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Helping Brazil to help itself

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The IMF should end its Washington consensus policies and encourage Brazil to strengthen, not eliminate, capital controls

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In an effort to stem the appreciation of its currency, the real, Brazil has twice resorted to capital controls. In response to these measures, IMF head Dominique Strauss-Kahn says capital controls are "not something that come from hell", but the IMF won't be recommending them any time soon to remedy the current crisis.

Enough is enough. Given the economic evidence and in the wake of the current crisis, the IMF should change more than its rhetoric and do away with its Washington consensus policies by encouraging Brazil to strengthen its capital controls, not eliminate them.

In some ways Brazil is a victim of its own success. With US and other western interest rates low and concern about the weakening of the US dollar high, investors have flocked to emerging markets. Brazil has been the most attractive, having rebounded much better than most. Brazil started growing again in the second quarter of 2009 and is set to grow by 3.5% in 2009.

However, massive capital inflows this year have caused the Brazilian real to appreciate 34% on the dollar and over 40% over the Chinese yuan. This could make Brazil's exports less attractive, accentuate its current account balance, and potentially make Brazil slide back into its crisis-ridden 1990s.

In response to these shocks, on 20 October Brazil placed a 2% tax on foreign exchange inflows. At first the controls seemed to have a positive effect. Shortly after they were announced the real slid by 2% and the stock market by 3%. Yet both markets regained ground.

Despite the IMF's intransigence, taxes on inflows like Brazil's have a good track record. In a recent report by the National Bureau of Economic Research (NBER), Carmen Reinhart and Nicholas Magud assess the most rigorous studies on capital controls and conclude "in sum, capital controls on inflows seem to make monetary policy more independent, alter the composition of capital flows and reduce real exchange rate pressures."

Why then have Brazil's controls not had the desired effects? There are two reasons. First, the level of Brazil's tax is too low relative to the more successful cases analysed by Reinhart and Magud. Second, in globalised financial system, investors increasingly learn how to circumvent capital controls.

Two of Brazil's neighbours, Chile and Colombia, have successfully used taxes on capital inflows. To dampen the effects of massive inflows in the wake of the earlier crises, both nations deployed an unremunerated reserve requirement (URR). A URR is a mandatory non-interest-bearing deposit in foreign currency at the Central Bank for a certain period in an amount proportional to the size of the capital flow (30% for Chile, 47% for Colombia). The tax

equivalent of Chile's controls averaged 4.24% and was as high as 7.7%. Colombia's ranged from 6.4% to 13.6%.

Each of these tax equivalents is almost two to seven times stronger than Brazil's current controls.

Another reason why Brazil's controls aren't working is because investors have invented creative ways to circumvent them. According to another NBER report, by Bernandro Carvalho and Marcio Garcia, investors have loopholed controls by disguising short-term capital as foreign direct investment, through currency swaps and other derivatives, and by purchasing American depositary receipts (ADRs).

ADRs are issued by US banks and allow investors to buy shares of firms outside the US - enabling investors to purchase Brazilian shares but in New York and thereby skirt controls in Brazil.

In a step in the right direction, on November 18, Brazil moved to put a 1.5% tax on ADRs to stem speculating around the October controls. Thus, a Brazilian bank or investor that deposits shares with foreign banks will be charged the tax.

How much is enough? At the time of writing it is not clear that Brazil's capital controls are stiff enough, or loophole-free enough. Rather than scorn Brazil, the IMF should be working to help Brazil design stronger and more effective ways to stem the rapid appreciation of its exchange rate. Enough with the business as usual, the IMF must change to reflect economic thinking and 21st century realities.

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