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CAPITAL CONTROLS : A STUDY APPLIED TO BRAZIL

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1 - INTRODUCTION

The recent turmoil in the international capital markets rose a series of discussions about whether the free capital movements among countries can harm some economies. Today, it is much more understood that global capital flows can drive both instability and economic growth. Especially since the Mexican peso crisis, in 1994, there has been a lot of discussion whether the less developed countries (LDC) should or should not adopt measures to regulate the capital inflow and outflow in their economies.

In face of the fact that Brazilian president, Mr. Cardoso, echoing the claim of many economists, has more than once expressed worries about the problems that the free capital movements could cause to the global economy, it seems not an unreal supposition that Brazil could once adopt measures in this direction.

The purpose of this paper is to analyze how Brazil would get affected by the imposition of capital controls, trying to balance the aspects that could help the country to rearrange internal and/or external imbalances, and the negative outcomes that should emerge from "insulation", or from an action that can be seen as "breaking the rules" of the capital markets.

The structure of this study starts with a brief overview of the problems that capital mobility can cause to the economy, and the theory that led countries to implement capital controls. After that, we will present some recent examples of countries that have adopted such controls, to finally conclude with a discussion of the possible outcomes of these policies, if they would be implemented in Brazil.

2 - CAPITAL FLOW RESTRAINTS – THEORY

The economic rationale behind the imposition of any kind of international capital flows controls is generally the need to correct balance of payments imbalances. In the model known as "impossible or inconsistent trilogy", in which a country wishes to have a flexible exchange rate, active monetary policy and an open capital account, all at the same time, we observe that when capital mobility is high, interest rates are determined by the need to avoid rapid depletion of reserves, and in effect fiscal policy is left as the only tool of stabilization. If this country is not in a situation of external balance, and wants to prevent the upcoming of speculative attacks against its currency, there are three possible options currently suggested:

1. Maintain the exchange rate, and rely on gradual internal adjustments of relative costs, knowing that it is usually a slow process;

2. Devalue or let the exchange rate float, hoping that the market will face it positively, and will not lose its confidence in the country;

3. Impose temporary restraints on capital flows to prevent a speculative attack, and use this time to rearrange internal and/or external imbalances.

We wish to concentrate this study in the third possibility, so let us analyze closer what the imposition of restraints on capital flows means. We can generally accept the division of the restraints on capital flows on two broad categories:

a. restraints on capital account transactions (capital controls);

b. restraints on foreign exchange (forex) transactions (exchange controls).

1. Capital controls

We may here insert the definition Fane (Fane, 1998) elaborated for capital controls as "measures which impose quantitative restrictions, or explicitly or implicitly tax broad categories of capital movements and which apply to all firms and households". Being the capital account divided in five main categories - foreign direct investment (FDI), portfolio investment, borrowing and lending by residents and non-residents, transactions through deposit accounts and other capital account transactions, a country wishing to regulate its capital account can impose controls involving direct constrains on one or more of these capital account elements.

2. Exchange controls

According to Fane’s definition, exchange controls "include restrictions on the right to remit or receive payments in foreign currencies, the right of non-residents to hold domestic currency deposits on-shore, the right of residents to hold off-shore deposits, and the right of residents to hold foreign currency deposits on-shore." We should include here also a mention to explicit and implicit taxes for forex transactions, including currency transaction taxes and multiple exchange rates.

In other words, the mechanics of exchange controls can vary a little from case to case, but generally it works this way: exporters are supposed to sell their foreign currency earnings to the government at a fixed exchange rate; then the government should sell, also at a fixed exchange rate, that currency for some approved payments to foreigners, as imports and debt service.

2.3 Different Restraints on Capital Flows

The restraints on capital flows are generally divided into three major categories:

a. restraints on capital *inflows* or *outflows*;

b. *permanent* or *temporary* controls;

c. *comprehensive* or *selective* restraints.

d. Restraints on capital *inflows* or *outflows*

The main reasons why restraints on capital outflows are imposed are generally: a) prevent or slow the pace of capital outflows, to soften the pressures of a (self-fulfilling or not) speculative attack to the currency, and b) break the link between domestic interest rates and the exchange rate. That way, the countries affected by severe economic problems could pursue expansionary monetary policies without worrying about capital flights and consequent weakening of the currency.

At the other hand, restraints on capital inflows are often seen as a preventive measure, willing to avoid a rapid *income* of foreign resources during periods of economic growth, which could turn into a quicker *outcome* in the future. Nevertheless the fact that among countries that imposed capital controls a majority of them opted for capital outflows curbs, empirical studies show that restraints on capital inflows are more effective than restraints on capital outflows to prevent currency crisis. (Reinhardt and Todd Smith, 1997).

2.3.2. *Temporary* or *permanent* controls

Temporary restrictions to capital flows are usually implemented as a measure to soften or deter capital inflows and/or outflows in periods considered "abnormal", when flows are beyond what a country could see as "acceptable". Evidently, these concepts are very subjective, but the idea is to give "breathing room" to economic recovery, or to policy-makers to implement corrective policies to mitigate or eliminate the distortions which are threatening the balance of payments. These threats can either be a real exchange rate appreciation that could lead to a loss of competitiveness in times when the capital inflows are high, or to a depreciation in the exchange rate, when capital outflows are predominant.

As a consequence, we can define *permanent* capital controls as those defined as necessary even in "normal" times, suggesting that the existence of some "market failures" impose the need of disciplining capital flows in order to assure that macroeconomics equilibrium will be sustainable. Obviously, this topic is subject of intense controversy, either in the definition of "market failures" and in the imposition of capital controls, if these "market failures" are really prevalent.

2.3.3. C*omprehensive* or S*elective* Restraints

We understand that there are different degrees of capital flow restraints, and a comprehensive restrain would be at its highest level the virtual inconvertibility on the capital account, as China is a notable example, and as Russia was in the Soviet Era.

But the most common practice is to impose some degree of selective restraints on some items of the capital account, and have more liberal rules in some others. For sure the frontier between comprehensive and selective restraints is not very clear, and the countries that imposes less liberal regimes tend to have some exceptions, notably in FDI.

4. Two Proposals for Softening Capital Movements

1. The Tobin Tax (TT)

The main idea of the TT is to impose a permanent, global and ad-valorem tax (generally proposed between 0.1-0.25 percent) in all forex transactions, in order to reduce the speculative element of forex flows. Since the influence of the tax on an investment diminishes over a long period, the tax would have a bigger impact on a one-week round-trip movement than in a one-year round trip movement.

In fact, the costs of short-term movements would be very high, while FDI would suffer minor impacts. There is also the hypothesis that (Tobin, 1995) by generating costs to forex transactions, the tax would create room for individual country monetary policies to be more effective. The financial viability of a global forex tax transaction is not simple, and many considerations have been placed (Sphan, 1996), like taxing all agents or exempting "market-makers"; how to apply it to the derivatives market; applying it only when there is a crisis or making it permanent; and finally, how should the tax revenue be distributed.

2.4.2 Paul Krugman’s Plan B

Paul Krugman’s so-called "Plan B" (Krugman, 1998), in opposition to the International Monetary Fund (IMF) recommended policies of economic orthodoxy, such as tight fiscal and monetary policies, (which he calls "Plan A"), advocates exchange controls on capital outflows in order to break the link between domestic interest rates and the exchange rate. That way, able to have an expansionary monetary policy, the country would avoid the economic slowdown or recession that would be brought by the high interest rates implemented to defend a currency from a speculative attack.

It is important to say that Krugman defends <u>temporary</u> exchange controls as an opportunity to gain space for economic recovery, and not to sustain an overvalued currency. It is also important to stress that these controls can be seen as positive only if the source of imbalances that caused the crisis can be attacked and solved during the period the restraints are effective.

In practice, exchange controls present a lot of problems, and all sorts of inefficiencies can occur. The bureaucratic system required to implement the controls is generally heavy, expensive and subject to abuses. The distortions should soon start to arise, as exporters have an incentive to hide their forex receipts, and the importers an incentive to overvalue their invoices. Black markets tend to flourish, as well as corruption.

We can sometimes observe that exchange controls can operate at the opposite way that they were intended to. For instance, rules that prevent capital flight tend to scare investors, so capital inflow is less likely to happen. The market tend to see this unilateral measures as "breaking the rules", and is probable that market agents will be less likely willing to help economies that did that than the ones that continued "playing by the book". It is also likely that economies that are strongly outer-oriented will suffer a more painful recovery than the more inward-oriented ones. By the various arguments above that show the different problems that can surge, we may conclude that the imposition of such controls are more a "desperate remedy" for countries facing a serious and disruptive currency crisis than a policy that can be recommended for countries that do not face this kind of problem.

3 - RECENT CASES AND OUTCOMES

3.1 The Chilean Case

When discussing capital controls, Chile is a case frequently cited as a model by the ones who are in favor of the implementation of some measures to restrain capital flows. The core of the argument that led Chile to adopt <u>inflow</u> capital controls is that emerging economies must beware of massive short-term foreign capital inflows. Real interest rates in emerging economies are higher than in rich ones because the capital stock is lower, which means that investments earn a higher return. When foreign money enters into a country, its real interest rates, in theory, should fall to the same level of the rich countries' rates. But what very frequently can happen in the short-run is a massive rise in the country's asset prices. This way, free capital flows would be likely to cause bubbles in the stock markets and in the prices of real estate assets, and a consumption boom.

This, however, would lead to a large current-account deficit, increasing the odds of a currency crisis even if the financial sector is solid. Paradoxically, an emerging economy which investors regard as stable can have this problem even more strongly than one which investors see as risky. We could conclude that a small developing country, whatever the state of its banking system, should maintain some controls on short-term capital until the expansion of their capital stock brings their real interest rates close to those of rich countries. So, gradually, these controls could be reduced.

Chile, although renowned for its free-market economic policies, actively discourages short-term capital inflows. Its reliance on short-term foreign money has diminished steadily since 1991, when <u>permanent</u> and <u>selective</u> controls were adopted in order to contain a growing inflow of capital, caused by bullish expectations, as the economy was undergoing a successful reform program. The main objective was to avoid the entry of short-term "speculative capital", the so-called "hot money". These were the main regulations in vigor in Chile:

Restrictions Over	Type of restriction
Foreign Direct Investment	No restrictions on repatriation of profit, but initial investment capital must stay in country for one year
American Deposit Receipts (ADRs) Issuance	Only companies classified by at least two credit rating agencies as "investment grade" are permitted to issue ADRs
EuroBond Issuance	Bonds issued in the international capital markets must have a minimum maturity defined by the Central Bank
All Other Portfolio Flows	Subject to a non-remunerated reserve requirement (in

(Including Trade Credit Lines)	percentage) to be deposited at the Central Bank for one-year

Source: The Economist (March 14, 1998)

As far as we can understand from the table above, the most important control is the fact that a percentage of all non-equity capital entering Chile must be deposited without interest at the central bank for one year. This amounts to an implicit tax on capital inflows, and the effective tax rate will vary inversely with maturity. In fact, this percentage has been adjusted over time, and it has mounted up to 30% during some period, and in October 1998 this percentage fell to zero. Regardless the percentage, this implicit tax can be really high if the capital stays in the country for only a brief time.

It seems to be a consensus that in Chile those measures have helped lengthen the average maturity of capital inflows. Chile has enjoyed greater levels of FDI, relatively to other Latin American economies. With relatively lower levels of external indebtedness -which is a key criteria determining the potential vulnerability of an economy to a currency and financial crisis -and a sound financial system, the Chilean economy has been much less impacted by the recent turmoil in the global capital markets, when compared to other Latin American economies. Also in terms of GDP growth, Chile has had better results in this comparison.

At the other hand, some can argue that exactly the sound macro fundamentals and the solid banking system are the reasons for the country's success. Valdes (Valdes,1998) sustains that the tax on short-term capitals was not imposed as a way to "improve" the composition of foreign borrowing but instead as a monetary policy tool, to stop a surge of capital inflows that might have raised the real dollar value of the peso and hurt exports. The author also suggests that the tax did not achieve its original purposes, but only created distortions, which have been costly to the country. He states that the central bank was unable to tax direct commercial credit from foreign suppliers, and evasion was considerable. Meanwhile, investors eventually found ways around controls. A large surge in capital inflows led to a considerable raise in the peso's real value.

According to the author, another motivation for the tax was increase the independence of the central bank. In the mid-1990s the central bank attempted to control inflation by tightening monetary policies. But the increase in domestic interest rates attracted foreign funds, even with the tax, which in turn drove up the real exchange rate. The central bank's response to this was to sterilize inflows by buying the reserves and issuing domestic debt. Since the cost of domestic debt was much higher than the interest earned on international reserves, the central bank ran massive quasi-fiscal deficits. Finally, we reach the point where the fear of further deficits limits the ability of the central bank to employ monetary policies as a tool for stabilization. Also the fact that trade credits are equally subject to the implicit tax resulted in the fact that Chilean's international trade has somehow been adversely impacted.

After the Russian crisis (September 1998), the Chilean authorities reduced the tax rate to zero, in face of the slowing of resources flow to emerging countries. In fact, one can argue that this measure would not help the recovery of inflows, once there is an uncertainty whether which measures could be taken in the future, and how would they affect investment.

2. - The Malaysian Case

Malaysia is another country frequently quoted when talking about capital controls. We can divide Malaysia's relation with capital controls in two periods. The first one happened during 1994, when faced with massive capital inflows, attributed to a conjunction of factors, including:

a. stable exchange rates;

b. high interest rates compared to the US Libor;

c. perception of a sustained and non-inflationary economic growth.

To prevent the problems that a massive "speculative" inflow could bring to the economy, the monetary authorities implemented a series of selective and temporary measures, affecting mainly the commercial banks relations with non-residents. The controls, allied to a decrease in real interest rates, led the net capital inflows to a sharp decline, and at the end of the eight months, the restraints were suspended.

The second period started at September 1, 1998, when the Malaysian government announced a series of selective and *temporary* restraints on capital outflows. These measures were taken as a response to the systemic crisis that was spreading all over Southeast Asia. Nevertheless the fact that the monetary authorities stated that the restraints will be removed when considered "appropriate", it stays unclear by the time of writing what the government considers the "appropriate" time to do so. The table below summarizes the controls announced. While details may have undergone some minor changes, the key factors remain present.

Restrictions on Capital *Outflows* by Malaysia as of September 1, 1998

Type of Restriction
External Accounts Transfers for external accounts would require prior approval for any amount. Transfers to resident accounts in Malaysian banks are permitted until Sept 30, 1998. Thereafter, such transfers require approval. Sources of funding the external account are limited to: - Proceeds from sale of ringgit instruments, securities registered in Malaysia or other assets in Malaysia; - Salaries, wages, commissions, interest, dividend; - Sale of foreign currency. Use of funds in the account is limited to the purchase of ringgit assets in Malaysia.
General Payments Residents are freely allowed to make payments to non-residents for any purpose up to RM10,0000 or its equivalent in foreign currency (reduction in amount), except for all payment for imports of goods and services. Residents are freely allowed to make payments to non-residents in foreign currency only for amounts exceeding RM10,000 equivalent. However, investment abroad in any form and payments under a guarantee for non-trade purposes require approval.
Export of Goods Prescribed manner of payment for exports in foreign currency only, other than currencies of Israel, Serbia and Montenegro.
Credit Facilities to Non-Residents Domestic credit facilities to non-resident correspondent banks and non-resident stockbroking companies are no longer allowed.
Investments Abroad Residents with no domestic borrowing are allowed to make payment to non-residents for purpose of investing abroad, up to an amount of RM10,000 or its equivalent in foreign currency per transaction. All residents require prior approval to make payments to non-residents for purposes of investing abroad, for an amount exceeding RM10,000 equivalent in foreign currency.

Foreign Currency Credit Facilities and Ringgit Credit Facilities from Non-residents

Residents are not allowed to obtain ringgit credit facilities from any non-resident individuals.

Securities

Ringgit securities are required to be deposited with authorized depositories.

Ringgit securities held by non-residents must be transacted through an authorized depository for good delivery.

All payments by non-residents for any security registered in Malaysia must be made in foreign currency or in ringgit from an external account.

All proceeds in ringgit received by a non-resident from the sale of any resident security must be retained in an external account (subject to the conditions on such accounts). However, should the ringgit security be held for more than one year, proceeds from the sale of such securities can be:

- converted immediately to foreign currency;

- or credited to the external account.

All payments to residents for any security registered outside Malaysia from non-residents must be made in foreign currency only

Import and Export of Currency Notes, Bills of Exchange, Assurance Policies, etc.

A resident traveler is permitted to import:

- ringgit notes up to RM1,000 only; and

- any amount of foreign currencies.

A resident traveler is permitted to export:

- ringgit notes up to RM1,000 only; and

- any amount of foreign currencies up to the equivalent of RM10,000.

A non-resident traveler is permitted to import:

- ringgit notes up to RM1,000 only; and

- any amount of foreign currencies.

A non-resident traveler is permitted to export:

- ringgit notes up to RM1,000 only and

- foreign currencies up to the amount of the foreign currencies brought into Malaysia.

Prior approval is required for the import and export of ringgit notes and the export of

foreign currency notes, other than as permitted above.

[Transitional Provision: Up to Sept 30, permission is given to a traveler (resident

and non-resident) to import any amount of ringgit on his person or in his baggage.]

Source: Bank of Negara (as reported in Business Times, September 2)

Note: Bank of Negara fixed the ringgit to 3.8 per US$

Among the measures above, we should highlight the one year holding period requirement prior to the sale of Malaysian securities, the limitations for tourism, the restraints on credit to non-residents, and the limitation of movements of ringgit offshore.

The main economic drive for these measures are: (1) regain monetary policy independence, by breaking the link between exchange rate and interest rates, making room for lower interest rates, in order to attempt an economic recovery, since economic activity went down 7% in the second quarter of 1998; and (2) insulate Malaysia from short-term capital flows.

Nevertheless, even if Malaysia can succeed and stabilize the ringgit, implement the necessary reforms and start a process of economic recovery without disrupting ordinary business, some long-term impacts are likely to appear. The cost of capital to Malaysia will probably be higher, retarding long-term growth. Rent-seeking activities that can be created by the controls could damage economic efficiency, and a monetary expansion with a weak banking system can bring more troubles in the near future. Some economic reports (Merrill Lynch, 1998) say the move should have been a policy miscalculation, and lists some reasons why:

1. The timing was not correct, since the exchange rate was getting stabilized, and exchange rates would fall anyway, certainly not as quick as the government wished, but would fall;

2. The country had a nearly two decades tradition of open capital account, except for the brief period in 1994 when capital inflows were curbed;

3. Controls are acceptable provided they are clearly temporary and intended to buy time for the economy to restructure. It cannot be used as a panacea to side-step the necessary reforms.

4 - BRAZIL AND CAPITAL CONTROLS

1. - The "Sequencing" of Liberalization

When discussing the Brazilian case, it is important to have in mind some aspects about liberalization policies. There is an extensive discussion on the international economics literature about the "sequencing" in which liberalization policies should be adopted in a semi-open economy in order to assure that the capital mobility can be present and that the macroeconomics policies can be effective, all at the same time (Edwards 1995).

The conventional wisdom states that the first-best situation for a country is to have an open capital account. Although, opposed to the "big bang" approach, where product and financial markets are liberalized domestically and at the same time opened to foreign competition, we must say that many successful experiences in liberalization followed a more gradual process. Some problems may arise in having an open capital account while other sectors of the economy are not liberalized.

The first problem that may arise is related to not having an open trade account. This way, the capital inflows made possible by the liberalization of the capital account may go into the "wrong", i.e., import-substituting, and maybe non-competitive industries. Later, when trade liberalization comes, this investment can prove itself a bad investment. The second problem is related to the efficient capital allocation. If capital inflows comes into a country with a non-developed or weak financial market, non first-best allocations are likely to happen, and financial crisis can appear. A third problem is that massive capital inflows, if not correctly managed in the aspect of the exchange rate policies, can lead to a real appreciation of the currency, and harm the export-led growth that usually is a very important factor in the development of the countries.

And finally we have the danger that the liberalization of capital inflows before the establishment of fiscal discipline will serve only to provide temporary financing for unsustainable budget deficits, which correction, if delayed, will be probably more costly and painful. In this case, the capital inflows will simply magnify the size of the future crisis.

Besides these concerns related to capital *inflows*, there are other arguments, somehow more obvious, and some of them already mentioned earlier, of how capital *outflows* can destabilize and harm a country’s economy, and these arguments can be used in defense of postponing the capital account liberalization.

At the other hand, we can include among the traditional benefits of the capital account liberalization the increase in welfare made possible by the availability of foreign savings to supplement the domestic savings, and constitute a larger capital stock. One can even argue that early liberalization of the capital account is desirable, since it will enhance the credibility of the reform programs. Our conclusion is that, somehow, other things being equal, capital account openness is preferable to capital controls. The former are usually used as a second-best option, in face of some existent or potential imbalance.

Nowadays Brazil is a relatively liberal country. The IMF's Exchange *Arrangements and Exchange Restrictions* Annual Report lists a series of different types of capital controls, and in fact Brazil has shown a relatively continued use of at least one kind of capital controls during the last three decades. These controls can be whether multiple exchange rate regimes for separate transactions in the current and in the capital accounts, restrictions on settlements and payments of the current and capital accounts, requirement of advanced import deposits and surrender of export proceeds.

This is no surprise for us, once among not only the newly industrializing countries (NICs), but also among the OECD countries, the existence of some form of capital control was the rule during most of this period. Only in the late 1990s, the number of restrictions, and/or the number of countries that have some restrictions have been decreasing , not only among the OECD countries, but also among the NICs and the less developed countries(LDCs), and so it did in Brazil .

But before that, Brazil has always had some kind of "relatively effective" capital controls (Nembhard, 1996), specially against capital flight. Apart from trade restrictions as the "*Law of Similarities*" that persisted under different forms until the early 1980s, Brazil maintained until the early 1990s an extensive and complex system of capital controls whose specific regulations have often changed, but, in general, could be divided in the following categories:

a. forex restrictions - including quotas and/or regulations on banks' holding of foreign currency and on individuals' use of them when traveling abroad; taxes and duties on forex transactions; advanced import deposits, surrender of export proceeds;

b. regulation of FDI and restrictions on percentage of foreign equity, repatriation of capital, remittances and transfers of foreign capital and its earnings;

c. regulation and restriction of access to foreign resources - minimum maturity, interest rate ceilings and prior approval for borrowing, quotas and obligation of government guarantees;

d. restrictions on domestic ownership of foreign resources, foreign bank accounts, securities and investment abroad.

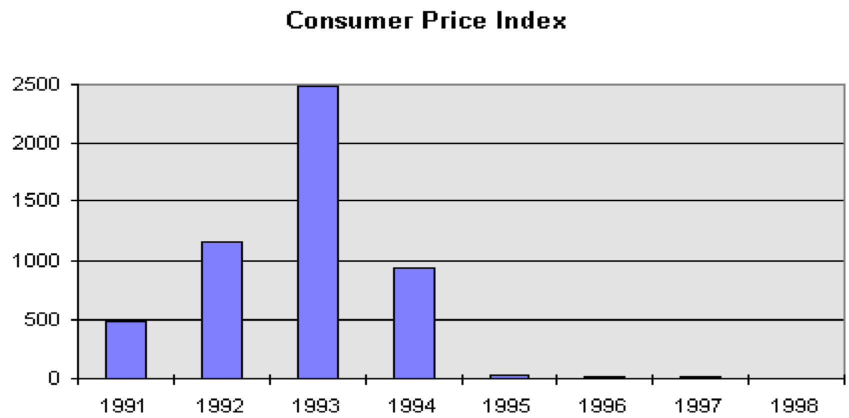
During some periods the degree in which these measures were present, or enforced, would vary, but until the early 1990s the capital outflows were not significant, or, at least, despite the unstable macroeconomics conditions, and the pegged exchange rate with frequent midi or maxi devaluation of the Brazilian currency, the volatility of the capital flows to and from Brazil was not a major concern of the Brazilian authorities.

Only in the beginning of this decade the process of opening the economy took effect. In the early 1990s a process of trade liberalization started, and many non-tariff barriers started to be removed. The economic integration with the neighbor countries, with the development of Mercosur, pushed Brazil in the direction of a general reduction in the level of the tariffs, along with a softening of the procedures required for international trade. The products market suffered an external shock, but the capital account was still starting to have some restraints removed. Only after 1994 the process of opening the capital account was really significant. And as we will see below, the reason for that was the stabilization plan Brazil was undergoing at that time

4.2 - Brazil's Recent Economic History

During the early 1990s, the main concern in the Brazilian macroeconomics picture was the hyperinflation threat (see graph 1). With consumer prices rising as much as 80% a month, as in mid-1994, the main concern of the companies was to have a good financial management, rather than care about quality and productivity to compete in the foreign markets. Among other perverse effects, inflation allowed the government to avoid tightened fiscal policies: it could reduce its real spending by delaying payments.

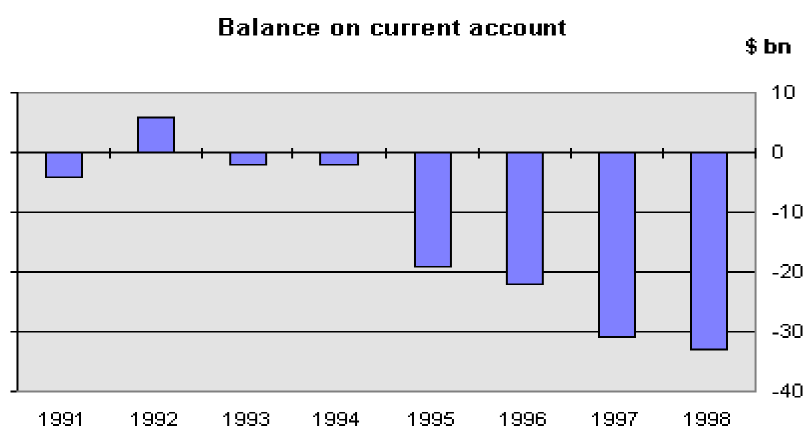
Graph 1



Source: Central Bank of Brazil

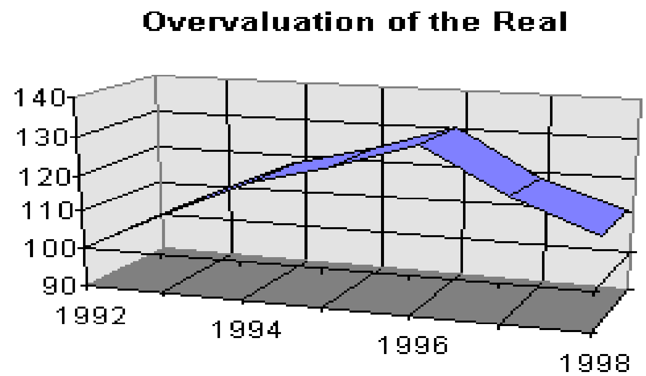
The Real Plan, launched in 1994, changed all that, bringing to the country an interlude of economic stability. The anchor of the stabilization program was the exchange rate. With a prior indexation period to the "URV", an index linked to the dollar, prices and wages were reasonably aligned. So, when the exchange rate was fixed and brought under Central Bank's control, the process of inflation was halted. Imports were stimulated, either via lowering import tariffs and a strong domestic currency, in order to avoid the surge of internal prices. Despite the success in combating inflation, massive deficits on the current account balance were an unavoidable consequence. (See graph 2)

Graph 2



Source: Central Bank of Brazil

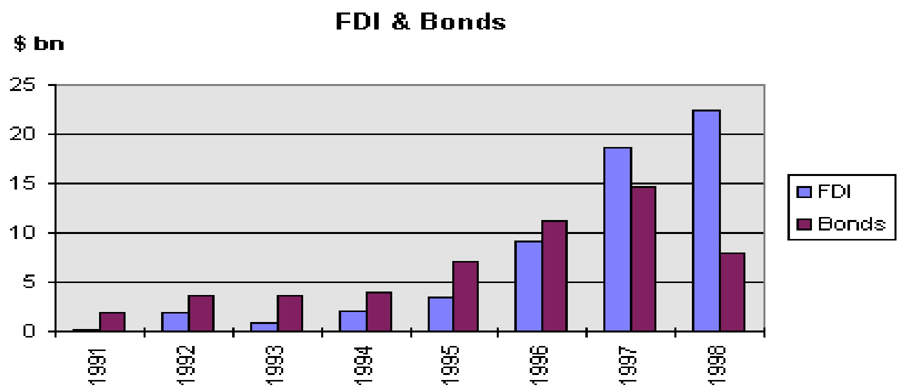
Combined with the trade openness, the overvalued, or as some would prefer, the strong and stable currency (graph 3) forced Brazilian business to cut costs and invest in new technology in order to be competitive. The vast privatization program introduced by the government, selling businesses worth a total of US$ 45 billion, boosted market's confidence in the country, and Brazil managed to attract record levels of FDI. Bond issuance was another important source of financing, and also in this aspect Brazil reached record levels (graph 4).



Graph 3

Source: Salomon Smith Barney

Graph 4



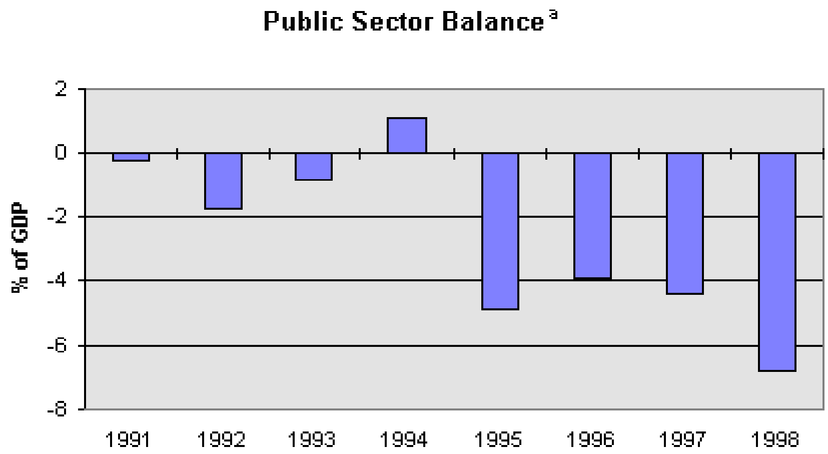
Source: Central Bank of Brazil

Besides that, the portfolio investment inflow to the country was also very high, as a consequence of high interest rate levels Brazil has held since March 1995, when the currency suffered its first speculative attack, as a consequence of the Mexican peso crisis. The introduction of a flexible exchange rate band, in March 1995, was important to the overvalued currency to start reverting this situation, with the pace of devaluation increasing, compared to falling levels of inflation.

The combination of the facts above took Brazil to an unusual high level of reserves, which reached its peak in April 1998, adding to a total of almost US$ 75 billion. If at one hand these reserves would give more strength to the Central Bank to defend the currency, on the other hand the fiscal costs implicit in the difference of Central Bank assets and liabilities interest rates were added to the fiscal side problems.

Along with the deficit in the current account, as seen above, Brazil has also been running large fiscal deficits since the implementation of the Real Plan (graph 5). More than a loosening in fiscal policies, it shows that the loss of the power of using inflation to reduce the real value of payments was not balanced by the needed fiscal reform. The two announced big fiscal squeezes did not have the wanted effect. The rise of tax side happened, but the cut in expenses was not significant.

Graph 5



Source: Central Bank of Brazil

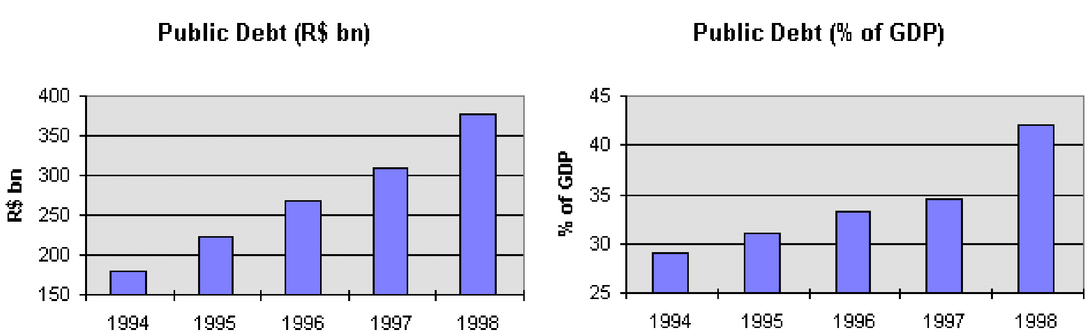
a Refers to the operational financial balance

In fact, the high interest rates and the massive inflows of foreign capital helped the country sustain a situation of external and internal imbalances. In order to operate monetary policies facing capital inflows, the Brazilian Central Bank had two option: it could simply convert the hard currency that was entering the country into *reais*, expanding the monetary base and facing the risk of the return of inflation, or could sterilize the inflows by issuing debt. The second option seemed the best in a country with such an extensive history of battling inflation without success, and that had so recently managed to bring the level of prices to a stability never seen in decades.

In the political aspect, the opinion polls in the country pointed that the high approval rate of the government was mainly due to price stability. Low inflation rates have a wealth redistribution effect, giving to the less wealthy sectors of the population access to a wide range of goods that were not available to them before. The end of the "inflationary tax", and access to credit rose the medium living standard of the poor. The level of poverty shrunk, and we can conclude that stability was really something the government should struggle to maintain. Especially when Mr. Cardoso was running for reelection, in 1998.

But all this did not come without a price. Choosing to sterilize the capital inflows with debt issuance, the pressure over the interest rates and the public balance tended to rise. The internal debt was pushed up from around R$ 180 billion in 1994 to almost R$ 400 billion by the end of 1998, which means 42% of GDP, from a previous level of 29% of GDP, in 1994 (graph 6).

Graph 6



Source: Central Bank of Brazil

The financial sector deserves special mention. Inflation developed a very modern and competitive banking system. The level of lending, although, was not very high, since investment and consumption were not privileged. After stabilization, the initial economic growth compelled many banks to raise the lending, but a quick surge in non-performing loans halted this process. Nevertheless, some banks that relied heavily on gains due to "floating" could not adjust themselves to stability times. That way, the government launched the "PROER", a program intended to restructure the financial sector, closing or selling to competitors, often foreigners, banks that were on an unsustainable financial situation. This way, although increasing public debt to finance the PROER, Brazil has today a sound banking system, which is a very important barrier in crisis periods to avoid dissemination of the crisis throughout the economy.

That was, in a brief overview, the situation of the country by the end of 1998. As we saw above, the capital flows played an important role in this economic environment. With the liquidity crisis in the international capital markets that started with the Asian crisis in October 1996 and achieved its peak with the Russian debt moratorium, in mid-1997, the capital inflows to Brazil were halted. In effect, Brazil started to observe capital outflows in a larger amount than the inflows. That was probably caused not only the adverse external environment, but also by the perception of the agents in the market that the needed structural reforms in the country were not underway.

By mid-January, 1999, internal political pressures and the deployment of the level of reserves of the Central Bank forced the country into devaluation. The capital flight was not only due to international investors, but also many Brazilian residents pushed the country into this, exchanging the domestic currency for dollars. Not even an agreement with the IMF that would make available for the country an emergency financial help up to US$ 41,5 billion was able to sustain the currency. The economic authorities adopted orthodox fiscal and monetary policies approved by the IMF, and now Brazil is expected to see its GDP shrink by 3,5-4% in 1999, to hopefully start the recovery in 2000.

By the end of March 1999, the public sector’s consolidated debt was expected to add up to R$ 506 billion, a rise to 52% of GDP, because of the heavy reliance on short-term variable interest rates and dollar-indexed debt. Some may worry that Brazil is close to a debt trap, where high interest rates may carry an unsustainable fiscal deficit cost to the government. The rollover risk of the debt is also likely to increase. To avoid that, Brazilian officials are counting on a steady fall in interest rates by the second half of 1999, allied with a strong fiscal surplus, to reach the debt/GDP ratio of 46% by 2001 agreed with the IMF.

3. - Capital Controls and Brazil

Trying to wonder how Brazilian’s situation would be today *if* some forms of capital flows restraints would have been adopted in the past years would certainly be a hard task. The defendants of capital controls would argue that a lower level of external savings inflow would avoid a certain moral hazard situation, pushing the government into a more restraining fiscal policy. That way, the market would have a better perception of the macro fundamentals of the country, and massive capital outflows would be less likely to happen. Also, less dependence on short-term capitals would make the country less susceptible to speculative attacks.

The arguments above sound logical, but we have to point out the fact that Brazil had, and still has, an instrument to regulate capital movements, and it was somehow used during this period. The IOF (Tax over Financial Operations) is an up-front tax imposed over forex transaction, except for trade operations, and since 1994 its percentage varied from 0% to 10%. This tax ultimately has the same effect of a "Tobin Tax", or the reserve requirement for portfolio flows in Chile. It can be seen that, the less the capital stays in the country, the bigger the burden of the tax is. In fact, while the tax was kept in higher levels, some shorter-term capital really had to stay away from the country.

Albeit the fact that the Brazilian monetary authorities claimed that IOF was intended to keep "short-term speculative capitals" away from the country, the frequent changes observed in this percentage did not exactly reflect the government’s willingness to let the country be more or less exposed to international capitals, but instead it was a response to the financing needs of the country. In other words, it was a reflection of the lack of the necessary reforms in the fiscal aspect.

Instead of wondering what could have happened if Brazil had adopted some more effective capital controls, it looks more useful to think what the country can do now, in face of the situation described above. It seems widespread consensus that in a country with sound macro fundamentals, the harms of capital controls would overwhelm its benefits. The only objection to this point is referred to the so-called "quality of the capitals", which means, in broader terms, short-term capital, or "hot-money".

For sure, the longer the term of the liabilities of any economic agent, the better its situation, all other things equal. But this is not a valid argument against the free mobility of capital, which can help, if properly used, developing countries in economic growth, and turn it into employment, wealth and ultimately better living standard to the poor. By properly used we mean not using the external outflows to finance consumption or fiscal deficits, but direct it to investment, preferably on the private sector. It would also be wishful that these investments could generate returns in hard currencies, in order to assure the reserve flows that would be necessary when the capital revenues start to get repatriated.

Today Brazil is a country fully integrated to the global economy, despite its relatively small participation in world trade. The biggest multinational companies are already present in the country, and while many of them have plans of investing even more, many others have plans of entering the country, to benefit from its enormous potential business opportunities. The main global financial institutions have a significant exposure in Brazil. Besides that, with the implementation of Mercosur, other countries of the region have strong economic links with Brazil. So, spillover effects of Brazilian's economic situation are very likely to be spread around South America, and not only that, but the perception of all other so-called "emerging markets" is influenced by the economic performance of the country.

So we believe that Brazil today is not only a single player in the world market, or just one more "small country", in the international economics theory sense, but a very important country in the world context. And if the country wishes to somehow benefit from that, it must be conscious of the importance of the world markets as an instrument to achieve its goals, by financing Brazilian's investment needs. Brazil must know that it depends, in many ways, upon "selling" itself not only as a profitable, but also as a safe place for investing, if it wants to keep receiving external savings.

The conclusion, then, is that Brazil must be aware that if any "unfriendly" or unilateral measures that ultimately implies in "changing the rules" in the middle of the "market game" will have severe consequences in terms of losing the confidence of international markets. Contracts, once established, must be respected, enforced and performed. This is a very important aspect in business that has to be settled inside a modern culture. As said before, capital controls should be adopted only if no other better alternative is possible. And the better alternative is to have no barriers to capital flows. Restraints should be imposed only in the case that the mobility of capital could cause extreme harms to a country, bigger than the harms of imposing controls.

For sure, the big problem here is how to measure which situation would be worse. That is a task too heavy for government officials alone. Some previous discussion with the society would be recommended. Finally, imposing capital flows restraints that would somehow harm the freedom of investments already started would be seen much worse than imposing controls over new investments. In other words, if some restraints should be taken, restraints on capital *inflows* are preferable to restraints on *outflows*.

5 - CONCLUDING REMARKS

We started the paper discussing some important concepts about capital controls. Basically, what they are, and in which ways they can be implemented. Then we highlighted two of the most often commented proposals for controlling capital flows.

In the following chapter, we presented two cases of countries that have recently adopted different measures affecting capital flows. Finally, we discussed Brazilian's recent economic evolution, and as a derivation from what we have seen before, how capital controls could help or harm the country's economy, if they should be implemented.

What we concluded after all is that capital controls, analyzed separately, in most common situations, are indeed not helpful. They tend to be costly, cause inefficiencies, and can be a potential source of corruption. Besides that, at the long term, market agents would tend to prefer, all other things equal, to invest in countries where freedom of capital movements has been more present throughout time. Despite that, some kind of restrictions that tend to push the profile of the liabilities towards a long term, productive investment directed capital, can be desirable. Especially if economic fundamentals are not solid, and if it is not possible, in the short-term, to promote the necessary reforms. If the government has decided to implement anti-cyclical measures to soften the economic activity patterns in the short run, controls can effectively help.

It may serve as a lesson to Brazil that, in spite of many negative forecasts due to the imposition of capital controls, Chilean economy is doing well if compared to others in Latin America. Malaysian economy, although the short period of observation since the adoption of capital flow restraints, seems to be in its way to recovery. So, capital controls, although can arguably have bad effects, do not necessarily imply total disruption of the economy of a country.

But it has to be kept in mind that controls will not work as a panacea, and will not adjust economic fundamentals by themselves. This way, when Brazil starts to develop economic recovery, the preferable situation is to have its fundamentals in order, so the incoming capitals are very likely to have the desired profile, and no restrictive measures will need to be taken.

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