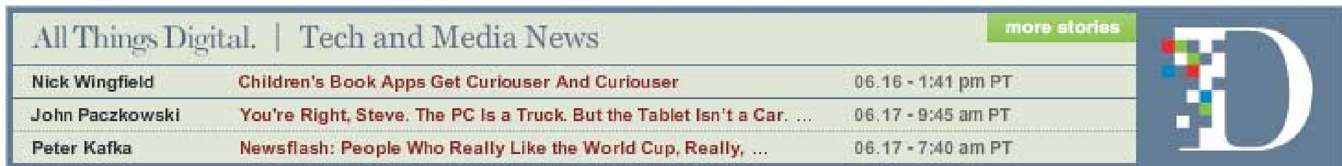

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Capital-Control Comeback?

Asia is in danger of embracing the wrong fix for destabilizing inflows.

Capital will go where it finds the highest returns, and right now for many investors that's Asia. Money is flooding into everything from Indian telecom licenses to Taiwanese insurance companies to Hong Kong property. Yet policy makers, far from welcoming these new flows, are starting to fret about how to "manage" them.

That's the takeaway from recent policy pronouncements in South Korea and Indonesia. The former wants to limit the amount of exchange-rate derivatives banks are allowed to trade; the latter, to curb trading in very short maturity central-bank debt. The goal is to discourage short-term capital flows that roil exchange rates, without thwarting longer-term investment flows. Taiwan tried this trick earlier this year with slightly tighter regulations on some deposit accounts.

These are far from the most stringent capital controls Asia has ever seen, but they point to growing monetary unease in the region's dollar bloc. The Federal Reserve shows no sign of dialing back its greenback spigot, while policies like ObamaCare and cap-and-trade—and a sovereign debt crisis in Europe—leave fewer outlets for that cash. So money heads to Asia in search of higher returns, as the nearby graph shows, bringing with it volatile capital flows and exchange rates. No wonder capital controls are coming back into vogue, cheered by the likes of the International Monetary Fund and the Asian Development Bank.

But standing on the shore like King Canute commanding the money tide to stop is the wrong approach, not least because it may make the problem of destabilizing capital flows worse. It's far more important for governments to recognize their own contribution to monetary instability and take steps to make their economies more resilient to external shocks.

In South Korea, the Asian economy most prone to volatile capital flows, the won's partial convertibility is the problem. Since investors are able to exchange the local currency into dollars only domestically, the market is narrow and shallow, and the regulatory environment uncertain. That makes investors more likely to pile out of the market at the first hint of trouble and then to pile back in again after the trouble has passed.

Indonesia and Taiwan suffer from an exchange-rate regime that's a hybrid between a full float and a peg. This encourages some investors to speculate on future policy decisions like central-bank tightening or interventions to defend a preferred exchange rate, on top of the capital flows that accompany "real" investments. China is the extreme case of this, where hot money has poured in on expectations of a yuan appreciation. The result is more volatility, not less.

Capital regulations only exacerbate these pressures by pushing money underground to bypass the rules, as China's case shows, or encouraging speculation. Worse, as economist Steve Hanke has noted, capital controls make long-term investors worry about their ability to exit investments, discouraging the kind of long-term capital governments say they want to attract. Malaysians can attest to this; since imposing strict capital controls in 1998, it has struggled to attract money back, even after lifting many of the restrictions. Asian governments seem to understand this, given their strenuous efforts to avoid calling their recent measures "capital controls."

There's no silver bullet to solve these problems, but a commitment to greater liberalization would help. That way, when money comes in it can find its way to growth-boosting uses. Full convertibility can help create a broader and deeper global market for currencies, boosting their resilience in times of crisis. And government commitments to an open capital account, the rule of law, anticorruption and other reforms give investors less reason to flee every time a crisis hits.

Korea and Indonesia already know all this. Korea saw capital outflows of around $65 billion, or 6% of GDP, after the 2008 Lehman crisis but its financial system survived, thanks largely to earlier rounds of banking reform and capital-account liberalization. Indonesia's own post-1997 reforms helped it maintain growth rates second only to China and India throughout the crisis despite a capital outflow of about $4.5 billion, or nearly 1% of GDP, in only three months at the end of 2008.

Asian policy makers are right to blame Ben Bernanke, President Obama and the U.S. Congress—and their cheerleaders among Keynesian "development" banks and newspaper columnists—for not maintaining the greenback as the stable spine of the global dollar bloc. But imposing capital controls represents a policy failure of its own: a failure to get to the root of why some economies are more vulnerable than others to exchange-rate vicissitudes. Rather than treating the symptoms, it's time for everyone in Washington and in Asia to focus on the diseases.

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