Putin has one weapon to protect the rouble — he must use it wisely

Olivier Jeanne

Capital controls can work if tied to a credible plan to boost confidence, writes Olivier Jeanne

On top of his Ukrainian tribulations Vladimir Putin now has to manage a war of attrition with currency speculators. Lack of confidence in the Russian economy has prompted a flight in capital as some investors seek to limit their losses on rouble assets while others actively bet on a continued depreciation of the currency. The president’s battlefield options range from strategic retreat (allowing depreciation) to raising interest rates and selling foreign exchange to imposing controls on capital outflows.

The first three options are close to being exhausted. The rouble has already depreciated by more than seems warranted even by a pessimistic view of Russia's economic fundamentals. Last week the Central Bank of Russia increased interest rates to 17 per cent, a level where further increases are likely to be self-defeating because of the economic costs they would impose. Finally, Mr Putin indicated in his press conference on Thursday that the country's international reserves, while still at a comfortable level, should no longer be wasted in market interventions to prop up the national currency.

This leaves capital controls. Would they work for Russia? What can we learn from international experience of the use of capital controls in currency crises?

The economics of capital controls on outflows are relatively straightforward. Controls impose a cost on investors for removing capital from the domestic economy — a cost the authorities no longer have to pay in the form of, say, an excessively depreciated exchange rate. So they open some breathing space for the authorities to put in place policies to revitalise the domestic economy or at least limit the damage. In particular, they allow monetary authorities to reduce interest rates as capital controls take up some of the burden of defending the currency.

But capital controls also leave room for policy inaction or bad policies. Either way, the respite offered by controls decreases over time as investors learn to circumvent them. This is especially true in Russia, where previous attempts to stem capital flight (for example, after the 1998 financial crisis) have quickly been circumvented with great ingenuity. It is crucial that the authorities use the limited breathing space offered by such measures to establish a credible policy path that makes investors willing to come back and stay in.

An often cited example of a successful use of controls is Malaysia in 1998. That year market participants were alarmed by the anti-market rhetoric and unorthodox economic views of Mahathir Mohamad, then prime minister. The authorities banned offshore trading and repatriation of investments held by foreigners. Meanwhile all ringgit assets held abroad had to be repatriated. These measures were sweeping, and effective in choking off speculation against the currency. But they were also temporary. The controls were gradually relaxed as the economy improved, allowing the country to return to the international bond market in 1999. It was clear to the authorities and to market participants that Malaysia, given its dependence on foreign direct and equity investment, would have much to lose from turning its back on international financial integration.

There is also evidence that controls on capital outflows are often ineffective. A recent International Monetary Fund study looking at the effectiveness of capital outflow restrictions in 37 emerging economies finds that, more often than not, controls failed to stem net capital outflows because they were not accompanied by credible policy adjustments. Furthermore, in some cases they have taken on a more permanent character and marked a shift to policy regimes with high inflation and chronic capital flight. Argentina since 2002 and Venezuela since 2003 are examples of this.
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So where would Russia fit in the spectrum stretching from Malaysia to Venezuela? The main lesson from international experience is that controls on capital outflows can work — but only if they are associated with a credible policy plan addressing the underlying cause of the confidence crisis.

In the case of Russia the plan needs two components, both related to the biggest problems facing the economy. The first is a clear plan for adjusting to a prolonged period of low oil prices; and the second is actions that will allow western powers to lift the economic sanctions imposed following Russia’s intervention in Ukraine.

Both, it should be noted, are of course desirable — whether or not capital controls are introduced.

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