Agenda, Volume 8, Number 3, 2001, pages 273-275

Capital Controls in Developing Nations

George Fane, ***Capital Mobility, Exchange Rates and Economic Crises***
Edward Elgar, Cheltenham, UK, 2000

Reviewed by ***Geoffrey Kingston***

Two decades ago the case for liberalising international capital movements was revived in Australia. The trailblazer was Michael Porter. He had recently graduated from Stanford University, where his teachers included E S Shaw and R I McKinnon, who were pioneering the case for freeing up capital markets in developing countries. Also at Stanford, William Sharpe was pioneering the development of the capital asset pricing model, which was rapidly becoming the workhorse of financial risk management.

Porter made liberal use of the two-period Fisher diagram in order to show that the argument for freeing up the capital and financial account of the balance of payments parallels the argument for freeing up the current account. This was at a time when some economists, including Treasury ones, were simultaneously supporting current account liberalisation and opposing capital account liberalisation.

Porter also used the basic Sharpe diagram, with expected portfolio returns on one axis and the volatility of returns on the other, to show that restricting domestic access to foreign equity markets could have the unintended consequence of *reducing* the domestic demand for domestic equities – Kim Beazley and Alan Jones (who are among the public figures claiming that Australian superannuation funds have invested too much offshore in the sense that risky yet superior domestic opportunities have been passed up) please take note.

Porter fine-tuned his ideas at the Australian National University (before serving briefly at Monash University.) Indeed, the ANU had previously acted as a sounding board for Max Corden's ideas on the inefficiency of current account controls, and was shortly to do the same for Ted Sieper and George Fane, who wrote a detailed critique of Australia's capital account controls at the behest of the Campbell Committee. A decade later, Tony Makin, now at the University of Queensland, was reviving the Fisher diagram at the ANU, in order to demonstrate that current account deficits are not necessarily harmful.

The book under review is a new landmark in this ANU tradition of powerful critiques of controls on the balance of payments. Having gone a considerable distance towards liberalisation during the 1980s – and in the aftermath of a handy rise to ninth position on the OECD League Table by 1999 — Australia has become progressively less in need of ANU strictures on the need for economic openness. Accordingly, the book under review reverts to Shaw and McKinnon's topic, namely, capital controls in developing nations. Particular attention is paid to countries in our part of the world, including Indonesia, Malaysia, Thailand,

Korea, Taiwan and Chile. Policy instruments first analysed by Porter, such as regulating offshore borrowings by means of a Variable Deposit Ratio, are treated in depth. As with Sieper and Fane's analysis of the Australian case two decades ago, Fane's solo work here is distinguished by patient efforts to unravel and explain the complexities of particular institutional arrangements; the book displays a real knack for this. On the other hand, elegant geometry built on solid microeconomic foundations is nowhere to be found. I admit to being ambivalent about this particular departure from ANU tradition.

Chapter One provides an outline of the book. There is also a handy thumbnail history of major speculative attacks during the 1990s: the crisis of Europe's Exchange Rate Mechanism in 1992-93; the 'Tequila' crisis of 1994-95; and the Asian/emerging markets crisis of 1997-98.

Chapter Two lays out a portfolio balance model of the exchange rate, the share price index, and the short-term interest rate in a small open economy. While this exercise is carried out professionally, it may be a little terse for students. Also, my personal preference would have been for more emphasis on arguments involving currency substitution. Although currency substitution models may have failed to live up to their initial promise, I know of no better way of modelling the contagion issues raised by exchange rate crises.

Chapter Three presents case studies of capital controls in Taiwan, Malaysia, Korea and Chile. It concludes by casting doubt on the proposition that controls were effective in ameliorating currency crises.

Chapter Four is a careful discussion of first-best and second-best arguments for capital controls. Chapter Five is mostly devoted to a review of the theory of speculative crises. The sources range from Friedman to Krugman. There is also a brief review of empirical evidence.

Chapter Six is on the interplay between banks, moral hazard and prudential regulation in developing countries, drawing on commentators spanning Bagehot to Kane, Merton and Bodie. This chapter sensibly recommends either much higher capital adequacy ratios for banks in developing countries or, alternatively, much higher risk weights on loans to borrowers in developing countries regardless of where the lending banks are domiciled.

Chapters Seven and Eight are on monetary and exchange rate policies. Their central concern is the familiar one of monetary authorities that are unwilling either to allow a clean float, or to accept that if fixing is in fact the preferred exchange rate policy then little or no scope remains for an independent national monetary policy. Problems created by attempting to sterilise the monetary impacts of capital inflows are explained. Currency boards are discussed. 'The case for a currency board is particularly strong when a country's reputation for monetary discipline is poor' (p. 171).

The final chapter is on 'reforming the international financial architecture'. The topics include expansion of the authority of the International Monetary Fund, the possibility of an Asian monetary fund, the desirability of official guarantees for loans to developing countries (a proposal championed by George Soros), and the desirability of taxes on spot transactions in foreign exchange (a proposal

championed by James Tobin). The author displays intelligent scepticism towards all these proposals. This reviewer was persuaded by the author's scepticism, and was reminded of the old adage for dealing with acquaintances who are financially down on their luck: either refuse outright to help, or give generously, so long as you don't acquiesce in half-baked schemes involving concessional loans.

Overall, this is a skilful blend of sound economic reasoning and institutional knowledge. The writing is clear and concise. The policy conclusions are valuable antidotes to various manifestations of economic snake-oil. Teachers of development economics and international money should find the book useful. Investors in emerging markets could also read it with profit. Above all, present and prospective policymakers in developing nations need to read this book.

References

Porter, M. (1979), 'Money and Finance: The Direction of the Australian Capital Market in the 1970s', pp. 62-128 in Reserve Bank of Australia (ed.) (1979), *Conference in Applied Economic Research,* Reserve Bank of Australia, Sydney.

Sieper, E. and G. Fane (1982), 'Exchange Control and Exchange Rate Policy', in pp. 129-282, Australian Financial System Inquiry (1982), *Commissioned Studies and Selected Papers,* Part 2, Australian Government Publishing Service, Canberra.

Geoffrey Kingston is Associate Professor of Economics at The University of New South Wales.