RESTATE THE CASE
Capital controls

Why is this important?

Following the global financial crisis, there has been much discussion around adopting capital controls. This has been seen in Brazil where a tax was imposed on financial assets purchased by foreigners. However, it is not just within developing countries that capital controls are gaining popularity. John McDonnell, the shadow chancellor, hinted at reinstating them under a Labour government in response to a fall in the value of the pound.[1]

What are they?

Capital controls are legislative measures taken by governments or central banks to regulate the flow of capital into or out of the country. Such measures may be taken in the form of taxes, tariffs, volume restrictions or legislation. Historically these have been seen in the UK with limits placed on the purchase of international investments. This allowed only a fixed number of investments, whereby the purchase of foreign assets by one UK resident had to be offset by a sale of another.

In the aftermath of the second world war, capital controls became an accepted part of the global financial structure. At the time, economists believed that capital controls protected people from the effects of international capital. This includes protecting the domestic economy from volatility caused by significant inflows of capital, and from negative effects of large capital outflows during crises.

During the 1970s numerous developed countries began to abolish their capital controls starting with the US, Canada, Germany and Switzerland. This approach was then followed by the UK from 1977 under the Callaghan and then Thatcher administrations. Most other advanced and emerging economies followed this approach in the 1980s and early 1990s.

Why is investment a good thing?

Unlike capital controls, free capital movement allows unrestricted capital mobility and investment into foreign countries. This can come in many forms, but one of the most successful is foreign direct investment (FDI). This is where an individual, or more typically a business, owns at least 10 per cent of a foreign company.[2] Usually these investments are made in developing countries with six out of ten economies in 2016 receiving the largest inflows of foreign direct investment.[3] This is because developing countries often have the best returns.

However, FDI does not just benefit investors, with recipient countries enjoying lower costs to adopt technology and increased economic growth. It also encourages the host country to invest in their human capital, thus making it more productive, as the growth rate of the economy is positively associated with the level of human capital. Hence, the higher the level of human capital, the greater the effect of the FDI on the growth rate of the economy.[4]

In India, FDI is considered a development tool which helps to achieve self-reliance in certain sectors and develops the country as a whole. Since liberalisation in 1991-92, India has seen significant inflows of FDI,

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[1] Belam, C. & Boughton, J., *Wealth tax and capital controls in the UK?,* 30 November 2018, https://private-wealth.bclplaw.com/insights-resources/blog-post/wealth-tax-and-capital-controls-in-the-uk, (accessed 28 October 2019).
[2] Chen, J., *Foreign Direct Investment (FDI),* Investopedia, 20 November 2019, https://www.investopedia.com/terms/f/fdi.asp, (accessed 3 December 2019).
[3] Mariana, R., *The importance and dynamics of foreign direct investment in the world economy,* Dunarea de Jos University of Galati, 2018, p. 186.
[4] Borensztein, E., De Gregorio, J. & Lee, J., *How does foreign direct investment affect economic growth?,* National Bureau of Economic Research, March 1995, p. 9.

placing ninth in 2018 for the most foreign direct investment.[5] India's large market size, availability of highly skilled human capital, and a variety of natural resources, make it an attractive investment destination. This allows the FDI to play an important long-term development role as it enhances the competitiveness of the domestic economy by transferring technology, raising productivity and generating new employment opportunities.[6]

Capital controls: What's wrong with them?

Capital controls distort the allocation of investment, preventing the free movement of capital internationally to where it is most productive. This hinders the development of a domestic economy.[7] A 2005 paper shows how the restriction of foreign investment impacts domestic firms heavily, as financing costs rise because of reduced amounts of available capital.[8] This particularly harms developing economies as it is typically these countries which provide the largest returns on foreign direct investment as developing nations have the largest growth rates.

Proponents of capital controls often point to China as the most prominent example of how long-term capital controls can be successful. These controls purportedly help its state banks give low interest rate loans to businesses. These are then used to support China's industrial production. Alongside this, China has consistently maintained an undervalued exchange rate to boost the growth of exports.[9]

However, such policy decisions have significant consequences. China's policy limits its ability to integrate into global capital markets and build a modern financial sector. Controls on outflows, especially overseas foreign direct investment, limit opportunities for citizens, and controls on inflows discourage foreign direct investment into specific sectors. While it should be accepted that maintaining an undervalued exchange rate can have a positive effect in supporting export growth[10], it also invites other countries to respond negatively by imposing protectionist policies. This has been evident with the Trump administration's response to China.

Other capital controls, such as Thailand's unremunerated reserve requirements on foreign capital inflows in 2006, can have wider consequences. The stock market plunged 15 per cent in a day, forcing the central bank to backtrack on the measure. Such an event emphasises that markets respond negatively to capital controls, whether these be on outflows or inflows.[11]

What should be done?

Rather than putting up barriers and limiting both individual freedoms and investments, nations should liberalise and be encouraged to open their economies and industries to overseas investment. In doing so the increased capital mobility will stimulate increased economic development and ensure efficient capital markets, with assets put to the most effective use.

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[5] United Nations, *Global foreign direct investment slides for third consecutive year,* 12 June 2019, https://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=2118, (accessed 19 November 2019).
[6] Anitha, R., *Foreign direct investment and economic growth in India,* International Journal of Marketing, Financial Services & Management Research, August 2012, pp. 108-124.
[7] Clement, D., *Capital controls – for better or worse?,* 31 March 2016, www.minneapolisfed.org/publications/the-region/capital-controls-for-better-or-worse, (accessed 25 October 2019).
[8] Forbes, K, *The Microeconomic Evidence on Capital Controls: No Free Lunch,* National Bureau of Economic Research, May 2005, p. 12.
[9] Shaw, W., & Eidelman, V., *Why are capital controls so popular?,* 9 June 2011, https://carnegieendowment.org/2011/06/09/why-are-capital-controls-so-popular-pub-44490, (accessed 29 October 2019).
[10] Ibid.
[11] Ghosh, A., & Qureshi, M., *Guilt by Association,* IMF, June 2016, www.imf.org/external/pubs/ft/fandd/2016/06/ghosh.htm, (accessed 25 October 2019).