

NECESSITY OF APPLYING RESTRICTIONS ON CAPITAL FLOWS FOR THE DEVELOPING COUNTRIES

VICTORIA TIMUȘ *

ABSTRACT: *Despite of the multitude of advantages provoked by foreign capital for the developing countries, and namely as a result of foreign investments' efficient implementation in real sector of national economy, international practice of many countries from the last years, emphasizes a very stringent picture – the financial international market is supposed to a high instability, volatility in the directionning of capital flows, currency and financial crisis. Also, nowadays another avalanche of inflows attack the transition economies, namely, those resulting from transferring money gained abroad by migrants, which destabilizes not only the capital account from the Balance of Payments, but also, the whole macroeconomic indicators. That is why, it becomes actual not the problem of attracting capital into the national economy of one's country, but, very often, of finding measures to discourage financial flows' entrance - so of applying restrictions on capital account.*

KEY WORDS: *Tobin Tax, capital inflows, capital outflows, financial crisis, "contagion" effect, capital account, capital disequilibrium, Balance of Payments, economic cycle.*

The interest in using capital flows' restrictions appeared in the wake of currency crisis attested in Thailand, Indonesia, North Korea in the second half of 1997, Russia and Brazil in 1998-1999, which demonstrated a "contagion" effect, when a crisis launched in one country extends to other countries in the frame of a region or economic union, or simply among countries having economic and financial relations.

Among all the ideas of supporting or rejection the financial liberalization, there can be emphasized at least two moments:

On the one hand, the promoters of introducing restrictions on the free movement of capital, put the accent on the crises, which attacked a lot of countries, inefficiency of markets' activity under new rules, speculative attacks over weak developing countries.

* *Scientific researcher, Ph.D. Student, Institute of Economy, Finance and Statistics, Academy of Sciences of Moldova*

On the other hand, the adepts of financial liberalization support the idea that any intervention for discouraging short-term capital flows will also affect long-term capital flows, which are vital for economic growth of transition countries.

The nature of transactions and structure of regulation that can influence international capital movements are, however, potentially numerous and highly complex. In some countries the use of capital controls is pervasive, while in others it is selective. In some countries the structure of controls appears to be a legacy of the past, while other countries appear to use controls as active instruments of macroeconomic and structural policy. In order to design programs of liberalization of the capital account, or the regulatory frameworks for capital movements, it would be helpful to know what factors have generally led to the regulation or deregulation of components of the capital account. In designing such programs, it would also be useful to know if the regulation or deregulation of certain capital transactions has generally been associated with the regulation or deregulation of other transactions.

Economists agree upon the fact that many developed countries are forced to contract loans from the markets in transition as a result of the high rate of recovering on the domestic capital and the investment can be financed from cheaper sources from the foreign markets. Investors from developed countries do not only have the opportunity to take advantage as a result of placing own resources on emergent markets, but also have the opportunity to diversify risks and diminish costs.

Also, due to penetration of foreign financial institutions on local market, the domestic financial market's efficiency increases. The over-regulated and potentially inefficient domestic institutions obtain a high stimulant to compete, and the Government is forced to consider international procedures of capital market regulation.

An efficient activity of any economy, where prevails foreign capital directly depends on the investor' or creditor's attitude. In countries where the Government applies inefficient policies, investors can suddenly change their investment behaviour, withdrawing the invested capital, thus, severely punishing the host country of the invested capital.

Also, the crisis can affect a developed economy, with apparently strong principles of activity. The macro-level extension of crisis through the whole region or group of countries, as shows the recent experience, proves the inefficiency of the whole global financial system.

So, international practice knows some ways of stopping capital flows, the measures of discouraging capital movement, the so called method of "*sand-in-the-wheels*", by means of which these capital flows can be easily controlled and managed.¹

Types of Capital Transactions possibly subject to controls are given in Table 1.

¹ R.B.Johnson & Natalia T. Tamirisa, Why do countries use capital controls, International Monetary Fund, Monetary and Exchange Affairs Department

Table 1. Types of Capital Transactions possibly subject to controls

INFLOWS	OUTFLOWS
Capital and money markets	
Shares and other securities of a participating nature	
Purchase locally by non-residents	Sale or issue locally by non-residents
Sale or issue abroad by residents	Purchase abroad by residents
Bonds or other debt securities	
Purchase locally by non-residents	Sale or issue locally by non-residents
Sale or issue abroad by residents	Purchase abroad by residents
Money market instruments	
Purchase locally by non-residents	Sale or issue locally by non-residents
Sale or issue abroad by residents	Purchase abroad by residents
Collective investment securities	
Purchase locally by non-residents	Sale or issue locally by non-residents
Sale or issue abroad by residents	Purchase abroad by residents
Derivatives and other instruments	
Purchase locally by non-residents	Sale or issue locally by non-residents
Sale or issue abroad by residents	Purchase abroad by residents
Credit operations	
Commercial credits	
To residents from non-residents	By residents to non-residents
Financial credits	
To residents from non-residents	By residents to non-residents
Guarantees, sureties and financial backup facilities	
To residents from non-residents	By residents to non-residents
Direct investment	
Inward direct investment	Outward direct investment Controls on liquidation of direct investment
Real estate transactions	
Purchase locally by non-residents	Purchase abroad by residents Sale locally by non-residents
Provisions specific to commercial banks	
Non-resident deposits Borrowing abroad	Deposits overseas Foreign loans
Personal capital movements: deposits, loans, gifts, endowments, inheritances and legacies	
To residents from non-residents	By residents to non-residents
Settlements of debts abroad by immigrants	
Transfer into the country by immigrants	Transfer abroad by emigrants
Provisions specific to institutional investors	
	Limits (max) on securities issued by non-residents and on portfolio invested abroad Limits (max) on portfolio invested locally

In their essence these practices base on the application of restrictions on either entry or outflow of capital, are the following:

Capital outflow discouraging - this method was not only used by small and developing countries, but also by the high industrialized countries. Among the well known examples are USA policies from '60s regarding the establishment of equivalence tax on interest and the volunteer program of minimizing the volume of credits granted to other countries by banks. The establishment of a limit on the volume of credits granted by banks abroad was practiced by Italy and France during the '80s.

Such measures prevent a possible sudden outflow of capital from a country, also they diminish the risk of the country's reserve volume, as well as of interest rate increase. Besides all the above mentioned, such practices decrease net national borrowing, because of the fact that investors don't want anymore to invest in such an economy due to the risk of uncovering costs and initially invested capital. China succeeded to avoid the Asian financial crisis, because of the fact that the capital account convertibility was very low, thus it was protected from over-borrowing.

Discouraging of capital inflow - can appear as a result of preventing from over borrowing or over appreciation. As indicators for wonder for a national economy serve a high volume of capital inflows as weight in GDP or volume of exports, as well as national currency appreciation. Before the financial crisis starting from Thailand and Mexico, the volume of capital inflows in these countries attested high dimensions.

Many economists consider that it is easier to control capital entries than capital outflows, as demonstrated the experience of many countries, as it is "easier to make the capital off ones country than to retain it contrary to its desire".

Borrowing is the process, which can bring advantages not only for the creditor-country, or the foreign investor, but also to local economy, in case if the domestic market functions according to efficient principles.

An economy, were governs the rule of law, good economic policies, exists a strongly regulated financial market, with a high capital marginal product, should resist to a high indebtedness rate and be able to absorb the advantages resulted from the efficient implementation of the attracted resources.

The application of restrictions on the inflows of foreign capital should be a temporary action, only in the moments of appearance of signs, which attest a possible risk event, or financial disequilibrium - "*the umbrella should be open only when it rains*". According to the experience of Chilli, such restrictions were introduced only during the boom phase of economic cycle, when the volume of inflows was too high. Also, restrictions can be useful, when the Government needs time to think upon the way of foreign capital directioning. In case if the restrictions continue to be applied after the crisis' over passing, the economy risks to get isolated from the rest of the world and, thus, forced to find by itself financial resources.

Capital inflows structure' modification - according to statisticians, the structure of funds entering one economy is important as sources of generating a financial crisis, and namely the currency crisis and their over passing.

Thus, two main hypotheses are observed:

1. *The more are the weight of FDI, the more reduced is the possibility of attacks on one economy by crisis;*

2. *The higher is the volume of foreign borrowing in foreign currency by banks, the more evident is the production of a currency risk*².

The bank flows are more vulnerable in face of financial crisis, despite of other ways of financing. A high gap between the short-term liabilities and long-term bank assets makes a country vulnerable. But there also should not avoid the fact that FDI also can be risk generating and can provoke volatility in the structure of Balance of Payments of one country. For example, during a crisis, foreign companies can transfer funds from their representatives placed abroad to their central headquarter, despite of the existent controls. In any case, it is less probable, that the host countries of FDI can have disadvantages as a result of currency crisis.

As one of the measure in the framework of the given restriction, would consist in application a tax on short-term capital entries, the fact which can stimulate long-term capital inflows in one economy. Such an action promoted on behalf of the Government, will directly contribute to the change of capital composition coming to a country and to the attraction of financial resources, which can be efficiently used for the economic development of a country.

The example of applying this measure is known in Chilli, in 1991 by local authorities. Initially it was foreseen to maintain an amount of 20% from the volume of foreign credits taken by banks on a special account opened at Central Bank. The deposits' maturity varied from 90 up till one year, according to the credit's maturity and no interest on this deposit was foreseen. Consequently, in 1992 the obligatory reserves' requirements increased up till 30% from the whole amount of contracted credits, with fixed deposit period – one year, irrespective of the nature of credit. Also, it was obligatory that all FDI remain at least one year in the country.

This way of retaining one part of funds, is a kind of penalty for those banks, which contract short-term credits in foreign currency. Also this method can be applied as a lever in the country's monetary policy, when it is necessary to sterilize some quantity in foreign currency, in order to prevent the increase of foreign currency supply and, thus, appreciation of national currency.

Tax applied on all transactions in foreign currency - „Tobin Tax”, supposes application of a small tax on all transactions of buying/selling of foreign currency, indifferently of the nature of transaction. Indirectly, this method discourages the movement of short-term capital movement. Taking into consideration that the efficiency of long-term transactions is about 30-40%, a small tax applied will not affect the transaction's efficiency, despite the short-term operations.

Also, it should be guaranteed that one uniform tax is applied on all markets for the expected result, because the participants on the currency market can easily use, for example, space arbitrage. Another condition stipulates that this method be applied in countries with a floating currency regime.

² IMF, Liberalization of the Capital Account: Experience and Issues, IMF Occasional Paper Nr. 103

Another problem which relates to the entrance of capital in one economy, concerns the transfer of money by migrants back home. Thus, the volume of foreign currency entering in one national economy has a very destabilizing effect not only on the currency exchange rate, but also on the whole currency reserves. In this domain, the applied policies, which refer to usage of some restrictions on capital entrance, or a tax on the volume of the remittances, can be inefficient, as migrants can easily use illegal ways of transferring money home. Thus there should be find measures which would stimulate the population to place money in real sector not in consumption. Relevant examples in this sense are attested in countries from Latin America, Japan, where were promoted the method of direct collaboration with the migrant, through creation of business consulting centres, propagation campaigns on education the patriotic spirit and enthusiasm, hiring the immigrants in representatives placed abroad, and so on.

Before applying a certain method of discouraging capital flows, the Government officials should consider very carefully the expected results, as well, through a careful analysis of the current macro-economic situation, foreseen the future outcomes as a result of introduced policies and reforms.

REFERENCES:

- [1]. **Johnson, R.B.; Tamirisa, N.** - *Why do countries use capital controls*, International Monetary Fund, Monetary and Exchange Affairs Department
- [2]. **IMF** - *Liberalization of the Capital Account: Experience and Issues*, IMF Occasional Paper Nr.103