The Economist

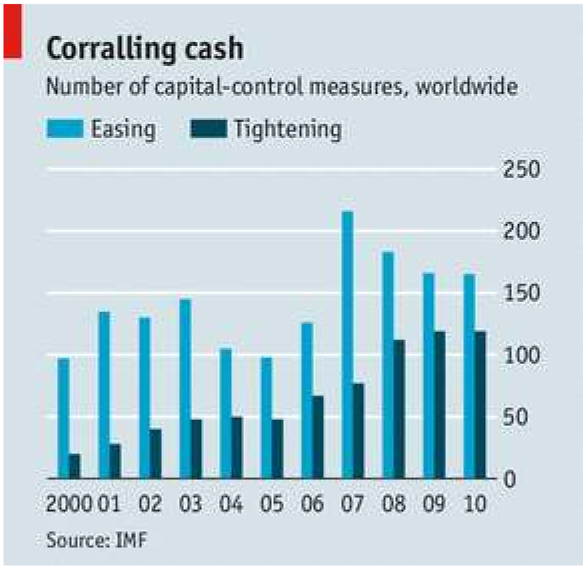
Capital controls

Cash cowed

Cyprus is only the latest country to restrict the movement of money

Apr 6th 2013 | From the print edition

THE capital controls imposed by Cyprus are hard to square with the idea of a "single" currency. To plug holes in the island's massive banking sector, its government has penalised uninsured bank deposits, and has thrown capital controls into the bargain to prevent nervous depositors from rushing for the exits. Cypriots may take no more than €300 ($385) out of banks each day and no more than €1,000 with them off the island. Transactions larger than €25,000 require central-bank approval. Deposit flight has been modest relative to expectations, and controls may be as temporary as promised. Yet recent history suggests cause for concern.



Capital controls were first widely imposed in the 1930s by countries going off the gold standard. Controls were institutionalised in the post-war Bretton Woods agreement, to allow countries some monetary flexibility within a system of fixed exchange rates. The Bretton Woods system unravelled in the 1970s, as countries were forced off unsustainable exchange rates. A new consensus grew up in its place, prizing free movement of goods and capital.

That orthodoxy now looks less sturdy. The International Monetary Fund, once an ardent defender of capital mobility, now reckons that limited and internationally co-ordinated controls on capital inflows may be warranted in some circumstances. Taxes on foreign purchases of debt or equity, for instance, may limit destabilising currency appreciations and financial bubbles. Restrictions on foreign bank-lending may reduce financial turmoil and protect banks from big losses. Recent economic uncertainty has contributed to the change in views, and resulted in the introduction of more controls (see chart).

Greater scepticism remains about the wisdom of controls on capital outflows, like those in Cyprus. Some reckon such controls can aid crisis management, pointing to the experience of Malaysia in the late 1990s. At the time capital flight threatened to weaken Asian currencies and swell their foreign-currency debts. The IMF advised fiscal and monetary austerity to help convince foreign money to stay put. Malaysia took a different course, imposing heavy restrictions on foreign-exchange transactions. Freed of the need to defend its currency from capital outflows, it was able to loosen monetary policy. Though economists still debate the effects of the strategy, Malaysia seemed to perform well compared with its neighbours. By 2002 it had eliminated its controls.

Others cite mixed results in Argentina. Dismal growth led to a loss of confidence in Argentina's dollar peg in 2001. That, in turn, led to capital flight as depositors rushed to convert their pesos into dollars. In late 2001 the Argentine government curtailed bank withdrawals and foreign-exchange transactions, a programme dubbed the *corralito* ("little fence"), before devaluing the peso substantially.

The *corralito* ended in 2002 and Argentina enjoyed several years of strong economic growth. Yet the government still interferes with international transactions whenever peso depreciation and inflation threaten economic trouble. Capital insecurity is one reason Argentine growth is expected to disappoint in coming years.

Cold comfort

The closest recent parallel to the Cyprus case is hardly reassuring. Iceland, another island with an outsize financial sector, responded to banking collapse in 2008 with an array of limits on capital outflows. These policies, designed to stanch financial collapse and prevent a plunge in its currency, helped stabilise the economy. They have also proved difficult to roll back. Five years on, controls remain in place.

Surveying the evidence, the IMF reckons outflow controls work best as a means to buy time for broad reforms aimed at improving the investment climate. They are not an enduring solution on their own. Depositors find ways to circumvent the restrictions through financial ingenuity and corruption. Trade restrictions may be needed to guarantee their integrity, lest corralled money buy goods to be shipped abroad and resold for foreign exchange.

The greatest concern for policymakers in the European Union may be that capital controls are often accompanied by devaluations. In the Cypriot case, that would imply a departure from the euro zone. If Cyprus's controls begin to look like a prelude to exit, depositors elsewhere on the periphery of the euro area might become very nervous indeed.

From the print edition: Finance and economics