Commentary: Capital flows and policy in emerging-market economies

Eric Schaling

Introduction

On the first page of his paper, Harris says that the basic tool an economist pulls out for considering the connection between capital flows, exchange rate regimes and monetary policy is the Mundell–Fleming model.

He points out that most relevant to the policy discussions engaging South Africa is the model's implication that a small open economy without restrictions on external capital flows cannot have a monetary policy that targets both a domestic interest rate and nominal exchange rate. When countries are faced with concerns over monetary targets and volatility of flexible exchange rates, the open-economy trilemma proposition stimulates some to focus on whether freedom of external capital flows can or should be restricted.

Harris then looks at evidence from experiments elsewhere on the feasibility of restrictions on capital flows. His conclusion on page 55 is that "[t]he benefits of policies to affect capital flows are difficult to judge . . . Moreover, any lessons that could be drawn from any one country's experiences [such as China, Chile and Malaysia] cannot be generalised, because the effectiveness and effect of such policies are specific to the particular circumstances of that country in the relevant time." Consequently, he believes no useful conclusions can be drawn for South Africa from the experiences of emerging economies reviewed in his paper.

Discussion

I think there are a few points that can be added in order to shed some more light on the South African experience. First, although the Mundell–Fleming model was the 'Volkswagen' of open-economy macroeconomics in the 1960s (as stated by Rudy Dornbusch (1980)), it has been replaced with the workhorse New-Keynesian model (Woodford, 2003) and its open-economy variants (see, for example, Bullard and Schaling, 2006). Therefore, my first point is that more up-to-date analytical macro frameworks are needed.

In addition, useful conclusions can be drawn from South Africa's own experiences with capital controls. In order to do this I want to introduce a useful concept, namely the law of unintended consequences.

As pointed out by Rob Norton (2007), the law of unintended consequences is that actions of people, and especially of government, always

have effects that are unanticipated or 'unintended'. Economists and other social scientists have heeded its power for centuries; for just as long, politicians and popular opinion have largely ignored it.[1]

Most often, the law of unintended consequences illuminates the perverse and unanticipated effects of legislation and regulation. In 1692 John Locke, the English philosopher and a forerunner of modern economists, urged the defeat of a parliamentary Bill designed to cut the maximum permissible rate of interest from 6 per cent to 4 per cent. Locke argued that instead of benefiting borrowers, as intended, it would hurt them. People would find ways to circumvent the law, with the costs of circumvention borne by borrowers. To the extent to which the law was obeyed, Locke concluded, the chief results would be less available credit and a redistribution of income away from "widows, orphans and all those who have their estates in money".

South Africa's 40 years of experience with capital controls on residents and non-residents (1961–2001) reads like a collection of examples of perverse unanticipated effects of legislation and regulation. Of course, those unintended consequences can add so much to the costs of policies that they make the policies unwise even if they achieve their stated goals.

Capital controls in South Africa exhibited substantial institutional inertia and this same institutional inertia also applied to the monetary policy regime. A plausible reason for this is that for most of the twentieth century in South Africa capital controls and exchange rate-based monetary policies were like Siamese twins; almost impossible to separate.

For example, it appears that in the period 1995–1998 the South African Reserve Bank (the Bank) tried to escape from the open-economy trilemma by using the policy of foreign-exchange market intervention. In the past this policy was partly motivated as being a way of managing the effects of capital flows on the exchange rate.

These interventions partially contributed towards the currency crises in 1996 and 1998: for example, after the Mexican crisis and the demise of the dual exchange rate (financial rand) system in early 1995, the Bank continued to target the exchange rate of the rand within an extremely narrow band to the United States dollar.

Thus, a 40-year-long and inert culture of capital controls in South Africa – via the style of monetary policy and thinking about the economy this culture implied – indirectly contributed towards the depreciation of the rand in 1996 and 1998.

In addition, in the context of the 2001 crisis, there is *prima facie* evidence that the implementation of the remaining elements of exchange control

on residents and non-residents contributed towards the rapid depreciation of the rand in the last quarter of 2001.

Conclusion

Therefore, my conclusion is that although emergency capital controls were applied with some success during crisis times in countries such as Chile and Malaysia, based on South Africa's 40 years of experience with capital controls on residents and non-residents (1961–2001), I do not recommend these controls for South Africa.

Note

[1] Rob Norton is a columnist for *eCompany Now* magazine and was previously the economics editor of *Fortune* magazine.

References

Bullard, J and Schaling, E. 2006. "Monetary policy, determinacy, and learnability in the open economy". *European Central Bank Working Paper* No. 611, April.

Dornbusch, R. 1980 *Open economy macroeconomics*. New York: Basic Books.

Norton, R. 2007. "Unintended consequences". In Henderson, D R (ed.). *Concise encyclopedia of economics*. [O:] http://www.econlib.org/library/Enc/UnintendedConsequences.html#biography.

Woodford, M. 2003. *Money, interest and prices: foundations of a theory of monetary policy*. New Jersey: Princeton University Press.