

The Political Economy of Capital Controls and Liberalization

Age Bakker

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Concerns

- Foreign investors acquiring key industries
 - intellectual property and security issues
 - state aid gives unfair competitive advantage
- Supervisors probe into provenance of money flows
 - know-your-customer requirements
 - fight against money laundering and illegal money flows
- Level playing field, reciprocity

Overview

- A brief historical overview
- Economic and political motives
- The *erga omnes* principle
- History revisited: the case of Japan
- A fast forward to investment screening
- Conclusion

Hopeful beginnings

- Trade liberalization
 - 1958 current account convertibility
 - Treaty of Rome: ultimate objective of capital liberalization
 - safeguard clause: 'to the extent necessary for the proper functioning of the Common Market'
- Capital liberalization directives
 - 1960 and 1962 long-term capital flows liberalized, including direct investment

The long road to liberalization

1970s Lost momentum

- 1968 France invokes safeguard clause
- 1972 Directive aimed at regulating capital flows

1979 Start of EMS, 'big bang' in UK

1980s Active gradualism

- 1988 Directive freeing all capital flows
- 1994 Greece is last to fully liberalize capital flows

The textbook

Freedom of capital movements

- improves allocation of scarce resources
- facilitates trade across borders
- facilitates raising capital for business

Potential source of vulnerability in crisis times

The reality: controls on *outflows* and/or *inflows*

- economic motives
- political motives

Economic motives

Reasons to control flows

- avoid pressure on exchange rate
- preserve degree of monetary autonomy
- keep domestic savings at home
- restrict participation of foreign capital in key industries

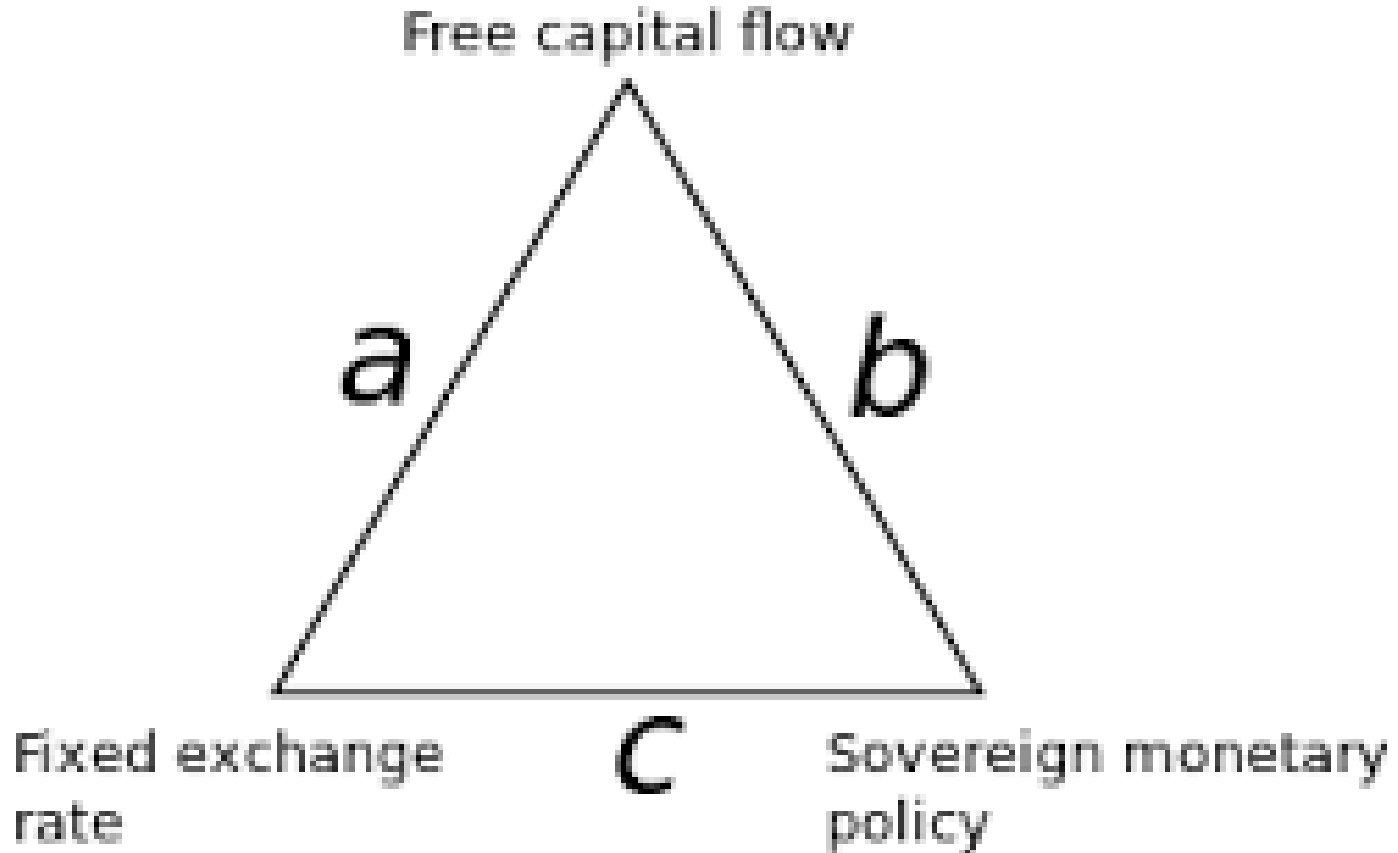
Counterarguments

- easily circumvented
- postponing needed adjustment of policies
- lack of judicial enforcement

Mousetrap currency



The incompatible triangle



Political considerations

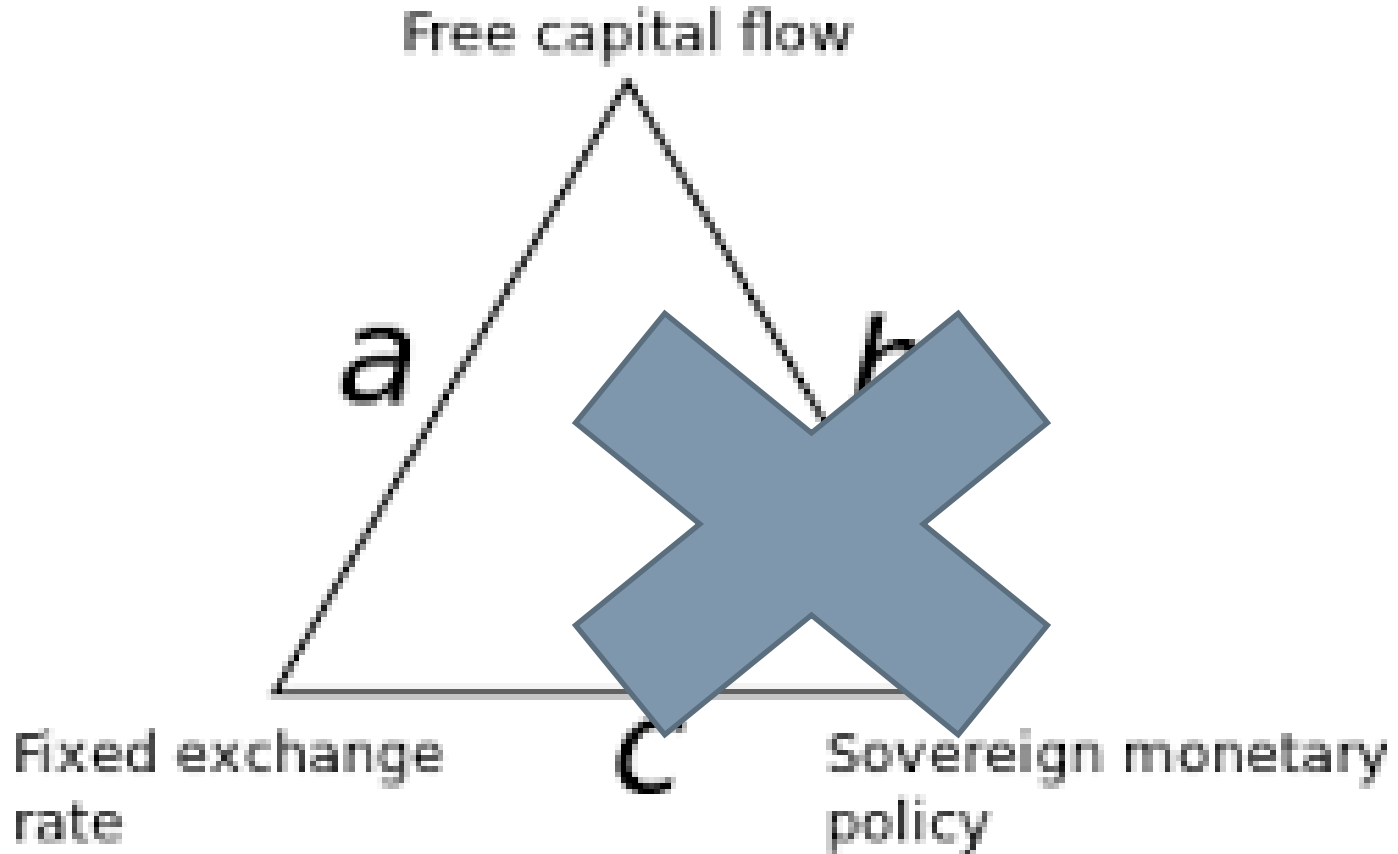
In favor of controls

- fits in 'dirigistic' economic approach
- savings to priority sectors
- avoid takeovers by foreign companies

Political forces

- Germany regards liberalization as disciplinary mechanism
- France modernizes economy, promotes financial center
- European Commission plays decisive role
- precondition for monetary unification

The incompatible triangle resolved



transferred to the ECB

The *erga omnes* principle

- Germany in favor of binding obligation
 - Deutsche mark as international reserve currency
- France in favor of common approach
 - a shielded European capital market
 - 1970 Werner report
- Compromise
 - freedom of capital movements *erga omnes*
 - leeway in domestic administrative regulations
 - confined to national security and public order
 - circumscribed by strict jurisdiction

The case of Japan in the 1980s

Accused of unfair trading practices

- controls on capital inflows, incl. direct investment
- high domestic saving rate
- large trade surplus with US

1985 Plaza Accord between G5

- liberalize capital movements
- deregulate domestic markets
- end currency manipulation: yen appreciates 50% in 2 years

Investment screening proposals

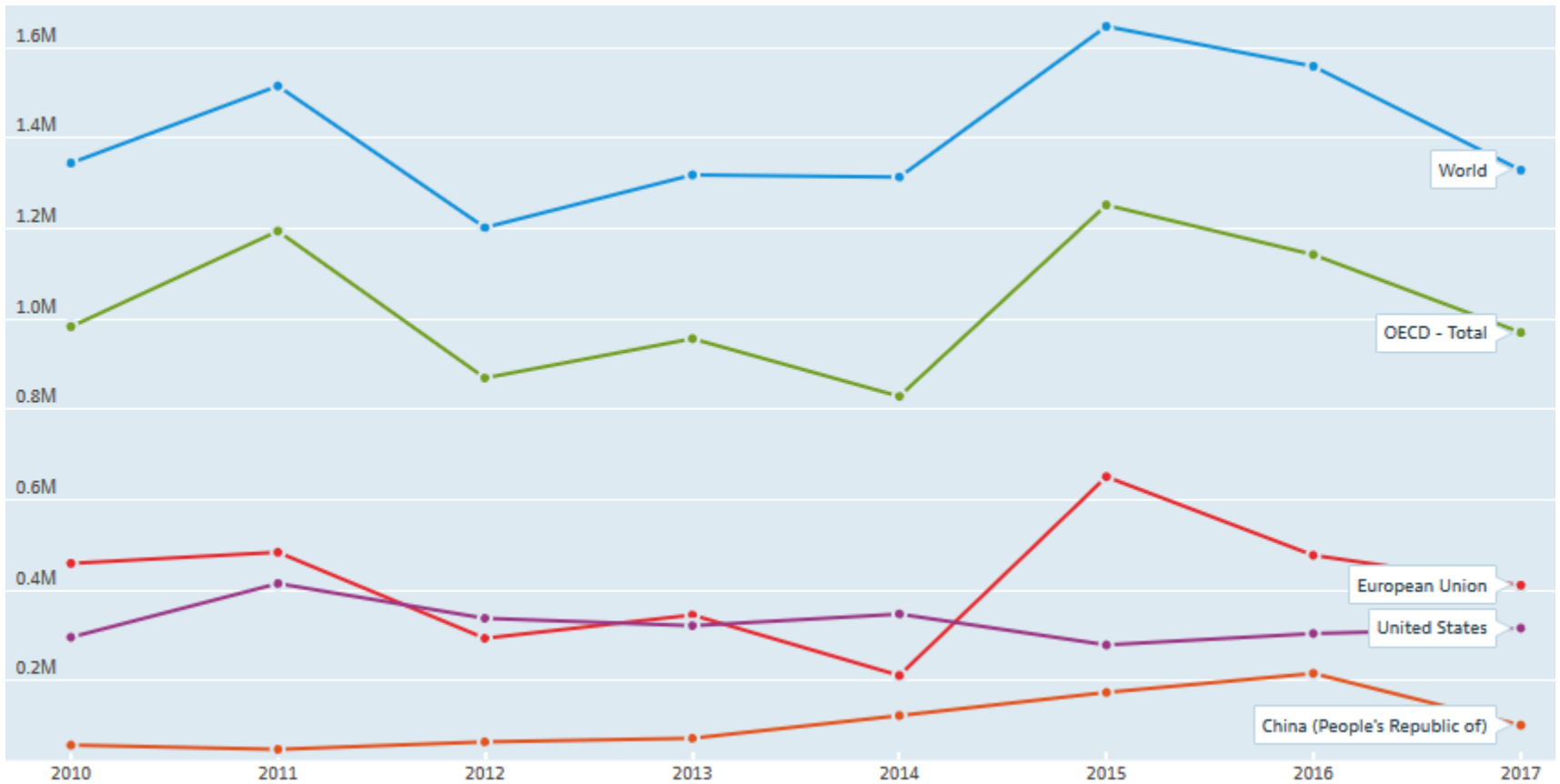
Capital controls no longer in toolbox

- would undermine single monetary policy

Changed international climate

- nationalist revival
- security and public order considerations
- risks for strategic technologies and public infrastructure
- trade tensions between US and China
- sharp downturn in FDI flows

Outward FDI flows



Way forward

Need to address genuine concerns

- unfair trading practices
- proper treatment of intellectual property
- subsidized state-owned enterprises
- reciprocity

An alternative approach for the new Commission

- bilateral investment treaty between EU and China
- political basis in EU-China Summit
- intellectual property, mutual access and state aid rules

Conclusion

Free capital flows linked to euro

- complete Banking Union and European capital market

Screening proposals should

- not infringe on acquis of free capital flows
- adhere to erga omnes principle
- not mix economic interests with security concerns
- not become an extension of industrial policy

A useful reminder

History: collapse of international trade is possibility

- before WW I free movement of goods, capital and people
- but also strong distributional effects
- large electoral shifts

Do not build walls but keep borders open

- Europe can be more proactive
- new impulse to multilateralism