MUNQSMUN ’17

“Rise** above the **Rest”

Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development
Background Guide

<u>LETTER FROM THE EXECUTIVE BOARD</u>

Dear Delegates,

Welcome to the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development being simulated at MUNQSMUN 2017. We're glad to be on the Executive Board panel for this committee, and hope to provide a substantively engaging and immersive competitive experience for you all.

This particular guide shall only give you a primer on the agenda to give you a head start by explaining the essence of the agenda and giving out the complicated things in a simple and short manner. However, the given guide is not exhaustive and it is not intended to be. The delegates are at full liberty to bring up any other relevant point for discussion and are in fact encouraged to do so.

Further, a suitable, competitive preparation not only needs extensive research but more importantly ability to analyze the overall viability and long-term sustainability of policy proposals, while keeping the political considerations due to the sensitivity of the topic in mind.

We're looking forward to seeing what the delegates, can bring to the table, both in terms of the ideas in committee and the creativity in drafting solutions. We fully expect impressive levels of effort, enthusiasm, and engagement from you all.

Please do not hesitate to contact us in case of queries pertaining to the agenda or the guide. All the best!

Chairman- Aditya Khurana (akadityakhurana@gmail.com)

Vice Chairman- Punya Miglani

Director- Naman Gupta

Agenda: Discussing the legality, implementation and implications of capital controls on global and domestic economies.

Capital controls

Capital control represents any measure taken by a government, central bank or other regulatory body to limit the flow of foreign capital in and out of the domestic economy.

These controls include taxes, tariffs, outright legislation and volume restrictions, as well as market-based forces. Capital controls can affect many asset classes such as equities, bonds and foreign exchange trades.
Capital controls are put in place specifically to regulate financial flows from capital markets into and out of a country's capital account. These controls can be economy-wide or specific to either a sector or industry.

Capital controls are enacted by government policy and work to restrict domestic citizens from acquiring foreign assets or restrict foreigners from acquiring domestic assets. The former is referred to as capital outflow controls and the latter is known as capital inflow controls. Tight controls are most often found in developing economies, where the capital reserves are lower and more susceptible to volatility.

Capital controls are the subject of much debate because some feel they inherently limit economic progress and efficiency while others see them as prudent, adding a measure of safety to the economy. Most of the largest economies have liberal capital controls policies and have phased out stricter rules from the past.

However, most of these same economies have basic stopgap measures in place to prevent against a mass exodus of capital outflows during a time of crisis or a massive speculative assault on the currency. Global factors, like globalization and the integration of financial markets have contributed to an overall easing of capital controls. Opening up an economy to foreign capital generally allows for companies to have easier access to capital, and can raise overall demand for domestic stocks. Capital controls are most often put in place after an economic crisis, to prevent domestic citizens and foreign investors from pulling funds out of a country.

HISTORY AND CURRENT USAGE OF CAPITAL CONTROLS

Highly restrictive capital controls were introduced around World War 1. One such capital control measure was the Reich Flight Tax. The Reich Flight Tax was a capital control law implemented in order to stem capital flight from the Weimar Republic. The law was created through decree on 8 December 1931 by Reich President Paul von Hindenburg. The Reich Flight Tax was assessed upon departure from the individual's German domicile, provided that the individual had assets exceeding 200,000 RM or had a yearly income over 20,000 RM. The tax rate was set at 25 percent. In 1931, the Reichsmark was fixed at an exchange rate of 4.2 RM per USD; 200,000 RM was equivalent to $47,600 USD (equivalent to $750,000 in 2016).

The implementation of the same took place as follows:
In order to legally emigrate, a "tax clearance certificate"was required from the Tax Authority, certifying the payment of the Reich Flight Tax and other taxes. When individuals were suspected of intentions to emigrate, the Exchange Control Office of the Tax Authority could require a security deposit equivalent to the amount of the tax.

A tight surveillance net was created to discover persons planning to flee the country: the Reichspost tracked change of address orders by Jews; freight companies were required to report moves; notaries reported sales of real estate; life insurance companies were required to report cancellations of life insurance. The Gestapo surveilled the letter and telephone correspondence of suspected individuals.
Even upon payment of the Reich Flight Tax, it was not guaranteed that an individual could leave the country with his or her remaining property. The exemption limit for foreign exchanges was set at 10 Reichsmark. Bank deposits and security holdings were moved into frozen accounts, from which funds could only be transferred abroad with the payment of high penalties.

Alongside this other growing countries also imposed certain capital controls. At the end of world war II the market had a substantial increase in the number of capital controls being exerted. For at least a decade they did not come under the limelight. But around the 1950s debates spurred up criticising the effectiveness of capital controls thereby creating a dilemma in people's minds. Around the 1960s a large part of capital controls were directed towards international financiers and banks, some were directed at individual citizens. For example, in the 1960s, British individuals were at one point restricted from taking more than £50 with them out of the country for their foreign holidays.
During the period spanning from approximately 1980–2009, the normative opinion was that capital controls were to be avoided except perhaps in a crisis. It was widely held that the absence of controls allowed capital to freely flow to where it is needed most, helping not only investors to enjoy good returns, but also helping ordinary people to benefit from economic growth.

During the 1980s many emerging economies decided or were coerced into following the advanced economies by abandoning their capital controls, though over 50 retained them at least partially. Post this there was an international understand and notion alongside the WTO regime that capital controls in the long run cripple the economic growth of a nation. But with the onset of the 2008 subprime mortgage crisis and it's spill overs agglomerating into the European financial crisis the market was flooded with various kinds of capital controlling measures.

Note: each country reacted differently to the above mentioned crisis and their safety measures were varied. For understanding this variety we urge delegates to research upon different capital controls by different countries during a crisis (Latin American crisis, Russian ruble crisis, Asian financial crisis, great depression etc). This will help you understand why same measures cannot be applied to solve all the above mentioned economic catastrophes.

Thinking behind Inflow Controls

The historical review, offers three key explanations why inflow controls have a bad name. First, with the rise of free market ideology in the 1980s and 1990s, it appears that capital inflow controls became inextricably linked with outflow controls. Traditionally, the latter were more prevalent, more stringent, and typically associated with autocratic regimes, financial repression, and financial crises. They were (and are) thus viewed highly unfavorably. In fact, simple cross-country correlation between capital controls and an index reflecting the intensity of the autocratic regime in the country suggests a positive and statistically significant association between such regimes and the presence of capital controls—which is twice as large for outflow controls then for inflow controls. Thus, it can be argued that more liberalized economies shunned the use of inflow controls as a short-term policy tool out of fear of being viewed as market unfriendly and institutionally weak.

Most of the other criticisms levied against inflow controls are actually much more pertinent to outflow controls. It is often argued, for instance, that inflow controls are highly persistent and pervasive. But that is generally true for outflow controls, when to prevent capital flight, authorities often resort to heavy-handed measures that are broad-based, and are only gradually removed as the domestic economy stabilizes.

The nature of (ad hoc) restrictions to control inflows is different—typically being taxes on certain types of (more risky) flows; withholding taxes on nonresident investments; or higher reserve requirements for nonresident investments. Such measures are easy to reverse, and are typically removed when the tide turns (as is evident from the experience of, e.g., Brazil, Chile, Colombia, Indonesia, and Peru). In addition, there is no evidence that inflow measures send a "bad signal" that deters foreign investors from reinvesting in these countries in later years. Again, the signaling concern—although often given as an argument against inflow controls—is also arguably more valid for restrictions on outflows, which may shake investor confidence, and lead to a "once bitten-twice shy" attitude toward the domestic market.

Inflow controls are also considered to be ineffective; yet ample evidence exists that they are successful in titling the composition of flows toward less risky and longer-maturity flows —which strengthens the case for their use as prudential instruments. By contrast, anecdotal evidence, and formal studies suggest that capital outflow controls tend to be ineffective in preventing a crisis by slowing down the drain of foreign exchange reserves and permitting time for corrective policies.

The upshot is that much of the criticism against inflow controls seems to be "guilt by association" with outflow controls. Thus, when emerging markets attempted to liberalize their capital accounts in the 1980s and 1990s, they did not distinguish much between inflow and outflow controls, and often jettisoned both at the same time. That the distinction between the two types of restrictions got blurred is even more apparent from the debates that surfaced in the aftermath of the Asian financial crisis, when calls for reining in speculative capital inflows to preserve financial-stability and prevent financial crises were overshadowed by the more contentious debate on capital outflow controls imposed by Malaysia.

Yet, many of those who favored unrestricted capital mobility, and vehemently argued against capital outflow controls, preferred a “system of preventive capital controls that limits the extent of capital inflows in the first place or, at least, structures their maturities”

This is not to say that inflow controls are not costly (or that emerging markets may not benefit from foreign capital—especially in the form of foreign direct investment). Controls may be administratively burdensome, distortionary, encourage regulatory arbitrage, hurt small domestic businesses more than large firms, damage liquidity, and encourage rentseeking—but it is not clear that these critiques apply any less to other policy tools often touted as superior to inflow controls (such as prudential measures or fiscal instruments). Even the more recent “spillover” concerns from the imposition of short-term inflow controls may be no less relevant for other policy instruments.

Lately, inflow controls have also been suspected of being used to vitiate multilaterally-warranted external adjustment—but this concern is mainly relevant for a handful of large economies and, by itself, does not explain why countries that are considering imposing inflow controls might have misgivings about doing so.
A second plausible reason for the resistance to adopt inflow controls is that capital account restrictions are often associated with current account restrictions. This is because, historically, the most common form of capital controls was exchange restrictions that impeded the movement of both goods and capital. As countries embraced greater trade liberalization, in contrast to the Keynes-White thesis, they viewed capital controls as incompatible with free trade rather than as aiding free trade. Growing internationalization of commercial activity, for instance, by multinational corporations, also made it more difficult to enforce capital account restrictions without also having an impact on current transactions.

Capital account restrictions were thus abolished along with current account restrictions — although the former was not part of the original “Washington Consensus”. This trend was further accentuated by the rise of regional trade agreements and bilateral investment treaties (for example, those with the US) that increasingly incorporated clauses prohibiting the adoption of any types of capital controls (except under highly exceptional circumstances).

Finally, the rise of free market ideology in itself considered all government intervention as inherently bad: where market failure was found to be extensive, it was considered to be less serious than state failure that was to replace it. Hence capital controls, traditionally viewed as instruments to fine-tune the economy (since part of their justification under the “trilemma” is that they give policy autonomy), became discredited more generally.

This is, however, not to say that emerging markets became entirely oblivious to the vagaries of capital flows, but they attempted to rely on the more benign-sounding—also viewed as more market-friendly—"macroprudential measures" to tackle the financial-stability risks posed by capital inflows.

Yet, for some of these measures, especially, those related to foreign currency transactions, the ultimate effect on capital flows is economically largely indistinguishable to that of more direct capital controls. That the use of such currency-based measures has increased notably since the East Asian financial crisis, and tends to move with the capital flow cycle of emerging markets, suggests that countries may be viewing these measures as a substitute for traditional inflow controls (that were imposed for financial-stability purposes). But if this is indeed the case, then it is merely a re-branding of capital controls, confirming that it is the negative connotation associated with the word "controls" that is the problem.

<u>Case Studies:</u>

1) <u>Greece-</u>

European Central Bank (ECB), on June 29, 2015, froze support to Greek banks in light of the European debt crisis. Greece responded by closing its banks and implementing capital controls on July 7, 2015, out of fear that Greek citizens would cause a run on domestic banks. The controls put limits the daily cash withdrawals at banks and placed restrictions on monetary transfers and overseas credit card payments.
Roughly one year later, on July 22, 2016, Greece's Finance Minister reported that Greece would ease the country's capital controls to help increase confidence in Greek banks. The easing is expected to increase the amount of money held at Greek banks. Thus, Capital Controls helped save Greece's economy.

Source: http://www.investopedia.com/terms/c/capital_conrol.asp#ixzz4nrgUN4gN

2) <u>Brazil-</u>

Brazil has implemented a series of controls on capital flows. The stock market in Brazil is well developed and the country also has firm-level export data that will allow us to examine both the firm-level response to capital flows as well as the impact of capital controls on the competitiveness of exporting firms.

Capital controls can drive up the cost of capital and curb investment. Credit constraints at the firm level are also more likely to bind for firms that are more dependent on external finance. In particular, if production is associated with fixed costs and dependent on external finance, financial constraints at the firm level become relevant. Firms with easier access to external finance or greater access to low-cost funds may be able to overcome the barriers associated with these fixed costs and experience increased investment and sales.

Capital controls, on the other hand, can increase uncertainty while reducing the availability of external finance, which can lower investment at the firm level. We use an event study methodology around the dates when the various capital control measures were announced using stock prices and firm level data from DataStream. The data points to a significant decline in cumulative abnormal returns for Brazilian firms following the imposition of capital controls on equity flows in 2008-2009 consistent with an increase in the cost of capital.

Large firms and the largest exporting firms appear less negatively affected compared to external-finance-dependent firms, and capital controls on equity have a more negative announcement effect than those on debt. Finally, real investment at the firm level falls significantly in the aftermath of the controls.

Source: https://www.google.co.in/amp/amp.weforum.org/agenda/2015/01/the-effect-of-capital-controls

3) Russian ruble crisis-

On 17 August 1998, the Russian government devalued the ruble, defaulted on domestic debt, and declared a moratorium on repayment of foreign debt. On that day the Russian government and the Central Bank of Russia issued a "Joint Statement" announcing, in essence, that: the ruble/dollar trading band would expand from 5.3–7.1 RUB/USD to 6.0–9.5 RUB/USD; Russia's ruble-denominated debt would be restructured in a manner to be announced at a later date; and, to prevent mass Russian bank default, a temporary 90-day moratorium would be imposed on the payment of some bank obligations, including certain debts and forward currency contracts. Thus, Capital Control was implemented.

On 17 August 1998 the government declared that certain state securities (GKOs and OFZs) would be transformed into new securities. At the same time, in addition to widening the currency band, authorities also announced that they intended to allow the RUB/USD rate to move more freely within the wider band. At the time, the Moscow Interbank Currency Exchange (or "MICEX") set a daily "official" exchange rate through a series of interactive auctions based on written bids submitted by buyers and sellers. When the buy and sell prices matched, this "fixed" or "settled" the official MICEX exchange rate, which would then be published by Reuters.

The MICEX rate was (and is) commonly used by banks and currency dealers worldwide as the reference exchange rate for transactions involving the Russian ruble and foreign currencies. From 17 to 25 August 1998, the ruble steadily depreciated on the MICEX, moving from 6.43 to 7.86 RUB/USD. On 26 August 1998, the Central Bank terminated dollar-ruble trading on the MICEX, and the MICEX did not fix a ruble-dollar rate that day. On 2 September 1998 the Central

Bank of the Russian Federation decided to abandon the "floating peg" policy and float the ruble freely. By 21 September 1998 the exchange rate had reached 21 rubles for one US dollar, meaning it had lost two thirds of its value of less than a month earlier. On 28 September 1998 Boris Fyodorov was discharged from the position of the Head of the State Tax Service. The moratorium imposed by the Joint Statement expired on 15 November 1998, and the Russian government and Central Bank did not renew it. Inflation Edit Russian inflation in 1998 reached 84 percent and welfare costs grew considerably. Many banks, including Inkombank, Oneximbank and Tokobank, closed as a result of the crisis.

Agriculture- The main effect of the crisis on Russian agricultural policy has been a dramatic drop in federal subsidies to the sector, about 80 percent in real terms compared with 1997, though subsidies from regional budgets fell less.

Political fallout- The financial collapse resulted in a political crisis as Yeltsin, with his domestic support evaporating, had to contend with an emboldened opposition in the parliament. A week later, on 23 August 1998, Yeltsin fired Kiriyenko and declared his intention of returning Chernomyrdin to office as the country slipped deeper into economic turmoil. Powerful business interests, fearing another round of reforms that might cause leading enterprises to fail, welcomed Kiriyenko's fall, as did the Communists. Yeltsin, who began to lose his hold on power as his health deteriorated, wanted Chernomyrdin back, but the legislature refused to give its approval. After the Duma rejected Chernomyrdin's candidacy twice, Yeltsin, his power clearly on the wane, backed down. Instead, he nominated Foreign Minister Yevgeny Primakov, who on 11 September 1998 was approved by the State Duma by an overwhelming majority. Primakov's appointment restored political stability, because he was seen as a compromise candidate able to heal the rifts between Russia's quarreling interest groups. There was popular enthusiasm for Primakov as well. Primakov promised to make the payment of wages and pensions his government’s first priority, and invited members of the leading parliamentary factions into his Cabinet. Communists and the Federation of Independent Trade Unions of Russia staged a nationwide strike on 7 October 1998 and called on President Yeltsin to resign. On 9 October 1998, Russia, which was also suffering from a poor harvest, appealed for international humanitarian aid, including food.

4) <u>Chile’s and Malaysia’s Case-</u>

Chile’s controls on capital inflows in the 1990s, and Malaysia’s controls on capital outflows in September 1998. In an effort to limit surging capital inflows, in June 1991 Chilean policymakers imposed an unremunerated reserve requirement (URR), first on foreign borrowing (except trade credit) and later on short-term portfolio inflows (foreign currency deposits in commercial banks and potentially speculative foreign direct investment). The reserve requirement rose from 20%, to 30%, but then fell to 0% when capital flows to Chile (and other emerging markets) dried up in 1998. A minimum stay requirement for direct and portfolio investment from abroad also was imposed (eliminated in May 2000), as were minimum regulatory requirements for corporate borrowing abroad.

Banks also were required to report capital transactions. The controls do not appear to have been very effective. Capital inflows rose, despite the controls, from 7.3% of GDP in 1990-1995 to 11.3% in 1996-1997, before falling in 1998; investors found ways to circumvent the controls, leading policymakers to expand the program. It is also unclear whether the controls succeeded in shifting the composition of foreign capital towards longer maturities. Finally, the program did not seem to give Chile increased monetary autonomy.

The real exchange rate continued to appreciate, at an average rate of 4% a year from 1991 to mid-1997. While the differential between domestic and foreign real interest rates rose (from 3.1% in 1985-91 to 5.2% in 1992-97), this may have been due to continued sterilized intervention in foreign currency markets, not the capital controls.

In 1998, as capital flowed out of East Asia, uncertainty about the stability of the Malaysian currency (the ringgit) and the economic outlook generated speculation against the ringgit. As noted earlier, the openness of the capital account limited Malaysia's (and other East Asian economies') options to boost growth. The government eventually decided to stimulate the economy by easing monetary policy aggressively. To prevent the capital outflows such a measure might trigger, on September 1, 1998, capital controls were imposed, focusing on two broad areas. First, to prevent speculation against the ringgit, access to local currency by non-residents was restricted, and rules requiring all ringgit to be repatriated effectively closed the offshore market in ringgit.

Second, the repatriation of portfolio capital held by non-residents was blocked for 12 months (this was subsequently replaced by an exit tax on short-term investments), and capital outflows by residents were restricted. Restrictions focused on short-term maturities and did not apply to international trade or long-term foreign investment transactions. The exchange rate was then pegged, interest rates were lowered, and commercial banks were encouraged to lend.

While Malaysia's capital controls successfully curbed capital flows, there is no agreement on whether they were needed to restore growth. The Malaysian economy recovered soon after controls were imposed, but strong demand for the region's exports brought about comparable recoveries in other East Asian economies that did not impose controls. For example, Malaysia's growth switched from -7.4% in 1998 to 5.8% in 1999. In Korea, which imposed no controls, the comparable figures are -6.7% and 10.9%. Malaysia was more vulnerable than the other Asian economies in 1998, so its performance would have been poorer without capital controls, but there is disagreement on this point.

Conclusions- Two broad conclusions emerge from the research and experiences surveyed here. First, recent research suggests that poorer countries face a tradeoff, as capital controls appear to be associated with faster growth (the reverse is true for wealthier countries), but less macroeconomic stability and a greater incidence of crises. Second, studies of the experiences of Chile and Malaysia highlight some of the difficulties in the design and application of capital controls. Chilean policymakers attempted to minimize the costs of capital controls by designing restrictions that were not too onerous or distortionary. As a result, however, the effectiveness of these controls was apparently limited. Changes in conditions may also make controls unnecessary. For example, the pattern of recovery in East Asia after recent crises suggests that Malaysia might have done as well without imposing capital controls.

Source- https://www.google.co.in/amp/www.frbsf.org/economic-research/publications/economic-letter/2001/august/capital-controls-and-emerging-markets/amp/

Links for further research:

1. https://www.economist.com/blogs/economist-explains/2015/06/economist-explains-21

2. https://onlineservices.cliffordchance.com/online/freeDownload.action?key=OBWIbFgNhLNomwBl%2B33QzdFhRQAhp8D%2BxrIGReI2crGqLnALtlyZexSRiez5%2BkRgkjgzwLHVV5np%0D%0A5mt12P8Wnx03DzsaBGwsIB3EVF8XihbSpJa3xHNE7tFeHpEbaeIf&attachmentsize=133694

3. https://www.imf.org/external/pubs/ft/wp/2016/wp1625.pdf

4. https://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&source=web&cd=6&cad=rja&uact=8&ved=0ahUKEwjVvf2Q2q7VAhWKro8KHR8vD5YQFghJMAU&url=http%3A%2F%2Fwww.livemint.com%2FPolitics%2F1PXwWuryZeovYJEDditxCP%2FFive-countries-that-have-used-capital-controls-recently.html&usg=AFQjCNEEqXxih5M4CYytzYRw1utG-IrL9A

5. https://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&source=web&cd=15&cad=rja&uact=8&ved=0ahUKEwio3dek2q7VAhVBKo8KHQXNCMEQFgh3MA4&url=http%3A%2F%2Fcepr.net%2Fdocuments%2Fpublications%2Fcapital-controls-2010-04.pdf&usg=AFQjCNFrUGgMZ9ofTDVCHT5c69K25bXs0w

6. https://www.google.co.in/url?sa=t&rct=j&q=&esrc=s&source=web&cd=17&cad=rja&uact=8&ved=0ahUKEwio3dek2q7VAhVBKo8KHQXNCMEQFgiHATAQ&url=https%3A%2F%2Fwww.imf.org%2Fexternal%2Fpubs%2Fft%2Fwp%2F2011%2Fwp11281.pdf&usg=AFQjCNG-sKFWP4gPof6yoHd9YXvidJFUtw