In or Out?

The looming prospect of capital controls complicates investment decisions

By John Rubino

For most Italians, 7 June was like any other day—which is to say uncertain and stressful, given their country's starring role in the eurozone crisis. But for customers of Italian Bank Network Investments SpA (BNI), things took an even darker turn when they discovered that the troubled bank had frozen their accounts, leaving many unable to pay rent or buy groceries.

Individual banks sometimes run into trouble, of course, so BNI was easy to dismiss as an isolated event—until two weeks later, when the eurozone announced that it was considering systemwide capital controls, including bank withdrawal limitations, to prevent the Greek crisis from spreading. Suddenly, the life-changing difficulties of BNI's Italian customers were a possible "new normal" for much of the continent.

And Europe is not alone. The whole world appears to have entered—or reentered—an era in which the rules governing financial accounts and capital movement are routinely changed with the stroke of a pen. Just consider a few examples: Iceland now requires that firms seeking to invest abroad get permission from the central bank, and individual Icelanders need government authorization to buy foreign currency or travel overseas. Greece is pulling funds directly from accounts of suspected tax evaders, without prior notice or judicial due process. Argentina has banned the purchase of U.S. dollars for personal savings and requires banks to make loans in pesos at rates considerably below the true inflation rate. And the U.S. Federal Reserve has proposed that money market funds be allowed to limit withdrawals of customer cash in times of market stress. The list goes on, but the point is disturbingly clear: Extreme times are spawning rules that limit capital movement and vastly complicate investment decisions.

EXCESSIVE DEBT AND HOT MONEY

For most of the past three decades, conventional wisdom held that capital should be free to wander the globe in search of its most efficient uses (see the sidebar "A Brief History of Capital Controls" on page 49 for a little background). So why the sudden trend reversal? In a word, debt. As developed countries have borrowed ever more excessively, their financial systems have become increasingly complex and fragile. "If your banks are levered 20 to 1 and assets waver by 5%, you have no capital," says Eric Sprott, CEO of Sprott Asset Management, a Toronto, Canada-based hedge fund family. According to Sprott, when bank assets are measured accurately, they have already fallen by enough to make most developed-world financial systems technically insolvent.

Central banks in Japan, Europe, and the U.S. have responded to this systemic fragility by slashing interest rates, which has sent hot money pouring across national borders in search of shelter and/or higher yields. The resulting carry trades, safe-haven flows, and localized banking crises have induced a growing number of governments to restrict capital movements to protect their domestic economies.

Policymakers, leading from behind, appear to have accepted the inevitability of this new world order. The International Monetary Fund (IMF), for instance, once considered capital controls to be unacceptable in virtually any circumstance. But "the unfettered, unambiguous embrace of free capital flows no matter what has been walked back a bit," says Douglas Rediker, a senior fellow at New America Foundation (a think tank in Washington, DC) and former member of the executive board of the IMF. "Now, the position is that capital controls are never the main choice but there are instances where they can benefit some countries."

IN OR OUT?

Capital controls come in a variety of forms, many of which overlap with monetary and fiscal policy and thus are tricky to analyze (see the sidebar "Capital Controls: You'll Know Them When You See Them" on page 52 for a discussion of what is and is not a capital control). But one key distinction involves the ultimate goal: Are they meant to keep capital in or out?

PLEASE GO AWAY. To have the whole world clamoring to buy your bonds, factories, and farmland certainly seems like a compliment, and to an extent, it is. But too much of a good thing is just as problematic in finance as in the rest of life. A large inflow of foreign capital can push up domestic inflation, making life harder for citizens while raising the local currency's exchange rate, potentially pricing domestic exporters out of world markets. Neither outcome is pleasant for politicians hoping to be reelected, and target countries are responding in a variety of ways. Some notable examples:

- Asia's strongest emerging economies are mirror images of the decadent developed world—they run trade surpluses and have well-capitalized banks. This combination of stability and growth is attracting hot money from virtually everywhere, leading most recipients to try to manage the flow. South Korea now restricts foreign currency loans to the purchase of raw materials, direct investment, and repayment of debts. China bars foreign investors from local money markets and derivatives and has a complex approval process for foreign firms wishing to trade equities. Taiwan prohibits foreign funds from investing in time deposits and limits the amount of foreign currency that can be held by banks—and has been publicly urging other Asian countries to do the same.
- Brazil's strong growth and double-digit interest rates attracted a massive carry trade in 2010, which sent the Brazilian real soaring, ignited a local property bubble, and threatened to price Brazilian exports out of world markets. After a bit of high-profile complaining about a "currency war," Brazil began taxing capital inflows and required Brazilian financial institutions to deposit part of their short dollar positions with the central bank.
- Switzerland, the perennial safe haven, has lately been inundated with capital fleeing the eurozone, which pushed the Swiss franc to troublesome levels in 2011. The Swiss government then pegged the franc at €1.20 and vowed to print as much new currency as necessary to maintain the peg, in effect committing the franc to eurozone levels of inflation going forward. If this policy doesn't work, Swiss National Bank chairman Thomas Jordan recently threatened capital controls and/or deeply negative interest rates.

NO EXIT. At the other end of the spectrum are the Greeces of the world, where past mismanagement has sent capital running for the exits, threatening to empty out banks and national treasuries and prompting governments to trap remaining capital behind regulatory walls. Some examples:

- Iceland allowed its banks to run wild in the previous decade and became the first casualty of the 2008 crisis. The government responded by allowing overleveraged banks to fail while protecting local depositors, denying foreign holders about US$85 billion in debt, and imposing comprehensive capital controls—with the active cooperation of the IMF. (For more on Iceland's case, see the interview on page 44 with Már Gudmundsson, governor of the Central Bank of Iceland.)
- Spain saw €195 billion depart its banking system in the first six months of 2012 (see chart on page 51). Bond yields soared, threatening a death spiral in which maturing paper is rolled over at ever-higher rates, causing interest costs to explode. In response, Spain banned equity short sales and cash transactions exceeding €2,500 and entered bailout negotiations with Germany and France (ongoing as this article was written in August).
- The U.S. is a tangle of contradictions. As the manager of the world's reserve currency it remains a magnet for global capital, and Treasury yields have plunged to record lows as the eurozone situation has crested. But it also has mounting public and private debt and a banking system encumbered with hundreds of trillions of dollars in derivatives.

"IT IS CLEAR THAT A NEW ERA HAS ARISEN. INSTITUTIONS SUCH AS THE IMF NOW RECOMMEND THE NATIONAL USE OF CAPITAL CONTROLS, AND MANY NATIONS ARE FOLLOWING SUIT."

At the moment, capital movement in and out of the U.S. is relatively free. "One of the reasons that people like the U.S. is that you can take your money back out again," says Alex Merk, president of the Palo Alto, California-based Merk Hard Currency Fund. But Washington's trillion-dollar structural deficit points to future instability, while some of its recent actions might be interpreted as preparation for capital controls: American taxpayers must now report offshore accounts on two different forms at two different times of the year, under the threat of large fines. Foreign banks with U.S. account holders must report those accounts in great detail to the Internal Revenue Service or risk losing access to U.S. markets. Two U.S. senators recently introduced a bill dubbed the "Ex-PATRIOT Act" that would raise taxes on wealthy Americans who renounce their citizenship. And as already noted, the Federal Reserve now favors giving money market funds a "minimum balance at risk" by locking up some portion of each account in an emergency.

Add it all up, and "the U.S. already has de facto capital controls," says Doug Casey, chairman of Stowe, Vermont-based investment advisory Casey Research. "It's rather clever how they've done this. It's very hard for an American to open a bank account elsewhere in the world. Foreign banks don't want American money because there's too much liability risk, too much reporting. So a lot of people who might want to move money overseas will be discouraged after the first bank tells them they don't want American business." In any event, says Casey, "There is no question that we've created conditions for future capital controls."

DO CAPITAL CONTROLS WORK?

Will ubiquitous capital controls moderate systemic volatility going forward? The answer depends on whom you ask.

Iceland, for instance, is thriving just a few years after a near-total collapse, reporting GDP growth of 4.5% year over year in the first quarter of 2012, returning to the market in early 2012 to raise US$1 billion, and repaying some IMF loans ahead of schedule. Its central bank now intervenes in the foreign exchange market to keep the krona *down*. This quick reversal of fortune provides ammunition for those who would like to see other countries emulate its aggressive capital controls.

They should think twice, says Arsaell Valfells, a business and economics professor at the University of Iceland. "Iceland is thriving within capital controls, but the devaluation and de-leveraging [which will result when markets are reopened and foreign capital is allowed to leave] is only being postponed. The delay will make the eventual correction even harder."

Brazil has seen a dramatic slowdown that

A BRIEF HISTORY OF CAPITAL CONTROLS

In the beginning there was mercantilism, a doctrine that viewed control of trade (and hence capital) as crucial to national success. To this end, the dominant European powers of the 15th through 18th centuries granted monopolies to certain firms and ports, banned colonies from trading with other nations, and restricted domestic consumption of certain products.

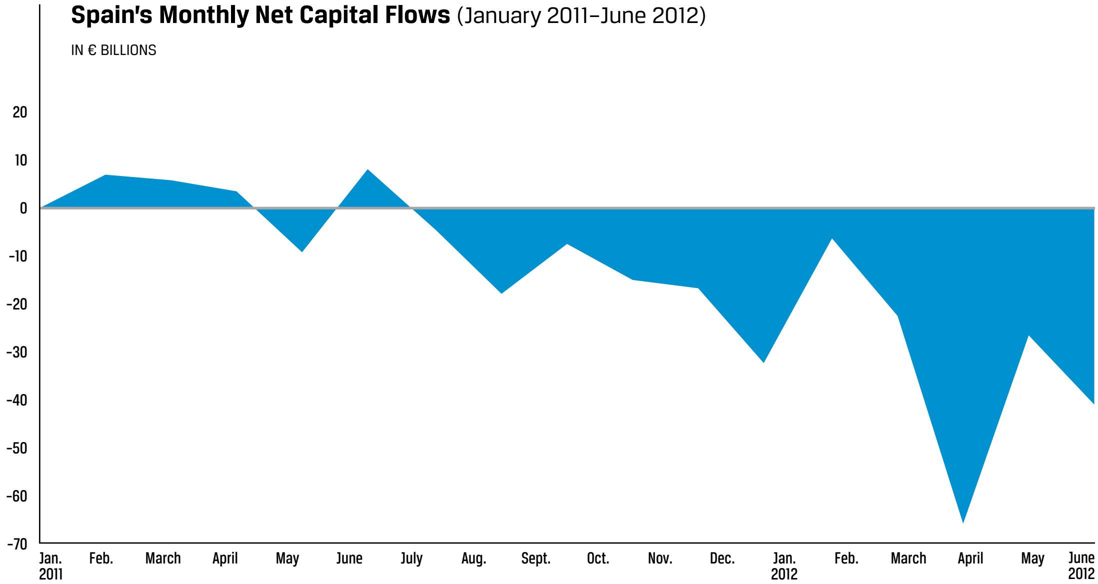
This system worked in the short run but had some longer-term drawbacks, including a tendency to antagonize competitors and cause wars. By the mid-19th century, with intellectual backing from Adam Smith and David Hume, mercantilism was largely passé in Britain and France and free trade was gaining favor.

This "first age of globalization" ended in 1914 with the start of the First World War, according to Federal Reserve Bank of St. Louis senior economist Christopher Neely in his report "An Introduction to Capital Controls."

"Modern capital controls were developed by the belligerents in the First World War to maintain a tax base to finance wartime expenditures," writes Neely. "Controls began to disappear after the war, only to return during the Great Depression of the 1930s. At that time, their purpose was to permit countries greater ability to reflate their economies without the danger of capital flight."

The post-Second World War Bretton Woods agreement explicitly permitted capital controls, with encouragement from such high-prestige proponents as British economist John Maynard Keynes. Under Bretton Woods, exchange rates were fixed and many countries limited asset transactions to control their balance of payments.

By the 1970s, these restrictions came to be seen as barriers to progress and began to lose credibility, once again in favor of free markets. This pendulum swing lasted, with some notable exceptions (such as the Asian Contagion of 1997), until the 2008 financial crisis created the current high-debt, low-interest-rate environment. Notes Boston University economist Kevin Gallagher, "It is clear that a new era has arisen. Institutions such as the IMF now recommend the national use of capital controls, and many nations are following suit." According to the IMF's annual report on exchange arrangements and restrictions, 144 countries reported engaging in some form of capital control in 2010.



Note: Based on data from Bank of Spain, which is excluded from the data set.

prompted it to put the welcome mat back out. "Now, they'd like some new capital, but people are scared, so good luck with that," says Merk.

A far better approach, argues Merk, is to run an economy correctly in the first place so it doesn't need unwieldy interventions like capital controls: "You need to provide a mature investment environment with clear rules and regulations that encourage people to start businesses. If you don't have that, then money will just chase whatever is available. China has a housing bubble because its citizens can't do anything else with their money. Spain's ban on short sales will lead investors to short the nearest proxy, which is the euro. … If you just made your system more attractive to capital, you would have less to worry about."

In Merk's view, one country exemplifies the benefits of floating exchange rates and free-range capital: Australia. When money flows in, "the [Australian] dollar rises, which slows down economic growth and does the work of the central bank. It's a healthy mechanism, a pressure valve. When you introduce capital controls, you take that valve away and end up creating much more havoc than the problems you're trying to solve."

But it's not that simple for most emerging countries. "Global capital markets dwarf individual countries," says Rediker. "One day, capital is pouring in and everybody's happy, and the next day, the bubble bursts and you're left with nothing. Capital controls can help manage this, especially on the outflow side. They're certainly not a first-choice tool. But they may be useful where there's a risk of something much worse."

ANOTHER LAYER OF COMPLEXITY

For institutions that invest globally, the reemergence of capital controls means that it's now possible to be right on a major trend or asset class and still lose because the host government changes the rules. "It's crucial to recognize that political risk is your biggest risk today, even bigger than market risk," says Casey.

For example, consider the possible impact of a major country such as Spain leaving the eurozone. "Money would pour out of Italy and Portugal and into Germany and Switzerland," predicts Sprott. This development could lead all concerned to impose capital controls to prevent bank runs and/or limit currency volatility. Investment capital might then be trapped for an indeterminate time while markets are moving in unfavorable directions.

How should investors deal with this kind of uncertainty? First, assume that capital controls will cause more problems than they solve and try to avoid them, argues Merk. "Clarity of rules and regulations is very important, especially with monetary policy," he says. "We need to know what the rule book is. One of the reasons we're out of the euro these days is because we don't know what's going to happen."

Merk believes better bets are countries "that allow market forces to play out as much as possible."

"They're rare because of policymakers' propensity to get involved," he says. "But a few countries have managed to preserve relatively free markets. Sweden has a hands-off approach. They let [automaker] SAAB go bust. New Zealand says, 'Hey, we're simply too small to intervene in the market, so we don't even try.' Australia's floating exchange rate causes short-term pain but produces lower long-term inflation. Also interesting are restrictive countries that are becoming less so. China is moving in the right direction via a series of small steps."

New capital controls have to be sprung as a surprise to prevent markets from reacting in advance and negating their effectiveness, so it's hard to predict where they will appear next. This catch makes geographic diversification even more important and makes non-financial assets relatively interesting as well, according to Casey. "Our clients are buying precious metals because none of these paper currencies are backed by anything; there's no government today that's really solvent," he says. His clients also like foreign real estate "because it's very hard to force a sale and repatriation."

COMING TO A MAJOR MARKET NEAR YOU?

Will the major economies introduce capital controls in 2013? "Certainly, [Europe] saying 'Gee, we're thinking of imposing capital controls' could catalyze the event they're trying to avoid," says Rediker. But this remains improbable. "Some bureaucrat somewhere is always planning for extreme events," he says. "That doesn't mean the official sector is embracing it. They're simply saying that if it happens, we need to be prepared for it." As for the U.S., "There's a big difference between reporting requirements and capital controls, and I don't see any scenario where the U.S. imposes controls."

Casey is less optimistic. "There are about US$7 trillion floating around outside the country, and those dollars are an additional form of debt," he says. Americans have been using this money to buy things "at essentially zero cost, giving us an artificially raised standard of living," Casey argues. "At some point, perhaps very soon, those dollars will come home and domestic prices will explode," creating the kind of crisis that, in today's world, seems tailor-made for capital controls.

Switzerland's euro peg is forcing the Swiss National bank to create francs to buy euros, resulting in a cumulative US$170 billion increase in foreign exchange reserves between May and July. In Sprott's opinion, "They can't keep buying this many euros without serious stress" and might therefore be forced to try capital controls.

In any event, "capital controls are a symptom of a bigger concern, which is the debasement of the major currencies," says Sprott. "What happens if we start questioning the currency system? Capital controls would be common, but it's not clear that they would prevent a financial crisis from getting out of control."

John Rubino, a former financial analyst, is the author of *Clean Money: Picking Winners in the Green Tech Boom* and *The Collapse of the Dollar and How to Profit from It*.

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CAPITAL CONTROLS: YOU'LL KNOW THEM WHEN YOU SEE THEM

To understand the return of capital controls, it's helpful to know what they are. One problem is that "It's not always clear where tax or spending policy ends and capital controls begin," says Douglas Rediker, a senior fellow at New America Foundation (a think tank in Washington, DC) and former member of the executive board of the IMF. Switzerland's franc/euro peg is monetary policy, and U.S. reporting requirements for foreign account holders are a tax policy. But China's limit on foreign participation in its equity markets is clearly a capital control.

The key distinction is the primary versus secondary goal. Monetary and fiscal policies aim for something else—a favorable exchange rate or faster domestic growth or higher revenues—and affect the movement of capital incidentally. True capital controls regulate the flow of funds directly.

Capital controls can also be categorized according to whether they're price or quantity based, argues Kevin Gallagher, Boston University associate professor of international relations, in a report titled "The IMF, Capital Controls and Developing Countries" (*Economic & Political Weekly*, 7 May 2011).

Brazil's tax on foreign currency transactions is price based because it raises the cost of a given deal. South Korea's limits on the uses to which foreign currency can be put are quantity based. However, "Some well-known measures combine each approach, as in the case of unremunerated reserve requirements [used by Chile, Colombia, and Thailand]," which require that "a certain percentage of a capital inflow has to be placed in a central bank for a minimum period," explains Gallagher's report. "Such a measure implicitly taxes inflows while it affects quantity by keeping certain investments in the country in the event of capital flight."

And so it goes. Putting such similar-sounding, closely-related policies into different boxes is tricky and frequently more intuitive than objective. "It's like the old definition of obscenity: I know it when I see it," says Rediker.