

What Are Capital Controls?

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Since many recent financial crises have been triggered by large reversals in international capital flows, maintaining the stability of the financial system is a big policy challenge of our time. Targeted at certain capital flows that exacerbate systemic risks, capital controls can be useful policy tools in preventing or mitigating financial crises of various kinds.

Capital controls are regulations that restrict or prohibit the movement of capital across national borders. The regulatory measures are designed to govern the capital account of a country's balance of payments and, therefore, include restrictions on the movement of capital into or out of a country. Capital controls can regulate a wide range of cross-border transactions carried out by non-residents and residents in a country. These transactions may include money transfers, direct investment, portfolio investment, bank loans, etc.

For example, a tax applicable only on non-residents' investments in domestic bonds or equities is a capital control. Similarly, caps on foreign equity investment in specific sectors (such as banking and defense) or limits on overseas investments by residents are classified as capital controls because these measures regulate the inflow and outflow of capital in a country.

Types of Capital Controls

Capital controls can be a combination of official, legal, and quasi-legal instruments and can take a wide variety of forms including taxes on cross-border flows, unremunerated reserve requirements, investment caps, minimum stay requirements, multiple exchange rate system, credit regulations, and outright prohibitions on certain types of capital movements.

Capital controls come in several varieties. Some capital controls are sector-specific or industry-specific, while others are applicable on the entire economy; some controls are specifically targeted at stemming short-term

capital flows, while others are intended for regulating medium-term or long-term capital flows; some capital controls are market-friendly while others are not.

Capital controls can be broadly classified into three categories: quantity-based, price-based and regulatory.

Quantity-based controls involve explicit limits or prohibitions on capital account transactions. Such quantity-based measures on inflows may include a ban on investment in money market instruments; limits on short-term borrowing; and restrictions on certain types of securities that can be owned. In India, for instance, there is a cap on the aggregate foreign ownership of rupee-denominated government debt. The quantity-based controls on inflows are often used to limit the foreign ownership of domestic financial assets and to insulate the domestic market from international developments. On outflows, quantity-based controls can take the form of an explicit moratorium. In September 1998, for instance, Malaysia imposed quantity-based controls on outflows to eliminate offshore ringgit market.

Price-based controls seek to alter the volume of capital transactions by altering their cost, with the intention of discouraging a particular class of flows and encouraging another set of flows. Price-based controls on inflows can take the form of a tax on stock market purchases and certain foreign exchange transactions; or imposition of unremunerated reserve requirements (URR) on certain types of capital inflows. The URR (known as *encaje*) on foreign loans imposed in Chile during the 1990s is a well-known example of price-based controls. Under Chile's *encaje*, anyone borrowing money from abroad had to deposit a set portion of the loan for one year in a non-interest bearing account at the central bank. In December 2006, Thailand also introduced the URR to deter short-term capital inflows and to curb one-way speculation on the baht.

The imposition of 2 percent tax on foreign portfolio investments in Brazil in 2009 is another example of price-based capital control because the tax increases the cost of the flow. Price-based controls on outflows can typically take the form of an exit tax.

Regulatory controls can be both price-based and quantity-based, and such a policy package usually treats transactions with non-residents less favorably than with residents and directly influences the volume of financial transactions.

Closely related to capital controls are macroprudential regulatory measures (such as limits on loan-to-value ratios or capital buffers – the mandatory capital that banks are required to hold in addition to other minimum capital requirements) that do not discriminate on the basis of residency of parties involved in a financial transaction but can indirectly influence inflows through restrictions imposed on domestic financial institutions. Many emerging market economies (EMEs) often use both capital controls and macroprudential measures to maintain financial stability.

– Kavaljit Singh

Balance of Payments

The balance of payments (BoP) is a statistical statement that comprises of a current account and a capital account.

Current Account deals with the payments and receipts for immediate transactions, such as the sale of goods and rendering of services. It is further subdivided into the merchandise or visible account (also termed the trade account) comprising the movement of goods; and the invisible account, comprising the movement of services, transfers (such as remittances, gifts and grants), and investment income.

Capital Account (also known as the financial account) deals with loans, investments, other transfers of financial assets and the creation of liabilities. Unlike current account entries, entries in the capital account indicate changes in future claims. It is further subdivided into long-term and short-term capital, the former relating to capital employed for investment purposes, the latter to bank advances, trade credit, etc. Long-term capital is again subdivided into direct investment capital and portfolio investment capital.

Capital Controls	Historic Usage
Direct tax on foreign investments or short-term external borrowing	South Korea 2011; Thailand 2010; Brazil 2009; Argentina 2001; Brazil 1994
Unremunerated reserve requirements (URR) on foreign borrowing	Peru 2010; Indonesia 2010; Thailand 2006; Argentina 2001; Malaysia 1994; Columbia 1993; Chile 1991
Minimum stay requirement on investments or extending maturity of debt	India 2014; Columbia 2007; Thailand 2006; Argentina 2001; Malaysia 1998; Brazil 1994; Chile 1991
Quantitative limits on investments	India 2014; Indonesia 2010; Columbia 2007; Thailand 2006; Argentina 2001; Malaysia 1994; Chile 1991
Foreign exchange restrictions on residents and non-residents	China 2016; India 2013; Iceland 2008; Argentina 2001; Malaysia 1998; Thailand 1997