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Capital controls to deter hot money can help the world economy

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From Prof Stephany Griffith-Jones and Dr Kevin P. Gallagher.

Sir, In your December 14 article "**Capital inflows to Turkey spur plan to cut interest rates**", you point out that the Turkish central bank is considering cutting interest rates even though its economy is growing very fast, which would rather suggest the need to raise interest rates. This is the dilemma facing many emerging economies – and even poorer countries such as Uganda.

With low interest rates in the industrialised world, nations such as Turkey could get swamped with hot money via the carry trade in the event that they raise rates to cool their economies.

The influx of hot money may accentuate the very problem the nation is trying to alleviate by raising rates.

Emerging and developing economies also have other options. One of them, which several are now pursuing, is to engage in prudential capital account management, by taxing or putting unremunerated reserve requirements on capital inflows. This is not a panacea, but does help provide greater monetary policy autonomy to those countries; this is essential, as their growth rates are at present high, and it is essential for them not only to avoid inflation in goods and services, but also asset price bubbles and overvalued exchange rates.

Actions taken by developing countries on their capital accounts may not be enough, as the wall of money presently coming towards them is so large. Therefore, it may be desirable to complement these measures with action by the countries where the capital is coming from, especially the US.

Indeed, the US could introduce measures to discourage the carry trade flows going from that country to the rest of the world, and especially developing countries; this could be done by taxing such flows or demanding unremunerated reserves (via, for example, collateral) against such short-term transactions.

Such a measure would benefit the US economy, as the purpose of quantitative easing (QE2) is precisely to encourage increased bank lending and lower interest rates in the US, and not for funds being channelled abroad; it would benefit emerging countries, whose economies are being harmed by excessive short-term inflows that could cause future crises. It would thus be a big win-win for the world economy.

Only a few traders would make a bit less money, but we have learnt at high cost that running economic policy to benefit purely financial interests can be very dangerous.

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