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POLICY PERSPECTIVES ON THE USE OF CAPITAL CONTROLS IN EMERGING MARKET NATIONS: LESSONS FROM THE ASIAN FINANCIAL CRISIS AND A LOOK AT THE INTERNATIONAL LEGAL REGIME

*Duncan E. Williams**

INTRODUCTION

In June of 1998, in the middle of the Asian financial crisis, life looked quite bleak for many Indonesians. Mrs. Tratiwoon, a young woman, worked barefoot scavenging through vast heaps of garbage for enough scrap material to earn a living recycling.[1] She expressed her hope that her three-year-old son would someday rise above her plight and grow up to work in a sweatshop.[2] She worried, however, that the Asian financial crisis, which had stifled much of Indonesia's economic activity, would put such a position beyond his reach.[3] While Indonesia's president called for his countrymen to fast twice a week to save rice, the number of prostitutes and beggars swelled in Jakarta.[4] Even in relatively well-to-do South Korea, stories abounded of laid-off workers killing themselves and their families or giving their children up to orphanages.[5]

These dramatic tales of suffering illustrate the human cost of financial crises in emerging market nations. Western nations assert that less developed countries ("LDCs") should open their capital systems to allow unimpeded movement of investments around the globe. LDCs should, however, carefully consider the full impact of such advice. While increased capital mobility may speed economic development in capital importing nations,[6] the destabilizing effects of

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1. Nicholas D. Kristof, *Asia's Crisis Upsets Rising Effort to Confront Blight of Sweatshops*, N.Y. Times, June 15, 1998, at A1.
2. *Id.*
3. *Id.*
4. *Still Sick and Gloomy, Now Rebellious*, The Economist, July 11, 1998, at 41.
5. *Id.*
6. *See, e.g.*, *Keeping the Hot Money Out*, The Economist, Jan. 24, 1998, at 69

unbridled international capital flows greatly aggravate the dangerous and degrading conditions that many Westerners so despise, such as the plight of Ms. Tratiwoon.

This Note examines the use of legal restrictions on international financial transactions, known as capital controls. Countries use capital controls to regulate financial transactions between residents and non-residents.[7] Capital controls can affect every type of financial transaction.[8] Countries typically impose capital controls to discourage capital inflows or outflows or to influence their make-up.[9] The key element of this diverse group of policy measures is that they "all attempt to restrict the movement of capital across national boundaries."[10]

Economists have only recently begun to build economic models to test empirically whether capital controls help LDCs achieve economic stability. A look at some of these empirical findings and the research into recent financial crises reveals that capital controls can be a useful policy tool, when properly employed, in easing a LDC's path of economic development. This Note begins by combining and presenting these findings. Using this conclusion as a basis, this Note then argues that the trend in the international legal regime towards the removal of capital controls in LDCs should be reevaluated and that the International Monetary Fund ("IMF" or the "Fund") and LDCs should adopt a more balanced approach to capital mobility. This Note ultimately concludes that neither the IMF nor any other new or existing multilateral institution should have jurisdiction over LDCs' use of capital controls.

Free-marketers consider capital controls anathema, characterizing them as government interventions that distort market economies and cause more problems than they solve. The Asian financial crisis that erupted in 1997, however, has reinvigorated the debate over the effectiveness of these measures since most East Asian countries

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(noting that for most of the 1990s Asia enjoyed large inflows of foreign capital that increased the region's growth rate).

7. *See* Ross B. Leckow, *The Role of the International Monetary Fund in the Liberalization of Capital Movements*, 17 Wis. Int'l L.J. 515, 515-16 (1999) (discussing the nature of capital controls and why countries impose them).

8. *See, e.g.*, *id.* at 515. One author notes that countries use capital controls to regulate

> i) the purchase or sale of debt or equity securities, mutual funds, or money market instruments, ii) the making of a financial loan or guarantee, iii) the making of a deposit in a bank account, iv) the purchase or sale of real estate, and v) the making of a direct investment such as the purchase of a majority interest in an enterprise.

Id.

9. *See, e.g.*, Government of Malaysia, *Economic Issues: Capital Controls*, (on file with the *Fordham Law Review*) (describing the uses of capital controls in developing countries).

10. *Id.*

largely eliminated capital controls in the early 1990s.[11] Part I of this Note looks at the causes of this crisis in order to give a brief illustration of the problems that capital controls are meant to overcome and to give some insight into how financial instability unfolds in emerging markets.[12]

Part II lays out the basic elements that define capital controls and explains why LDCs use them. Part II begins with a comparison of direct controls, such as quotas, which are more blunt policy instruments, and market-based, or indirect, controls, which impede capital flows by imposing costs on financial transactions.[13] After looking at what capital controls are, Part II next discusses why countries use them, paying special attention to two fundamental problems: the need to protect against the negative effects of foreign capital inflows and the instability caused by fickle foreign investors' decisions to remove capital invested in LDCs.[14] Part II explores the specific policy goals that capital controls are thought to serve with respect to these two persistent problems.

Part II concludes with a look at how the debate over capital controls has evolved. Many mainstream theorists have accepted that capital controls have a place in the development of a sound financial system in LDCs. Section C of Part II looks at the issue of whether LDCs should abandon capital controls early in the financial reform process or wait until the country has developed a stable and sound financial system.[15] To frame this debate this section lays out the steps needed to create an efficient financial system in an LDC.[16]

Part III argues that many of the justifications for capital controls are well-founded: capital controls can, if the right conditions are in place,[17] reduce financial instability in LDCs and help LDCs ensure their economic sovereignty.[18] This part discusses the capital controls used in Chile[19] and Malaysia[20] in recent years to support this argument. This part then goes beyond economic theory and looks at the non-economic and legal justifications for capital controls.[21] The human cost of financial instability[22] and economic sovereignty concerns[23] provide even greater justifications for capital controls.

11. *Keeping the Hot Money Out*, *supra* note 6, at 69.
12. *See infra* Part I.
13. *See infra* Part II.A.
14. *See infra* Part II.B..
15. *See infra* Part II.C.1.
16. *See infra* Part II.C.2.
17. *See infra* Part III.A.1.
18. *See infra* Part III.
19. *See infra* Part III.A.2.
20. *See infra* Part III.A.3.
21. *See infra* Part III.B.
22. *See infra* Part III.B.1.
23. *See infra* Part III.B.2.

This analysis of the types, uses, and justifications of capital controls ultimately leads to a discussion of the current international legal regime governing the capital account.[24] Part IV examines the multilateral legal regime to show that no international institution currently has jurisdiction to restrict LDCs' use of capital controls.[25] Building on the arguments showing the effectiveness of capital controls, and contending that continued use of capital controls in LDCs is a positive result, Part IV argues that this status quo should be maintained.[26] This is true not only based on the analysis in Parts II and III, but also because of the tendency of multilateral institutions to expand their "supranational authority"[27] and because of a lessening concern for the specific circumstances of LDCs.[28] Part IV discusses proposals to reform the IMF that seek to restrict LDCs' use of capital controls, and shows why such proposals would make LDCs worse off.[29] This Note shows why LDCs should maintain control and discretion over when and how to use capital controls and why LDCs should not cede authority to a multilateral institution to decide what capital controls are appropriate.

I. THE CAUSES OF THE ASIAN FINANCIAL CRISIS

This part will provide a brief analysis of the causes of the Asian financial crisis. Synthesizing the generally received explanations of this tumultuous event, this part familiarizes the reader with the problems that can occur in emerging market countries' financial systems that make them more vulnerable to volatility. In order to highlight the key problem of weaknesses in the banking sector and its special relevance to the issue of capital controls, this exposition will focus on the problems in Asian banking.

The 1997-99 Asian financial crisis resembled in many ways the Mexican banking crisis of 1994-95 and the ensuing financial market contagion, dubbed the "Tequila Effect."[30] These two emerging market crises differed from those of past decades in their sudden intensity and the quick reaction from the developed world.[31] The

24. *See infra* Part IV.
25. *See infra* Part IV.A, IV.B.
26. *See infra* Part IV.C.
27. *See infra* Part IV.C.1.
28. *See infra* Part IV.C.2.
29. *See infra* Part IV.A.
30. *See* International Monetary Fund, World Econ. Outlook, May 1998, at 45-46, 96-97 (discussing similar factors that led to banking and currency crises in the two regions); International Monetary Fund, World Econ. Outlook, Dec. 1997, at 10 (comparing the causes of financial crises in Thailand and Mexico).
31. International Monetary Fund, World Econ. Outlook, May 1998, at 74 (noting that financial crises in recent years differ from those earlier in the twentieth and late nineteenth centuries in that the "spillover effects and the contagious spread of crises seem to have become both more pronounced and far reaching"). To illustrate the sudden reversal in Asia, net private capital flows in Indonesia represented 6.3% of

Mexican crisis was novel "due to the speed with which it developed, the possible disastrousness of its consequences, and the amount of money required to remedy it."[32] The Asian financial crisis replicated this new scenario, with even greater severity and a more intense overreaction by financial markets.[33] These severe disruptions in the operation of international financial markets have been dubbed "post-modern" financial crises as the confluence of conditions giving rise to them—technological innovations allowing for instantaneous transactions, the use of riskier financial instruments, and increased financial integration and liberalization—did not occur until the early 1990s.[34]

These severe disruptions also shared common underlying economic causes: short-term financial liquidity problems, sparked by sudden speculative pressure on the domestic currency, laid bare fundamental regulatory shortcomings that, once revealed, in turn deepened the severity of the liquidity problems.[35] The instability seen in both crises began in the most vulnerable countries (Thailand and Mexico) and then spread to other susceptible, but more stable countries (Korea, Indonesia and Argentina) through a "contagion effect,"[36] the intensity of which was much greater than that experienced in previous decades.[37]

The "East Asian Tigers"[38] all began to experience economic difficulty in 1996, when the booming growth rates of the previous decades slowed.[39] Early 1997 saw large-scale bankruptcies of important firms in all economic sectors in Korea, Thailand, and Indonesia.[40] Asia's economic bubble had burst, and this economic

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GDP in 1996, while at the end of 1997 they stood at 1.6%of GDP. International Monetary Fund, World Econ. Outlook, Dec. 1997, at 6. Similarly, in the Philippines they were 9.8% of GDP in 1996 and 0.5% in 1997; in Thailand, 9.3% in 1996 and negative 10.9% of GDP in 1997. *Id.*

32. John H. Chun, Note, *"Post-Modern" Sovereign Debt Crisis: Did Mexico Need an International Bankruptcy Forum?*, 64 Fordham L. Rev. 2647, 2650 (1996).

33. *See* International Monetary Fund, World Econ. Outlook, May 1998, at 10.

34. *See* Chun, *supra* note 32, at 2650-51.

35. International Monetary Fund, World Econ. Outlook, May 1998, at 10.

36. *Id.* at 74-75. The term "contagion effect" denotes a general withdrawal of foreign investors from the markets and downward pressure on the currencies of countries in reaction to a downturn in another country. *See id.* at 83-88 (discussing the major factors behind financial contagion in the context of currency crises); *see also infra* notes 146-56 and accompanying text.

37. *See* International Monetary Fund, World Econ. Outlook, May 1998, at 83.

38. The term "East Asian Tigers" originally referred to four countries whose economies and foreign trade expanded dramatically in the second half of the twentieth century: Hong Kong, Singapore, South Korea, and Taiwan. John Black, A Dictionary of Economics 135 (1997). The term expanded to include other East Asian countries whose aggressive economic growth called to mind the ferocious animal.

39. *See* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 2-4.

40. *See, e.g.*, Donald Kirk, Korean Crisis: Unraveling of the Miracle in the IMF Era 2-16 (1999).

downturn laid bare the problems of many countries' banking sectors.[41] By the late summer of 1997, foreign portfolio investors began an exodus from Asia by pulling out of Thailand.[42] As the liquidity shortfalls of Asian financial sectors became apparent one by one, the IMF stepped in to broker loans to Thailand ($17 billion) in July 1997, Indonesia ($40 billion) in November, and Korea ($55 billion) in December.[43] The primary seeds of this economic disintegration were an excessive build-up of short-term foreign investment, an economic bubble, and a poor financial regulatory and supervisory environment.

A. *Build-Up of Short-Term Investment Leads to Asset-Price "Bubble"*

The build-up in short-term foreign investment in Asian economies began with a decline in asset yields in the industrial economies, which induced a "surge in capital inflows to emerging markets in the early to mid-1990s."[44] The successful performance of most of the economies concerned[45] made them prime targets of investors from developed countries looking for higher returns.[46] Underdeveloped and under-supervised financial systems in LDCs could not productively intermediate and deploy this large inflow of capital.[47] The potential variability of the inflows also posed problems for the financial systems involved, as well as for macroeconomic and exchange rate policy.[48] These intermediation and volatility problems are associated much less with foreign direct investment ("FDI")[49] and other long-term flows

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41. *See infra* Part I.B.

42. *See* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 16-17.

43. *See, e.g.*, Dan Taylor, *The International Monetary Fund: Wallet Sore to the West or Savior to the Global Financial Crisis?*, Currents: Int'l Trade L.J., Winter 1999, at 79, 81.

44. International Monetary Fund, World Econ. Outlook, Dec. 1997, at 4.

45. The Asian economies most affected by the financial turmoil were Korea, Thailand, Indonesia, Malaysia and the Philippines.

46. International Monetary Fund, World Econ. Outlook, Dec. 1997, at 4.

47. A financial system serves as an intermediary between savers of funds and borrowers of funds. Financial intermediaries must find borrowers that will use the funds productively so that savers can be repaid. Black, *supra* note 38, at 175-76; *see also* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 10-14 (discussing financial intermediation problems in Asian economies).

48. Variability of inflows causes excessive upward and downward swings in LDC stock markets and exchange rates that lead to an overall unstable climate for investment activities. *See, e.g.*, Barry Eichengreen, *Taming Capital Flows* (Aug. 1999), http://elsa.berkeley.edu/users/eichengr/worlddevelopment2.pdf [hereinafter Eichengreen, *Taming Capital Flows*].

49. FDI refers to the acquisition of real assets in another country. FDI typically connotes the purchase, expansion, or creation of a foreign subsidiary. The most common characteristic of FDI "is that it involves not only a transfer of resources but also the acquisition of *control*." Paul R. Krugman & Maurice Obstfeld, International Economics: Theory and Policy 168 (4th ed. 1997) [hereinafter Krugman & Obstfeld, International Economics].

than with short-term portfolio and debt flows.[50] In East Asia, short-term inflows were, however, substantial.[51]

This surge of short-term foreign investment created structural problems for Asian countries whose financial systems were not sophisticated enough to deal with such an inflow.[52] The inflow of capital spurred the growth in many Asian economies, most notably Thailand's, of "bubble" economic booms based on rapidly increasing investment in cyclical assets such as real estate.[53] The growth of credit to the private sector accelerated the expansion of these economic bubbles and the inflation of asset prices.[54] The rapid growth of private sector credit was largely attributable to burgeoning capital inflows, many directly into the banking system, which were reflected in rising official foreign exchange reserves.[55]

B. *Financial Regulatory Problems*

Poor regulation and supervision of Asian financial systems allowed large amounts of short-term capital to flow unchecked into unsound investments.[56] The poor foundations of the financial sector and other structural weaknesses led to low-quality and excess investment that made many of Asia's economies extremely vulnerable to adverse developments.[57] Also leading to East Asia's precarious position was the fact that bank credit plays a larger role in the region's economies than in those of other emerging market countries.[58] For example, in

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50. *Cf.* International Monetary Fund, World Econ. Outlook, May 1998, at 3 (discussing the excessive build-up of short-term foreign borrowing as a factor contributing to the Asian financial crisis). Portfolio investment denotes the acquisition of financial securities and bank deposits, Black, *supra* note 38, at 184, and typically involves a shorter time horizon and a less committed investment.

51. The most precariously positioned borrower was Thailand, where loans and portfolio investment were dominant, making up 7 to 10% of GDP in each year from 1994 to 1996, while FDI represented a meager 1% of GDP. International Monetary Fund, World Econ. Outlook, Dec. 1997, at 4. Similar investment inflow maturity profiles were evident in other East Asian nations. *See id.*

52. Asia's financial system had not developed to a point where banks were making credit decisions based on risk assessment. Government-directed lending to risky companies and crony-lending, particularly in Korea, further weakened banks' balance sheets. *Id.* at 12.

53. *Id.* at 10.

54. *See, e.g.*, *id.* (discussing the rapid growth of private sector credit in Thailand).

55. Thailand's foreign exchange reserves more than doubled between 1992 and early 1996, while over the same period its commercial banks' foreign liabilities grew from 7% to 24% of their total liabilities. *Id.* at 54. A similar pattern emerges for many of the other Asian countries mired in crisis. *See id.* at 52-54.

56. *See id.* at 12 (discussing the weakness of Korea's financial regulation system).

57. *See id.* at 12-13; *see also* John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, Kan. J.L. & Pub. Pol'y, Spring 1998, at 70 (discussing the causes of the Asian financial crisis and giving prescriptions for improving banking practices in Asia).

58. *Asia's Economies: On Their Feet Again?*, The Economist, Aug. 21, 1999, at 16, 17.

Malaysia outstanding loans represented 150% of GDP, while the comparable figure in Brazil was 43%.[59] Despite a lack of transparency[60] that initially retarded widespread awareness of the problems, unsound points in the financial sector became apparent in Thailand, Indonesia, and Korea once the speculative bubble of asset prices burst.[61] Inadequate regulation and supervision of financial institutions, limited experience among financial institutions in pricing and managing risk, a lack of commercial orientation, and poor corporate governance all combined to drive many institutions into insolvency.[62]

Compounding the problems in the banking system, some governments' implicit approval of unsound banking practices led to a classic "moral hazard."[63] As in much of the world, Asian governments made no attempt to disabuse the public of the mistaken belief that many of their deposits with financial institutions were explicitly guaranteed.[64] Bankers also felt less exposed to risk, thinking that government would step in and nationalize bad debts.[65] This encouraged bankers to take on excessive risk, as they reaped the benefits of successful risky investments while taxpayers cleaned up the mess of unsuccessful ventures.[66] Where financial intermediaries do not bear the risk of their investments, they will not carefully select their borrowers.

Under-regulation and inadequate supervision compounded this excessive risk-taking. While many Asian bank regulatory authorities required adherence to the Basle Committee on Banking Supervision capital adequacy standards,[67] they did not monitor carefully enough

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59. *Id.*

60. International Monetary Fund, World Econ. Outlook, May 1998, at 80 (noting that "[w]hen banking difficulties first emerge, bank owners and managers, and public authorities, are often tempted to conceal their extent").

61. International Monetary Fund, World Econ. Outlook, Dec. 1997, at 10-12.

62. *See id.* at 82-83. A key problem in Asia, most prevalent and well-documented in Korea, was the practice of banks lending to related enterprises and the cross-guaranteeing of debt by corporations within the same conglomerate. Kirk, *supra* note 40, at 7, 9; *see also* Ellen J. Shin, Note, *The International Monetary Fund: Is it the Right or Wrong Prescription for Korea?*, 22 Hastings Int'l & Comp. L. Rev. 597, 600-04 (1999) (giving background information on the origin of the financial problems in Korea in the chaebol system).

63. "Moral hazard" results when economic agents are protected against the risks of failure of an economic activity by insurance or a promise to pay by another party. The implicit or explicit protection against economic loss makes people take greater risks, which raises the likelihood that the economic failure will occur. Black, *supra* note 38, at 309.

64. *See Why Did Asia Crash?*, The Economist, Jan. 10, 1998, at 66.

65. *See id.*

66. Paul Krugman, What Happened to Asia? (1998) (unpublished manuscript), *at* http://web.mit.edu/krugman/www/DISINTER.html [hereinafter Krugman, What Happened to Asia?].

67. The Basle Committee on Banking Supervision is a forum where senior representatives from the central banks of the Group of Ten work to formulate a set of

the components of banks' loan portfolios.[68] The minimum requirements of the Basle Core Principles are not sufficient to cover all of the bad loans made in the asset-price-bubble environment described above. A central feature of the Asian crisis is that a number of insolvent institutions in Thailand, Korea, Indonesia and other countries were permitted to continue operations with central bank subsidies.[69]

In some Asian countries, regulatory authorities not only failed to supervise banks adequately, they also directed banks to lend to state-favored industries and companies.[70] Lending associated with political relationships,[71] corrupt practices,[72] and loose internal controls accelerated the financial crisis. The Korean government's heavy-handed control of the industrial sector through direct credits, tight regulation, and subsidies artificially promoted less competitive companies and kept companies from developing sound business practices.[73] Directed lending and other ways of favoring certain entities introduced other structural weaknesses into Asian economies.[74] Trade restrictions, import monopolies, and regulations similarly stifled economic efficiency and prevented investment from finding its most productive outlets.[75] In Thailand and Indonesia, political disarray delayed the implementation of necessary financial sector reforms.[76]

C. *Lessons from the Asian Financial Crisis*

International capital mobility may not maximize economic efficiency if banks are over-guaranteed and under-regulated.[77] This is one of the more novel discoveries brought on by the Asian crisis and the 1994 peso crisis.[78] Asia's macroeconomic fundamentals were for

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Core Principles for sound banking supervision. *See* International Monetary Fund, World Econ. Outlook, May 1998, at 84-85 & n.1.

68. *See* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 12-13.

69. *See Why Did Asia Crash?*, *supra* note 64; *Asia's Economies: On Their Feet Again?*, *supra* note 58, at 17.

70. *See* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 12.

71. *Id.*

72. Government corruption is widely thought to impede the development of regulatory institutions. Jared Levinson, *"Fragile, Handle with Care": Indonesia and the Issue of Capital Controls in a Nation Facing Disintegration*, 17 Wis. Int'l L.J. 529, 532 (1999).

73. International Monetary Fund, World Econ. Outlook, Dec. 1997, at 14; *see also* Su-Hoon Lee, *Crisis in Korea and the IMF Control*, *in* The Four Asian Tigers: Economic Development and the Global Political Economy 209, 210-15 (Eun Mee Kim ed., 1998) (discussing the Korean model of state-directed lending and conglomerate-led economic expansion).

74. *See* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 12.

75. *Id.* at 14.

76. *See id.* (discussing political disarray in Thailand).

77. *Why Did Asia Crash?*, *supra* note 64, at 66.

78. *See Asia's Economies: On Their Feet Again?*, *supra* note 58, at 16, 17-18

the most part quite sound (with governments throughout the region having more or less achieved fiscal balance and inflation being quite low), despite a cyclical recession in 1996 brought on by the downturn in Japan.[79] Conventional currency-crisis theory suggests that the currencies of stable economies should not come under speculative attack.[80] The diverse economies of Thailand, Indonesia, Korea, Malaysia and the Philippines were, nonetheless, still susceptible to a loss of confidence by foreign investors.[81] Asia's susceptibility lay in its heavy reliance on short-term foreign inflows that were certain to be withdrawn once the unhealthy position of its financial institutions became known.

The Asian crisis differs from conventional exchange-rate crises[82] because it was seemingly brought on entirely by the problems in the financial sector.[83] When asset-price bubbles burst and the currencies began to depreciate, the many problems of banks and other financial intermediaries were laid bare. Further decline in currency values and a deepening of banking problems became intertwined in a vicious cycle.[84]

This brief exposition of the causes of the Asian financial crisis illustrates why many commentators have argued that the unchecked flow of foreign investment into emerging market and newly industrialized countries can exacerbate an array of economic problems. LDCs often turn to legal restrictions on the movement of some types of foreign investment as a way to mitigate these problems. The following sections will explore the use of capital controls as a means of stabilizing emerging market economies.

II. Types of Capital Controls and the Primary Policy Reasons for Their Use

This part first lays out the different types of capital controls. Both direct, or administrative, controls and indirect, or market-based controls, are used by LDCs to control foreign investment. This part then examines the relationship between external and internal factors

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(discussing problems with Asia's banks); *Survey: Banking in Emerging Markets: After the Quake*, The Economist, Apr. 12, 1997, at 18.

79. *See* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 2-3.

80. *See* Krugman, What Happened to Asia?, *supra* note 66.

81. *See infra* notes 146-55 and accompanying text (discussing "herding behavior" among investors and the "contagion effect").

82. *See, e.g.*, International Monetary Fund, World Econ. Outlook, Oct. 1993, at 29-36 (discussing the causes and factors leading to the 1992-93 crisis in the European Monetary System's exchange rate mechanism); *see also* Timothy A. Canova, *Banking and Financial Reform at the Crossroads of the Neoliberal Contagion*, 14 Am. U. Int'l L. Rev. 1571, 1609 (1999) [hereinafter Canova, *Banking and Financial Reform*] (discussing the Swedish banking crisis in the early 1990s).

83. *See* International Monetary Fund, World Econ. Outlook, May 1998, at 74-75 (discussing the link between exchange-rate and banking crises).

84. *See id.* at 75.

that lead countries to implement capital controls, examining the theoretical justifications cited by economists and policymakers. Finally, this part will explore the parallel debates over whether capital controls reduce volatility and, if so, how far an LDC's financial institutions and infrastructure must develop before the country can successfully remove its capital controls. To frame the debate over how much an LDC's financial system must develop before it can prudently remove capital controls, this part outlines the long process of reforming an LDC's financial network into an efficient and well-functioning system.

A. *Types of Capital Controls*

Any type of transaction that causes financial resources to move from one country to another is a potential target for restrictions by capital controls: purchase by foreigners or sale abroad by domestic residents of securities, money market instruments, credit operations, or FDI.[85] Capital controls often augment a country's prudential measures (i.e., financial regulations and oversight seeking to limit risk-taking of financial intermediaries and borrowers).[86] Capital controls fall into two broad categories: "(1) administrative or direct controls and (2) market-based or indirect controls."[87] Direct controls involve prohibitions on specific types of transactions, quotas, rule-based or discretionary approval, and minimum-stay requirements. Indirect controls rely primarily on explicit or implicit taxation to discourage capital flows.[88]

An analysis of capital controls requires an understanding of their relationship to prudential regulations. As the discussion below illustrates, capital controls, when used appropriately, can overlap with prudential regulations. They differ, however, in that their direct objective is somewhat more immediate. Prudential regulations attempt to permanently alter and improve the behavior of economic agents. Capital controls try to artificially alter the choices made by economic agents while a country's financial system develops to the point where the capital controls are no longer necessary. Thus, capital controls and prudential regulations overlap and reinforce each other but do not necessarily serve the same functions.[89]

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85. R. Barry Johnston & Natalia T. Tamirisa, *Why Do Countries Use Capital Controls?* 5-6 (IMF Working Paper, 1998).

86. *See id.* at 16.

87. *See* Akira Ariyoshi et al., *Capital Controls: Country Experiences with Their Use and Liberalization* 6 (IMF Occasional Paper 190, 2000).

88. *Id.*

89. *See id.* at 52.

1. Direct Controls

Direct controls usually involve outright prohibitions on specified transactions between residents and non-residents.[90] These can also take the form of cumbersome approval procedures that seriously deter foreign investment, even FDI.[91] While often broadly implemented, governments sometimes effectively tailor direct prohibitions to prevent specific types of transactions. The usual methods of administrative or direct controls are prohibitions, quantitative limits (quotas), rule-based or discretionary approval, and minimum-stay requirements for direct and portfolio investment.[92] Direct capital controls usually seek to reduce the overall volume of capital inflows.[93]

Quantitative limits, or quotas, often take the form of outright bans, or ceilings, on investment.[94] Quotas are extremely "blunt instruments" of economic policy, and are considered to have a highly distortionary impact on investment decisions.[95] Considerations other than economics, such as nationalism or history, often drive quotas on investment.[96] But quotas do have some potential as an effective control to correct for market imperfections.[97] For example, quantitative limits on bank lending may be appropriate as a prudential measure in many LDCs.[98] Limitations on offshore borrowing and non-trade-related swaps are similarly used to limit banks' and domestic residents' foreign borrowing.[99]

Quantitative limits and other administrative controls can be an important information signal to foreign investors that banks and other

90. *See id.* at 6.

91. *See id.*; *see also* Cheryl W. Gray & William W. Jarosz, *Law and the Regulation of Foreign Direct Investment: The Experience from Central and Eastern Europe*, 33 Colum. J. Transnat'l L. 1, 12-13 (1995) (discussing transaction costs as a disincentive to FDI).

92. *See* Ariyoshi, *supra* note 87, at 7. Portfolio investment denotes the acquisition of financial securities and bank deposits. Black, *supra* note 38, at 184. FDI is usually differentiated from portfolio investment in that the former involves ownership and management of businesses rather than mere ownership of securities. *See supra* note 49 (defining FDI); *see also* Roman Terrill, *Coping with Private Capital Markets*, 9 Transnat'l L. & Contemp. Probs. 303, 312-13 (1999) (discussing the differences between portfolio investment and FDI).

93. *See* Ariyoshi, *supra* note 87, at 7.

94. Donald J. Mathieson & Liliana Rojas-Saurez, *Liberalization of the Capital Account: Experiences and Issues* 4 (IMF Occasional Paper 103, 1993).

95. S. Neal McKnight, Note, *Stepping Stones to Reform: The Use of Capital Controls in Economic Liberalization*, 82 Va. L. Rev. 859, 889 (1996).

96. *See* Ariyoshi, *supra* note 87, at 7.

97. McKnight, *supra* note 95, at 891 ("[C]ontrols in the form of prudential regulations may correct for market imperfections in the financial sector."); *see also* Guillermo A. Calvo et al., *Capital Inflows and Real Exchange Rate Appreciation in Latin America*, 40 IMF Staff Papers 108, 143-44 (1993).

98. Calvo, *supra* note 97, at 149; McKnight, *supra* note 95, at 890.

99. *See* Ariyoshi, *supra* note 87, at 52.

financial market agents are following prudent practices.[100] Such prudential controls[101] can form part of a permanent regulatory regime.[102]

Similarly, part of a prudential regulatory regime can include requiring foreign investors to gain administrative approval before being allowed to own a country's securities. Taiwan's Qualified Foreign Institutional Investors ("QFII") requirement is an example of this type of administrative control.[103] Under the QFII, foreign investors must gain approval from Taiwan's security markets regulatory agency prior to making investments in the Taiwanese stock exchange.[104] Designed to prevent speculation in a country's securities, the QFII tries to reduce financial market instability.[105]

2. Indirect Capital Controls

In general, indirect, or market-based, controls "discourage particular capital movements by making them more costly."[106] Market-based controls often involve explicit or implicit taxation "on external financial transactions, thus limiting their attractiveness."[107] A country can also tax dividends or repatriation of profits to the same effect. Tax rates on different types of transactions can vary in order to encourage or discourage certain transactions.[108]

Another method of market-based capital controls is to employ dual or multiple exchange rates.[109] This means that different exchange rates apply to different transactions.[110] Such a system restricts

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100. *See* McKnight, *supra* note 95, at 891. Other types of capital controls, such as outflow restrictions, can make markets nervous that the country is reneging on policy commitments to economic liberalization in general. *See id.* at 892; *see also infra* notes 326-34 and accompanying text (discussing investors' reactions to Malaysia's use of capital controls in reaction to the Asian financial crisis).

101. Capital controls used to limit banks' risk-taking in foreign currency borrowings closely resemble a prudential measure, or regulations that restrict overly risky behavior by financial intermediaries.

102. *See* McKnight, *supra* note 95, at 892-93.

103. *See* Richard N. Watanabe, *Foreign Exchange and Capital Movement Controls in Taiwan*, 16 UCLA Pac. Basin L.J. 1, 10-11 (1997). The QFII also requires approval for inward and outward remittances. *Id.* at 11. While this last element makes the QFII somewhat restrictive, the general policy could be an effective means of reducing destabilizing inflows.

104. *See id.* at 10-11.

105. *Id.*

106. Ariyoshi, *supra* note 87, at 6.

107. *Id.* at 7. Explicit taxation involves a direct levy by the government on a financial transaction, while implicit taxation involves a cost imposed by the government that is not explicitly called a tax. *See infra* notes 117-21 and accompanying text (discussing the most widely used method of implicit taxation, the unremunerated reserve requirement).

108. Ariyoshi, *supra* note 87, at 7.

109. *Id.*

110. *Id.*

speculators' access to foreign exchange, but still allows access to trade flows,[111] FDI, and equity investment. These restrictions usually attempt to change both the quantity of financial transactions and their price.[112]

Other indirect controls include provisions for commercial banks' net balance in foreign currency, limitations on unpaid foreign currency option contracts "that discriminate between long and short currency positions or between residents and nonresidents," and the requirement of a minimum credit rating to borrow abroad.[113] Minimum rating requirements for corporations and banks allowed to borrow abroad can be considered a prudential measure, but are similar to indirect controls.[114] In the same vein, stringent reporting requirements on banks for all capital account transactions look like a prudential measure, but greatly enhance regulators' ability to monitor capital movements, make key determinations, and enforce capital controls.[115]

Indirect taxation has received the most attention in the literature on capital controls, and has been used quite frequently in the past decade in LDCs.[116] The most widely discussed method of indirect taxation is the unremunerated reserve requirement ("URR"), where "banks and nonbanks dealing on their own account are required to deposit at zero interest with the central bank an amount of domestic or foreign currency equivalent to a proportion of the inflows or net positions in foreign currency."[117] In other words, in addition to the actual investment, a URR requires foreign investors to put an amount equal to a certain percentage of that investment into an account with the central bank that earns no interest. Investors can get back increasing portions of the deposited funds as the investment remains longer in

111. For a discussion of the effect of capital controls on trade flows, see Natalia T. Tamirisa, *Exchange and Capital Controls as Barriers to Trade* 3-7 (IMF Working Paper, 1998) (arguing that capital controls "represent a noticeable barrier to trade," but that the theoretical effect of controls on trade is "somewhat ambiguous" and there is little empirical evidence either way).

112. *See* Ariyoshi, *supra* note 87, at 7.

113. *Id.* An investor who holds a "long position" in foreign currency holds foreign assets or currency that he does not currently have an arrangement to sell, as he anticipates a rise in their price. Black, *supra* note 38, at 279. An investor with a "short position" has entered into "[a] contract to sell, for future delivery, [currency or assets] in excess of the amount [he] actually holds," planning on a fall in the price so that the promised asset or currency can be purchased at a lower price in the spot market and sold at a profit. *Id.* at 428.

114. *Cf.* Watanabe, *supra* note 103, at 27-30.

115. *See* Ariyoshi, *supra* note 87, at 7. Monitoring derivative transactions takes on special importance in enforcing capital controls. *Id.*

116. *See id.*

117. *Id.*; *see also* Bernard Laurens & Jaime Cardoso, *Managing Capital Flows: Lessons from the Experience of Chile* (IMF Working Paper, 1998) (discussing Chile's use of the URR); *Keeping the Hot Money Out*, *supra* note 6, at 69-70 (same).

the country.[118] A URR serves many functions. It makes borrowing abroad more expensive for domestic banks.[119] A URR can target specific kinds of investment,[120] can be imposed on all liabilities denominated in foreign currency,[121] or can require all foreign investors to deposit a percentage of their investment as a deterrent to a volatile departure.

B. *Why Countries Use Capital Controls*

This section explores the practical considerations that lead LDCs to employ capital controls. Controls are implemented in reaction to two fundamental problems: First, despite all the benefits of foreign capital inflows, imported financial resources also have negative effects on the domestic economy; second, foreign capital flows are extremely fickle, which leads to domestic economic instability.[122] LDCs justify the use of capital controls as a means of overcoming these two fundamental problems and other difficulties stemming from them. More specifically, capital controls are justified as a way to stabilize the domestic exchange rate, correct market information imperfections that occur in LDCs, control short-term speculative transactions, reduce financial market volatility, curtail excessive risk-taking by economic agents, induce capital formation, and give the domestic financial system time to develop without undue pressure. Each of these justifications is discussed below.[123]

Throughout the developing world, "[r]ecourse to controls on capital flows . . . is generally quite pervasive."[124] Within individual countries, use varies from omnipresent implementation to more selective restrictions.[125] The history and purpose of controls also vary widely from country to country. Some controls are holdovers from past regimes whose purpose and effectiveness is no longer certain, while others are innovative tools of macroeconomic and structural policy.[126]

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118. *See* Ariyoshi, *supra* note 87, at 7 (discussing the URR).

119. McKnight, *supra* note 95, at 885; *see also* David Folkerts-Landau & Takatoshi Ito, International Capital Markets: Developments, Prospects, and Policy Issues 97 (1995) (discussing uses of the URR).

120. McKnight, *supra* note 95, at 886. But since capital controls need to be broad to be effective, *see infra* text accompanying notes 262-68, this element might not be such an advantage to most developing countries.

121. *See* McKnight, *supra* note 95, at 886; *see also* Susan Schadler, et al., *Recent Experiences with Surges in Capital Inflows* 19 (IMF Occasional Paper 108, 1993) (noting the impact of such a control in curbing excessive foreign borrowing by domestic banks).

122. *See infra* Part II.B.1.

123. *See infra* Part II.B.3.

124. Johnston & Tamirisa, *supra* note 85, at 1.

125. *See id.* at 4.

126. *See id.* When capital controls in all sectors of financial activity are considered, there are quantitatively more controls in place to restrict capital outflows than inflows. *See id.* at 7. This is true for all areas other than FDI, where controls on

Just as the types of capital controls vary considerably, the policy reasons behind their use also differ. This section explores the policy objectives that propel countries to employ capital controls, focusing on the use of capital controls to stabilize domestic financial markets in the face of large inflows of foreign investment. It also explains the theoretical justifications used to support these policy considerations.

1. Impact of Foreign Capital Flows on Economic Development

To understand why countries use capital controls, one must first appreciate the effect of capital account liberalization[127] in LDCs. Two extreme views prevail as to whether international capital flows into LDCs produce the net effect of encouraging economic development. Most economists believe that exporting capital to developing nations enhances economic efficiency and increases the rate of economic growth.[128] This "neoliberal consensus" argues that the pain and adjustment of financial instability will only persist in the short-run and that financial liberalization will lead to increased living standards in the long-run.[129]

The other side of the argument, led by such scholars as Jagdish Bhagwati[130] and Dani Rodrik,[131] contends that there is no evidence that opening a country's capital account causes significant increases in the growth rate.[132] This group argues that LDCs will not necessarily employ foreign capital in the most efficient way because of

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inflows are more prevalent than controls on outflows. *See id.* The higher incidence of controls on inflows of FDI than on outflows can largely be explained by the fact that controls on inflows of FDI are often used for non-economic reasons. See *infra* text accompanying notes 189-92, for a discussion of the non-economic reasons for restrictions on inflows of FDI.

127. Capital account liberalization refers to a country allowing foreign capital to move freely into and out of its territory through financial transactions. This is also referred to as "opening the capital account." Black, *supra* note 38, at 51 (defining "capital mobility").

128. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 1 (discussing how imported capital is used more efficiently in developed countries than in LDCs); *see also* Marco Rossi, *Financial Fragility and Economic Performance in Developing Economies: Do Capital Controls, Prudential Regulation and Supervision Matter?* 3 (IMF Working Paper, 1999) (discussing the "broadly accepted" notion that "financial liberalization, by fostering financial development, can increase economic performance").

129. *See* Timothy A. Canova, *Financial Liberalization, International Monetary Dis/order, and the Neoliberal State*, 15 Am. U. Int'l L. Rev. 1279, 1361 (2000) [hereinafter Canova, *Financial Liberalization*].

130. *See* Jagdish Bhagwati, *The Capital Myth: The Difference Between Trade in Widgets and Dollars*, Foreign Aff., May/June 1998, 7.

131. *See* Dani Rodrik, *Who Needs Capital-Account Convertibility?*, *in* Should the IMF Pursue Capital-Account Convertibility?, Essays in International Finance No. 207, Department of Economics, Princeton University (Peter Kenen ed., 1998); Dani Rodrik, *Growth Versus Poverty Reduction: A Hollow Debate*, Fin. & Dev., Dec. 2000, 8.

132. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 1-2, 4.

information asymmetries.[133] Information asymmetries worsen as the geographic and cultural gap between capital exporters and capital importers grows.[134] This analysis of the problems leads to the conclusion that "the analogy between free trade and free capital mobility . . . is fundamentally flawed."[135]

The intermediate view between these extremes holds that LDCs can achieve the benefits of partial capital mobility (allowing capital to flow to what productive investments can be found in a country) while still protecting against the worst effects of portfolio capital volatility.[136]

Regardless of whether financial inflows ultimately have a positive impact on a country's rate of development, experts agree that capital-importing countries do not exclusively control the factors influencing foreign capital inflows.[137] It is widely accepted that "[t]he primary forces driving investor interest in emerging markets . . . are the search for higher returns and risk diversification."[138] When faced with the inability to control the factors that induce foreign investment inflows and the destabilizing effects that follow, developing countries often seek to artificially limit their attractiveness to foreign investors.

At a minimum, the free-marketers (or neoliberals) agree that the "banking crises of the 1980s and 1990s have pointed out the link between financial liberalization and financial fragility and the existence of a . . . trade-off between the benefits of liberalization and the costs of increasing financial fragility."[139] This is not to say that a very closed capital account will allow a country to escape all of the volatility of international financial flows,[140] but rather the more open a country's capital account, the more susceptible it is to volatile inflows and outflows of foreign capital. Capital controls seek to find the right balance between the benefits of openness to foreign investment and its costs in terms of instability. Once the fact that financial inflows can cause instability in LDCs' economies is accepted, the major reasons for employing capital controls become easily understandable. The

133. *See id.* at 2. Information asymmetries arise when some economic agents have more information than others. This is obviously the case in any real economic environment, and it is heightened in the context of foreign investment in LDCs by the fact that investors are often unfamiliar with the country, its legal and financial systems, and its business culture. Black, *supra* note 38, at 16.

134. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 6.

135. *Id.* at 2.

136. *See* Canova *Financial Liberalization*, *supra* note 129, at 1315-19.

137. *See* Linda M. Koenig, *Capital Inflows and Policy Responses in the ASEAN Region*, (IMF Working Paper, 1996) (analyzing the nature of and factors influencing foreign inflows into the ASEAN region); Alejandro López-Mejía, *Large Capital Flows: A Survey of the Causes, Consequences, and Policy Responses* (IMF Working Paper, 1999) (analyzing the factors behind capital flows to LDCs and the patterns and trends of these flows, emphasizing the external factors).

138. López-Mejía, *supra* note 137, at 15.

139. Rossi, *supra* note 128, at 3.

140. *Cf.* Ariyoshi, *supra* note 87, at 29-30 (discussing the effects of financial crises on countries with very closed capital accounts, such as India and China).

next subsection looks more closely at the causes of financial instability in LDCs.

2. Instability and the Contagion Effect

Most capital controls seek to reduce "the vulnerability of developing countries to the volatility of international capital markets."[141] In designing a capital control regime to address this problem, the key principle emphasizes that "[p]ortfolio investment... tends to be more liquid and sensitive to changes in yield," and hence more volatile than longer term investments such as FDI.[142] When used both for prudential concerns and macroeconomic reasons, capital controls have attempted to alter maturity composition[143] as well as the volume of inflows.[144] Short-term inflows have typically been seen as more volatile and more destabilizing, especially in places where financial institutions cannot efficiently intermediate the inflows.[145]

The "contagion effect," whereby a financial crisis in one LDC spreads to other seemingly unrelated economies, produces another key element in the vulnerability of LDCs to volatility.[146] One of the primary culprits in financial contagion is a market phenomenon known as "herding behavior,"[147] meaning, in short, that investors are prone to collective actions.[148] Investors "infer information about the fundamental value of their investments from one another's actions," in what economists call "information cascades."[149] Herding behavior causes investors to "stamped[e] in and out of markets."[150] This stampeding is compounded by the tendency of "international investors... to overlook weaknesses in the domestic policy environment until they are abruptly brought to their attention, at which point markets over-react."[151] These two market imperfections

141. McKnight, *supra* note 95, at 872.

142. *Id.*; *see also* López-Mejía, *supra* note 137, at 16 (finding that portfolio flows are the type of investment most sensitive to interest rates). Sensitivity to yield changes denotes an investment vehicle's use as a speculative device, as most speculation involves interest rate arbitrage. *Cf.* Geoffrey G.B. Brow, *The Tobin Tax: Turning Soros into Plowshares?*, 9 Transnat'l L. & Contemp. Probs. 345, 346-47 (1999).

143. "Maturity composition" means the relative amounts of long and short term investment that make up the total amount of foreign investment.

144. *See* Ariyoshi, *supra* note 87, at 9.

145. *See Keeping the Hot Money Out*, *supra* note 6, at 70.

146. *See* McKnight, *supra* note 95, at 872-73.

147. *See* López-Mejía, *supra* note 137, at 22-23 (discussing herding behavior).

148. *See* Barry Eichengreen, Capital Controls: Capital Idea or Capital Folly? 5-6 (Nov. 1998), (unpublised manuscript) *at* http://elsa.berkeley.edu/users/eichengr/capcontrols.pdf [hereinafter Eichengreen, Capital Controls].

149. *Id.* at 6.

150. *Id.*

151. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 2. "If [a fund manager's mandate] stipulates the fund has to perform at least as well as the median fund, the incentive to herd increases." López-Mejía, *supra* note 137, at 22; *see also* International Monetary Fund, World Econ. Outlook, May, 1998, at 7 (noting the "apparent

combine to mete out a punishment to LDCs that is "disproportionate to the crime."[152] As discussed above,[153] the farther afield investors wander, the more the information problems that lead to herding behavior and overreaction are aggravated.[154] Speculation and herding behavior even afflict countries with sound economic fundamentals.[155]

3. Justifications for Capital Controls

While some argue that capital controls are implemented in LDCs primarily for domestic political aims,[156] the five major justifications for imposing capital controls focus on decreasing financial instability. First, the most widely used theoretical justification in the economic literature comes from what welfare economics calls a "second-best solution."[157] The term second-best solution describes the situation where "an economy . . . suffer[s] from one distortion [that] is difficult to tackle . . . directly," and welfare can be increased "by adding another, off-setting distortion."[158] Here, the second distortion is the capital control, which is used to correct an even more welfare-reducing distortion, such as an information asymmetry.

A country can correct for distortions such as information asymmetries either by improving market regulation and supervision or by imposing capital controls. As discussed above, the distortions, or market imperfections, in LDC economies are not easily corrected, making reliance on capital controls the best short-term solution to stability problems.[159] "[W]eak or insolvent banking systems [and] moral hazard problems related to official guarantees and the absence of developed financial markets" are other distortions that can be corrected in a "second-best" way by capital controls.[160]

Capital controls also commonly aim to control short-term speculative transactions that induce exchange rate volatility and lead to other macroeconomic problems such as inflation.[161] In addition to instability in the financial sector, large foreign inflows can cause problems for a country's balance of payments[162] and its domestic

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tendency for investors to react exuberantly to success, belatedly to emerging concerns, and eventually to overreact as sentiment changes").

152. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 2.

153. *See supra* notes 133-35 and accompanying text.

154. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 6.

155. *See* McKnight, *supra* note 95, at 874.

156. *See, e.g.*, Levinson, *supra* note 72, at 544 (characterizing Malaysia's use of capital controls as primarily for "domestic political reasons" (quoting James Clad & David Steinberg, *A Post-Crisis Look*, Geo. Mag., Winter 1999, at 37)).

157. Johnston & Tamirisa, *supra* note 85, at 15.

158. *Id.* (discussing this finding as made in M. Dooley, *A Survey of Literature on Controls over International Capital Transactions*, 43 IMF Staff Papers 4 (1996)).

159. *See supra* notes 146-55 and accompanying text.

160. Johnston & Tamirisa, *supra* note 85, at 15.

161. *See* Watanabe, *supra* note 103, at 3.

162. Balance of payments accounting tracks the changes in a country's

monetary policy targets.[163] Capital controls often try to resolve the economic policy dilemma of having more objectives than policy tools. Using capital controls, countries can maintain a somewhat fixed exchange rate while also keeping inflation down. Governments try to reconcile these ordinarily contradictory policies in an open capital account economy through capital controls.[164]

Before imposing new controls on capital inflows, countries typically try to counter heavy foreign inflows with the economic tools of sterilization[165] and fiscal policy.[166] Most stabilization programs used by countries to counter a surge in foreign inflows start with sterilization and then move to capital controls once the cost of sterilization, in terms of reduction in central bank reserves and increases in interest rates, becomes pronounced.[167] Capital controls have been used extensively in the past two decades to reduce reliance on sterilization while still allowing countries to follow the conflicting goals of stabilizing their currency and keeping inflation low.[168] While in the past these types of macroeconomic concerns have been the primary impetus to impose capital controls,[169] empirical research suggests that countries today are using capital controls for reasons more closely related to the development of their financial systems.[170]

When a country's financial system is not relatively well developed, keeping financial agents from engaging in excessively risky activities proves difficult. This points to the third major reason countries use controls: To stem excessive risk-taking by economic agents when insufficient government supervisory and regulatory institutions exist or when an implicit exchange rate guarantee encourages a build-up of unhedged foreign currency borrowing[171] by banks and companies.[172]

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indebtedness to the rest of the world and the amount of net income it receives from imports over exports. Krugman & Obstfeld, International Economics, *supra* note 49, at 302.

163. The primary monetary policy concern of most countries is price stability, i.e., keeping inflation down, but some monetary authorities also actively manage the country's exchange rate, especially in LDCs. Black, *supra* note 38, at 303 (defining monetary policy).

164. *See* Ariyoshi, *supra* note 87, at 5 (discussing the conflicts between maintaining a fixed exchange rate and price stability).

165. Sterilization refers to the central banks selling securities on the open market to counteract the expansionary effect of capital inflows on the money supply. For a thorough discussion of sterilization, which is beyond the scope of this Note, see Krugman & Obstfeld, International Economics, *supra* note 49, at 494-96.

166. *See* McKnight, *supra* note 95, at 877. Fiscal policy responses to foreign inflows would consist primarily of reducing the level of government spending to curb inflationary pressures. *See id.*

167. Ariyoshi, *supra* note 87, at 49.

168. *See id.* at 6; Johnston & Tamirisa, *supra* note 85, at 13-14.

169. *See* Ariyoshi, *supra* note 87, at 8.

170. *See* Johnston & Tamirisa, *supra* note 85, at 3 ("[R]ecourse to capital controls reflects the overall framework for economic regulation and the degree of financial market development.").

171. Hedging foreign currency borrowing involves buying derivative instruments to

These prudential concerns, or measures to rein in the risk-taking of financial intermediaries and borrowers, have historically played a less important role in the decision to implement capital controls.[173] Prudential concerns, however, offer a better basis for future capital control measures. Controls, in this context, are put in place to preserve "systemic stability" by limiting "excessive foreign exchange exposure of domestic institutions, or help[ing] lengthen the maturity of liabilities of financial institutions."[174] In the absence of effective bank supervision, capital controls are a second-best solution to prevent excessive foreign borrowing while proper prudential standards take hold.[175]

A fourth reason to control capital flows is to prevent domestic citizens' savings from leaving the country and thereby preventing capital formation.[176] Controls on outflows serve primarily to prevent capital flight, or large-scale departure of residents' and non-residents' capital sparked by fears of instability or rampant inflation.[177] Outflow controls can also stimulate domestic capital formation.[178] In the same way that capital controls on inflows can prevent a build-up of capital that is suddenly withdrawn, causing financial instability, controls on capital outflows can prevent capital already built up, both domestic and foreign, from suddenly pulling out of the country.[179]

Finally, and perhaps most importantly, LDCs impose capital controls to allow their emerging economies time to develop to the point where they can withstand the cycles of the international financial markets without excessively destabilizing volatility.[180] "[C]lear and efficient legal, accounting, and taxation systems and standardized legal practices" form the basis of a sound market economy.[181] These practices and rules take time to implement and enforce. In addition, regulatory authorities must have sufficient capacity to supervise a sophisticated financial system. To do this, different regulatory authorities must learn to share information, and

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protect against an unexpected depreciation in the domestic currency, as the cost of repaying foreign loans consequently goes up in terms of the local currency. Unhedged foreign currency borrowing would not protect against this risk. John Downes & Jordan Elliot Goodman, Dictionary of Finance and Investment Terms 237 (4th ed. 1995).

172. *See* Ariyoshi, *supra* note 87, at 5.

173. *See id.* at 3-4.

174. Johnston, *supra* note 85, at 15.

175. *See id.* at 16.

176. *See, e.g.*, Krugman & Obstfeld, International Economics, *supra* note 49, at 504-06.

177. *See, e.g.*, Black, *supra* note 38, at 49.

178. *See* Watanabe, *supra* note 103, at 3.

179. *See infra* Part III.A.3 (discussing Malaysia's use of controls on capital outflows).

180. *See* Toyoo Gyohten, *East Asian Capital Markets*, 21 Fordham Int'l L.J. 371, 374 (1997).

181. *Id.*

countries have to learn to standardize financial institution supervision.[182] Lastly, well-regulated and institutionalized domestic capital markets form the basis of a country's ability to absorb foreign capital inflows efficiently.

While many mainstream theorists accept that capital controls can play some role in helping to achieve each of these policy objectives, how useful they are and for how long an LDC can use them are two debated issues. The next Section looks at the issue of whether LDCs should maintain capital controls once their financial system development begins to gain momentum or whether they should lift controls relatively early in the development process.

C. *When Should Countries Use Capital Controls?*

In between ardent supporters of the free market and equally ardent protectionists, the central debate over capital controls concerns whether LDCs should abandon them early in an economic reform process, or continue to use them until all the major kinks in a country's financial infrastructure have been smoothed out. This Section describes the debate over capital controls and looks at how it has evolved in light of the Asian financial crisis.

The primary controversy over capital controls relates to when a country should liberalize its laws governing capital transactions and whether capital controls can help put in place the financial system infrastructure necessary to an open capital account. This discussion begins by examining the generally accepted uses of capital controls and looks at support for them among mainstream economists, for in some situations the wisdom of particular controls is largely beyond reproach. The more contentious issue—how much a country must reform its financial infrastructure before opening its domestic capital markets—follows. This analysis looks at the steps a country should take before liberalizing its capital account in order to ensure financial stability.

1. Acceptability of Capital Controls

The world community does not roundly reject all capital controls. In fact, most Western European nations used capital controls to attain full convertibility of their currencies and to limit inflows of short-term capital.[183] International law widely accepts some uses of capital controls, such as to protect vital national interests.[184] Whether a

182. *Id.*

183. *See* Timothy A. Canova, Commentary, *The Disorders of Unrestricted Capital Mobility and the Limits of the Orthodox Imagination: A Critique of Robert Solomon,* Money on the Move: The Revolution in International Finance Since 1980, 9 Minn. J. Global Trade 219, 221-22 (2000) [hereinafter Canova, *Unrestricted Capital Mobility*].

184. *See infra* notes 189-91 and accompanying text.

capital control could be considered restrictive depends on the jurisdictional context used to evaluate the measure.[185] The Organization for Economic Cooperation and Development ("OECD") Code of Liberalisation of Capital Movements provides a good starting point for determining whether a certain type of control is considered restrictive by the standards of the industrialized nations.[186] Membership in the OECD now precludes the use of most capital controls,[187] reflecting the view that most capital controls restrict the workings of the free market.[188]

Countries have historically limited foreign investment for reasons including nationalism, economic instability, and "ideological opposition to capitalism."[189] A country might limit FDI in particular sectors to protect its sovereignty, i.e., sectors that it thinks are important for "economic, political, military, or cultural independence."[190] Parallel to the nationalistic reasons are historical reasons: Many LDCs were, until relatively recently, colonies controlled by the now-industrialized nations. The cultural legacies of LDCs' disdain for this period are apparent in many of these countries' legal institutions, including controls on foreign investment.[191] Capital controls can, arguably, allay this fear of neo-colonialism in LDCs and allow gradual introduction of foreign-owned businesses.

Until recently, most Western economists and policymakers largely accepted that capital controls were inefficient and pressured LDCs to liberalize their financial markets.[192] The Mexican banking and currency crisis in 1994-95 began the current debate over capital controls,[193] but the Asian crisis has intensified the debate and increased support for capital controls.[194] With the onset of the Asian

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185. Johnston, *supra* note 85, at 5 n.3.

186. *See id.*

187. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1614-15.

188. *See id.* at 1615 n.180 (noting that art. 1(d) of the OECD Code of Liberalisation of Capital Movements requires "all OECD members to 'endeavour to extend the measures of liberalisation to all members of the International Monetary Fund'").

189. McKnight, *supra* note 95, at 868.

190. Leckow, *supra* note 7, at 516. While FDI has commonly been thought important to capital-importing countries' development by bringing "managerial and technological knowledge [sic]," it is clear in the context of this discussion that FDI also has costs. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 3. Another cost of FDI is the anti-foreign sentiment that special treatment for foreign FDI often receives in capital-importing nations. *See* Gray & Jarosz, *supra* note 91, at 16.

191. *See, e.g.*, Kirk, *supra* note 40, at 1 (discussing Korea's fear of control by outsiders stemming from its fifty-year colonial domination by Japan in the beginning of this century).

192. *See* Antony Anghie, *Time Present and Time Past: Globalization, International Financial Institutions, and the Third World*, 32 N.Y.U. J. Int'l L. & Pol. 243, 256-57 (2000).

193. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1597-1604; McKnight, *supra* note 95, at 860-62.

194. *See* National Bureau of Economic Research, Proceedings on Capital Account Convertibility: Capital Controls in Emerging Market Countries (Nov. 6, 1998),

financial crisis, the debate over capital controls changed: Prior to this event a broad consensus advocating the removal of capital controls had emerged; after 1998, the debate centered on "when, and what type of capital controls are [sic] appropriate."[195]

Economists at the IMF produced strong evidence of the effectiveness of capital controls in some situations for the better part of the 1990s.[196] The idea of "taxing financial transactions to discourage speculative activities [that] are not in line with economic fundamentals," however, goes back to John M. Keynes.[197] Keynes developed the idea to increase the transaction costs of speculative activities.[198] Nobel laureate economist James Tobin's 1978 proposal of a tax to "throw sand in the hyperactive wheels of international capital movements" received much attention and has been much debated.[199] Capital controls gained wider acceptance almost overnight when Paul Krugman, the leading thinker in modern international monetary economics, came out in support of their use to allow countries some breathing room in the midst of financial crises.[200]

2. Steps in the Reform Process

This subsection shows why the use of capital controls has gained

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http://www.nber.org/crisis/capital.html; *see also* Tito Cordella, *Can Short-Term Capital Controls Promote Capital Inflows?* 4 (IMF Working Paper, 1998) ("The financial crisis in [Asia] . . . weakened the case for an early and complete liberalization of capital transactions."). *But see* Cynthia N. Lichtenstein, *Dealing with Sovereign Liquidity Crises: New International Initiatives for the New World of Volatile Capital Flows to and from Emerging Markets*, 29 McGeorge L. Rev. 807, 811 (1998) (stating at the outset of the Asian financial crisis that "there seems to be considerable agreement . . . that the reinstitution of capital controls for countries facing an exchange crisis resulting from volatile outflows is not a solution").

195. Betty Whelchel, *Preventing Asia Type Crises: Who, If Anyone, Should Have Jurisdiction over International Capital Movement?*, 5 ILSA J. Int'l & Comp. L. 417, 417 (1999).

196. *See, e.g.*, McKnight, *supra* note 95, at 864 & nn.25-27 (noting earlier research showing the effectiveness of capital controls). Empirical testing of capital controls continues to evolve. Economists are still developing econometric models to accurately reflect their effects on LDCs. *See* Ariyoshi, *supra* note 87, at 5.

197. *See* Howell H. Zee, *Retarding Short-Term Capital Inflows Through Withholding Tax* 3 (IMF Working Paper, 2000) (discussing Keynes's introduction of the idea in his work The General Theory of Employment, Interest and Money (1936)); *see also* Canova, *Banking and Financial Reform*, *supra* note 82, at 1611-12 (arguing that Keynes foresaw the use of art. VI of the IMF Arts. of Agreement as a means of forestalling destabilizing speculative activity in financial markets).

198. Zee, *supra* note 197, at 3.

199. *Id.* The Tobin tax would tax all financial transactions involving the conversion of one currency into another. *See* James Tobin, *A Proposal for International Monetary Reform*, 4 E. Econ. J. 153 (1978); *see also* Francisco Nadal-De Simone, *The Tobin Tax: Coping with Financial Volatility—A Review Article*, 42 Singapore Econ. Rev. 32 (1997); Brow, *supra* note 142, at 384-89 (discussing implementation of a Tobin tax in the United States).

200. *See* Paul Krugman, *Saving Asia: It's Time To Get Radical*, Fortune, Sept. 7, 1998, at 75, 79.

wider acceptance among economists as an effective part of a financial reform process. Certain steps must be taken before an emerging market country can productively employ foreign capital, as this subsection shows. The country should first strengthen its financial sector and then gradually allow different types of investment, starting with FDI and ending with domestic borrowing from foreign banks. While this lengthy process unfolds, capital controls, some have argued, can prevent excessive foreign borrowing. This section describes the process of reforming an LDC's financial sector to the point where more or less full capital account liberalization is appropriate. Subsection III.A.1., *infra*, describes the somewhat analogous, but much less strenuous, conditions necessary for successful implementation of capital controls.

In order for inflows of foreign capital to have net benefits for a country, some crucial conditions must be in place.[201] The right conditions include sound and effective prudential regulation[202] and other steps that take several years to implement. The essential policy question is how to find the right balance of risk and return—of openness and its benefits—but measured with enough restrictions to minimize the risk of destabilizing swings in capital flows.[203] The question is not whether to cut off international capital flows completely, but how to reduce the flows to a manageable level.[204]

Liberalization does not just mean removing government from the operation of the economy.[205] To the contrary, developed countries have successful financial systems because they have highly sophisticated and active regulatory agencies.[206] Government's role is not to direct with a high degree of specificity where investments must be made, as happened in Asia, but to confine financial institutions within broadly defined limits of prudent financial activity.[207]

201. See *supra* notes 128-29 and accompanying text for a discussion of the evidence on the benefits of foreign capital inflows in LDCs.

202. *See* Asli Demirgüç-Kunt & Enrica Detragiache, *Financial Liberalization and Financial Fragility* 3 (IMF Working Paper, 1998) (using statistical research to "support the view that financial liberalization should be approached cautiously where the institutions necessary to ensure law and contract enforcement and effective prudential regulation and supervision are not fully developed"). One of the principal lessons of the Asian crisis is a realization of the importance of a sound "domestic financial system in achieving the benefits and avoiding the risks of liberalization." Rossi, *supra* note 128, at 3.

203. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 3 (noting that countries should "liberalize flows just to the point where the benefits, in terms of additional stimulus to growth, continue to dominate the risks, in the form of susceptibility to financial disruptions").

204. *Id.*

205. *See* McKnight, *supra* note 95, at 893.

206. Even developed countries' financial institution regulators sometimes fail to supervise market activity with sufficient caution. The savings and loan crisis in the United States demonstrates that no country is immune to such lapses in supervision.

207. *See* International Monetary Fund, World Econ. Outlook, Dec. 1997, at 12-13.

Governments in LDCs should search for the legal controls that change the composition of capital inflows or limit them with the least amount of market distortion.[208]

Most economists agree that capital account liberalization should come at the end of a reform process.[209] Considering that developed countries took several decades to open their own capital accounts, most commentators think that LDCs should be permitted some leeway in getting to this stage.[210] Capital account liberalization "is the logical culmination of the process of developing a deep, mature and efficient domestic financial system."[211]

Although the interrelationships of "capital account liberalization, prudential regulation and supervision, financial fragility and economic performance" needs more empirical research to make a precise blueprint for gradual liberalization of the capital account,[212] some general steps have been identified. A country should "first strengthen the domestic financial sector, remove implicit guarantees, and impose hard budget constraints on domestic financial institutions."[213] The banking sector should be recapitalized before liberalization, and prudential supervision and regulation must be improved.[214] As a measuring stick, capital controls "are justifiable only where financial markets are thin, the private sector's risk-management practices are underdeveloped, and the regulators' capacity to supervise the financial sector is limited."[215]

Some countries have liberalized their capital accounts rapidly to signal a strong commitment to reform to the financial markets.[216] The experiences of countries like Argentina, Kenya and Peru highlight the need for financial reform before rapid liberalization, lest the country be more prone to seriously adverse shocks.[217] The slow pace of reform in post-crisis Asia's banking sectors, financial markets and bankruptcy laws demonstrates how long this process can take.[218] Structural reforms of this magnitude have "an unavoidably long time-scale,"[219]

208. *See* McKnight, *supra* note 95, at 865 (arguing for limiting "capital flows with the least distortion").

209. *Id.*

210. *See* Eichengreen, Capital Controls, *supra* note 148, at 4-5.

211. *Id.* at 4.

212. *See* Rossi, *supra* note 128, at 4.

213. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 8.

214. *Id.* at 9.

215. Eichengreen, Capital Controls, *supra* note 148, at 8.

216. *See, e.g.*, Ariyoshi, *supra* note 87, at 31 (discussing the rapid liberalization process in Argentina, Kenya and Peru).

217. *See id.*

218. *See Asia's Economies: On Their Feet Again?*, *supra* note 58, at 16 (discussing the slow pace of reform in many Asian countries' banking sectors, financial markets and bankruptcy laws).

219. Chakravarthi Raghavan, *Capital Controls Needed to Manage Crises*, (Sept. 1998), *at* http://www.twnside.org.sg/title/mana-cn.htm (reiterating the point that LDCs will also need the decades that developed countries took to produce the institutions

and some economists have in fact recognized that the "transitional" use of capital controls may be over a long period.[220] At a minimum, the proper sequencing of a liberalization program requires the use of capital controls, at least temporarily.[221]

The sequencing of a capital account liberalization program should begin with FDI, as FDI is less likely to "aggravate weaknesses in the domestic banking system."[222] FDI is thought to bring several benefits to a developing economy: longer time frames are involved; investors are more involved in planning and managing projects, so inefficient investments are less likely to result; and FDI is typically thought to involve a transfer of technology and management skills.[223] FDI stimulates trade, as almost 50% of international trade is between affiliated companies, in what is known as intra-firm trade.[224]

The next step in a capital account liberalization program should be the limited opening of securities markets to foreign investment.[225] Stock and bond markets should be liberalized before banks and companies are allowed to borrow abroad.[226] Here again, information about corporations' financial health does not flow to foreign investors without a solid regulatory framework. Such a regulatory structure takes a considerable amount of time to build up.[227] Legal rules "requiring disclosure, discouraging insider trading and protecting the rights of minority shareholders"[228] will not immediately start working effectively. Markets for corporate bonds usually follow the solid formation of a market for a "benchmark asset" within the country, such as government treasury bonds,[229] which markets have yet to develop in many parts of East Asia. Importantly, once securities markets are opened, capital controls will still be needed for some time

required to function with a fully liberalized capital account).

220. Eichengreen, Capital Controls, *supra* note 148, at 5.

221. *See* McKnight, *supra* note 95, at 883.

222. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 9. This advice is taken as "obvious" by most economists and others, but the 144 of 184 members of the IMF who still maintain controls on FDI have not heeded this advice. *Id.* This highlights the fact that the non-economic reasons for restricting FDI often win the debate. *See infra* Part III.B. (discussing the non-economic reasons for restricting foreign investment).

223. McKnight, *supra* note 95, at 880-81 & n.111.

224. *See* Michael A. Geist, *Toward a General Agreement on the Regulation of Foreign Direct Investment*, 26 Law & Pol'y Int'l Bus. 673, 673 (1995).

225. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 11 ("[F]oreign investment in securities poses fewer risks than short-term foreign deposits.").

226. *See id.* at 12 (arguing that the "most reliable predictor . . . of currency crises is the term structure of portfolio capital inflows"—that is, when portfolio inflows come primarily in the form of foreign borrowing of banks and companies directly from foreign banks rather than through capital markets).

227. *See id.*

228. *Id.*

229. *Id.*

to prevent them being used as speculative conduits.[230] Local derivatives markets, similarly, help financial agents hedge against risk and reduce volatility,[231] but foreign access to such markets must initially be limited with capital controls to prevent local derivatives markets from becoming vehicles for speculation.

One of the chief lessons of the Asian crisis is that bank borrowing abroad should be the last element of the capital account to be liberalized, rather than the first.[232] LDCs should limit corporate borrowing in foreign currencies until deep and liquid markets for corporate debt in the local currency develop and the companies learn to operate under restraints imposed by financial markets.[233] Also, limitations on foreign borrowing by banks can be circumvented by corporations borrowing from abroad and onlending to banks.[234]

The majority of economists roughly agree on the foregoing discussion of the proper sequencing of capital account liberalization.[235] The primary debate over this liberalization process instead involves the timing of such reforms and whether capital controls can effectively contribute to them by stabilizing financial markets while they are in place. Arguments against using capital controls while financial system infrastructure goes into place highlight the costs of capital controls. Capital controls may discourage desirable capital flows and current account payment transactions in addition to discouraging "hot money."[236] Capital controls also involve "nontrivial administrative costs."[237] If regulatory reform does not simultaneously occur when capital controls are implemented, controls reduce the incentive for the domestic financial industry to make structural changes and may also prevent the domestic market from adjusting quickly to changing international conditions.[238] Finally, capital controls give rise to "negative market perceptions," i.e., they shake investors' confidence and make borrowing more expensive.[239]

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230. *See* Ariyoshi, *supra* note 87, at 50 (discussing corporate debt used as a speculative device). The governor of Mexico's central bank said the 1994 crisis was a "direct result of the sudden and complete opening of the Mexican securities market to capital inflows." Watanabe, *supra* note 103, at 22.

231. *See* Watanabe, *supra* note 103, at 29-30.

232. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 13.

233. *See Asia's Economies: On Their Feet Again?*, *supra* note 58, at 18.

234. Eichengreen, Capital Controls, *supra* note 148, at 7.

235. *See* Whelchel, *supra* note 195, at 417.

236. *See* Ariyoshi, *supra* note 87, at 6. The term "hot money" connotes investment capital that "capriciously seek[s] high, short-term yields. Borrowers attracting hot money . . . should be prepared to lose it as soon as another borrower offers a higher rate." *See* Downes & Goodman, *supra* note 171, at 246; *see also* Canova, *Financial Liberalization*, *supra* note 129, at 1287 (defining the term "hot money").

237. Ariyoshi, *supra* note 87, at 6. Administrative costs include the cost to the government of setting up a bureaucracy to supervise financial transactions and police them for avoidance of capital controls. *Id.*

238. *Id.*

239. *Id.*

Even a relatively well-developed region such as East Asia has many steps to take before its capital markets develop enough to deal efficiently with foreign inflows.[240] Many Asian countries do not yet have primary and secondary markets for equity and long-term bonds, or secondary markets for government bonds to function as benchmark securities.[241] Development of financial markets in East Asia has been slowed by a lack of transparency, or companies' reluctance to release reliable information.[242] Much of the problem comes from the lack of a proper legal framework for the functioning of financial markets.[243] Other legal reforms needed to ensure efficient functioning of Asia's capital markets include cracking down on insider trading, ameliorating currently uncertain settlement procedures, and increasing the number of regulatory and supervisory agencies to monitor capital markets.[244] While such reforms form the basic foundation of efficient capital markets, they take many years to fully implement.

LDCs have lately pressed the case for capital controls.[245] They insist they need controls to manage crises, rather than having to resort to fiscal and monetary tightening. Such fiscal and monetary austerity, they contend, only deepens the decline by driving otherwise solvent businesses into bankruptcy when interest rates are ratcheted up.[246] LDCs argue that markets are imperfect and do not always perform optimally, and that not even the best financial regulation can prevent financial crises.[247] When the markets do fail, citizens of LDCs bear a greater level of hardship than people in industrialized nations.[248] Developed countries, many LDCs further argue, used capital controls until recent decades, and this allowed their regulatory structures and financial markets to develop to the point of remaining stable in the face of volatile capital flows.[249] For example, most European nations, after World War II, while in a somewhat analogous position to that of

240. *See* Gyohten, *supra* note 180, at 372; *Asia's Economies: On Their Feet Again?*, *supra* note 58, at 17-18.

241. *See* Gyohten, *supra* note 180, at 373.

242. *Id.*

243. *See, e.g.*, *Asia's Economies: On Their Feet Again?*, *supra* note 58, at 18 (discussing the need for stricter auditing of companies and more rights for minority shareholders).

244. *See* Gyohten, *supra* note 180, at 373.

245. *See* Terrill, *supra* note 92, at 303-04 (describing the debate on capital controls between the industrialized nations and the LDCs).

246. *See* Raghavan, *supra* note 219.

247. *See id.*

248. *See* Levinson, *supra* note 72, at 539-42 (discussing the human cost of the Asian financial crisis in Indonesia); *see also supra* notes 1-5 and accompanying text.

249. *See* Raghavan, *supra* note 219. "Countries with both open and closed capital accounts" have experienced financial crises, but much evidence indicates that a liberalized capital account increases the risk of a currency crisis, and the costs incurred from a crisis with an open capital account are also increased. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 7 (discussing evidence on this point).

LDCs, employed capital controls to stem excessive inflows of foreign investment during the decades of their reconstruction.[250]

While the multilateral institutions and industrialized nations have put pressure on LDCs to open up their capital accounts prematurely,[251] only the staunchest free-marketers argue against all capital controls.[252] Finding an equilibrium between economic liberalization and the use of capital controls and other non-market policy measures is difficult.[253] The next part argues that this equilibrium is best achieved by a proactive regime of modern capital controls, coupled with a committed reform and strengthening of the domestic financial sector.

III. CAPITAL CONTROLS CAN EFFECTIVELY REDUCE FINANCIAL INSTABILITY IN LDCS AND ENSURE COUNTRIES' ECONOMIC SOVEREIGNTY

This part argues that capital controls effectively reduce financial instability in LDCs, if employed under the right conditions. It begins by exploring the conditions necessary for an effective capital control regime and then examines the successful use of inflow controls by Chile and the implementation of outflow controls by Malaysia. This part then moves beyond economic theory to argue that non-economic reasons validate LDCs' use of capital controls. Unchecked capital mobility coupled with inefficient investment produces financial instability that in turn generates a great human cost and a reduction in LDCs' economic sovereignty. These results make a persuasive case for continued use of capital controls by LDCs.

A. *Effective Capital Control Regimes*

Economists measure the effectiveness of capital controls in terms of how well they have helped countries achieve the policy goals driving their implementation.[254] In most countries this goal is to increase domestic financial stability. The majority of economic literature on capital controls has focused on their effectiveness (or lack thereof), and much contention surrounds this area of research.[255] In any case,

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250. *See* Government of Malaysia, *supra* note 9.

251. *See* Anghie, *supra* note 192, at 255-56.

252. *See, e.g.*, Ian Vásquez, The Irrationality of Capital Controls, Cato Institute Commentary (Nov. 3, 1998), *at* http://www.cato.org/dailys/11-03-98.html (arguing that proposals to implement capital controls to correct market imperfections are misguided).

253. *See* McKnight, *supra* note 95, at 863; Eichengreen, *Taming Capital Flows*, *supra* note 48, at 3-8.

254. *Cf.* Ariyoshi, *supra* note 87, at 5; Eliana Cardoso & Ilan Goldfajn, *Capital Flows to Brazil: The Endogeneity of Capital Controls*, 45 IMF Staff Papers 161, 166 (1998).

255. For thorough studies presenting evidence for and against the effectiveness of capital controls, see Ariyoshi, *supra* note 87, and Barry Eichengreen & M. Mussa,

"no unique best approach" arises from the literature—while some types of controls work better than others, a country must choose a mix of policies that best suits the conditions prevailing in its economy.[256] This section looks at the necessary elements of an effective capital control regime, and discusses what steps an LDC must take before it can successfully implement capital controls. This contrasts with Part II.C.2., *supra*, which discusses the steps needed to reform an LDC's financial system to a point where capital account liberalization is appropriate. While some of the steps may overlap, the entire reform process entails much broader transformation. A discussion of the use of capital controls in two countries, Chile and Malaysia, follows to illustrate what effective capital control regimes can accomplish.

Empirical research, as illustrated in the Chile discussion, shows that capital controls can effectively alter the *maturity* profile of inflows towards the longer term, but the evidence also suggests that capital controls generally do not reduce the overall *volume* of inflows into LDCs.[257] New research suggests increased stability does not require an overall reduction in inflow volume, provided maturity composition is affected.[258] The discussion of Malaysia indicates that controls on outflows are less effective than inflow controls. Whether capital controls can prevent banking crises remains under examination,[259] but some beneficial effects have been identified when the right conditions are in place.

1. Conditions Necessary for an Effective Capital Control Regime

Before any country can effectively employ capital controls to reduce financial instability, certain conditions need to be in place. In general, three elements are necessary: (1) coverage of transactions needs to be comprehensive; (2) the controls must be forcefully implemented;[260] and, perhaps most importantly, (3) increased prudential regulation and supervision of the financial system must be simultaneously implemented.[261]

Capital Account Liberalization: Theoretical and Practical Aspects, IMF Occasional Paper No. 172 (1998).

256. *See* Ariyoshi, *supra* note 87, at 4, 17.

257. *Id.* at 16.

258. See *infra* Part III.A.2. for a discussion of this research in the context of an assessment of Chile's URR.

259. *See* Demirgüç-Kunt & Detragiache, *supra* note 202, at 3 (finding that "banking crises are more likely to occur in liberalized financial systems"). *But see* Rossi, *supra* note 128, at 15 (finding that the "degree of liberalization of capital inflows . . . turn[s] out to be statistically insignificant" with respect to banking crises).

260. *See* Ariyoshi, *supra* note 87, at 17.

261. *Cf.* Lichtenstein, *supra* note 194, at 812 (noting that "financial sector reform and the creation of a domestic banking system that adheres to adequate . . . prudential standards and is regulated and supervised by an independent technically adequate

The first element requires that a capital control regime cover a broad swath of transactions. Research has shown Brazil's capital controls did not stabilize the country, largely because Brazil's highly developed financial markets found ways to exploit loopholes in the controls.[262] Such controls may be useful, however, in countries with less well-developed financial markets, such as most of the East Asian economies. Even in Chile, where the URR has been acclaimed by many as a stabilizing force,[263] the regulatory authorities were frequently revising their capital controls to cover the new avoidance techniques.[264] As Chile learned, a broader coverage of different types of financial transactions is most effective.

Strong enforcement requires fluid communication between the central bank and the commercial banks and comprehensive disclosure from the latter.[265] The government must also continue to police the financial markets for avoidance of its capital controls, as financial markets learn to exploit derivatives to negate capital controls.[266] An effective capital control program requires setting up a legal framework that corrects existing market distortions while introducing the least number of new distortions.[267] "Interventions which rely on markets instead of bureaucrats minimize [the] risks" of "rent seeking and corruption" by the officials who administer capital controls and also the risk that as sophisticated financial markets develop they will evade controls by simply "relabeling positions and repackaging obligations."[268]

An effective capital control regime also requires strengthening of the financial sector. If controls are imposed without financial sector strengthening, such as improved asset quality requirements for banks and increased supervision, capital controls will allow the system to become less efficient and less able to handle foreign inflows when capital account liberalization finally arrives. Empirical research shows that countries whose capital controls did not work as a means of

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supervisory system" is the "sine qua non" of stabilizing emerging markets (emphasis omitted)).

262. *See id.*; *see also* Laurens & Cardoso, *supra* note 117, at 21 (noting that countries lacking the expertise to enforce capital controls will not be able to use them effectively).

263. *See* Cardoso & Goldfajn, *supra* note 254, at 167; Laurens & Cardoso, *supra* note 117, at 19-21.

264. *Cf.* Cardoso & Goldfajn, *supra* note 254, at 166-68. Even trade credits might have to be subject to capital controls, as their exemption has been shown to reduce the effectiveness of a URR-type regime. *Id.* Colombia achieved success with its URR while extending it to cover trade credits. *Id.*

265. *See* Ariyoshi, *supra* note 87, at 17.

266. *See id.*

267. *See* McKnight, *supra* note 95, at 892 (arguing that capital controls should reduce the risk of foreign capital in the most efficient way possible).

268. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 13.

inducing stability did not, by and large, implement extensive prudential reform before opening their capital accounts.[269]

Before capital controls can be effective, proper administration must be in place.[270] More than just a measure related to capital control effectiveness, prudential regulations and capital controls can replicate and reinforce the effects of each other. Strengthening prudential regulations can reduce capital inflows.[271] "More restrictive systems of domestic regulations tend to be associated with fewer controls on inflows and outflows . . . suggesting some substitution between an effective system of domestic regulation and the need to resort to capital controls."[272] Prudential regulations generally function to limit the risk vulnerability of the financial system, similar to one of the functions of capital controls.[273]

The Asian crisis accelerated appreciation of the importance of prudential regulations in managing the risks of volatile capital flows and increasing the health of financial intermediaries.[274] Prudential regulations and supervision force financial institutions to manage external risk more effectively, and this reduces the volatility of foreign inflows.[275] In many LDCs, banks are the primary means of channeling foreign inflows, so prudential limits on bank activity can have an especially effective impact.[276] While prudential measures on banks are being implemented and bank managers are learning to work within their parameters, capital controls can operate as an immediately effective limitation on banks' risk-taking activities.[277]

A discussion of two countries' experiences using capital controls will demonstrate how they can work to reduce instability, provided the necessary conditions are in place.

2. Chile's Experience with Capital Controls

The most substantial information on the effectiveness of capital controls comes from the experience of Chile.[278] Starting in 1991, Chile

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269. *See* Ariyoshi, *supra* note 87, at 52.

270. *See* McKnight, *supra* note 95, at 893.

271. *See* Ariyoshi, *supra* note 87, at 17.

272. Johnston & Tamirisa, *supra* note 85, at 25 (emphasis omitted).

273. *See Keeping the Hot Money Out*, *supra* note 6, at 70; Ariyoshi, *supra* note 87, at 32; Laurens & Cardoso, *supra* note 117, at 19-21.

274. *See* Ariyoshi, *supra* note 87, at 32. "[F]inancial institutions are prone to excessive risk-taking," and prudential regulations can increase effective risk management, and thereby "dampen transmission and contagion, and contribute to stemming the development of a major financial crisis." *Id.*

275. *Id.*

276. *See id.*

277. This assumes that the capital controls are implemented in an effective way (i.e., with sufficient administrative and enforcement capacity and sufficient breadth). *See id.* at 33.

278. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1626 (discussing the "enthusiastic attention" given to Chile's capital-control regime, while

adopted the following measures: a selective URR of 20% on certain investments, a minimum-stay requirement for both direct and portfolio investment, regulatory requirements on corporations borrowing abroad, and extensive reporting requirements for banks on all capital transactions.[279] The URR was intended to encourage equity rather than debt financing, and long-term rather than short-term investments.[280] The URR initially covered one-half of gross inflows, but coverage eventually declined to 24% of inflows.[281]

From 1990 to 1998, short-term debt as a proportion of total Chilean debt fell from 25% to 12%.[282] Coverage of the URR was extended to nondebt flows that were potential conduits for speculative investments, such as foreign currency deposits, secondary depository receipts and FDI of a potentially speculative nature. The rate of the URR was raised to 30% and then eventually lowered to 0% in 1998, once the Asian crisis caused most inflows to LDCs to dry up.[283]

Before implementing these controls, the government had already begun to improve prudential regulations in the early 1980s with a thorough revision of the general banking law.[284] This involved "higher disclosure standards; stringent rules for loan classification and provisioning; strict limits on connected lending and on banks' exposure to foreign exchange risk; . . . clear procedures for the correction of liquidity or solvency problems;" a capital adequacy ratio of 11.5%; a targeting of connected lending; and minimum rating requirements for all companies borrowing in international capital markets.[285]

No absolute conclusions on the effectiveness of Chile's capital controls can be drawn.[286] The general consensus on Chile's capital controls, however, agrees that they did in fact change the maturity composition of capital inflows, regardless of whether the actual volume of inflows was affected.[287] Empirical research has differed

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characterizing it as "relatively modest").

279. Ariyoshi, *supra* note 87, at 47; *see also* Terrill, *supra* note 92, at 312 (discussing the capital controls implemented by Chile).

280. Ariyoshi, *supra* note 87, at 70 (characterizing the URR as an "asymmetric Tobin tax"). The URR puts a higher implicit cost on a shorter term inflow—its cost decreases with the length of the stay. *See id.*

281. *Id.*

282. *Id.* at 76.

283. *See id.*

284. *Id.* at 72-73; *see also Keeping the Hot Money Out*, *supra* note 6, at 70.

285. Ariyoshi, *supra* note 87, at 47, 73.

286. *But see* Terrill, *supra* note 92, at 312 (stating that the result of Chile's capital control program "was a steep *initial* decline in the amount of short-term capital flows in and out of Chile" (emphasis added)).

287. Ariyoshi, *supra* note 87, at 48; Cardoso & Goldfajn, *supra* note 254, at 166-67; Laurens & Cardoso, *supra* note 117, at 19-20; *see also* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 14 (citing further unpublished evidence that the no-volume "objection can be dismissed on the grounds that the goal was never to limit the level of foreign borrowing but to alter its average maturity, and on the maturity front the

over whether this maturity composition effect lasted over the long-term.[288] As the effects of the Asian crisis have been more closely dissected, it appears that more economists and policymakers have been forced to acknowledge that the maturity effect by itself helped reduce instability.[289] But regardless of how the maturity/volume debate is finally settled, some research does suggest that Chile's controls experienced some volume reduction "on impact."[290]

Critics of Chile's URR typically admit that the measure did alter maturity composition, but stress that it failed to lower the overall volume of inflows, and was therefore ineffective.[291] One author advances an interesting argument recently used to counter this critique.[292] Controls can be shown to effectively reduce a country's vulnerability to financial contagion, and this can encourage a higher volume of inflows of a more stable nature.[293] "If the supply of capital to emerging markets depends on the vulnerability of these markets to financial crises, capital controls that make these markets less vulnerable should, *certeris paribus*,[294] increase the supply of capital."[295] When viewed in light of this argument, findings that capital controls do not reduce investment inflow volume "corroborate . . . the view that short-term capital controls can be effective instruments in reducing the vulnerability of such markets to financial crises."[296]

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evidence is compelling"). Chile's URR has also been lauded as "transparent and insulated from administrative discretion." Eichengreen, *Taming Capital Flows*, *supra* note 48, at 13.

288. *See, e.g.*, Laurens & Cardoso, *supra* note 117 (discussing other researchers' findings of a long-term maturity effect, but showing only a temporary maturity composition effect in their study).

289. *See* Cordella, *supra* note 194, at 4 ("'Even critics of the Chilean system acknowledge that the reserve requirement has significantly lengthened the maturity composition of capital inflows to Chile. This . . . may be the reason that Chile has been relatively unaffected by recent financial crises.'" (quoting Joseph Stiglitz, *Boats, Planes and Capital Flows*, Fin. Times, Mar. 25, 1998)).

290. *See* Ariyoshi, *supra* note 87, at 48. Also, volume can effectively be reduced by implementing outflow controls, whose effect in Malaysia, as discussed below, was to make many investors shy away from the country. *See infra* Part III.A.3.

291. *See* Cordella, *supra* note 194, at 4 (discussing criticism of Chile's controls in Sebastian Edwards, *The Americas: Capital Controls Are Not the Reason for Chile's Success*, Wall St. J., Apr. 3, 1998). There is also clear evidence that Colombia's URR effectively altered the maturity profile of foreign capital inflows. *See* Ariyoshi, *supra* note 87, at 48-49.

292. *See* Cordella, *supra* note 194, at 4.

293. *See id.* at 4-5. Cordella argues that capital controls improve stability by raising the price to the investor of a panicked withdrawal, which in turn raises the expected return of keeping the investment in the country, even though market uncertainty has increased. *Id.* at 9 ("Taxes on short-term capital . . . reduce the probability of bank runs, and, . . . [thereby] increase the volume of foreign investments.").

294. *Ceteris paribus* is "Latin for 'other things being equal.' This means that other things that could change are for the moment being assumed not to." Black, *supra* note 38, at 58.

295. Cordella, *supra* note 194, at 9.

296. *Id.* at 3.

Most empirical literature suggests some effectiveness of Chile's capital controls, but emphasizes that the URR does not provide a "lasting solution to [the problems posed by] short-term . . . inflows."[297] The development of a prudential framework is the essential component for long-term stabilization.[298] The literature further states that a high level of enforcement capacity is necessary to make the capital controls effective.[299] This reinforces the observation that capital controls on short-term investments are most effective and most necessary in emerging market economies at a relatively higher level of development, which are the most attractive to foreign investment, but whose regulatory framework has not yet developed the necessary capacity.

The most commonly cited problems with Chile's URR typically start with the fact that it only provided partial coverage of short-term inflows, and particularly that it did not cover trade credits, which were covered by Colombia's URR, and which served as one of the prime loopholes in Chile's URR regime.[300] Another often-discussed problem with Chile's URR is the sophistication of Chile's financial system relative to the government's enforcement capacity.[301] But as one author retorts, paraphrasing Chile's finance minister, "'[i]f these capital-import taxes are so easily evaded, then why do we have so many non-interest-bearing foreign deposits at the central bank?'"[302]

3. Malaysia's Experience with Capital Controls

While Chile's capital control measures have been thoroughly investigated by economic researchers, the same cannot be said of Malaysia's controls on capital outflows implemented in 1998.[303] Chile's capital control program was a forward-thinking, proactive policy that tried to remedy the problem of excessive inflows before they became destabilizing. Malaysia's 1998 capital controls, on the other hand, were a reaction to an immediate crisis and differed radically in their approach. Because Malaysia only recently implemented this program of capital controls, it is too soon to draw many conclusions about their effectiveness.

Malaysia's implementation of a capital-control regime in 1998, in the midst of the Asian crisis, brought the brewing debate over capital controls to the center of attention.[304] While Malaysia's controls

297. Laurens & Cardoso, *supra* note 117, at 20.

298. *See* Ariyoshi, *supra* note 87, at 47-48 (citing Chile's early recognition of the importance and early implementation of financial sector prudential reforms).

299. *See id.* at 48.

300. *Id.*

301. *See id.*

302. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 14.

303. *See* Ariyoshi, *supra* note 87, at 28.

304. When Malaysia's Prime Minister, Mahathir Mohammed, denounced currency

differed dramatically from Chile's,[305] a comparison sheds light on how LDCs use capital controls in different situations. Malaysia's controls were more directly targeted at transactions that were vehicles of speculation and were also emergency measures to stem outflows,[306] while Chile's capital-control regime was developed to retard inflows.[307]

The 1998 emergency controls came at a time when Malaysia had substantially liberalized its capital account.[308] When the Asian crisis spread to its shores, Malaysia adopted a strict capital control program, targeted at outflows of speculative investments.[309] The primary concern was the stability of the country's exchange rate, which was on a managed-float regime.[310] Malaysia sought to prevent a financial market decline that would surely follow a fall in the currency, as had already happened in Thailand, Korea and Indonesia.[311] Using capital controls to stabilize the currency allowed Malaysia to keep interest rates low.[312] Lower interest rates put less pressure on domestic banks and helped save the country from the huge number of bank failures experienced in Korea and Indonesia.[313] Malaysia's capital controls have also made cleaning up the banking sector easier through interest rate cuts and exchange rate stability.[314]

Malaysia's capital outflow controls have generally been assessed as effective.[315] Malaysia eliminated the offshore ringgit (the Malaysian currency) market and succeeded in stemming outflows.[316] This program showed that eliminating the offshore currency market is the most important element of a capital outflow control regime.[317] These outflow controls also significantly contributed to the stabilization of

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speculators in general, and George Soros in particular, the world's attention was drawn to the subject of capital controls. *See, e.g.*, Terrill, *supra* note 92, at 314 (discussing Prime Minister Mahathir's comments).

305. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1627 (characterizing Malaysia's capital controls as surpassing Chile's in breadth).

306. *See* Ariyoshi, *supra* note 87, at 18.

307. *See* Terrill, *supra* note 92, at 313-14 (noting that Malaysia's controls were directly targeted at certain types of transactions).

308. *Id.* at 312.

309. *See* International Monetary Fund, World Economic Outlook, Dec. 1998, at 22.

310. *See id.*

311. *See id.*

312. *See* Ariyoshi, *supra* note 87, at 17.

313. Keeping interest rates low may have reduced the number of nonperforming loans, thereby reducing the number of bank failures in Malaysia, which in turn reduced the cost of recapitalizing the banking sector after the crisis had passed. *See id.* at 100 & n.103 (discussing Standard & Poor's assessment that nonperforming loans would have been much greater had the interest rate not been kept low in Malaysia).

314. *See id.* at 100.

315. *See* International Monetary Fund, World Economic Outlook, Oct. 1999, at 54-55.

316. *See* Ariyoshi, *supra* note 87, at 24.

317. *See id.* at 28.

the exchange rate.[318] No more signs of speculative pressure on the currency have appeared, which has allowed Malaysia to use loose monetary and fiscal policy to mitigate the far-reaching effects of the crisis.[319] Significantly, no major signs of "circumvention efforts have been reported."[320] The main benefit of the controls was to give the country a temporary respite from the destabilizing outflows.[321] This gave the country time to implement further banking reforms,[322] and also assuaged domestic businesses by establishing greater stability.[323]

Another important element of Malaysia's program was its transparency. The government clearly indicated the nature, scope and reasons for the controls.[324] Also critical were concomitant efforts to improve financial regulations. This seemed to help the "acceptability of the measures both domestically and internationally."[325]

The long-term impact of the capital-control regime on investor confidence remains to be seen, but there were demonstrably negative investor reactions in the short-term.[326] Even though outflows on FDI are not covered by the controls, investors are still cautious, needing time to make sure that FDI is not covered and to confirm that Malaysia will not soon extend coverage of the outflow restrictions to FDI.[327] This demonstrates the need to publicize the reasons behind any control program and its extent.[328] The major cost of Malaysia's capital outflow controls has been the higher risk premium demanded by the market than elsewhere in Asia for investment in the country.[329]

Although Malaysia's capital controls brought a measure of stability to the economy in the midst of a financial crisis, such outflow controls

318. *See id.* at 24.
319. *Id.* at 24-25.
320. *Id.* at 25.
321. *See id.* at 28.
322. *Id.*
323. *See id.* at 54.
324. *See id.* at 28, 54.
325. *Id.* at 28.
326. *See id. But see* Canova, *Banking and Financial Reform*, *supra* note 82, at 1628 (noting that Malaysia has used the "breathing space provided by its exchange controls [to] slowly bring back foreign investors" (citation omitted)).
327. *See* Ariyoshi, *supra* note 87, at 102.
328. This education of investors is, however, costly to both the government and investors, in the sense that informing investors about the intricacies of such a capital control regime requires extensive time and effort. *See id.*
329. *See id.* at 54-55. This discrimination, albeit rational, when combined with the fact that Malaysia had a better banking system before the crisis, *Asia's Economies: On Their Feet Again?*, *supra* note 58, at 17; *see also* López-Mejía, *supra* note 137, at 42 (discussing Malaysia's efforts to "strengthen[] [its] banking system[] during the capital inflow and lending boom period"), and felt itself undeserving of the market's herding behavior and indiscriminate withdrawal, particularly galls Malaysians and enhances the anti-foreign, anti-market sentiment fanned by Prime Minister Mahathir's inflammatory comments. *See Keeping the Hot Money Out*, *supra* note 6, at 69 (quoting Prime Minister Mahathir as "liken[ing] the global capital markets to 'a jungle of ferocious beasts'").

are generally less effective than a program of prudential regulations and capital controls on inflows. In the final analysis, "the case for taxing outflows is weaker than taxing inflows because the former merely treats the symptom rather than the cause of the problem."[330]

B. *Non-Economic Justifications for Capital Controls*

Broader social welfare and sovereignty concerns also weigh in favor of LDCs using capital controls. Financial instability has a higher human cost in LDCs than in industrialized nations, which have more generous social safety nets to absorb the shock of economic turbulence. LDCs, moreover, cede much of their ability to determine their own economic future by liberalizing their capital accounts prematurely. This section contends that both of these non-economic arguments justify using capital controls in LDCs.

1. Protection against Instability and Inefficient Investment

By and large, the primary motive for implementing capital controls is to reduce instability. This is more than just an economic goal in light of the grave human cost of financial volatility in LDCs.[331] A moral responsibility falls on governments to provide some measure of protection against such traumatic shifts in market sentiment. Sovereignty concerns[332] also come into play: Entire countries should not have to suffer a dramatically and precipitously reduced standard of living because foreign investors couldn't be bothered to do their "homework" and got skittish.[333] Capital controls are a primary means of reducing instability available to LDCs.

Some authors argue that economics is really free-market ideology masquerading as a hard science, and that much of neoclassical economics' theories are unprovable and therefore also irrefutable in economic terms.[334] The economist's measure of progress has been called amoral because it ignores the human cost of liberalization.[335] These conclusions lead commentators to look for non-economic as well as economic justifications for capital controls.

330. Zee, *supra* note 197, at 6 n.11 (citing Barry Eichengreen, Toward a New International Financial Architecture: A Practical Post-Asia Agenda (Institute for International Economics, 1999)).

331. *See supra* notes 1-5 and accompanying text (illustrating the human cost of the Asian financial crisis).

332. *See infra* Part III.B.2. (discussing sovereignty concerns).

333. With respect to foreign investors not doing their "homework," see the discussion of "herding behavior," *supra*, in text accompanying notes 146-55.

334. Canova, *Unrestricted Capital Mobility*, *supra* note 183, at 219; Canova, *Financial Liberalization*, *supra* note 129, at 1285.

335. *See* Canova, *Unrestricted Capital Mobility*, *supra* note 183, at 229-30 ("[Orthodox economist's] measure of success . . . is not just short-sighted and narrow, but actually amoral in its studied neglect of the human suffering that results from the neoliberal project." (footnote omitted)).

Regardless of the motives for implementing capital controls, if investment finds inefficient employ in a country experiencing large inflows of foreign capital, the benefits of capital controls on capital inflows will outweigh their costs.[336] Large capital inflows can overwhelm regulatory officials' capacity to effectively supervise the financial system, and might also be more than the private sector can efficiently absorb.[337] Misallocation of resources becomes rampant in such a situation.[338]

For most of the past two decades, industrial nations and multilateral institutions have been encouraging the liberalization of developing countries' capital accounts as the default policy option.[339] The assumption of economists and policymakers in the industrialized world is that "markets know better than governments."[340] Overcoming this assumption requires quite a bit of evidence.[341] If industrialized and developing nations are going to work together to confront the jarring instability of these two worlds' financial interactions, this default approach will need to be changed. The policy mindset in both developed countries and multinational institutions must evolve. "For emerging markets, an open capital account should be the exception, not the rule."[342]

The prevailing policy mindset has led the industrialized nations to pressure LDCs to open their capital accounts before the steps needed to liberalize and decontrol financial markets had been taken.[343] The international community needs to recognize that it jumped the gun in pressuring premature liberalization. But, the "Washington Consensus"[344] suspects that capital controls will only lead to more regulation,[345] rather than being a step on the way to an orderly liberalization of the capital account. The IMF Articles of Agreement[346] allow the use of capital controls,[347] but the IMF has

336. *See* McKnight, *supra* note 95, at 876 (arguing that when investment is used productively its benefits to the capital importer outweigh its costs).

337. *Id.* at 862 & n.20.

338. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 4.

339. *See id.*; McKnight, *supra* note 95, at 863; *see also* International Monetary Fund, World Economic Outlook, Oct. 1998, at 80 (advocating the superiority of free capital movement).

340. *See* Eichengreen, Capital Controls, *supra* note 148, at 2.

341. *Id.* at 4.

342. *Id.* at 8.

343. *See id.*

344. "[A] ... networking of like-minded luminaries among the powerful institutions—Wall Street, the Treasury Department, the State Department, the IMF, and the World Bank ... [which] is unable to look much beyond the interest of Wall Street, which it equates with the good of the world." Bhagwati, *supra* note 130, at 11-12.

345. *See* McKnight, *supra* note 95, at 863.

346. The IMF Articles of Agreement govern the operations of the IMF and compliance with the Articles is a prerequisite to receiving assistance from the IMF.

347. *See* IMF Articles of Agreement art. VI, § 3.

advocated their use only in dire balance of payment situations, and only tepidly at that.[348] The difficult reality of liberalizing the capital account becomes more apparent when one considers that Europe and Japan both have only recently abandoned fairly extensive capital controls, and the latter only begrudgingly.[349]

This kind of market intervention should not be considered as in conflict with the ultimate goal of free markets and financial liberalization. "Liberalization is not an all-or-nothing process: Measures that are appropriate for a country at one level of development are not appropriate for countries at another level."[350] Capital controls play an important role in correcting market imperfections and operate as a step towards allowing markets to function freely. A country imposing a legal regime of capital controls must, however, be clear about what that goal is, or markets will lose confidence in the country, and the controls will also risk outliving their usefulness.

Some argue that capital controls such as taxes and quantitative measures should only be imposed where other prudential measures have been tried but have been ineffective.[351] But the financial crises in LDCs in the 1990s have taught us nothing if not that capital controls need to be in place before instability hits. The experience in Chile and Malaysia with capital controls shows that the distortion from controls has a lower cost than instability. There is no need to wait for a crisis to begin to calculate the costs and benefits. "After Mexico in 1994 and Asia in 1997, do we really need a third reminder of the dangers of premature and precipitous financial liberalization?"[352]

2. Sovereignty Concerns

The modern notion of sovereignty intrinsically connotes a nation's ability "to be the master of its own destiny ... in the economic field."[353] Modern international law also recognizes a right of defensive sovereignty to states—an "inalienable right to avoid being adversely affected by decisions and events happening outside [a state's]

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348. *See* International Monetary Fund, World Economic Outlook, Oct. 1999, at 54-55 (discussing Malaysia's use of capital controls during the Asian financial crisis).

349. *See* Eichengreen, Capital Controls, *supra* note 148, at 2; *see also* Canova, *Banking and Financial Reform*, *supra* note 82, at 1612 ("[C]apital controls were widely used throughout Western Europe to shield those countries from speculative capital flows during post-war reconstruction. In fact, for most Western European countries, capital controls remained in place throughout most of the 1950s, and for some countries until the early 1990s." (citations omitted)).

350. McKnight, *supra* note 95, at 864-65.

351. *See, e.g.*, *id.* at 892.

352. Eichengreen, Capital Controls, *supra* note 148, at 8.

353. Mary C. Tsai, Note, *Globalization and Conditionality: Two Sides of the Sovereignty Coin*, 31 Law & Pol'y Int'l Bus. 1317, 1319 (2000) (quoting Ignaz Seidl-Hohenveldern, International Economic Law 22 (3d ed. 1999)).

jurisdiction."[354] States' ability to determine their own economic sovereignty faces a serious challenge from globalization and the increasing mobility of capital.[355] The further industrialized nations press LDCs to liberalize their capital accounts, the more LDCs will relinquish their economic and defensive sovereignty.[356]

As the contagion effect of the Asian financial crisis demonstrated, nations' ability to maintain their own economic goals and shield their economy from the influences of the larger world have greatly diminished.[357] In the face of this growing inability to stave off financial contagion, nations will exercise whatever means they have to protect their economic sovereignty. The industrialized world should recognize this and allow LDCs to employ capital controls as a means of shielding their economic self-determination.

But rather than ensuring the sovereign economic integrity of LDCs, the industrialized world has pressured them to liberalize cross-border financial transactions.[358] The IMF and other multilateral institutions seek to bolster LDCs' ability to withstand financial contagion by encouraging the development of open markets.[359] Not allowing countries to use capital controls to protect themselves from financial contagion appears, however, to actually weaken countries' economic and defensive sovereignty.[360] While the West also actively encourages the development of democracy in LDCs, the policy of simultaneously encouraging open markets may paradoxically counteract democratic advances in LDCs.[361] Some commentators argue that free markets must take a backseat to democracy until the social and cultural

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354. *Id.* at 1318.

355. *See id.* at 1329 (noting that "[g]lobal economic integration" pushes nations to participate in the global economy whether they want to or not).

356. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1602 (discussing Mexico's loss of its economic self-determination when it relinquished control over short-term capital flows).

357. Tsai, *supra* note 353, at 1325 (noting that the Asian crisis spread to several disparate nations, and that "[w]hat began as a simple recession in Thailand turned into one of the worst global economic disasters in history").

358. *See infra* Part IV.

359. Tsai, *supra* note 353, at 1326.

360. *Id.*

361. *See* Canova, *Financial Liberalization*, *supra* note 129, at 1280 (arguing that financial liberalization has created an "undemocratic check on once-sovereign nation-states to pursue progressive social and economic policies"); Amy L. Chua, *The Paradox of Free Market Democracy: Rethinking Development Policy*, 41 Harv. Int'l L.J. 287 (2000) (discussing the inherent conflict between free markets and democracy and noting that the West has developed institutions to mediate the conflict between the two that LDCs have yet to acquire); Chantal Thomas, *Does the "Good Governance Policy" of the International Financial Institutions Privilege Markets at the Expense of Democracy?*, 14 Conn. J. Int'l L. 551 (1999) [hereinafter Thomas, *Good Governance Policy*] (arguing that "good governance policy" requirements in IMF conditionality encroach on the economic sovereignty of LDCs and privilege free market mechanisms at the expense of redistributive choices of the democratic process).

institutions needed to mediate the inherent conflict between the two have evolved.[362]

Rapid financial liberalization and austerity measures imposed on LDCs under IMF tutelage has provoked a rash of criticism. Many commentators argue that "it is an ultra vires act of international law for the IMF to exercise financial, economic, and ultimately social policy leverage over [LDC's] domestic affairs."[363] When the IMF reaches beyond its multilateral mandate, it violates the national sovereignty of LDC members.[364]

In light of this evidence of the potential for capital controls to reduce instability in LDCs' economies, the international legal regime that governs capital controls appears sub-optimal. Although Western nations have used various international legal institutions to encourage rapid financial liberalization in LDCs, the current policies embodied in international law allow the use of capital controls in these countries. The next part argues that the Western nations should limit or reverse their practice of inveigling LDCs into premature capital account liberalization.

IV. THE INTERNATIONAL LEGAL REGIME FOR THE CAPITAL ACCOUNT AND THE IMF: WOULD AN ENHANCED MULTILATERAL FRAMEWORK RATIONALIZE LDCS' USE OF CAPITAL CONTROLS?

This part begins by looking at the role of the IMF in encouraging capital account liberalization in LDCs. Although the IMF is prevented by the terms of its charter from imposing capital liberalization on member LDCs through the terms of its "conditionality" loans, the Fund has been a driving force in encouraging LDCs to open their financial markets to free foreign investment. This discussion of the IMF looks at proposals to reform the Fund to allow it to push more overtly for capital account liberalization in LDCs.

This part then looks at other multilateral institutions that make up the international legal regime for the capital account and determines that no multilateral institution has the authority to regulate LDCs' use of capital controls. Finally, this part argues that this status quo should remain unchanged and that neither the IMF nor any other multilateral institution should have jurisdiction over capital controls in LDCs, given the tendencies of existing multilateral institutions to favor the objectives of developed countries over LDCs.

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362. Chua, *supra* note 361, at 308-38.

363. Anthony Galano III, Comment, *International Monetary Fund Response to the Brazilian Debt Crisis: Whether the Effects of Conditionality Have Undermined Brazil's National Sovereignty?*, 6 Pace Int'l L. Rev. 323, 324 (1994).

364. *Id.*

A. *IMF Reform*

The IMF was created in 1944 at Bretton Woods, New Hampshire, as a multilateral agency to oversee member nations' conduct of monetary policy, to monitor a fixed-exchange-rate regime established by the signatories, and to lend financial assistance to countries facing currency problems.[365] Since 1944, the IMF has evolved to take on roles that differ from what its founders envisioned, a development that has provoked a great deal of criticism.

As international political-economic problems have become more complex and interrelated, the IMF has taken on a more active—and very different role—as a negotiator for LDC debt restructuring and as a "'lender of last resort' for the indebted [LDCs]."[366] Much of the criticism of the IMF can be linked to the fact that the institution is now called on to perform often-contradictory functions never anticipated at the time of its organization.[367] In recent years, a swirl of ideas to reform the IMF has circulated all over the world.[368] Most reform ideas seek to solidify the international financial system to ward off destabilizing financial crises such as that in Asia.[369] Many authors have called for a regional IMF in Asia that would be a more sympathetic figure to handle such regional crises.[370] Others have suggested new international financial institutions and a new international legal regime.[371]

For the foreseeable future, however, such arguments will remain on the fringe.[372] Given the divide between industrialized nations and LDCs on the timing and celerity at which capital-account liberalization should proceed, a new multilateral arrangement is unlikely to happen any time soon.[373] Pragmatic reform of the

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365. Lichtenstein, *supra* note 194, at 807 (describing the original role of the IMF).

366. Galano, *supra* note 363, at 337; *see also* Chantal Thomas, *Balance-of-Payment Crises in the Developing World: Balancing Trade, Finance and Development in the New Economic Order*, 15 Am. U. Int'l L. Rev. 1249, 1263 (2000) [hereinafter Thomas, *Balance of Payment Crises*].

367. *See* Anghie, *supra* note 192, at 264-65; Jerome I. Levinson, *The International Financial System: A Flawed Architecture*, 23 Fletcher F. World Aff. 1, 39-40 (1999).

368. For a good synopsis of many of the criticisms of the IMF, see Taylor, *supra* note 43, at 86-87.

369. *See* Dominique Carreau, *Why Not Merge The International Monetary Fund (IMF) with the International Bank for Reconstruction and Development (World Bank)?*, 62 Fordham L. Rev. 1989 (1994) (arguing for a renovation of the international financial architecture by merging the IMF and the World Bank); Francois Gianviti, *The Reform of the International Monetary Fund (Conditionality and Surveillance)*, 34 Int'l Law. 107, 108 (2000).

370. *See, e.g.*, Gyohten, *supra* note 180, at 374.

371. *See, e.g.*, Levinson, *supra* note 72, at 530.

372. *See* Lichtenstein, *supra* note 194, at 810-11 (deriding "the unedifying sight of academics criticizing the Fund's approach," and suggesting that such limitless and unpragmatic criticism impedes the development of an international consensus on IMF reform).

373. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 17 ("There is not

institutions already existing, starting with the IMF, would more likely achieve wider acceptance of LDCs' use of capital controls as prudential measures.[374]

The IMF "plays an active role in promoting the liberalization of capital movements," but "the mechanisms presently available to the Fund for this purpose are . . . limited."[375] The Fund's Articles of Agreement currently permit the use of capital controls.[376] When the IMF's Articles of Agreement were drafted in 1944, "much greater emphasis [was placed] on liberalization of payments and transfers associated with international trade in goods and services, or 'current international transactions[,]' than . . . on capital movements."[377] J.M. Keynes, one of the negotiators of the Bretton Woods agreement, envisioned article VI as a means of preventing exactly the kind of capital mobility the IMF now seeks to encourage.[378] Keynes described article VI as "a permanent arrangement [that] accords to every member government the explicit right to control all capital movements. . . . [I]t follows that our right to control the domestic capital market is secured on [a] firmer foundation than ever before."[379] This limited ability of the Fund to insist on capital account liberalization explains why it pushes so aggressively for removal of capital controls when it makes an agreement for assistance with a member.[380]

A few capital movements are required to be liberalized under the obligations in article VIII, but "[p]ayments and transfers associated with international capital transactions fall largely outside the scope" of this provision.[381] Each member can implement measures restraining the flow of international capital transactions across its borders, provided it "does not restrict or unduly delay the making of

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going to be radical reform resulting in dramatic changes in the international financial landscape.").

374. Many call for an abolition of the IMF, *see* Terrill, *supra* note 92, at 315-16, but such a drastic step is clearly a far-off prospect. *See id.* at 317 (discussing support for the IMF).

375. Leckow, *supra* note 7, at 517.

376. *See* Watanabe, *supra* note 103, at 10-11; Canova, *Banking and Financial Reform*, *supra* note 82, at 1610. Most IMF members used capital controls throughout the post-war period. *See* Watanabe, *supra* note 103, at 3 & n.8.

377. Leckow, *supra* note 7, at 518.

378. Canova, *Banking and Financial Reform*, supra note 82, at 1611.

379. John M. Keynes, unattributed (quoted in Canova, *Banking and Financial Reform*, *supra* note 82, at 1612).

380. The IMF cannot use conditionality agreements to force countries to open their capital accounts. Gianviti, *supra* note 369, at 112-13. "At the behest of creditor countries, [however,] the scope of [IMF] conditionality has gradually expanded." *Id.* at 114.

381. Leckow, *supra* note 7, at 520. Capital movements that the IMF's Articles of Agreement require to be liberalized include "payments of [a] moderate amount for the amortization of loans or for the depreciation of direct investments and normal short-term banking and credit facilities." *Id.* at 521.

payments or transfers for current international transactions."[382] This provision allows countries the leeway needed to prevent destabilizing short-term inflows. Article VI section 1 recognizes the usefulness of capital controls in crisis situations, and gives the IMF the authority to require a member to impose controls on capital movements to prevent a "large or sustained outflow of capital."[383]

The Articles of Agreement do not allow the IMF to use conditionality[384] and Fund assistance to force open a country's capital account.[385] This potentially overwhelming bargaining tool is not available to unlimited use by the Fund because the Articles require that "any conditions imposed by the Fund on the use of its resources by members must be consistent with the purposes of the Fund."[386] While the IMF cannot require capital account liberalization, this does not stop it from pressuring countries to include capital control removal in reform packages, or when advising countries.[387] Countries accept the onerous terms of conditionality because following them not only gives access to IMF funds, but also gives a country the IMF "seal of approval" that encourages private international capital to flow into the country.[388] The importance of conforming to the Fund's advice gives it significant authority, in practice, over countries' decisions to eliminate capital controls.

The terms of conditionality currently permitted by the IMF charter are often onerous and force countries to cut back spending on a variety of domestic programs.[389] IMF conditionality often requires LDCs to cut back on their social safety nets, "programs that the poor, women, children, and other vulnerable groups heavily rel[y] on—e.g., food subsidies, health care, and education."[390] In the wake of the Asian financial crisis, the IMF has allowed more spending on food subsidies, and the like,[391] but austerity is still a key part of conditionality. While the IMF is softening its rigid doctrine on the

382. *Id.* at 520-21.

383. *Id.* at 521.

384. *See* Galano, *supra* note 363, at 338-39 ("'Conditionality [is] understood as being the policies the Fund expects a member country to follow in order to be able to use the Fund's general resources.'" (citations omitted)); Tsai, *supra* note 353, at 1321 (defining and discussing conditionality).

385. *See* Leckow, *supra* note 7, at 521-22; *see supra* note 380.

386. Leckow, *supra* note 7, at 521-22. The Fund cannot therefore "establish conditionality which would require members receiving financial assistance to remove particular capital account restrictions." *Id.* at 522.

387. *See* Gianviti, *supra* note 369, at 112.

388. *See* Galano, *supra* note 363, at 339.

389. "Many critics have claimed that the IMF has placed most of the burdens of market-based adjustment on vulnerable groups in member countries." Nicole Wendt, *Citizens, National Governments, and International Financial Institutions: Changing Conceptions of Development in the 1990s*, 9 Transnat'l L. & Contemp. Probs. 165, 166 (1999).

390. *See id.* at 166-67.

391. *Id.* at 167.

terms of its conditionality programs,[392] many of the Fund's critics argue that conditionality terms still do not serve all, or even most, of the interests in an LDC's society. Despite the improvements in IMF policies towards the social safety net in LDCs, it is nevertheless true that

> the treatment of such a broad range of public activity as properly managed by economic experts rather than by the people, however conceived, suggests such institutions are committed to a very limited model of procedural democracy. The means chosen to achieve [the] end of market liberalization often infringe on the right to self-determination or democratic governance understood in substantive terms.[393]

The policies of market liberalization are often justified as bringing greater democracy and self-determination to people in LDCs, but the analytical models underlying these policies often assume that substantive democracy and access to the benefits of enhanced economic activity are already in place.[394] Given the questionable impact of conditionality on the democratic and social structures of LDCs, the international community should hesitate before giving the IMF another method of twisting the arm of LDCs' social and economic policies.

In 1997, the IMF's Interim Committee called for an amendment to the Articles of Agreement that would allow the Fund to require capital account liberalization.[395] Even after the onset of the Asian financial crisis, in the spring of 1998, the IMF still actively sought "explicit jurisdiction over the process of capital account liberalization."[396] The Committee's report recognized that "[s]afeguards and transitional arrangements are necessary,"[397] but it failed to recognize the great length of time needed to put a sound regulatory structure in place.

Such an amendment would undoubtedly require a repeal of article VI section 3,[398] removing LDCs' major hold-out to the onslaught of liberalization pressure from the developed countries. This amendment would be a legally binding requirement on countries to remove restrictions on capital movements, allowing only for narrowly

392. *See* Thomas, *Good Governance Policy*, *supra* note 361, at 560 ("By the early 1990s, the [international financial institutions] had moved significantly towards publicly and explicitly recognizing that basic individual and social needs could not be ignored without serious jeopardy to economic goals.").

393. Anne Orford, *Locating the International: Military and Monetary Interventions After the Cold War*, 38 Harv. Int'l L.J. 443, 468 (1997).

394. *Id.* at 469.

395. Leckow, *supra* note 7, at 522.

396. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1613.

397. Leckow, *supra* note 7, at 522 (citation omitted).

398. *Id.* at 524; *see* Canova, *Banking and Financial Reform*, *supra* note 82, at 1610-13.

defined exceptions.[399] Repeal of article VI would ostensibly represent a mandate from the entire IMF membership to pursue capital account liberalization.[400] Even in the absence of such a consensus, however, the IMF has "effectively pushed capital liberalization through its surveillance, financing, and technical assistance activities."[401]

Armed with this new regime, the IMF could freely use conditionality to force members to liberalize their capital accounts.[402] This would destabilize emerging markets, as the Fund currently recognizes only balance of payments and traditionally acknowledged sovereignty issues as sufficient to warrant capital controls.[403] Until the IMF explicitly accepts prudential concerns and proactive use of capital controls to stabilize financial systems, a repeal of article VI would eliminate one of LDCs' best means of economic self-determination.[404] The Fund has recognized that "[p]rovision could also be made for Fund approval of restrictions imposed for other reasons—in particular, for reasons of national security and for prudential reasons."[405]

The evidence demonstrating the effectiveness of capital controls implemented to meet prudential concerns is strong and applies broadly across the developing world.[406] While the IMF modestly supports limited capital controls in the short-run, a substantial expansion of its jurisdiction in this area would likely encourage the Fund to press for less use of capital controls in LDCs.[407] Given the steps the IMF has taken to increase capital mobility even with the constraint of article VI,[408] the Fund would likely continue this policy with even ardent pursuit. While under the proposed amendment the IMF would ostensibly allow countries to use capital controls in some situations,[409] it would not likely approve such departures from its ideology with alacrity. It would be a mistake to require LDCs to wait for IMF approval before implementing capital controls. As its widely criticized mistakes in Asia demonstrate, the Fund's indecision can sometimes be very costly.[410]

399. *See* Leckow, *supra* note 7, at 524.
400. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1613.
401. *Id.*
402. *See* Leckow, *supra* note 7, at 524.
403. *Id.*
404. *See* Terrill, *supra* note 92, at 314-15 (noting that the proposed amendment would eliminate most uses of capital controls).
405. *See* Leckow, *supra* note 7, at 526.
406. *See supra* Part III.A. (discussing the effectiveness of capital controls).
407. *See* Terrill, *supra* note 92, at 314-15.
408. *See supra* note 387 and accompanying text (discussing the IMF's use of its current means to press for capital mobility).
409. *See supra* note 405 and accompanying text.
410. *See* Terrill, *supra* note 92, at 316-17 (discussing criticism of the IMF's handling of the Asian financial crisis).

The Fund argues that this amendment is needed because "no universal international organization ... has jurisdiction over capital transactions," and therefore there is no unified body of nations to press for capital account liberalization.[411] There is already ample pressure from the developed world to liberalize capital flows, however.[412] If an international institution eventually has jurisdiction to set the rules obliging countries to liberalize, it should not be the IMF, where the United States alone has 17% of the votes and the developed countries together have almost 60%.[413] Such binding decisions should be taken in a forum where each member has one vote, such as the World Trade Organization ("WTO") system.[414]

Rather than follow this course of rapid liberalization, the IMF and the international community should support the retention of capital controls in countries whose financial systems have not improved up to the level that is a prerequisite to sound liberalization of the capital account. The Fund should not view capital controls as restrictions on the inherently positive free flow of capital, but rather as necessary prudential regulations that correct unavoidable problems in emerging markets. Once the IMF acknowledges that capital controls should be used in most LDCs, it can advocate for the soundest ways to limit capital flows, like the URR or a withholding tax, and can help countries train regulators to effectively supervise such controls. This acknowledgement on the part of the IMF would improve its reputation among its critics. Meeting LDCs halfway on this issue will allow the Fund to work constructively with developing countries to open their capital accounts in the best way.

The IMF should encourage countries to follow international standards and codes of conduct in "prudential supervision, securities-market regulation, auditing and accounting, bankruptcy and insolvency procedures, and corporate governance," rather than on imposing austerity measures.[415] The Basle Committee of Banking

411. *See* Leckow, *supra* note 7, at 525.

412. *See infra* note 427 (discussing Western pressure on LDCs to liberalize their capital accounts during bilateral investment treaty ("BIT") negotiations). The U.S. and the U.K. have the most voting power in the IMF, which gives them the dominant voice in the agency and affords these two countries great influence over the policies and actions of the agency. Galano, *supra* note 363, at 335-36.

413. *See* IMF Art. of Agr., art. III § 1 & schedule A.

414. *See* Marrakesh Agreement Establishing the World Trade Organization, art. IX.

415. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 19-20; *see also* Lichtenstein, *supra* note 194, at 821 (noting that "Fund conditionality ... does not aid in the ... development of international norms of best practice banking, accounting and financial market supervision"); Lawrence L. C. Lee, *The Basle Accords as Soft Law: Strengthening International Banking Supervision*, 39 Va. J. Int'l L. 1, 36-39 (1998) (arguing that the IMF should use its surveillance facility to encourage adherence to the Basle Standards); *Still Sick and Gloomy, Now Rebellious*, *supra* note 4, at 41-42 (discussing the IMF austerity measures of forcing countries to tighten budget deficits and keep interest rates high).

Supervisors[416] started this movement on international financial standards, and other groups have set forth standards in their areas. Such codes are, however, still being avoided as much as possible in countries like Japan.[417] Fuller adherence by the industrialized nations would encourage adoption of and adherence to these measures in LDCs. The IMF would better spend its resources by taking on a new role as standards supervisor and enforcer in conjunction with its article IV surveillance and review programs.[418] The IMF should expand its role as a forum of real debate over regulation of international capital markets, instead of remaining devoted to liberal orthodoxy.[419]

The Interim Committee and IMF Board have already relaxed their stance on capital account liberalization which peaked with the proposed liberalization amendment.[420] The proposed amendment has, fortunately, fallen by the wayside.[421] In another move signaling a shift in the developed world's stance on capital controls in LDCs, the United States government has even lent tentative support to the URR. In 1999, Treasury Secretary Robert Rubin endorsed the URR as a potentially effective policy tool.[422] Whether such comments reflect a genuine shift in Western governments' attitudes toward capital controls remains to be seen.[423] Although several officials at the IMF, the World Bank and other institutions have made similar comments,[424] no real change in the commitment to rapid liberalization has yet to materialize. Strong U.S. support of short-term capital controls for prudential reasons would, however, show that our government favors a stable liberalization process, and that our main goal is not to unleash hordes of financial imperialists and speculators to colonize LDCs' banking and financial sectors.

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416. *See supra* note 67 (discussing the Basle Committee).

417. Eichengreen, *Taming Capital Flows*, *supra* note 48, at 20.

418. *See id.* at 20-21.

419. *See* Stephen Zamora, *Regulating the Global Banking Network—What Role (If Any) for the IMF?*, 62 Fordham L. Rev. 1953, 1970-71 (1994).

420. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 18. While the IMF stepped back somewhat from its liberalization agenda during the worst of the Asian financial crisis, its focus on liberalization has not fundamentally changed. Canova, *Financial Liberalization*, *supra* note 129, at 1284-85.

421. *See* Canova, *Financial Liberalization*, *supra* note 129, at 1284.

422. *See* Eichengreen, *Taming Capital Flows*, *supra* note 48, at 18 (citing Stephen Fidler, *Rubin Says IMF Shouldn't Support Pegged-Exchange Policies*, Fin. Times, April 21, 1999, at A1).

423. See Canova, *Banking and Financial Reform*, *supra* note 82, at 1624 (remarking that each time officials of Western government make comments signaling such a shift in attitude, they "quickly backpedal or even retract their earlier expressions of misgivings about the dangerous direction of today's neoliberal policies").

424. *Id.* at 1622-23.

B. *The International Legal Regime for the Capital Account*

The IMF is not the only multilateral institution with the potential authority to restrict LDCs' use of capital controls. Other international organizations could provide the forum for such jurisdiction. This section looks at the other major multilateral economic institutions and determines that none of them currently have jurisdiction over LDCs' use of capital controls.

While the developed nations agree that capital account liberalization is necessary to improve economic conditions, it is far from clear that all LDCs share this view.[425] Considering this lack of consensus, "[t]here is [unsurprisingly] no international agreement covering a majority of the world's countries which provides a comprehensive set of rules defining the circumstances in which restrictions on capital movements should be maintained or removed."[426] Instead, a patchwork of multilateral, regional and bilateral agreements covers capital movements, but does not present a "unified system for capital account liberalization."[427] One could conclude from this arrangement that, rather than being ready for a unified system, the world is far from a consensus about what obligations should be imposed on countries at different levels of development in order to build a unified agreement.

The OECD Code for the Liberalisation of Capital Movements presents the "most comprehensive legal framework for capital account liberalization."[428] This agreement applies, of course, only to OECD members, who have mostly already liberalized their capital accounts. The Code "provides that signatories abolish all restrictions to the free movement of capital, excepting those measures that further: the protection of public order, health, morals, and safety; essential security interests; and the fulfillment of international peace and security obligations."[429] This agreement includes some safeguard

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425. *See, e.g.*, Lichtenstein, *supra* note 194, at 819-20 (discussing the consensus in favor of liberalization, but failing to mention any institution representing LDCs that favors this view); Terrill, *supra* note 92, at 307-14 (discussing LDCs' alternatives to liberalization); Kenneth J. Vandevelde, *A Symposium on Implementation, Compliance and Effectiveness: Sustainable Liberalism and the International Investment Regime*, 19 Mich. J. Int'l L. 373, 375-90 (1998) (discussing the history and development of the liberal consensus).

426. Leckow, *supra* note 7, at 523. When the IMF was established, short-term capital flows were insignificant. This is partly why there is no multilateral institution to deal with them. Zamora, *supra* note 419, at 1966.

427. Leckow, *supra* note 7, at 523; *see also*, Canova, *Banking and Financial Reform*, *supra* note 82, at 1616-18 (noting that BITs predominate over multilateral agreements, and arguing that the West uses BITs to strong-arm LDCs); Vandevelde, *supra* note 425, at 395-97 (discussing predominance of BITs in regulating capital movements between countries).

428. Leckow, *supra* note 7, at 523.

429. Geist, *supra* note 224, at 681.

provisions for specific crisis situations,[430] but does not include an adequate level of protection for LDCs to serve as a starting point for a unified legal framework.[431] This agreement is appropriate for developed countries, and may soon be for Mexico and Korea, once financial system improvements take hold.[432] This agreement is not appropriate, however, for countries like Indonesia and Thailand.[433]

The OECD's attempt to fashion a multilateral investment treaty, the Multilateral Agreement on Investment ("MAI"), failed to bring the industrialized nations to a consensus on the treatment of international investments.[434] If the developed world cannot reach a consensus on the issue, a good deal of time will pass before nations at all levels agree to a legal framework for capital account liberalization.

The MAI did include provisions recognizing the importance of "temporary safeguard[s]," providing that treaty parties "may adopt or maintain measures inconsistent with [their] obligations" to permit free transfers of capital.[435] These provisions allowed such suspension of cross-border capital transactions only in the event of "serious balance-of-payments . . . difficulties" or "serious difficulties for macroeconomic management."[436] This provision means that capital controls may only be implemented in a crisis situation, rather than as preemptive measures.[437] The treaty further provides that such measures "shall be temporary and shall be eliminated as soon as conditions permit."[438] The MAI also had the IMF serving as arbiter of whether such controls are in fact necessary.[439] As we have seen, such restrictions should not be placed on LDCs—proactive use of capital controls, while somewhat distortional, can improve financial sector development.

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430. *See* Leckow, *supra* note 7, at 522-23.

431. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1615-16 (noting that the OECD liberalization measures would overturn IMF article VI protections for signatories).

432. *See id.* at 1615 (noting risks for Mexico of implementing the OECD liberalization standards).

433. Leckow, *supra* note 7, at 523.

434. *See* Gianviti, *supra* note 369, at 111-12 (noting that the failure of the MAI highlights growing opposition to the principle that capital account liberalization should soon be extended to LDCs); *cf.* Canova, *Banking and Financial Reform*, *supra* note 82, at 1616 (noting that "intense opposition by trade unions and environmental groups forced the suspension of MAI negotiations due to their concerns regarding the broad rights that MAI would grant to corporations to challenge national laws and regulations"). For a general discussion of the MAI, see Stephen J. Canner, *The Multilateral Agreement on Investment*, 31 Cornell Int'l L.J. 657 (1998).

435. Multinational Agreement on Investment, draft treaty, May 1998, annex 6, art. 2-1.

436. *Id.* annex 6, art. 2-1(a)-(b).

437. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1616 (arguing that the MAI would have "effectively overturn[ed] Article VI of the IMF Articles [of Agreement] on a grand multilateral scale").

438. Multinational Agreement on Investment, *supra* note 435, annex 6, art. 2(c).

439. *See id.* annex 6, art. 2-5(c)

The MAI does permit the use of "prudential measures with respect to financial services . . . to ensure the integrity and stability of its financial system," provided they do not serve as a means of avoiding capital account liberalization.[440] If the developed world accepts the use of capital controls on short-term investments in LDCs, such as a URR or withholding tax, as a prudential measure, this treaty could provide the starting point for a unified investment regime. LDCs will, however, require that any potential agreement clearly articulate such an understanding.

The international agreement actually in force that treats investment in the largest number of countries is the General Agreement on Trade in Services ("GATS").[441] GATS is not designed primarily to stimulate capital account liberalization. It merely "promote[s] the liberalization of capital movements as a by-product of [another] principal goal," which is trade in services.[442] Trade in services, unlike trade in visible goods, requires some kind of presence in the target market for effective delivery of the service. This can be the opening of a subsidiary or a branch in the host country, for example. An agreement that allows such a presence necessarily requires that service providers be allowed some means of freely investing in the target market. Under GATS, members are required to negotiate concessions that are then extended to all parties to the agreement. Article XIX recognizes the need for "appropriate flexibility . . . for opening fewer sectors, liberalizing fewer types of transactions, [and] progressively extending market access in line with [countries'] development situation."[443] Financial services are, however, exempted from the general GATS provisions on progressive liberalization, and are subject only to specific concessions.[444] Any future multilateral agreement on investment between developed and developing nations will need stronger provisions recognizing the special situation of LDCs with respect to capital account liberalization.

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440. *Id.* annex 6, art. 3.

441. *See* General Agreement on Trade in Services, *reprinted in* World Trade Organization, the Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations 300 (Cambridge University Press, 2000) [hereinafter GATS]; Gianviti, *supra* note 369, at 111 (noting that GATS "contains provisions on the liberalization of capital movements related to the provision of certain services"). GATS is primarily an offshoot of the General Agreement on Tariffs and Trade ("GATT"), and some commentators consider it poor policy to link trade policies with internal domestic goals, such as balance of payment stability and financial liberalization, as this "undermine[s] both the trade order and the attainment of the objectives in those nontrade policy areas." Frieder Roessler, *Domestic Policy Objectives and the Multilateral Trade Order: Lessons from the Past*, 19 U. Pa. J. Int'l Econ. L. 513, 514 (1998) (emphasis omitted).

442. Leckow, *supra* note 7, at 523.

443. GATS, *supra* note 441, art. XIX (2).

444. *See id.* art. I.

While a multilateral agreement on investment would undoubtedly make for a much more effective means of furthering capital account liberalization,[445] negotiating large-scale liberalization on a world stage might also give LDCs greater bargaining power than in bilateral investment treaty ("BIT") negotiations with industrialized nations.[446] If one accepts that the last multilateral effort at a liberalization regime under the WTO auspices, the Trade-Related Investment Measures Agreement ("TRIMs"), failed to accomplish anything substantive,[447] it would appear that an impasse exists between LDCs negotiating as a block and the developed nations. Such a supposed impasse would indicate the moment has yet to ripen for another such effort.

C. *The Time Is Not Right for a New Multilateral Solution*

This section analyzes the current nature and understanding of multilateral institutions and determines that the solution to financial instability in LDCs lies neither in giving jurisdiction over capital controls to a new multilateral institution, nor in expanding the authority of the IMF to manage capital controls.

Two counterbalancing problems need to be weighed when considering whether a multilateral institution should gain jurisdiction over capital controls: the danger of unregulated capital markets versus countries' sacrifice of sovereignty to an international entity. "[A] system of unregulated capital markets . . . has the potential to undermine the governmental authority necessary to ensure sound economies, in individual nations as well as in the world as a whole."[448] And at the same time, "[t]rade and financial liberalization conducted through multilateral and regional trade regimes has begun to limit the degree to which people are able to shape the economic, social, and cultural policies of their [own] governments."[449] Given the often negative ramifications of multilateral solutions on the poorest citizens of LDCs,[450] the regulation of capital mobility is, for the moment, best carried out by individual nations. The current climate and evolution of multilateral organizations does not portend a multilateral solution responsive to the needs of LDCs' citizenry.

445. *See* Vandevelde, *supra* note 425, at 396-97 (arguing that a multilateral agreement would "make a far greater contribution to promoting a sustainable liberalism").

446. *See* Canova, *Banking and Financial Reform*, *supra* note 82, at 1616-18 (noting that BIT negotiations produce lopsided results favoring capital exporting nations).

447. *See* Paul Civello, Note, *The TRIMs Agreement: A Failed Attempt at Investment Liberalization*, 8 Minn. J. Global Trade 97 (1999).

448. Zamora, *supra* note 419, at 1973.

449. Orford, *supra* note 393, at 471.

450. *See supra* notes 389-94 and accompanying text (discussing the negative impact on the poor of IMF conditionality policies).

1. Expanding "Supranational Authority" of Multilateral Organizations and Lessening Concern for the Specific Circumstances of LDCs

The debate over whether countries should use capital controls logically leads to a discussion of whether an international institution "should have the ability to assist or sanction a country's imposition of capital controls."[451] International organizations do not usually have explicit "supranational powers," but over time "'they gain . . . institutional strength . . . that enables them to influence the behavior of individual [nation] states to a significant degree,'" thus enabling them to become autonomous actors in the "international political-economic system along with nation states."[452] International organizations have a propensity to "expand their jurisdiction,"[453] and to become autonomous agents with "supranational authority." Given these tendencies, the international community must carefully consider how a new agency will expand its authority over time and which members will dominate it.

At the same time that their jurisdiction naturally expands, the current international economic law of these multilateral institutions has "moved away from a relative acceptance of 'special and differential treatment' for developing countries, and towards a relative intolerance of that principle."[454] This shift became most apparent when in 1986, "[d]uring the Uruguay Round of [GATT] negotiations, leading voices representing the industrialized and developing worlds moved away from an emphasis on special and differential treatment towards a stronger commitment to bringing developing countries fully within GATT discipline."[455] The paradigm has shifted from an acknowledgement that government intervention is needed to correct the chronic balance of payment problems of LDCs, to a belief that government intrusion is the real source of the severity of such problems and "that more liberal economic discipline is necessary to help prevent such difficulties."[456] "[T]he end of the Cold War, the debt crisis, and the death of the [New International Economic Order] movement have decreased the relative bargaining influence of developing-country governments, at least insofar as they seek policies different from those preferred by industrialized countries."[457]

Given these results, it is not surprising that many "now . . . recogniz[e] that the WTO has failed in significant ways to meet the

451. Whelchel, *supra* note 195, at 417 (emphasis omitted).

452. Galano, *supra* note 363, at 330 (alteration in original) (citation omitted).

453. Zamora, *supra* note 419, at 1954.

454. Thomas, *Balance of Payment Crises*, *supra* note 366, at 1250.

455. *Id.* at 1264.

456. *Id.* at 1275.

457. *Id.* For background on the New International Economic Order movement, see *id.* at 1260 n.43.

aspirations of developing countries."[458] Until there is greater public participation in these institutions, they will remain fundamentally undemocratic and unresponsive to the needs of the majority of LDCs' citizens.[459] Negotiating to create a new multilateral institution with jurisdiction over capital controls, or even to grant such jurisdiction to an existing one, would inevitably force LDCs to cede much control over their own economic fortunes in return for extremely uncertain results.

A new multilateral system is not the right solution for another reason: Law plays no part in most public "discourses" about capital liberalization.[460] The liberalization camp focuses on economic criteria, and this makes any real solutions to "hot money" problems unobtainable, as this limited scope of analysis cannot find a middle ground with legal arguments about economic sovereignty and the human cost of financial instability.[461] The international financial institutions use these economic criteria as their operating premise and do not explicitly concern themselves with equity and social justice.[462] The liberal economic paradigm carries with it a fundamental inequity: "[I]t requires that a disproportionate share of the burden of adjustment to successive financial crises be borne by workers in ... [LDCs]."[463] The exclusive focus on economic criteria leads to the inequitable outcome that resolved the Mexican crisis in 1995 and the Asian in 1997-98: Creditors in the West gave up little, but the LDCs involved had to follow austerity programs to reassure foreign investors.[464]

Multilateral treaties and organizations are, furthermore, inherently inflexible.[465] In order for them to evolve and effectively deal with new situations and conditions, a mechanism to provide for authoritative interpretation of multilateral treaties and the charters of multilateral organizations needs to be developed.[466] Until an institutional means of authoritatively adapting multilateral organizations becomes widely accepted, a new multilateral institution with jurisdiction over capital controls should not be implemented.

2. Ceding Sovereignty to Multilateral Institutions

Any discussion of expanded multilateral jurisdiction over

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458. Anghie, *supra* note 192, at 274.
459. *See* Chi Carmody, *Beyond the Proposals: Public Participation in International Economic Law*, 15 Am. U. Int'l L. Rev. 1321, 1322-23 (2000).
460. Canova, *Unrestricted Capital Mobility*, *supra* note 183, at 228.
461. *See id.* at 230.
462. Anghie, *supra* note 192, at 247.
463. Levinson, *supra* note 367, at 1.
464. *See id.* at 17, 22.
465. *See* Eric J. Pan, Note, *Authoritative Interpretation of Agreements: Developing More Responsive International Administrative Regimes*, 38 Harv. Int'l L.J. 503 (1997).
466. *See id.* at 505.

international economic matters must consider the sovereignty problems inherent in multilateral solutions. The idea of sovereignty is evolving. The "international community can no longer define sovereignty as an absolute and rigid-individual right of every State where nation-states are only subject to international rules they accepted."[467] The modern conception of sovereignty now permits greater intrusion into a nation's internal affairs and policies, as nations consent to infringements on their sovereignty in exchange for the benefits of belonging to multilateral institutions.[468] When LDCs, or any nations, join a multilateral organization they cede some of their sovereignty to the organization.[469] LDCs in particular must be careful what sovereignty they cede, as they cannot get it back once ceded and they cannot stop the natural institutional development of the organization and its tendency towards increased control in other areas.

At the same time LDCs cede sovereignty to multilateral institutions like the IMF, these institutions operate to protect the sovereignty of the economically dominant states.[470] With the trend toward defining the limits of sovereignty by consensus, ceding authority to Western-dominated multilaterals like the IMF allows the West a larger role in determining this consensus.

Liberalization to appease the IMF and foreign investors takes away the social safety net in LDCs—the same social safety net that allows the West to successfully absorb and offset the negative impact of open trade and financial liberalization.[471] The West, furthermore, is not subject to bouts of IMF conditionality because Western nations typically do not have to borrow from the IMF. This creates a double standard,[472] with the Western nations telling LDCs to do as they say, not as they do. This perverse result leads to the poor nations suffering greater hardship from liberalization than the West.[473]

Conditionality and imposed rules interfere with sovereignty not only in the theoretical sense, but also in the sense enunciated in the Corfu Channel case, a landmark case in international law, that "sovereignty is a notion that 'has its foundation in national sentiment and in the psychology of the peoples.'"[474] Ceding authority over financial liberalization leads LDCs to trade away their rights to

467. Galano, *supra* note 363, at 342.

468. *See id.* at 343; John W. Head, *Supranational Law: How the Move Towards Multilateral Solutions Is Changing the Character of "International" Law*, 42 Kan. L. Rev. 605, 627 (1994) (noting that the IMF, the World Bank and the GATT "represent . . . surrenders of sovereignty by states to international organizations").

469. Thomas, *Good Governance Policy*, *supra* note 361, at 556.

470. Head, *supra* note 468, at 631.

471. Wendt, *supra* note 389, at 166.

472. *See id.* at 168.

473. *See* Anghie, *supra* note 192, at 255-56.

474. Galano, *supra* note 363, at 342.

protect their citizens and sacrifice their national self-image in exchange for lender-of-last-resort facilities and the approval of the Western financial community. Is this a fair bargain? It may be in some instances, but it is certainly a bargain questionable enough to to warrant waiting and seeing before LDCs cede sovereignty over capital controls.

3. Significant Proposals to Expand the Multilateral Framework Governing Capital Controls

The first issue that warrants consideration at the multilateral level with respect to capital controls is that of the foreign exchange and derivatives markets. The foreign exchange and derivatives markets experienced the greatest increase in financial activity in the 1990s.[475] These markets remain largely unregulated.[476] Derivatives, especially short-term currency derivative contracts, increased in importance as short-term investment flows have grown.[477] These markets hedge against risk and instability but also help to create it by reacting to more than just underlying economic conditions, which do not change as rapidly or in such a pronounced way as capital movements.[478]

One of the best proposals circulating in academic circles is a multilateral means of imposing standstills, moratoria, or involuntary deferrals on payments of derivative and other financial contracts when financial instability hits a developing country.[479] Such proposals call for an international organization to have powers similar to a U.S. Bankruptcy Court, i.e., to enforce standstills and to negotiate reductions in payments.[480] This would force creditors to swallow some of the risk they have taken with respect to financial contracts, instead of creditors having all the authority to dictate concessions to LDCs, which they effectively do through IMF conditionality.[481] While such an institution offers much promise in improving the bargaining position of LDCs vis-à-vis foreign creditors, the current international climate makes such an institution unlikely. Until the West is ready to set up an institution that will treat LDCs fairly, the latter are better off without one.

Another commentator has argued that the orthodox policy presents liberalization as a choice between the benefits of short-term

475. Zamora, *supra* note 419, at 1956.
476. *Id.* at 1957.
477. Whelchel, *supra* note 195, at 417-18.
478. Zamora, *supra* note 419, at 1963.
479. *See* Whelchel, *supra* note 195, at 418; Chun, *supra* note 32, at 2652-53.
480. Whelchel, *supra* note 195, at 418; Chun, *supra* note 32, at 2674-76 (arguing that such an institution should have the power to issue: "(1) an automatic stay; (2) a post-petition creditor preference; (3) a plan of adjustment; and (4) a cramdown provision").
481. *See* Chun, *supra* note 32, at 2700.

investment and the "dangers of controls on . . . capital flows," and that this dichotomy need not be the only two choices.[482] If Western nations could accept a large-scale transfer of public capital, something akin to the Marshall Plan, the LDCs could get the stability benefits of capital controls without suffering a net reduction in foreign investment.[483] While this idea is intriguing, Western nations show little sign of garnering the political will to effect such a massive transfer of wealth to LDCs.

Finally, other commentators have recently advocated a system of "cooperative capital controls," such as an international Tobin tax[484] regime, saying such a system could bring the benefits of capital mobility while mitigating its socially regressive and catastrophic consequences.[485]

All such proposals have in common that they recognize the Asian financial crisis and the Mexican crisis not as aberrations, but as indicators revealing fundamental problems with the current financial architecture.[486] Until the problems with the international financial system gain wider acknowledgement, any new multilateral institution will be organized according to the liberalization-dominated approach. The fundamental causes of these crises are not even agreed upon, and given this "intellectual anarchy," a new consensus seems unlikely to emerge soon.[487] Once new multilateral organizations are established, membership can become a requirement for LDCs to avoid being ostracized.[488] If a new multilateral institution were set up with jurisdiction over capital controls, or if that jurisdiction were given to the IMF, and the Western liberalization mania came to dominate, LDCs would be worse off than if there were no such institution.

Not all LDCs need capital controls, as many have difficulty attracting foreign investment at all. Others need capital controls only when falling returns in developed countries send too many investors in search of too few productive investment opportunities in comparatively attractive LDCs. The LDCs that most need capital controls are those whose financial systems have evolved to the point where they give foreign investors an initial sense of confidence that their money is finding efficient employ, but where the systems also fail to productively channel large flows of short-term investment. Such countries can quite efficiently absorb many types of foreign

482. Canova, *Unrestricted Capital Mobility*, *supra* note 183, at 224.
483. *Id.* at 225.
484. *See* William R. White, Note, *The Tobin Tax: A Solution to Today's International Monetary Instability?*, 2 Colum. Bus. L. Rev. 365 (1999) (exploring the justifications for the Tobin tax and arguing that excessive volatility in the foreign exchange markets show that a Tobin tax would be efficient).
485. *See* Canova, *Financial Liberalization*, *supra* note 129, at 1316-18.
486. Chun, *supra* note 32, at 2651.
487. Levinson, *supra* note 367, at 48-49.
488. Head, *supra* note 468, at 657.

investment without creating financial instability. Chile, Mexico, Malaysia and other LDCs only need capital controls when foreign investors over-anxiously flock to their shores without properly assessing the country-specific risks involved.[489] Such relatively developed countries do not need controls during times of relatively low inflows of foreign investment. Given the many shortcomings of multilateral institutions vis-à-vis the special problems of LDCs, the economic sovereignty and other interests of the latter will be best served by continuing to determine on their own when to use capital controls, rather than allowing a Western-dominated multilateral consensus to make this decision for them.

CONCLUSION

This Note has argued that LDCs mainly use capital controls to enhance stability in their domestic financial markets. Used in this way, capital controls fulfill a moral necessity when the human cost of financial instability confronts LDC governments. Capital controls most effectively achieve this goal by altering the inflow of foreign investments into the country before a financial crisis erupts. To mitigate instability, capital controls need primarily to change the maturity composition of foreign inflows rather than to effect a large reduction in the overall volume of inflows.

To achieve the desired enhancement of financial stability, a simultaneous improvement of financial regulations and supervision must also be implemented. Developing the regulatory structure necessary to allow an LDC to efficiently absorb unrestricted inflows of foreign capital takes a great deal of time. The developed world and multilateral institutions should recognize the amount of time necessary to achieve such financial development and accept that capital controls provide an effective means of providing stability in the interim.[490] Continued dogmatic insistence on immediate capital account liberalization will likely lead to further traumatic instability in LDCs, which will in turn further alienate these nations from the path of long-term liberalization. Capital controls can form a part of an effective long-term liberalization process.

The financial crises of the 1990s have primarily taught us that capital controls should be imposed when inflows of foreign capital become heightened. Capital controls can be reduced in times of general investor withdrawal from emerging markets in order to

489. *See* Graham Gori, *Investors Are Rushing to Mexico, Despite Slowing Growth*, N.Y. Times, May 25, 2001, at W1 (noting that, as investment returns lag in the developed world, investors are seeking out higher returns in Mexico despite warning signs that the Mexican economy is slowing and will not likely be able to absorb all foreign investment productively).

490. *See* Terrill, *supra* note 92, at 308 (discussing the extended amount of time required to adopt the necessary structural reforms).

stimulate investment, but LDCs should not wait until a large-scale pull back begins to impose emergency outflow control measures. A proactive use of capital controls can ease a country's transition into a higher state of development.

No multilateral institution has jurisdiction to restrict LDCs' use of capital controls. LDCs and developed nations should realize that this inures to the benefit of both. Economic sovereignty concerns and the ability of LDCs to shield their citizens from the harshness of financial instability, as well as the current tendency of multilateral institutions to protect the interests of developed nations over those of LDCs all dictate that capital controls should remain under national rather than supranational control.

Notes & Observations