning the role of increased capital mobility in promoting growth and development. Our objectives are first, to show that, in practice, it may be that promoting increased capital mobility is counterproductive as it reduces macroeconomic 'policy space' and restricts the state's ability to use fiscal and monetary policy to enhance welfare. Second, we introduce and use a development of the international policy 'trilemma' in the form of a variant of the idea of the 'quadrilemma'*[1] *in order to underpin our policy suggestions.*

*We suggest that, in most cases, the key policy driver in the promotion of economic growth is fiscal policy but it may be that its unconstrained use (and that of monetary policy) is not possible either under fixed exchange rates or when free capital mobility exists; in fact, a nation may face a 'demi-quadrilemma. We contend that, in practice, a country can only adopt 'two from four'; if it chooses to retain free use of monetary and fiscal policy it must sacrifice both fixed exchange rates and capital mobility. We hope to demonstrate that a nation facing the 'demi-quadrilemma' should discard both the use of fixed exchange rates and the acceptance of free capital mobility in order to allow the retention of requisite monetary and fiscal policy space and that a multi-national approach to the design of capital control policy would be an effective contributor to a strategy designed to enhance growth and development.*

**Key Words:** Capital controls, Capital liberalisation, instability, financialization, *demi-quadrilemma*

**JEL Classification:** E44, E52, F 21

## I. Introduction

Financial globalisation is a very important development in the recent global economy. In the current phase of globalisation, capital is far more mobile than ever in the past. The colonial period of the nineteenth century was characterised by a *de facto* segregation of the world economy, despite free trade and *de jure* absence of barriers to capital mobility between European powers themselves and the colonies. Notwithstanding the availability of low wage labour, capital did not move freely in the colonies, except within certain limited spheres like mining, railways and plantations. (Chang and Grabel, 2014; Siddiqui, 2012) The neo-classical model of perfect competition, with perfect information and perfect capital markets did not hold in the real world of that period any more than it does today.

[1] 'A quadrilemma is a seldom–used and unconventional term describing a problem requiring a choice among four alternatives. It is in contrast to the standard term dilemma, which is between two opposing alternatives in which a person can only choose one. A less common term trilemma [see the example from international economics shown above] involves choosing either one or two choices among three possibilities' (http://en.citizendium.org/wiki/Quadrilemma).

The first aim of this study is to examine the impact of capital controls on selected nations and also to highlight the potential influence capital controls may have upon the dynamics of growth faced by developing economies.

It is essential, at the outset, to consider the meaning of 'capital mobility.' The word capital can be used in two senses; firstly with reference to "foreign direct investment", which means capital invested into productive assets, which are not liquid and secondly, "portfolio investment and bank loans", which are highly liquid and could have a potentially wide impact on a country's economy when allowed to flow unrestricted across borders. In contrast, capital controls refer to a range of policies that are designed to manage global capital flows. Such controls can take many forms. For instance, restrictions have been put on foreign investments in certain sectors. In addition, particular nations have put restrictions on capital outflows and on access to domestic or foreign currencies[2].

The capital mobility debate is set within a broader context of increased global financialisation and liberalisation. Epstein (2005a: 4) defines financialisation as, "the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of domestic and international economics". Financialisation works differently in countries where the financial system is based on capital markets and banking structures, and in the developing countries these systems are unlikely to mirror the Anglo-American market economies. He notes that, in the developed nations, the predominant form of capital is financial capital, such that the financial sector has displaced the real or productive sector, giving it a subordinate position.

Financial liberalisation is a term which refers to a set of measures including the autonomy of the central bank, freedom of movement of capital, free convertibility of currency, abandoning of 'priority sector' lending and differential interest rate policy to promote 'strategic' sectors or industries in the domestic economy. (Chang and Grabel, 2014) and is one of the most controversial aspects of modern political economy. Problems often associated with free capital mobility seem to be due not only to liberalisation of the rules governing long term flows of capital but also to those affecting portfolio capital investment which is short-term and speculative. We intend to examine why capital liberalisation has become so significant a part of the policy mix of many countries and why the absence of planning or a laissez-faire 'hands-off' approach of 'leaving it to market forces', has often led to economic instability in LEDCs. The experiences of Latin American and East Asian countries in the 1990s show that those countries that became financially more open and integrated witnessed higher instability (Ocampo and Stiglitz, 2008).

With regard to LEDCs, there has been a rapid increase in the inflow of capital in recent years; gross inflows of private capital stood at nearly 6% of GDP in 1991 but were more than double that amount in the developing countries by 2013 (Ostry et al, 2016; Gallagher, 2014). This can be considered as an unprecedented development; such a rate of increase has never been seen in the past. Worryingly, this development has made these economies increasingly vulnerable to the perils of financial globalisation.

In the post war period, capital controls, both in the developing and the developed countries were considered as a normal part of policy. Such policy measures were seen as essential government tools of economic management. Domestic governments deployed capital control measures to enhance macroeconomic policy effectiveness and to control and promote financial and currency stability. They were seen by many nations as key tools within the policy mix used to promote industrialization and competitiveness. (Grabel, 2006)

Capital controls include government-implemented restrictions upon foreign capital or overseas savers'

[2] For a detailed analysis and assessment of recent capital control measures see Kaltenbrunner (2016)

investment in domestic assets (government securities and bank deposits) or domestic capital moving abroad or investment in foreign assets. As an extreme measure to exert control over market forces, a government may impose control over international transactions. If the government would like to acquire total control over access to foreign exchange it could allocate the right to deal with and distribute those foreign currencies only to specifically designated institutions. Capital controls can enhance policy space especially in the use of fiscal and monetary policies and also reduce the chance of balance of payments problems- an issue we revisit later.

Developing countries received significant capital inflows, particularly in the period 2000-2007. These capital inflows were fuelled by the availability of cheap credit in the developed countries and booming commodity prices. (Bonizzi, 2014) The experiences of nearly two decades of crises, from the Mexican crisis of 1997, the East Asian crisis of 1997-98 to the Argentinian crisis 2001, sparked discussions about the need for prudent measures to manage capital flows in the developing countries. The cycle of boom and bust experienced by several developing countries necessitated the development of a clear policy for dealing with the capital inflows during the boom and for responding to a situation of sudden and rapid outflows of capital during the ensuing economic crisis.

The experience of the last two decades suggests that capital liberalisation may lead to increased consumption and output variability especially if dominated by the portfolio investment which, in turn, could have adverse consequences for developing countries. As Stiglitz (2004) argues, ‘capital market liberalization (in East Asia and Latin America) has played a role in contributing to economic instability. Money rushed into the country, often financing a consumption binge, and then rushed out; as it left, financial institutions were weakened, often bankrupted, and exchange rates plummeted, leaving those with dollar-denominated debts hard pressed to meet their obligations. During the inflows, the exchange rate appreciates, posing problems for the import competing and export sectors. Some governments (Thailand in the mid-1990s) attempted to prevent this and at the same time, avoid the economy overheating; this necessitated cutting back on high-return public investment and raising interest rates… During the outflows, financial institutions are devastated, and the lack of credit contributes to the economic downturn”. (Stiglitz, 2004:63, parentheses in the original)

As noted above, in the post-war period state control of cross-border capital flows was seen as a very important measure within the macroeconomic policy framework. It ensured that the state could act without fear of triggering capital outflows, i.e. it was effectively unconcerned with what “disgruntled” financiers, who might otherwise have taken their funds out, thought of its actions. The Bretton Woods system introduced soon after the Second World War allowed countries to employ capital controls and their use was widespread. This is not surprising; capital controls increase the power of nations to control their exchange rate and thus keep to their agreed parities.

The neo-liberal period beginning around 1980 has been characterised by the removal of capital controls. Deregulated financial markets have been a key aspect of the unleashing of the power of markets. According to the much vaunted 'efficient markets' hypothesis, the free movement of capital should lead to widespread benefits in terms of increased growth and improved efficiency. However, in practice, capital controls have apparently been required on numerous occasions especially by LEDCs. Their use has received more support from leading international institutions following the East Asian crisis of 1997-98- albeit with significant reservations. This occurred after the observed impact of the previous policy of capital liberalisation (often instigated by IMF pressure). Free capital movement had resulted in a huge inflow of foreign capital into the East Asian economies, which was reflected in a lending boom and an environment in which domestic banks took on greater risks. This necessitated government action in terms of preventing bank lending being directed towards unproductive and inherently unstable speculative activities. (Arestis and Glickman, 2002)

In the wake of East Asian crisis of 1997, many developing countries greatly increased their foreign exchange reserves providing a bigger 'cushion' in the event of future crisis. The additional foreign exchange reserve was not used to promote growth- by allowing the purchase of growth-enhancing imports- rather they were held as a contingency in case they were required to support the exchange rate. LEDCs have often felt the need to maintain higher rates of interest that would be compatible with domestic public purpose in order to discourage capital flight and avoid the resultant crash in the exchange rate.

However, the general promotion of free capital movement by international institutions is still in evidence. For example, in December 2015 at the WTO's ministerial conference in Nairobi delegates explicitly discussed *GATS* (General Agreement on Trade in Services). During this meeting- following on from the direction set in past meetings- it became obvious that the developed countries were pressing for full liberalisation. This follows from the fact that, in the developed countries, services account for a rising share of output and employment and the manufacturing sector has become less competitive. Clearly, the liberalisation of service trade in general would greatly benefit the developed nations across the board. (Mitchell, 2016b) The most important element of the globalisation has been the liberalisation in financial services, which increased the access of developed countries into the developing countries' markets. This effect was facilitated by the removal of domestic capital control measures and reduction in domestic financial regulation in recent years.

## II Capital Controls: An analysis of the experience and a critique of IMF prescriptions for selected LEDCs

Governments in the developing countries have been consistently told that capital controls are impossible to enforce or too disruptive to normal global business relationships as well as encouraging corruption. Notwithstanding the fact that IMF prescriptions for financial management in recent years have shown more understanding of the need for greater flexibility than in the past (as illustrated with recommendations regarding capital controls since the time of East Asian crisis) the IMF still holds on fast to neo-liberal ideology and sees capital controls -although expedient in particular crisis circumstances-as something best avoided in the long term. 'Notably, views on capital controls at the IMF evolved significantly during the crisis, though in some respects … this was a grudging evolution revealing of continuing discomfort.' (Grabel, 2016: 1)[3]

In the last twenty years or so, some developing countries have imposed capital controls as a means to protect their domestic economies from the effects of globally liberalised financial markets. As stated

[3] Grabel (2016) provides a detailed study of the use of capital controls since the global financial crisis (GFC). Her paper provides a thought-provoking analysis of the grudging acceptance (or re-acceptance) of capital controls as a legitimate part of a state's policy 'tool kit' in the trying circumstances associated with the aftermath of the GFC. She accounts for an 'extraordinary evolution of [views] on capital controls' by specifying five factors (Grabel 2016: 3), two of which are directly related to changes in the views and policy scope of the IMF. She refers to 'the evolution in the ideas of academic economists and IMF staff' and 'pragmatic adjustment by the IMF to an altered global economy in which the geography of its influence has been severely restricted, and in which it has become financially dependent on its former clients' (Grabel 2016: 3), as significant contributors. Referring to an earlier paper of her own (Grabel, 2015b), she notes, 'The IMF's staff faces the challenges of protecting its restored franchise and image in an environment in which many of its former clients have pursued strategies that insulate them from the institution, are among its lenders, and have exercised increasing assertiveness in several domains. The IMF has been forced to negotiate to retain the influence that, until the East Asian crisis, it was able to take for granted. This negotiation is especially apparent in the domain of capital controls, where the IMF has often responded after the fact to unilateral decisions made by national authorities. Even where it retains substantial authority, its economists are responding to capital controls in ways that diverge from past practice'. (Grabel, 2016: 10)

above, in general, the IMF may have been less critical of such policies since the crisis but its stance, as a neo-liberal institution at heart, was typified by its treatment of Malaysia when it imposed capital controls in the late 1990s (during the East Asian crisis). The IMF disapproved of controls on capital outflows, called for a 'step back', and its representative suggested that funds belonging to 'foreign investors in Malaysia have been expropriated, and the Malaysian economy will bear the cost of their distrust for years'. (Cited in Kaplan and Rodrik, 2001:11) Interestingly, a later paper by Ostry et al (2010) supported the use of capital control policy during recessions and also stated that "such controls, moreover, can retain their potency even if investors devise strategies to bypass them … the cost of circumvention strategies acts as sands in the wheels". (Ostry, et al 2010: 5) In addition, an earlier IMF study on capital control measures provided some guidelines for member countries and acknowledged their possible role in minimising currency appreciation and asset bubble development following the 2008 international financial crisis. (IMF, 2012) However, such concessions are at best pragmatic, applicable under 'special circumstances' and do not signify a change in ideology. This situation is reflected in a post-crisis 'rebranding' of capital controls noted by Grabel.'The IMF now refers to capital controls matter-of-factly as 'capital flow management' techniques (IMF, 2011b). IMF rebranding is particularly significant. The new, entirely innocuous term is suggestive of a neutral, technocratic approach to a policy instrument that had long been discredited as a vestigial organ of wrong-headed, *dirigiste* economic meddling in otherwise efficient markets. ' (Grabel, 2016: 4)

Faith in long term in 'market efficiency' remains strong, confidence in governments to follow the right policies when left to their own devices, correspondingly weak.

In contrast to the IMF, heterodox economists have always expressed doubts about the supposed merits of free capital mobility and frequently argued that developing countries should keep restrictions on capital mobility to be able to exercise monetary autonomy while enjoying stable exchange rates. In the face of crisis, India and China, for instance, have been advised to slow down their plans to liberalise their capital account. (Siddiqui, 2009) India, like China, has not fully liberalised capital flows and short-term debt inflows, in particular, have remained under tight control. This did help financial stability even during the global financial crisis of the 2008. (Siddiqui, 2015a) To reduce the frequency of financial crises, following heterodox economic logic, an increase in the use of controls on capital inflows by developing countries represents a sensible policy option. These controls could be applied by a number of methods such as limiting inflows or prohibition of capital entry into a country. Such controls could reduce the risk of financial crisis by preventing large inflows and are expected to reduce the risk of a sudden capital outflow if foreign capital decides to pull out of the country. In addition, they could reduce short-term speculation and borrowing.

When the Chilean government undertook measures towards controlling capital inflows-where foreign investors were required to keep their investment in the country for at least one year- and a percentage of investment was placed in an interest free deposit with the central bank there was an effect on short-term debt flows. (Crotty and Epstein, 1999) In the pre-East Asian crisis period, East Asian countries increased their borrowing on the global capital market; much of which was ultimately destined to boost demand and largely went into real estate. As a result prices rose sharply in this sector. Moreover, an increased capital flow brings upward pressure on the exchange value of the currency, adversely affecting domestic manufacturers by making output less competitive in global markets. Therefore, it seems some forms of capital control may be necessary. (Chang and Grabel, 2014) Excessive short-term foreign currency instability could occur when local banks borrow significant amounts of overseas capital. Under such a situation imposing capital controls may help to establish and strengthen the supervision and regulation of the country's financial system. Some argue that this may be rendered less effective in the long period, as investors and borrowers may find the ways to undermine such regulation. (Magud and Reinhart, 2006)

It is argued that financial integration allows domestic businesses in the developing countries to borrow in anticipation of future incomes and also borrow capital for investment and production which are ultimately assured to raise income. Accepting such arguments leads LEDCs to open up their capital accounts to international finance giving rise to potential instability. In response to the dangers inherent in free capital mobility, as noted above, Malaysia undertook capital control measures in 1998 -in conflict with orthodox policy recommendations- to prevent capital flight and increase control over the capital domestic capital market and exchange rate value of the currency. The government adopted a number of measures including monetary and fiscal policies to address domestic imbalances and to deal with recession. (Siddiqui, 2012)

Malaysia's capital control policies apparently produced a faster economic recovery from the East Asian crisis, a lower reduction in employment and more rapid upturn in the stock market. Kaplan and Rodrik (2001) analysed how Malaysia was able to achieve these outcomes relative to South Korea and Thailand. South Korea and Thailand followed the recommended IMF approach. 'In return for financial assistance from the IMF (and other multilateral and bilateral donors), these countries committed to float their exchange rates, raise interest rates, tighten fiscal policy (at least initially), open up their financial markets to foreigners, close troubled banks and financial institutions, and undertake a range of other structural reforms'. (Kaplan and Rodrik, 2001; 2)

Unlike the Thailand and South Korea, the Malaysian government was careful to target short-term speculative capital inflows, while insulating long term capital investment. The government was able to able to achieve its target, successfully to controlling speculative capital flows and underpinning greater monetary policy independence. Malaysia recovered from the East Asian crisis more quickly and its exchange rate was stabilised, while those countries which adopted orthodox polices experienced a longer and deeper crisis. Malaysia's Prime Minister, Mahathir Mohamed was criticised for moving against the trend which essentially required the acceptance of liberalisation policies. However, some critics have contended that Malaysia's capital control policies could only benefit (or provide relief) to the economy in the short term, while damaging the long term competitive prospects of the economy. (Siddiqui, 2012)

From a heterodox perspective, capital controls mean a government has more scope to pursue its domestic economic policies without the worry of an exchange rate or balance of payments crisis. Speculative attacks on currencies in East Asia and Mexico were fuelled by large movements of capital. These negative consequences were avoided by the Malaysian government as it set a limit on capital outflows in 1998 to help the economy and to regain financial stability. Gallagher's (2014) cross country study found that among the East Asian countries, those countries which had applied capital controls were able to perform better. Similar results were found in other empirical studies. (Magud and Reinhart, 2006) Studies by Kaplan and Rodrik (2001) concerned Malaysia's use of capital controls and their implications for macroeconomic stability and found a positive outcome resulted from the application of such policies. Malaysian capital control was a significant contributory factor, enabling the country to perform relatively well during the East Asian crisis. In contrast, Thailand and South Korea, in return for financial assistance from IMF, had adopted neoliberal reforms. This constrained the use of active fiscal policy and interest rates were adjusted in the line with market determined rates, leading in turn, to reduced growth and prosperity.

The Malaysian response to the East Asian financial crisis of 1997 offers an interesting lesson that other nations may decide to follow; soon after the crisis the country witnessed a rise in the state ownership as large numbers of family-owned businesses were merged into state owned firms. The government increased its grip on the corporate sector and banks and ultimately was enabled to exert increased influence on the lending policies of the financial sector with a shifting emphasis favouring towards government owned -companies. However, political factors were significant; after the differences between Mahathir and his deputy Anwar Ibrahim became apparent this resulted in the latter's removal in 1998. As a result Mahathir consolidated his power and all those businesses seen as close to Anwar Ibrahim lost out in terms of government support.

Capital controls were designed to minimise the risks of large scale investor exit and currency conversion by domestic and foreign asset-holders. (Gallagher, 2014; Stiglitz, 2004) These measures were intended to enhance the domestic policy autonomy and to insulate the domestic economy from crises originating in other countries. Another important point is that capital controls imposed during the economic crisis could be heterogeneous in design and applied with flexibility, even in countries facing similar problems or were operating at similar developmental levels. (Chang and Grabel, 2014)

## III Warning signs ignored; the experience of LEDCs in the neo-liberal period

When we look back at the financial problems experienced by developing countries in the late 1970s we can identify a foreshadowing of the negative effects of free capital mobility which were to pose significant threats to LEDCs throughout the neoliberal period. Increasing globalisation and international financialisation led banks based in the developed countries to increase their lending and investment in the developing countries. The elevated commodity price levels of the day enhanced the creditworthiness of borrowers in developing nations making LEDCs appear a strong source of profitability. However, following falls in the relative price of primary products, the debt crisis of the 1980s set in. LEDCs were unable to repay the foreign currency-denominated debt they had acquired. (Siddiqui, 2015a)

The East Asian financial crisis of 1997 and more recently the global financial crisis of 2008 further illustrate the dangers associated with increased financialisation, free capital mobility and weak regulation. These were the ingredients of a dangerous cocktail for LEDCs. It is clear that financial deregulation can lead to capital flight, currency instability, and most importantly a loss of policy sovereignty. It seems that, in essence, financial liberalisation leads to a stranglehold of finance over governments- preventing them from exercising independent control over economic policy. Since we live a world where countries remain nation states, globalisation of capital produces great stresses and effectively undermines democracy. Financial liberalisation enhances the power of international capital and governments are constrained in their use of policy by the needs of global capital. (Armstrong, 2015)

Capital controls have been proposed as an effective means of protecting developing economies from the instability associated with the financial globalisation. Without them a change in the international economy might generate shockwaves adversely affecting the economy. In an economy which is integrated with free movement of international capital, the absence of controls on capital and exchange rates may render a LEDC highly vulnerable. A 'developmental model' -essentially a mix of state intervention and selective introduction of market forces-followed earlier in the East Asian countries (Wade, 1990; Siddiqui, 2016), illustrates how governments can undertake a number of independent policy measures to reduce this vulnerability to global financial shocks. Prior to 1990, most of the East Asian countries used this mixture of state intervention and market forces to build a competitive environment and achieve higher growth rates (e.g. MITI's role in Japan). However, in the early 1990s with the change of political direction, the IMF pushed for an increased role for market forces and capital liberalisation in the region (Ocampo and Stiglitz, 2008).

Financial liberalisation expands access to capital, particularly manifested by increased foreign direct investment and portfolio investment flows. However, it also requires the adoption of international standards with regard to the governance of capital accounts, financial market regulation, exchange rates, accounting systems auditing and banking operations oversight. Another major consequence of capital liberalisation is a magnified impact of the monetary policy stance of international financial institutions such as the Federal Reserve and the European Central Bank. For example, a low interest rate policy adopted by international central banks might result in elevated lending from their banks to developing counties who appear more creditworthy at these lower rates. However, a loose international monetary policy environment heightens the risks for developing economies. When international monetary policy tightening is imposed a slowdown in growth rates in the global economy may lead to a reduction of foreign investment, even withdrawal, as foreign investors lose confidence or attempt to 'downsize' their balance sheets by reducing their exposure to higher risk loans. This withdrawal can impact significantly on LEDCS which have become reliant on these inflows and result in a domestic economic slowdown and political unrest. (Siddiqui, 2015b)

The issue of international creditworthiness in an age of global finance has become a matter of great importance for the governments of developing nations and it may appear prudent to pursue only polices which are approved of or are in line with the perceived wishes of 'global finance'. The obligation to prioritise international 'financial credibility' over domestic needs such as priority sector lending targets and the use of differential interest rates could have adverse consequences particularly on small and medium enterprises and, as a result, cause a rise in unemployment.

During the East Asian crisis, capital flows were seen as an important contributory factor in the currency and exchange rate crisis. Therefore, controls on capital movements were suggested to support exchange rate stability and as a positive step in the avoidance of speculative attacks on currencies. As a result, during crises, many developing countries have imposed capital controls with the aim of regulating capital flows, especially to reduce the flow of speculative inward foreign capital. This step was designed to help control inflationary pressure and currency appreciation. For example, in December 2007, Taiwan imposed restrictions on capital inflows with the aim of minimising speculative pressures from overseas investors (Zhang, 2009) and in June 2015, Argentina imposed capital controls and a 6% surcharge was imposed on investment with an overseas origin.

A comparison of the experiences of Latin America and East Asia may well prove worthwhile. It seems that the relatively 'mercantilist' strategy of some East Asian countries was more successful than the neoliberal open capital account policy of many Latin American nations in terms of stimulating growth and employment. Specifically, India's approach of opening its capital account to inflows in order to accelerate growth and investment following a neoliberal blueprint was far from successful; the trade deficit grew and improved access to foreign capital inflows have not led to an investment boom in India.

Prior to the 1981 economic crisis, Mexico had followed import-substitution industrialisation (ISI), which ran into deep crisis and led to the dismantling of government interventionist policies. Among the economic reforms, the government began with a deregulation programme with the aim to introduce 'efficiency' into banking and reduce government intervention in the financial sector. In 1990, the internationalisation of Mexico's financial system took place; as a result its capital market was opened up to foreign portfolio investment. Finally in 2000, with the further implementation of NAFTA agreement, Mexico embraced financial innovation. It created conditions conducive to securitization activities and encouraged greater involvement of both foreign international banks and corporations. As a result, these foreign companies increased their control over the banking and non-banking sectors for example, investment banks, insurance companies and pension funds. (Levy-Orlik, 2014)

The major activities of the foreign companies operating in the Mexico's financial sector have been to advance credits, however the availability of more capital did not lead to benefit its economy. As Levy-Orlik (2014:113-114) finds, "the Mexican economy has not benefitted from greater access to credit.

On the contrary, Mexico has the lowest ratio of credit to GDP (an average 14%) among Latin American countries. Small and medium-size businesses constitute an important sector that has faced reduced credit availability, partly because these businesses have little to no credit history or collateral and are therefore unable to guarantee payment in case of default. While the dynamic part of credit (channelled to households) has expanded, its share continues to be relatively small".

The manufacturing sector, which had an important role under the previous ISI strategies, did not expand particularly following the adoption of NAFTA and market polices. Despite the increase of exports in the post-NAFTA period, the foreign trade sector was unable to achieve a surplus. In fact, the increased exports were accompanied by elevated imports leading to an overall trade deficit. In addition, reduced investment spending contributed to weak economic performance. Despite the fall in overall investment spending, those manufacturing industries which specialised in exports of high technology have done relatively well, while the traditional manufacturing industries have seen a sharp decline in exports. The high tech industries are based on a *maquila* structure, which specialises in assembling goods that have strong import content and therefore to increase exports, imports of materials have to rise. (Levy-Orlik, 2014) In Mexico, the banking sector has experienced profound institutional changes as bank ownership was been transferred to foreign corporations, who have taken advantage of oligopolistic banking structures to gain further control over the sector. During the period of financialisation and capital liberalisation inflows of foreign capital and portfolio investment have increased but to attract the international capital Mexico has had to offer higher financial returns than those generally available on the global financial markets (Ocampo and Stiglitz, 2008).

An examination of the record of capital control policy in South America is interesting. Colombia's policy, introduced in 2007, required all multinational corporations operating in the country to keep a percentage of their investment in the central bank and helped to minimise the worst impact of the international financial crisis. (Levy-Orlik, 2014) In the 1990s, Brazil began to accelerate the integration of its banking system within the global financial system. Preparatory measures were taken by the Cardeso government and were built upon when Lula took over. Despite financial integration Brazil's exports remained technologically backward and were increasingly dominated by the mineral and agrarian sector along with steel production. In these sectors low wages and abundant natural resources have allowed Brazil to maintain a competitive edge. Since the beginning of the new century, increasing efforts have been to make Brazil appear a profitable centre for international finance. The increasing level of foreign interest payments gives an indication of the impact of this policy; it increased from US$ 12 billion in 1990 to US$ 21 billion in 2002, to US$ 29 billion in 2005 and had reached more than US$ 35 billion by 2007. Similarly portfolio investment also increased rapidly from US$ 400 million in 1990 to US$ 8 billion 2002 and again to US$ 13 billion by 2007 (Kaltenbrunner and Painceira, 2015).

Chamon and Garcia (2014) explain the nature of Brazilian capital control policy since 2008 and assess its success and, overall, they seem guardedly positive. Brazil is an interesting case to examine due to the wide range of techniques employed (for example, in 2009 a tax of 2% was levied on portfolio equity and fixed income inflows) and the controls were 'effective in making the domestic assets more expensive, partially segmenting the Brazilian financial market from the international market'. However, they consider that the early techniques, used from late 2009 to mid-2011, had 'very limited success in containing the appreciation of the real'. (Chamon and Garcia, 2014: 24) Overall they contend that their results indicate that 'capital controls can be effective, but only if they are very comprehensive'. (Chamon and Garcia, 2014: 24-25)

## IV The Indian Experience

After independence from Britain in 1947, India embarked upon a policy of 'import-substitution', based on industrialisation with the state playing a key leading role controlling the 'commanding heights' of the economy. In 1969, India's Prime Minister, Indira Gandhi introduced a populist policy and nationalised fourteen commercial banks. A decade later, some public sector organisations, who were allowed to borrow at high interest rates from the government-owned banks, were criticised for rising inefficiency.

It seemed such an approach- based on state direction and limited capital mobility- would not lead to long term gains and by the 1980s, the Indian economy was beginning to open its doors to foreign capital and a greater role for foreign trade was envisaged. By 1991, such market-oriented policies had become more entrenched and when India approached the IMF for a 'bail out' loan it was required to accept further implementation of neoliberal economic reforms i.e. it was forced to open up its economy for trade in goods and services, improve capital mobility and agree to the privatization of public industries; to use a familiar phrase, it needed to 'roll back the frontiers of the state' (Siddiqui, 2014). The increasing economic crisis of the 1980s led India to assign a greater role to foreign capital and overseas business investment which, in turn, required a relaxing of capital control policy. Against a backdrop of rising criticism of government financial policy, the government appointed the Narsimham Committee in 1991. The committee recommended relaxing interest rate ceilings and the encouragement of competition, especially by allowing the entry of foreign banks into the domestic market. Foreign capital inflows were encouraged and overseas based companies were allowed to remit their sales proceeds, profits and dividends as they saw fit.

Since the early 1990s, the Reserve Bank of India (RBI) has moved towards market-oriented economic policies. Under such policies, issues related to international monetary transmission mechanisms have gained increased importance (Siddiqui, 2009). Central banks in developing countries have increasingly focused upon factors of a foreign origin when deciding upon their monetary policy stance. Monetary policy in the developing countries is constrained by the decisions made by international central banks such as Federal Reserve, the European Central Bank and the Bank of Japan. Foreign trade is primarily invoiced in US dollars and any drastic variations in exchange rates might well have adverse effects on foreign trade and business profitability. For this reason central banks in developing countries often try to stabilise exchange rates without explicitly stating that this is their policy stance. The situation is exacerbated by the fact that developing countries have often taken on debts denominated in foreign currencies such as in US dollars. Any fall in the exchange rate would lead to an increase in the real burden of these debts and, in an extreme case, lead to default. Hence the hoped-for policy of allowing the exchange rate to fluctuate freely- in order to increase domestic policy space- is not deemed possible. For this reason, Indian policy makers have remained much more cautious about permitting foreign borrowing even after liberalising their capital account; 'while the framework for foreign investment, both for FDI and for portfolio flows, is relatively liberal, India has a number of restrictions on debt.' (Patnaik and Shah, 2012: 16)

Since 2005, bank credit provided to the commercial sector has accounted for more than 70% of total domestic credit in India. Indian banks have been active in financial intermediation but the non-financial productive sector has lacked alternative sources of funding. (Siddiqui, 2015a) In India, compared to the developed countries, capital markets are not sufficiently developed and thus there seems to be a basis for capital account liberalization.

However, capital account convertibility may not be in the interest an economy like India. First, there is a fear that 'Dutch Disease'[4] may emerge, Inflows of financial capital and inward remittances can

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[4] 'Dutch disease is the negative impact on an economy of anything that gives rise to a sharp inflow of foreign currency, such as the discovery of large oil reserves. The currency inflows lead to currency appreciation, making the country's other

generate a real appreciation of the rupee and thus detrimentally affect the trade goods sector by reducing its competitiveness. The fear of such a situation developing supports the idea that India should continue to resist further neoliberal reforms and retain strong government control of the financial sector. Increased inflows also increase the level of 'footloose capital' (often of a speculative nature) which can be easily withdrawn resulting in exchange rate instability. Indeed, increased short term speculative capital flows can constrain governments' ability to use fiscal and monetary policy to pursue expansionary policy, for example, if the government runs a fiscal deficit in an attempt to expand the economy any rise in income might lead to a current account deficit. This, in turn, could trigger capital outflows if the financial sector loses confidence in the ability of the Indian economy to compete on world markets. We might expect the end result to be a large depreciation of the rupee.

With such fears in mind, India imposed capital controls in mid-2007, which aimed to reduce the volume of capital inflows leading to the appreciation of the rupee. They were also designed to discourage portfolio capital inflows and to reduce the volatility on the Mumbai stock exchange (Balin, 2008). Balin found that for various reasons these measures achieved very little. He pointed out that the majority of the stated goals were unattainable and investors were able to circumvent the capital control measures. Patnaik and Shah (2012) concur with this view and conclude that, in India's case, capital controls do not appear to have been an effective macroeconomic policy tool. However, they conclude that 'capital controls can achieve lower debt flows when prohibitory price, quantitative and administrative controls are imposed in the framework of a financial regulatory regime where all financial transactions are *illegal unless explicitly permitted'*. (Patnaik and Shah, 2012: 21, emphasis added)

## V A European Comparison

A comparison with Iceland, a very small, open, developed economy proves enlightening. Until the late 1980s, Iceland's largest banks were state owned and as a result the flow of credit for its different sectors and specific industries was controlled by the government. The government fixed nominal interest rates, and the Central Bank of Iceland (CBI) was seen to be implementing government policies. However, banks were considered to be managed largely in the interest of political parties. In the late 1980s, real interest rates were low and even negative on occasions and as a result, credit demands increased and banks allocated credits to favoured businesses. Such a policy was criticised as it apparently led to inefficiencies in resource allocation. (Mitchell, 2012)

Market forces were introduced to break the political stranglehold on the domestic economy. Such steps were taken because the state ownership of banks and other big businesses placed limits on the capitalist class in general and upon on their profit opportunities in particular. From a neoliberal perspective, therefore, the privatisations of the 1990s were seen as providing good avenues for profit-making for the financial sector. In 1991, Iceland followed neo-liberal economic policies including the privatisation of public assets. Stock markets and the housing sector experienced massive growth, all of which combined to make Iceland's per capita GDP one of the highest in the world by the 2006.

However, 'success' proved short-lived and in 2008 the Icelandic economy collapsed; the three largest banks were forced into bankruptcy and its GDP shrank sharply. Iceland's policy experience is interesting; the country had discontinued capital control policy in line with the IMF's views on capital control. Iceland was the first country to sign the Small Business Act for Europe (SBA), which forms part of the EU's flagship policy initiative to support small and medium sized enterprises (SMEs). Its

products less price competitive on the export market. It also leads to higher levels of cheap imports and can lead to deindustrialization as industries apart from resource exploitation are moved to cheaper locations. The origin of the phrase is the Dutch economic crisis of the 1960s following the discovery of North Sea natural gas'.(FT.com/lexicon) introduction is designed to improve entrepreneurship in Europe and ‘simplify the regulatory and policy environment for SMEs, and remove the remaining barriers to their development’. (European Commission website)

At the onset of the global financial crisis (GFC) Iceland initially approached its Scandinavian neighbours for help and then, in 2008, Russia. When all these efforts failed other West European countries suggested that Iceland negotiate an arrangement with the IMF, which the country did in the late autumn of 2008. In the SBA negotiation provision it was recommended that the country should adopt stringent capital control measures. The IMF deputy managing director emphasised that Icelandic capital controls are an essential feature of the monetary policy framework, given the scale of potential capital outflows (apparently a reverse of ‘traditional’ free capital mobility’ policy support). Iceland initially imposed capital controls prior to signing of SBA in October 2008. The IMF recommended that there is a necessity to maintain financial stability. The central bank enacted the provisions for capital control in November 2008. (Mitchell, 2012)

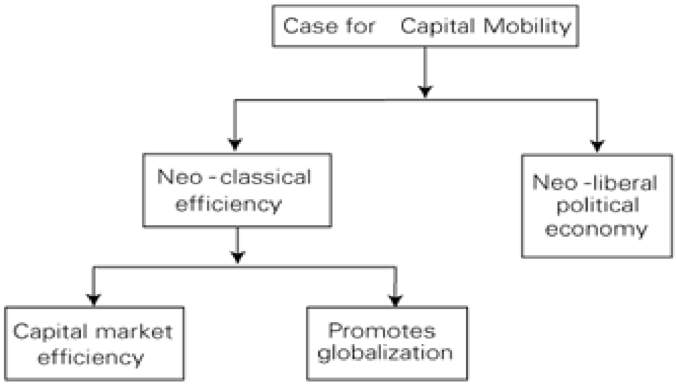
Iceland's use of capital controls illustrates that governments can use their power to pursue public purpose and do not have to actively follow policies that are designed to appease international finance. 'Capital controls do not sit well with mainstream economists but the controls in Iceland (as in Malaysia in the late 1990s) have certainly helped them stabilise the economy and put it back on a growth footing'. (Mitchell, 2012)

## VI The application of orthodox theory

It would be useful to revisit the merits of a widely used economic formulation, namely the Mundell-Fleming “impossible trinity”. According to the Mundell-Fleming model, a country can have only two of the following three: monetary sovereignty, a fixed exchange rate, and free capital flows. Similarly, Obstfeld, et al (2004) have supported the view of impossibility of maintaining free capital flows, a fixed exchange rate and an independent monetary policy at the same time. Given this view, the perceived benefits of interest rate sovereignty and capital mobility have meant that orthodox neo-classical theory has tended to encourage the rejection of fixed exchange rates in favour of flexible regimes. We might consider why capital mobility is s thought to be beneficial.

Palley (2009) outlines two categories of arguments- one based the neo-classical pursuit of an efficient resource allocation, another on a Hayekian preference for individual liberty over state activism- which he illustrates with the Figure 1. Palley (2009) notes that, from a neoclassical perspective, capital mobility, by increasing the range of investment opportunities, improves the efficiency of investment portfolios, and leads to a more efficient resource allocation and thus improves economic welfare. Palley also stresses the claim made by mainstream economists that ‘capital mobility fosters trade, FDI, technology transfer, global production chains, and financial development, and together this improves efficiency and growth' and contends that, 'from a conventional neo-classical perspective these developments increase global productive efficiency through application of the principle of comparative advantage, thereby benefitting all countries’. (Palley, 2009: 17-8)

Figure 1: The case for capital mobility




Source; Palley, 2009: 18

Palley is somewhat doubtful concerning the validity of these claims and considers that empirical support is lacking; see Kose et al. (2006).

The orthodox view of the nature of the saving/investment nexus is of critical importance to the theoretical underpinning of the neo-classical argument for free capital mobility. For neo-classical economists savings and investment interact in the loanable funds market to determine the rate of interest. The supply of savings – or 'loanable funds' provides a source of funds for investment. From a neo-classical perspective, when private sector agents spend less than their income, they consume less than their full potential and instead (in the general case) provide a monetary flow of savings to banks. Real resources will be 'freed up' by this reduction in consumption. Banks act as financial intermediaries and lend the 'loanable funds' to firms to finance business investment. The interest rate is critical and must be allowed to find the 'correct' level i. e. one which means the demand for loanable funds exactly matches supply. In this situation, the 'spare' resources made available when households spent less than their income ae fully utilised in productive investment and equilibrium at full employment is attained. If the monetary authorities set the rate at a level they deem correct which is out of line with the market equilibrium the result will be either unused resources or excess credit creation leading to 'malinvestments'[5] and, eventually a banking failure.

The policy recommendations that follow from this view are clear. First, an LEDC may suffer from a 'shortage of savings'. If consumption absorbs nearly all income and few resources are available for investment then openness to foreign capital inflow would obviously appear to be a positive step in assisting growth and development. Second, the interest rate should be subject to market forces, rather than political control, in order to reach an efficient equilibrium position as described in the above analysis

Before producing a powerful case for the use of capital controls, Bill Mitchell (2016a) reviews the nature of the argument provided in support of free capital mobility by mainstream economists. He

[5] 'Malinvestments' or badly allocated business investments are an important element of Austrian business cycle theory. Excessive credit expansion, facilitated by loose central bank policy- setting the interest rate below the optimal equilibrium market rate which coordinates the preferences of savers and borrowers- leads to an impairment of the critical ability of the price mechanism to allocate resources efficiently, in turn generating over-investment, an unsustainable boom and a necessary, corrective contraction. 'The popularity of inflation and credit expansion, the ultimate source of the repeated attempts to render people prosperous by credit expansion, and thus the cause of the cyclical fluctuations of business, manifests itself clearly in the customary terminology. The boom is called good business, prosperity, and upswing. Its unavoidable aftermath, the readjustment of conditions to the real data of the market, is called crisis, slump, bad business, depression. People rebel against the insight that the disturbing element is to be seen in the malinvestment and the overconsumption of the boom period and that such an artificially induced boom is doomed. They are looking for the philosophers' stone to make it last.' (von Mises, 1966)

refers to Aroshi *et al.*2000 and notes that, according to the orthodox position, capital controls are costly to administrate and private sector innovation may well enable them to be circumvented. In addition, they are a crude instrument the use of which fails to discriminate between desirable and non-desirable transactions. Inefficient domestic industries are shielded from international competition which in turn reduces attractiveness of a nation imposing them to inward investment (Mitchell, 2016a)

Mitchell (2016b) also refers to another perceived advantage of free capital mobility. He quotes Obsfeld who notes that such a policy is able to discipline governments and 'discourage them from exploiting a captive domestic capital market. Unsound policies–for example, excessive government borrowing or inadequate bank regulation–would spark speculative capital outflows and higher domestic interest rates. In theory, a government's fear of these effects should make rash behavior less attractive.' (Obsfelt, 1998)

**VII A critique of the mainstream argument**

At the Bretton Woods Conference of 1944, where the new post-war monetary arrangements were agreed, J.M. Keynes noted the importance of all countries retaining the right to restrict capital movements provided that those restrictions were not aimed at restricting trade. Keynes strongly believed that the earlier crises, in particular the Great Depression, had been greatly exacerbated by the volatility induced by free capital movements. For Keynes, in contrast to the neo-classical view, the benefits of trade would be at risk if countries removed capital controls. 'Keynes favored capital controls, especially over short-term capital movements. While he favored an open international economy that facilitated foreign investment, Keynes drew a sharp distinction between mobile capital and completely unregulated capital. As a result, the rules of the IMF were written to explicitly accommodate capital controls'. (Kirchner, 1999: 315)

Keynesians provide strong support for the use of capital controls. This advocacy is based upon a deep understanding of the *general nature of the international monetary system* and is not restricted to situations when nations operate under fixed exchange rates. (Kirchner, 1999)

The US dollar is the dominant international currency. At present about three-quarters of the total world reserve currency stock is held in US dollars. The US has the biggest and most liquid capital markets in the world and they are continuously maintained and supplied by US deficit financing. The US has been also doing all they can to see that rest of the world open their capital accounts and remove all impediments to the inflows and outflows of capital. These neo-liberal reforms primarily benefit developed nations- in particular the US-and reduce the capacity of democratically elected governments to pursue public purpose.

The macroeconomic policy supposedly applicable in the case of developed countries have been too often recommended for developing countries, despite the fact that in the latter group economic structures, institutions and capital markets are very different to those present in the former. On this issue, Mishkin (2004) distinguishes the developed and developing countries by noting that the latter are characterised by weak fiscal structure, underdeveloped financial institutions and ineffective government regulation which leads to heightened vulnerability to sudden variations in capital flows.

Klein (2012:4) argues that "There may be political reasons that make it difficult to impose capital controls during booms". As the financial system is becoming increasingly integrated the different time horizons applicable to FDI and portfolio capital investment are quite significant. Foreign direct investment is generally seen as long term and may be beneficial under certain circumstances while portfolio investment has a narrower span of time period as has great potential to destabilise the financial system in LEDCs.

Aizenman and Pasricha (2013) analysed the macroeconomic causes of changes in capital control of capital inflows and outflows in 22 emerging economies. They found that the following factors were influential; fiscal concerns, overheating concerns, foreign exchange valuation concerns, macroeconomic stability and financial stability concerns. They concluded that the decision to liberalise capital vis-a-vis the application of controls was influenced by concerns about net capital inflows, particularly the possibility of higher appreciation pressure in the foreign exchange market, and accumulation of reserves (a national government might need to guard against exchange rate appreciation by accumulating international reserves). In addition, the currency appreciation generated by an upsurge of capital inflows could decrease export competitiveness and adversely impact the manufacturing sector and the employment situation in the country. If the export sectors of developing countries are not able to attain a current account surplus and they may be find increasingly difficult to attracting capital inflows. Under such circumstances, in order to attract foreign investment, these countries have to offer increased financial returns to capital and also pursue lower wages so their exports are able to compete in world markets. (Epstein, 2005b)

When we consider the evidence to support the contention that capital market liberalization would be benefit developing countries we do not find strong support for the views expressed by the most influential global financial institutions. The IMF claimed that capital liberalisation was good for growth, as it provided more capital for investment. However, it did not provide any clear evidence that it is promoting stability in the developing countries. (Crotty and Epstein, 1999)

The key issue seems to be openness to portfolio investment. Considering the East Asian countries which have seen success in terms of growth, Sen both contrasts Japan and Korea with Singapore and China but, more significantly, contrasts all four nations with India, whose growth and development record has been comparatively poor. Sen (2007) argues that, "Japan and Korea had almost no foreign direct investment (FDI) flows, while others such as Singapore, and later China, had these in ample quantities. (Zhang, 2009) The common policy approach for all four nations was the absence of any portfolio flows in the early stages of development. But in sharp contradiction to the fast-growing economies of Asia, India liberalised both the current and capital account components of its balance of payments …"this in spite of evidence showing that those who opened their capital accounts to anything more than FDI quickly landed themselves in trouble as the Latin American experience". (Sen, 2007:293-94)

It is claimed that capital inflows can help the developing countries to achieve higher economic growth rates as many of these countries lack domestic savings. In this case capital from abroad could help to finance business activities. However, the advocates of free entry of foreign capital ignore the critical distinction between long term investment, bringing business commitment and short term capital inflows which are often speculative in nature. When economic crisis hit the developing countries, short term capital rapidly left these countries and moved towards the comparative safety of the developed economies. In contrast to openness to long term investment from abroad -which may be beneficial- free access of short term speculative capital seems to have been destabilising and had a negative effect on LEDCs overall. At present, the developing economies that that have followed capital liberalization policies are far more vulnerable to short-term capital flows than those that regulate capital flows and these flows also inhibit the government's ability to counter destabilising tendencies that arise from external sources. (Crotty and Epstein, 1999)

Stiglitz and Rashid (2016) note the lessons of the last twenty years and considers that, 'following the successful Malaysian example in 1997, developing could also temporarily suspend all capital withdrawals to stabilise capital flows and exchange rates. This is perhaps the only recourse for many developing countries to avoid a catastrophic financial crisis. It is important that they act soon.'

Grabel is scathing of the work of neo-classical economists and remarks positively on heterodox contributions. 'Empirical research by economists outside the profession's mainstream reaches beyond the tepid, conditional endorsement of capital controls that we find in the recent work of neoclassical economists (e.g., Epstein, 2012; Erten and Ocampo, 2013; Gallagher, 2014; Grabel, 2015b). Erten and Ocampo (2013) provide what is perhaps the most expansive support for the achievements of a range of capital controls, including those on outflows. Using data from 51 emerging and developing economies from 1995-2011, they find that capital controls that target inflows, outflows, and foreign exchange-related measures were associated with lower foreign exchange pressures, and reduced exchange rate appreciation. They also find that these three types of measures enhanced monetary policy autonomy, that increasing their restrictiveness in the run-up to the global crisis reduced the growth decline during the crisis (and thereby enhanced crisis resilience), and that countries that used these measures experienced less overheating during post-crisis recovery when a new surge in capital inflows occurred'. (Grabel. 2016; 29)

At this point, we might note that the neo-liberal approach has led to the ascendancy of international finance over national democracy. In turn, this has resulted in the drastic reduction of individual nations' 'policy space' and greatly reduced their effective ability to use monetary and fiscal policy in particular. For neoliberals this is *good thing* (as discussed above) but for those who believe that market forces should be subjugated in order that public purpose might be best served it is very much a *bad thing*.

## VIII Alternative approaches

### (i) A Post- Keynesian prescription

A Post-Keynesian critique of the mainstream neoliberal advocacy of free capital mobility involves several elements. First, the neo-classical analysis of the savings/investment nexus might be replaced with one which reflects the actual nature of real world money and banking and is based upon the *endogenous approach to money*. In reality, banks do not take in deposits and then lend them out- this would make them merely pure intermediaries. Banks create money (in the form of bank deposits) by crediting customers' accounts; Indeed banks may make loans without the possession of prior deposits (or reserves). Banks take a position in assets by granting credit to borrowers and at the same time accept liabilities upon themselves. A bank customer who is granted a loan gains a bank deposit (a liability to the bank) and at the same time the bank acquires an asset – the loan. Assuming the loan is spent and the receiver of the credit holds an account in a different bank the lending bank will find that initially its balance sheet shrinks i. e. it loses the deposit and reserves (excluding any overdraft or loan form the central bank). However, once the loan is repaid (with interest), the reserves are replenished (with additional reserves equivalent to the interest) on the asset side (as above, excluding any loan repayment to the central bank). On its liability side the interest payment has boosted the bank's net worth (and reduced a deposit or other liability somewhere else in the system since the bank's profit has to have from somewhere!) Provided the borrower repays the debt in full the bank makes a profit on the transaction. (Armstrong, 2015)

It is clear from this mechanism that 'loans create deposits' not the other way round. The money supply expands endogenously in response to demand. Mainstream theory considers saving to be a *source* of investment funds. However, from a heterodox perspective it is clear that saving is never an ex ante source of investment, rather it is the ex post accounting record of the investment. *Investment is always logically anterior to saving*. (Armstrong, 2015) The idea that a 'shortage of savings' can result in a lack of investment becomes nonsensical. Rather, lack of finance in the form of credit might result in less investment and lead to a lower level of saving. In developed countries with highly developed banking systems, we might expect (at least in the usual circumstances) there to be no shortage of finance for credit-worthy firms to allow productive investment to take place. In contrast, In LEDCs the prevalence of underdeveloped banking systems may mean that there is a role for FDI, provided, as noted earlier, that it leads to increased output and involves a long term commitment. In contrast, there is no acceptable role for short term speculative flows which should be subject to stringent capital controls. The point is that LEDCs need to be able to act in their own interest, allowing long term inflows to boost growth whilst blocking short term speculation.

### (i) A Quadriliemma

Second, at this point it is worth referring to the traditional trilemma of monetary economics (Mundell 1963; Obsfelt, Shambaugh and Taylor, 2004) and developing this theme. From a Post Keynesian perspective the most influential element in fostering positive macroeconomic outcomes is neither monetary policy nor free capital mobility; it is *fiscal policy*. (Mosler, 2010, 2012; Wray, 1998, 2012; Armstrong, 2015, 2016) An alternative approach might replace the 'trilemma' model with a variant of a 'quadrilemma' model (Figure 2). Widening the range of options from three to four means we now need to consider the compatibility or otherwise of adopting fixed exchange rates, allowing free capital mobility and retaining independent use of both monetary and fiscal policy. It is our contention that, in practice, *a country can only choose 'two from four' (*a situation we might refer to as a *'demi-quadrilemma')*; if it chooses to retain free use of monetary and fiscal policy it must sacrifice both fixed exchange rates and free capital mobility.

Figure 2: The choice matrix consistent with the *'Demi-Quadrilemma'* model

| | Fixed Exchange Rates | Free Capital Mobility | Fiscal Policy Sovereignty | Monetary Policy Sovereignty |
|---|---|---|---|---|
| Gold Standard | Yes | Yes | No | No |
| Bretton Woods | Yes | No | No | Yes |
| Neo-liberal | No | Yes | No | Yes |
| Progressive/ Democratic* | No | No | Yes | Yes |

*a suggested post-neoliberal monetary order

In order to see the how this insight applies in practice we might consider three historic periods; the Gold Standard, the Bretton Woods system of fixed exchange rates and the neoliberal period. The available data spanning all three periods refers to developed nations (we will consider developing nations below). During the gold standard participating countries accepted fixed exchange rates and free capital mobility but were forced to subjugate both monetary and fiscal policy to the needs of membership of the gold standard 'club' (Polanyi 1944/1957; Armstrong, 2015).

Real growth data (*Adapted from work by Meltzer and Robinson (1989). For details of methodology and data set used see Meltzer and Robinson (1989: 170-193)*

Table 1: Real Growth (average % per annum) under different monetary regimes

| Country | Up to 1896 | 1897-1913 | 1950-1972 | 1973-1985 |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Denmark | 2.9 | 3.4 | 3.7 | 1.3 |
| Germany | 2.1 | 2.4 | 5.9 | 1.6 |
| Italy | 0.9 | 2.8 | 5.3 | 1.8 |
| Japan | 3.8* | 3.9 | 7.5 | 3.4 |
| Sweden | 3.3 | 2.2 | 3.6 | 1.1 |
| UK | 1.9 | 1.8 | 2.6 | 1.2 |
| USA | 2.8 | 3.8 | 3.4 | 2.0 |

*1876-96 under bimetallic standard

The introduction of the gold standard forced governments to subjugate the use of their budget to the requirement to maintain the value the currency in terms of gold (Polanyi, 1944/1957: 147). The appearance of any 'unsoundness' in the budgetary position might have negative consequences on the exchanges, instigating a conversion of domestic currency. This would lead to a drain of gold. Budgetary prudence had the positive effect, in contrast, of protecting a nation's precious gold reserves. Central banks would need to adjust their interest rates to the situation vis-à-vis protection of gold reserves, to this extent interest rates were 'market determined'. The central bank could not set interest rates at a level suitable to optimise domestic performance; its priority was to maintain the nation's integrity as a member of the gold standard (Armstrong, 2015).

When part of the Bretton Woods system, nations retained fixed exchange rates and were able exercise sovereign control of interest rates. However, in order for the latter capacity to persist capital controls were required and fiscal policy space was greatly reduced. The use of expansionary fiscal policy was inherently limited by the need to maintain exchange rate parity. This situation was illustrated during the so-called 'stop-go' phase in the UK. If the government was concerned about unemployment reaching a level deemed to be too high it would pursue expansionary fiscal policy (the 'go' phase). However, expansionary policy would raise income and imports, placing downward pressure on the exchange rate. The government – given its finite supply of international currency reserves with which to defend the international value of its currency- was effectively forced to abandon its expansionary stance (the 'stop' phase).

The neoliberal age has been characterised by another pair of choices. Most nations, in general, have abandoned fixed exchange rates in favour of floating rates (not all, of course, as some countries have retained fixed exchange rates or currency boards) and accepted free capital mobility and enjoyed, in large part, sovereign use of monetary policy[6]. However in so doing, they have lost the ability to use fiscal policy to pursue public purpose. Nations are constrained in their use of fiscal policy by the perceived possibility that such a policy stance might lead to capital flight and speculative selling of the currency significantly undermining the value of the currency. Although this threat is almost certainly greatly overestimated in the mainstream media (certainly for developed nations such as the

[6] The principle that operating within a floating exchange rate system allows a country complete monetary sovereignty may not apply when totally free capital mobility is allowed. In practice, it may be that, even after adopting the use of floating exchange rates, a dilemma still exists; free capital mobility may introduce such a degree of volatility into the exchange rate so as to require the subjugation of monetary policy to the promotion of increased stability of capital flows.

US, UK and Japan), *the fear of it effectively constrains the active use of fiscal policy to pursue full employment policies and enhance domestic living standards.*

Skidelsky (2010) compares the nature of the monetary system under Bretton Woods with the neoliberal phase which followed it (Skidelsky, 2010: 116-117) and then provides a detailed analysis of the available data. He concludes, 'to sum up, then, the comparison between the Bretton Woods and Washington Consensus [neoliberal] years shows that the former had less unemployment, higher growth, lower exchange rate volatility and lower inequality. (Skidelsky, 2010: 125-126, parentheses added)

It is our contention that the neoliberal phase should be replaced with a new era- a 'progressive/democratic' phase- which is based upon the idea that democratically elected governments, accountable to their own electorates, should pursue policies designed to improve the living standards of their own population as a whole rather than their own or foreign elites. *It is our belief that MMT (Modern Monetary Theory) provides clear insights into the operation of the world monetary system and should form the framework for developing policy.* As we have seen, from a MMT perspective the most potent tool of economic management is fiscal policy ('Mosler's Law' states that "*no financial crisis is so deep that a sufficiently large fiscal adjustment cannot deal with it*") so the ability to use fiscal policy, without external constraint, is critical.

Monetary Policy sovereignty is also significant and the insights provided by MMT introduce a compelling alternative to the traditional demarcation between the two[7] (Mosler, 2012: Wray, 1998, 2012; Armstrong, 2015). Given this view we believe that all nations should reject the pair of choices recommended by the neo-liberal mainstream and instead opt for floating exchange rates combined with ability to employ capital controls as necessary and in so doing gain the obvious advantages that follow from the unconstrained use of fiscal policy and monetary policy in pursuit of the twin objectives of full employment and price stability[8]

When we consider the available evidence (Table 1) we see that the two periods characterised by free capital mobility (the gold standard and neo-liberal period) have tended to deliver lower growth rates than the Bretton Woods period for the nations considered. Clearly our inability to carry out controlled experiments means that we cannot attribute this outcome entirely to the absence of capital controls or,

[7] The key principles of MMT are well-documented and I will not repeat them here (Mosler, 2010, 2012; Wray, 1998, 2012; Armstrong, 2015, 2016) however, it is worth stressing a key aspect of MMT- the provision of a different perspective on the relationship between fiscal and monetary policy. Advocates of MMT of provide an interesting insight which relates to the operational reality facing governments of nations which have their own sovereign, non-convertible currency and operate under floating exchange rates. In this case, governments face no financial constraints- they spend state money into existence and tax it out. The size of the public sector deficit and public sector debt, both in absolute terms and expressed as a percentage of GDP, have no significance *per se*. Government spending must be sufficient to enable the non-government sector to cover its tax liability and satisfy net saving demand at the full employment level of income. The existence of unemployment above 'full employment' (Mitchell, 2016b, suggests 'full employment' means unemployment of 2-3%, with no underemployment or hidden unemployment) is *de facto* evidence that the deficit is too small not too big, no matter its size or its proportion of GDP (Armstrong, 2016).
An understanding of MMT makes it clear that *the sale of government bonds is not a fiscal operation-rather it is a monetary operation or a means to manage the interest rate.* Without bond sales, the excess reserves caused by state deficit spending would remain within the private sector banking system This would drive the overnight interest rate to zero (unless other action was taken – such as the central bank agreeing to paying a rate of interest all bank reserves at a rate equal to its target rate). (Mosler, 2012; Wray, 1998; Armstrong, 2015)

[8] The advocates of MMT stress the importance of fiscal policy as means to ensure full employment with price stability. However, in itself this is not enough. Inflation can arise from sources other than excess demand – indeed this is usually the case. In order to create the best conditions for price stability, advocates of MMT suggest that monetary policy (in practice, managing the short-term interest rate) should be replaced by a buffer stock policy. The most notable of these schemes is the Employer of Last Resort (ELR) policy (Wray, 1998). Mosler and Silipo (2016) expand on this approach and produce a compelling case for the replacement of the current approach with the use of an *employed buffer stock of labour policy*.

indeed, the reduced degree of national sovereignty over monetary and fiscal policy. There are clearly many factors that influence economic growth and the relative impact of these forces varies between nations and between time periods. However, we can, at least tentatively, suggest that free capital mobility did not directly lead to superior growth performance when compared to the Bretton Woods era when capital controls were the accepted norm.

In the case of developing countries the data for making such long term comparisons is not readily available and the rich variety of the experiences of developing countries makes producing meaningful summaries difficult. However, we feel that Gershman et al (2002) get it about right in "Dying for growth" when they conclude that '100 countries have undergone grave economic decline over the past three decades. Per capita income in these 100 countries is now lower than it was 10, 15, 20 or in some cases even 30 years ago. In Africa, the average household consumes 20 percent less today than it did 25 years ago. Worldwide, more than 1 billion people saw their real incomes fall during the period 1980-1993. Meanwhile, according to the United Nations Development Program's 1998 Human Development Report, the 15 richest people in the world enjoy combined assets that exceed the total annual gross domestic product of sub-Saharan Africa. At the end of the 1990's, the wealth of the three richest individuals on earth surpassed the combined annual GDP of the 48 least developed countries' (Gershman et al, 2002).

In making a comparison we must remain aware that free capital mobility is by no means the only difference between the Bretton Woods period (or 'Golden Age') and the neoliberal or Washington Consensus period. 'The limited extent of globalization was hardly the only important determinant of the Golden Age, nor even the most important condition underlying its existence. But the acceleration of the process of globalization of finance and capital investment and the increase in the openness of trade that took place as the Golden Age evolved does seem to have been an essential element in the dynamics of its demise. The continuation of the globalization process over the past two decades has created tenacious impediments to the restoration of a regime of sustained full employment and real wage growth.' (Crotty and Epstein, 1996: 118)

Clearly, there have been many cases of rapid growth during the neoliberal period but equally there has been heightened instability. The question to attempt to answer is 'has increased capital mobility helped or hindered the growth and development of developing nations? The first section of this paper provided an overview of the experience of a range of developing nations with regard to capital mobility. The weight of evidence tends to support the contention that, in contrast to the neo-liberal view, free capital mobility does not deliver the best growth and development outcomes.

All nations face real resource constraints. Their ability to deliver enhanced living standards is limited by their resource endowments including land and natural resources, quantity and quality of labour, infrastructure and institutional structure. We might generalise and note that although advanced nations face real resource constraints such limits will be effective at much higher living standards than is the case for LEDCs. This situation has seriously implications for the design of foreign aid policies (see below).

In addition, countries may also face financial constraints. These first of these financial constraints may relate to an underdeveloped banking system which is unable to furnish businesses with the elastic supply of currency necessary to underpin the monetary circuit. (Lavoie, 2009) From the point of view of advanced nations with fully developed banking systems, this financial constraint is unlikely to be significant (accepting, of course, both the well-documented failings of contemporary banks and the possibility of a financial crisis or 'credit crunch'!) However, for developing nations the presence of this constraint is very likely to be present at least to some extent[9].

The state may also face a financial constraint, as described above, i.e. fear of the response of 'international finance' might prevent them pursuing an expansionary fiscal stance if this was required to enhance growth and employment. Capital mobility makes this threat especially potent in the case of LEDCs. An understanding of MMT allows economists to look beyond political structures and recognise that governments of nations with their own sovereign, fiat currency face no operational financial constraints. In other words, the government has unlimited operational capacity to spend (though they may have limited political willingness to spend to the point where they 'live up their means') Taxes do not 'fund' public spending, rather they give value to state money and give the government the power to regulate aggregate demand (see note 7) .

MMT distinguishes clearly between countries that issue their own non-convertible currencies under floating exchange rates and those that don't, for example, nations operating under fixed exchange rates or 'currency boards' or using the euro. Euro-using nations have ceded their money-issuing power to another entity, the European Central Bank. Each nation's government is forced to act as a 'currency user' (rather reminiscent of US states). In this case taxes do fund spending, borrowing from private sector euro holders may be necessary to fund spending, default is technically possible and, in the absence of ECB assistance, the need to sell debt on bond markets may drive yields to very high levels.

Against this backdrop, focusing specifically on developing nations, we would argue that their priority in terms of the *demi-quadrilemma* should be to maintain sovereign control of fiscal and monetary policy and reject both fixed exchange rates and free capital mobility. This should allow them maximum 'policy space' to follow policies designed to achieve full employment with price stability. However, given the relative underdevelopment of their banking systems there seems to be a legitimate role for long term FDI. The best policy for the future would be to improve the ability of the domestic banking and financial systems in LEDCs. This would enable them to provide the elastic currency required for productive enterprise to flourish. In the current situation, the crucial aspect of policy is not that LEDCs eliminate capital mobility, rather that they *control capital flows so they act in their own interest*. This essentially involves allowing long term foreign investment that enhances growth and the living standards of the domestic population whilst reserving the right to prevent potentially destabilising, mainly speculative, short-term flows which may be detrimental to the welfare of developing nations.

The contention that national governments should adapt policy on capital controls according to the circumstances they face, whilst still taking account of international consequences is noted by Grabel (2016).'In my view it is critical that efforts be made to maintain and expand the opportunity that has emerged in the crisis environment for national policymakers to experiment with capital controls and to adjust them as circumstances warrant. Hence, the pressing policy challenge today is to construct regimes that expand national policy autonomy to use capital controls while managing cross-border spillover effects. This certainly suggests abandoning (or, at the very least, renegotiating) the strictures on capital controls in existing and pending bilateral, and multilateral trade and investment agreements. It also suggests the need (ideally) to develop frameworks for burden sharing and international cooperation in the case of spillover effects'. (Grabel 2016: 35)

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[9] Stepany Griffith-Jones provides a detailed analysis of how banking and financial institutions have affected growth and development in low-income countries (LICs) in Africa and how they could be designed foster growth and development. 'Evidence suggests that a diverse set of banking institutions would improve both the quantity and quality of finance for different borrowers, and thus have positive impacts on inclusive growth and stability. As regards the latter, the benefits of diversification for reducing risk is well known, within institutions, but should also be applied across institutions. Further research and policy discussion seems needed for the desirable composition of the financial system in LICs, for example the balance between public and private banks, large and small institutions, domestic and foreign, and between more universal banks and those focused on particular sectors such as SMEs.' (Griffith Jones 2016)

Of course, once the principle that capital controls are potentially beneficial is accepted the practical process of putting the correct policy tactics into action takes centre stage. The track record of capital controls in terms of delivering beneficial outcomes is mixed to say the least across a range of developing countries- interest rate limits and quantitative controls have not always delivered the results that policy-makers have hoped for. The problems facing LEDCs when administering capital controls are exacerbated by inefficient (or even corrupt) governance and administration, fear of international response and the ability of private sector agents to circumvent controls. Given this situation, international cooperation to control international financial flows and the pursuit of speculative gains would be greatly beneficial. 'Any regime that seeks to develop a framework for capital controls should err on the side of generality, flexibility, and permissiveness; should involve and promote cooperation by both capital source and recipient countries; and should embody an even-handed acknowledgement that monetary policies, like capital controls, have positive and negative global spillover effects that necessitate some type of burden sharing'. (Grabel 2016: 36)

## IX. Concluding remarks

Grabel summarizes the current situation eloquently by noting that '[i]n this environment of disruption, economic and institutional change, intellectual aperture and uncertainty we find a productive expansion of policy space for capital controls and a movement away from the reification of capital flows and other aspects of financial liberalization within neoclassical economics, something that may ultimately be seen as an important legacy of the global crisis. This change, messiness, and uncertainty exemplify what I see as the productive incoherence[10] of the present environment'.

In this context of 'productive incoherence', we do not think that the imposition of country-by-country capital controls is the best way to eliminate the destructive macroeconomic impacts of rapid inflows or withdrawals of financial capital. Bill Mitchell makes a strong case for capital controls, 'If we consider that the only productive role of the financial markets is to advance the social welfare of the citizens – that is, advancing public purpose – then it is likely that a whole range of financial transactions, which drive cross-border capital flows, should be made illegal. Capital inflows that manifest as FDI in productive infrastructure are relatively unproblematic. They create employment and physical augmentation of productive capacity which becomes geographically immobile. However, financial flows that are speculative (especially short-term flows) and not connected with the real economy are unproductive and should be declared illegal. However, the policy should be introduced on a multi-lateral basis spanning all nations rather than being imposed on a country-by-country basis'[11]. (Mitchell 2010).

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[10] 'By productive incoherence I refer to the proliferation of responses to the crisis by national governments, multilateral institutions, rating agencies and the economics profession that have not yet congealed into a consistent vision or model. Instead, and in response to diverse economic challenges, we find a proliferation of strategies that defy encapsulation in a unified narrative. I argue that incoherence is productive because it has widened the policy space to a greater and more consistent degree than in the years following the East Asian crisis (cf. Chwieroth, 2015; Moschella, 2014; Gallagher, 2014).'(Grabel 2016: 2)

[11] Mitchell (2016b) summarises his perception of an initial position consistent with the tenets of MMT as: '1.The imposition of country-by-country capital controls can help eliminate the destructive macroeconomic impacts of rapid inflows or with-drawals of financial capital but may not be sufficient. If we adopt a progressive view that the only productive role of the financial markets should be to advance the social welfare of the citizens then it is likely that a whole range of financial transactions, which drive cross-border capital flows, should be made illegal rather than controlled through capital re-strictions. In this context, capital controls may be an interim strategy while the nation sorts through the legislative tangle that would be involved. We will discuss this point further in the next instalment. 2. Capital inflows that manifest as FDI in productive infrastructure are relatively unproblematic. They create employment and physical augmentation of productive capacity which becomes geographically immobile. However, financial flows that are speculative (especially short-term flows) and which are not connected with the real economy are unproductive and should be declared illegal. This approach

The exact nature of such a multi-national approach would require much discussion in the future. However, the IMF's role (if any) might be expected to be smaller than may have been imagined in the era before the Asian crisis. LEDCs may utilise their apparent new-found confidence to act on their own. 'In the end, whether the IMF's new openness on capital controls fades with the crisis may not matter insofar as the institution has been rendered less relevant as it faces increasingly autonomous and assertive developing country members (some of which emerged as its lenders earlier in the crisis' (Grabel, 2016: 34)

The 'loss of purpose, standing and relevance of the IMF' (Grabel, 2016) which followed on from the East Asian financial crisis meant that the IMF faced a historically low level of demand for its assistance. During the global financial crisis (GFC) many nations avoided turning to the IMF even *in extremis*. We might reasonably hope that the experience of the GFC might be expected to embolden LEDCs when considering a unified approach to capital control policy. 'The fact that economies that performed relatively well during the crisis successfully utilized controls has eliminated the long-standing stigma around the instrument.' (Grabel 2016: 34)

However, it remains to be seen if collective, purposeful action on the part of LEDCs is indeed possible with or without contributions from existing multi-national agencies such as the IMF. However, we believe that a multi-national approach to capital controls, where each nation contributes in accordance with policies designed to improve the living standards of its population and is prepared to compromise with other such nations who are adopting the same approach has much to recommend it. In addition, the support of developed nations acting in the same spirit would clearly enhance the chances of such a policy being successful.

As we have noted, neo-liberal advocates of free capital mobility see its primary benefit as lying in its ability to discipline potentially profligate and inefficient government. On the other hand there are those, like us, who believe that a democratically elected government should maximise its capacity to pursue public purpose and favour capital controls as a means of embedding or subsuming the influence of market forces and requiring markets to serve the broader needs of society; 'capital controls can place a sort of 'reverse' discipline on the financial markets by forcing them to exhibit behaviours that support the government's objectives in relation to its citizens.' (Mitchell 2016b)

The population of LEDCs have in general, more limited access to real resources than their counterparts in developed nations. If and when we enter a more enlightened world order – we have termed this era a 'progressive/democratic' phase-the first priority must surely be to address the issue. Developed nations might transfer real resources from themselves to developing nations as well as promoting an international system which helps poorer nations to enhance their own exploitation of real resources in an environmentally sustainable way as well as encouraging a more equitable distribution of income (both within nations and globally). These are big aims. As a first step we contend that all nations- developed or developing- as a key priority, should ensure that they retain fiscal and monetary policy sovereignty and avoid fixed exchange rates, free capital mobility and borrowing in foreign currencies. *Importantly, we argue that a coordinated, multi-national approach to capital mobility policy would complement such an approach*. In the here and now, sustainable and ethical FDI has a part to play in the development process; the same is true of assistance of different types- including helping to improve the efficiency and fairness of banking systems. However, free capital mobility is an idea deeply rooted in the failed 'efficient markets' hypothesis' and has no part in future in progressive/democratic policy.

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would best be introduced on a multi-lateral basis spanning all nations rather than being imposed on a country-by-country basis. The large first-world nations should take the lead. However, given that such leadership is unlikely to be forthcoming a single nation could still act unilaterally in this regard.

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