The Political Economy of Capital Controls and Liberalization

Lecture by Age Bakker, State Councilor in Extraordinary Service, for the conference 'A Common European Law on Investment Screening', University of Gothenburg, March 7, 2019

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The subject of this conference is well-chosen and topical. In the face of rising global trade tensions the free flow of direct investment capital across borders is in dispute. The self-evidence of free capital movements since the birth of the euro no longer can be taken for granted.

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Concerns have emerged about the intentions of foreign investors acquiring domestic key industries. There have been suspicions of intellectual theft and improper state involvement which may raise security issues. Supervisors in the financial sector are asking probing questions about the provenance of money flows. Know-your-customer requirements have been strengthened in order to cope with money laundering and illegal money flows. There are also the more general questions about reciprocity, where markets are closed for European investments, and about a level playing field, where state aid gives an unfair competitive advantage to competitors. Political tensions are growing. Politicians are wary of losing the popular vote which seems to be in favor of back-tracking on liberal policies.

As we discuss these issues we should not lose sight of the strictly regulated world where we come from and the tremendous efforts it took to liberalize. Many have forgotten the post-World War world in which borders were tightly controlled and largely closed for international capital movements. Many countries applied negative exchange control systems where all cross-border capital transactions were prohibited unless explicitly permitted. As recently as 1983 France imposed limits on tourist travel allowances. Until the late 1980s strict limits applied for foreign investments by pension funds. Nowadays, citizens and corporations are free to move capital in and out of the country. This is a great achievement.

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In this lecture I will elaborate on the philosophy behind the liberalization of capital movements which took effect over the past decades in the European Union and the issues which have remained. For me personally this means revisiting the subject matter since I wrote my thesis on capital liberalization in the mid-1990s and subsequent work on the issue for the IMF.

I first will give a brief historical oversight of the process which has led us from the strictly regulated post-world war to the liberalized financial environment of today.

I will then focus on the economic and political considerations which played a role and which may continue to be of importance. Over time there was a changed appreciation of the economic and political motives for capital controls, which led to their eventual abolition. In Europe the drive toward monetary union was decisive for liberalization.

I will then take two short side-steps which are relevant for this conference. First, I will address the reasons why the *erga omnes* principle was embraced by the European Union while liberating capital movements. Second, I compare present day concerns vis-à-vis China with the case of Japan in the 1980s when similar fears concerning intellectual property, reciprocity and state support prevailed.

To round-up I will switch forward to the situation of today and assess the implications of investment screening proposals for the freedom of cross-border capital flows. Finally, I will draw some tentative conclusions.

A brief historical overview

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Over time there has been a major shift in the assessment of the pros and cons of free capital flows. In the period following World War II, trade liberalization took precedence over capital account liberalization. Free trade was seen as having a more direct positive impact on economic growth than free capital movements. Current account convertibility was achieved within a relatively short period, implying that residents could freely purchase foreign exchange for buying foreign goods and services.

The Treaty of Rome provided for the eventual freedom of capital movements in Europe. However, it was felt that one needed to tread carefully and a safeguard clause was inserted, which clarified that this obligation was limited ‘to the extent necessary to ensure the proper functioning of the Common Market’. Improved economic conditions made it possible to adopt two capital liberalization directives in the early 1960s allowing free movement of long-term capital flows, including direct investment. This helped alleviate the shortage of capital to finance much needed investment in European countries at the time.

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However, soon the momentum was lost when France had to evoke the safeguard clause in 1968 in the face of serious domestic disturbances. When soon thereafter the Bretton Woods system of fixed exchange rates collapsed, it was widely believed that capital controls were needed to maintain a measure of exchange rate stability among countries with diverging economic performance.

In 1972 a directive was adopted which, in a complete reverse of the earlier drive for liberalization, required member states to have instruments at their disposal to ward off unwanted capital flows. This marked the beginning of years of euro sclerosis in which capital liberalization in the EU was deadlocked for a prolonged period of time. At the national level though there were exceptions. All along Germany generally adhered to liberal policies, like the United States, Canada and Switzerland.

The establishment of the European Monetary System in 1979, where European currencies were linked to one another, marked a new beginning, as did the switch to liberal policies in the Anglo-Saxon world. Under the Thatcher administration in a major upheaval of economic policies all capital controls were abolished in one stroke. This was also inspired by the wish to position London as a major international financial center.

The abrupt abolition of exchange control in the United Kingdom and the rapid integration of world financial markets contributed to a different appreciation of the pros and cons of controls in other European countries. Official thinking evolved and from 1983 liberalization of capital movements was again on the European agenda after an absence of more than a decade. However, unlike the UK, most countries followed a gradual approach, mindful of the potential disruptive effects of speculative capital flows. The process was called *active gradualism*, ensuring that liberalization was linked to reform in other policy areas.

The liberalization process gathered momentum in the second half of the 1980s, enhanced by a general adherence to stability-oriented budgetary and monetary policies. The lifting of capital controls generally was seen by financial markets as a sign of strength. The pace accelerated when political discussions toward monetary unification in Europe gained strength. In 1988 a directive was agreed in which the full liberalization of capital movements was agreed upon within a given time schedule. When on 1 July 1990 the first stage of EMU started, eight member states had abolished capital restrictions. Eventually, when Greece abolished controls in 1994 the liberalization of capital movements in Europe was completed. Europe now has 25 years of complete freedom of capital movements.

Economic motives for balancing capital controls and liberalization

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The free movement of capital improves the allocation of scarce resources to their most productive use. Free movement of capital facilitates trade and investment across borders. And free movement of capital makes it easier for businesses to raise money. These are the textbook arguments in favor of the freedom of capital movements. However, capital flows can also be a source of vulnerability in crisis times if these flows transmit shocks across borders and disrupt local financial systems. In reality therefore a range of other motives played a role for imposing capital controls on capital outflows or inflows and sometimes on both. These included economic motives, most importantly macroeconomic considerations and industrial policy considerations, and political motives.

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Most common were controls on capital *outflows*. These helped countries to avoid downward pressure on the exchange rate, preserve a degree of national monetary policy autonomy and reduce the need to raise interest rates in case of a speculative attack on the currency. Controls also helped keep domestic savings at home and avoid tax evasion. They were supplemented by regulations for institutional investors like pension funds, requiring them to invest a large share of their assets domestically.

Controls on *inflows* were only sparingly used, chiefly by countries in a strong economic position, to help avoid too strong upward pressure on the exchange rate and consequently a decline in competiveness. Some countries controlled inflows for industrial policy reasons, restricting the participation of foreign capital in sensitive sectors.

Europe thus had a very diverse landscape concerning capital movements in the wake of the discussions on EMU. Different traditions and country-specific arrangements resulted in a wide range of controls, often camouflaged by complex administrative rules. For a long time the stabilizing role attributed to capital controls outweighed the textbook costs of controls. However, their effectiveness was questioned as they were easily circumvented by increasingly sophisticated financial markets. Controls were seen as having the undesired side-effect of postponing necessary adjustments of domestic policies. It was realized that controls did not address the fundamental causes of speculative capital flows and negatively impacted the investment climate.

Controls resembled playing cat and mouse; it was impossible to put a cat for every hole. Judicial enforcement was lacking as well. Only very rarely were violators prosecuted. Nevertheless, the controls deterred investors.

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To stay with the mice: controls on outflows created ‘mousetrap’ currencies: investors could bring in money but it was difficult to legally withdraw. Investors were trapped. International investors preferred to bring their money into countries where cross-border transactions were freely allowed and shied away from countries which had a history of imposing controls on outflows.

Political motives

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In the face of the ‘incompatible triangle’ of having at the same time autonomous monetary policy, free capital movements and a stable exchange rate, capital controls for a long time had been seen as the lesser evil. One cannot have three sides of the triangle at the same time. Capital controls bore fewer political costs than devaluing the national currency or raising interest rates.

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For France capital controls fitted in the post-war dirigistic approach to economic development. Industrial policy was geared to channeling savings towards priority industrial sectors and avoiding the takeover of domestic companies by foreign interests.

Germany, on the other hand, supported by the Netherlands, was the driving force towards capital liberalization. Politically it had been put on the defensive by repeated initiatives by France and other countries to strengthen monetary arrangements in Europe. Germany feared that this in practice would only lead to more financing requests from economically weaker countries. Therefore, Germany declared that it would only be willing to discuss further proposals for European monetary cooperation if cross-border capital controls were dismantled. Freedom of capital movements was seen as forcing economic discipline in neighboring countries: they could no longer behind the protective shield of capital controls follow expansionary policies as this would be punished by financial markets.

Better economic performance in the 1980s and a generally stable political environment created the right climate for gradually dismantling capital controls. In particular, the major reorientation of French policies in the mid-1980s swayed the balance within the European Union toward abolishing exchange control altogether. One of the major architects was the then Minister of Finance Jacques Delors, who later was to become the President of the European Union. When France changed strategy other countries eventually had to follow suit. This included the opening-up of markets and the gradual privatization of nationalized companies and banks. The aim was to encourage the rationalization of French industry through increased foreign competition. The position of Paris as an international financial center was at stake as well, since this would only flourish in a liberal environment.

The European Commission, under the inspired leadership of Jacques Delors, played a decisive role by seizing the moment and persisting on full and unconditional capital liberalization. Freedom of cross-border capital flows thus became a *sine qua non* for European monetary integration. The Commission expected that this would compel the member states to take the necessary adjustment measures in other areas and follow disciplined economic policies, which would create the right setting for monetary unification. Countries had to show that their policies generated sufficient confidence in financial markets without the protection of capital controls.

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The eventual abolition of controls thus must be understood in the political context of European monetary unification. Monetary union implies that *position a* of the triangle is chosen and that sovereignty of monetary policy is transferred to the European Central Bank.

The erga omnes principle

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While pushing for liberalization of capital movements Germany all along insisted that this should be applied *erga omnes*, i.e. in a non-discriminatory fashion. An important reason was that the deutsche mark was an international reserve currency and such status was not compatible with common EU restrictions vis-à-vis third countries. Likewise the euro should be a freely tradeable currency with no strings attached.

France, on the other hand, was of the opinion that the erga omnes principle should be a political declaration of intent rather than a legally binding obligation. It felt that Europe should be capable of taking steps vis-à-vis third countries if their policies were a hindrance for the good functioning of the European monetary arrangements.

These diverging positions betrayed the more outward-looking attitude of Germany, which favored a Europe open to the outside world, versus the more Eurocentric attitude of France which, at least initially, upheld the concept of a shielded European capital market.

The French preferences interestingly already had transpired in the Werner report of 1970, which provided the first blueprint for monetary union. The report took issue with the erga omnes principle and advocated a regime which discriminated between intra-European capital movements and those with third countries. But most members states opposed this, also because it was technically difficult to make such distinction. If at all possible, discriminatory rules could be easily circumvented by financial market participants.

When capital liberalization again came on the agenda in the late 1980s the compromise was that while capital movements would be freed *erga omnes*, countries would preserve a certain measure of leeway in the grey zone of domestic administrative regulations. To that effect some countries maintained screening mechanisms which in practice could provide an obstacle for foreign investors. In order that this grey zone, which explicitly is confined to the protection of national security or public order, was not abused the Commission and the Court of Justice have given strict interpretations in subsequent jurisdiction to uphold the notion of free capital flows.

Looking back at the discussions about the erga omnes principle it is interesting to note that the prevalent concern at the time was the threat of increased foreign influence in the financial services sector, unlike today where concerns focus on foreign influence in technological industries and public infrastructure. Many member states felt at the time that reciprocity should be maintained as a negotiating tool, in particular vis-à-vis Japan which at the time when these discussions took place was seen as a threat for a level playing field.

History revisited: the case of Japan

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Japanese financial institutions in the 1980s were aggressively entering European markets. Member states felt that this could only be allowed if the Japanese domestic financial market would be opened up to foreign banks as well. There was a lack of reciprocity as controls on inward direct investment restricted the share of foreign ownership in various Japanese industries. Domestic industrial policy was aimed at preventing the takeover of innovative Japanese companies by foreign competitors. The high domestic saving rate in Japan reduced the need for foreign capital.

Faced with a rapidly deteriorating balance of payments the US took issue with the huge bilateral trade deficit with Japan. Japan was accused of manipulating the currency in order to gain a competitive advantage. Controls on capital inflows into Japan, which would have caused more demand for the yen, contributed to its weakness. There were also accusations of copying intellectual property and infringement of patents. In US Congress the question was asked ‘are the Japanese picking our brains?’ International pressure to end these unfair trading practices intensified.

Key changes eventually resulted from the Plaza Accord, signed in 1985 by the five major industrial countries which built upon earlier bilateral agreements reached between the US and Japan. Japan was forced to play according to the rules of the game and deregulate domestic financial markets and liberalize capital movements. This agreement proved to be a success as the Japanese yen appreciated by more than 50% in two years, making Japanese exports less competitive. Outward direct investment from Japan increased dramatically in the late 1980s as the strong yen encouraged Japanese manufacturers to open manufacturing plants in third countries. Inward direct investment eventually picked up following Japanese financial market reform in later years.

What is striking about this period is that the final outcome of external bilateral pressure on Japan and multilateral negotiations has been the full incorporation of Japan at an equal footing in the international system. The Plaza Accord was based on an inclusive strategy where Japan was made part of a rules-based system by taking responsibility for international monetary order. Eventually all parties gained as mutual obligations were recognized.

There are striking parallels to the situation vis-à-vis China nowadays. China similarly has a very high domestic saving rate and is not dependent on foreign capital for its domestic investment drive. China manipulates its currency in order to stay competitive. The large current account deficit vis-à-vis the US is a bone of content. Again there are fears of others picking our brains. So, let’s take a fast forward to the present-day situation.

Fast forward to the present investment screening proposals

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Most economic motives for controlling capital movements for Europe no longer apply as the incompatible triangle is resolved by the introduction of the euro. Capital controls would undermine the premises on which the single currency is built and would hinder the unity of monetary policy of the ECB. Of course, capital movements within the euro area can cause trouble, as became clear in the financial crisis. More recently, the stand-off between Italy and the Commission on the budget caused large capital flows out of Italy, raising domestic interest rates. However, capital controls to stop outflows are no longer in the toolbox of the authorities.

The political agreement reached on an EU framework for screening foreign direct investment reflects a changed international climate. This is characterized by a nationalist revival where the political appreciation of liberal policies and open borders has changed as it is increasingly realized that the benefits of globalization are not evenly spread. The political appreciation of what constitutes key industries is changing as well. In particular, there are concerns about foreign investments which are not driven by market considerations and pose risks for strategic technologies and public infrastructure. With rapid technological advances national security and public order considerations have become more forceful. This the context for the proposed European screening framework which aims to ensure in the words of Commissioner Cecilia Malmström 'to protect our collective security while keeping Europe open for business.'

Strengthened screening is taking place at a time when international tensions are already running high because of the trade conflict between the US and China. The unilateral tariff increases imposed by the US and the retaliatory measures taken by China have hurt international trade. Both countries suffer from the protracted trade war and bilateral FDI flows have come close to a halt. In the US, the Foreign Investment Risk Review Modernization Act has empowered the government to block even small minority foreign investments into sensitive technologies. Meanwhile China has imposed very stringent capital controls on outbound investment. FDI flows into the US and Europe combined amounted to only $ 30 billion in 2018, that is 73% lower than in 2017. The number of canceled Chinese investment deals increased significantly.

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There is thus already a visible effect of tighter investment screening policies, with possible negative effects on the global economy. The chart shows figures up till 2017, but there are clear indications that the 2018 figures will show another sharp downturn. Industries are moving supply chains back home. Strengthened investment screening is creating uncertainty to the Asian region that has been the main driver of the global economy for the past decade. International institutions as the IMF see this as a major risk for the global economy.

Therefore, in elaborating the present investment screening framework it is imperative that the concept of national security is not stretched or mixed with other motives. It is clear that member states have the right to take measures for the protection of national security or public order. But the framework should ensure that screening is based only on grounds of national security and not on other industrial policy objectives. There is a vulnerable line here. Why, for instance, has Europe accepted the hegemony in strategic IT sectors by US companies, such as the 'big five', while being concerned about Chinese investments in similar sectors?

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This not to say that there are not genuine issues which need fixing. Current trade negotiations between the US and China may ideally end up with reforms to end unfair trading practices and proper treatment and protection of intellectual property. This already would constitute a major improvement. A reform of China's system of state-owned enterprises, allowing more market-led principles, would be welcome as well, as would be a deal on the yuan renminbi. But all this will take time.

Regardless of strengthening investment screening procedures one could envisage alternative approaches which would more effectively address these genuine concerns. A more effective way of dealing with concerns of both security and reciprocity would be the negotiation of a bilateral investment treaty between the EU and China where mutual access rules can be agreed. The political basis could be laid in a EU-China Summit in which also state aid rules are put on the agenda.

We can learn from the experience in the 1980s when the open global system was challenged by severe tensions with Japan. The trade system came out of that dispute in a much stronger fashion once a deal was reached. Also here the US first took the lead, but at a later stage bilateral agreements were codified in multilateral agreements. The multilateral negotiating table is a better place to address the issues we are facing today than taking bilateral actions which risk countermeasures being taken. What we really need is a reformed trade system in which trade in services is liberalized within an agreed set of measures limiting state aid and protecting intellectual property.

Conclusion

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International mobility of capital was in most countries strictly limited until the mid-1980s. The application of capital controls under the Bretton Woods system reflected a preference for isolating domestic financial markets from international developments. However, their effectiveness varied and tended to erode over time. Eventually, countries came to the conclusion that controls involved more costs than benefits and they embarked on a policy of gradually lifting them. By establishing common budgetary targets and setting up the

independent ECB, an important element of divergence among European countries was removed. This eventually made monetary unification possible, which by definition is characterized by the free flow of cross-border capital.

Liberalization of capital movements overall has been a success and it has proven a catalyst for further economic reform. In the EU the political dimension was evident since capital account liberalization was part of the process of achieving economic and monetary integration. Nevertheless, liberalization has not been without its difficulties and costs. Insufficient time has been paid to the need to strengthen supervision of the financial sector. In the euro area finishing the banking union and creating a truly European capital market are still needed to make the euro area less prone to financial crises.

I believe that it is important that the investment screening proposals on the table do not infringe upon the acquis of free capital flows and adhere to the erga omnes principle. Presently EU member states have very open investment regimes and this has served us well as our relatively small and open economies are dependent on trade. Europe should take care that screening procedures will not disrupt cross-border flows.

In particular, economic interests should not be mixed with national security concerns. Investment screening should not become an extension of industrial policy. Therefore, the screening should be limited in time and transparent, with clearly defined criteria leaving as little room for interpretation as possible. The framework should not become too generic and focus only on those sectors which are needed for public order or where national security is at stake. Political influencing can be avoided by having the screening carried out by fully independent committees. One should realize that investment screenings have their limitations as they deal only at one point at time and cannot focus on the more relevant lifecycle of the investment.

The Dutch perspective coincides with the European perspective. The Netherlands is a very open economy which is largely dependent on free trade and whose welfare therefore depends on open borders and an attractive investment climate. The Netherlands consistently is in the top five of global FDI investors. Investments in and out of the country are regarded as an inseparable part and parcel of our successful business model. At the same time Dutch companies, like other member states, face barriers outside the EU. There is a need for a better balance in reciprocity and for a level playing field vis-à-vis foreign companies which receive government subsidies.

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Europe should not be on the wrong side of history. History shows that a collapse of international trade is a possibility. Globalization is not a new phenomenon, nor is it irreversible. More than a century ago, between 1870 and 1913, open borders allowed a rapid international distribution of modern technology. That period was one of unprecedented

global integration, where goods, money, and people could move across borders with minimal impediments. There were large gains in exports and FDI as a share of GDP in many economies—a sign of increasing openness. It was also an era of rising inequality. As now, globalization had strong distributional effects which led to large electoral shifts which negatively impacted on trade policies. The Great Depression of the thirties was the ultimate example of de-globalization.

The message of history is clear. We need a new impulse to multilateralism and try to rediscover the previous spirit of international cooperation in which the broader spectrum of challenges can be tackled, including the issues we are discussing now. The international agenda should aim at not building walls but keeping borders open while addressing national security issues as part of mutual understandings which would bind us closer together instead of setting us apart. I am confident that Europe can play a proactive and constructive role in this.