Financial Crises Prevention: Should the IMF support capital controls?

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Content

1. Introduction

Due to financial liberalisation, portfolio investment as well as the volume of foreign exchange transactions have increased dramatically. These short term and potentially reversible capital flows pose the risk of sharp reversals. Sharp reversals of capital flows on the other hand can result in financial crises, losses of output, investment, employment and lead to poverty. This concerns especially developing countries. While the integration of developing countries into the world economy has brought many benefits such as lowering the costs for credit worthy firms and providing technological know-how, especially the integration into the international financial market poses certain risks. Thus developing countries have become very vulnerable to variations in capital flows due to the opening of their financial markets. The risks and problems caused by financial liberalisation are clearly revealed by the Asian crisis.

The following paper will focus on the question of whether or not the IMF should support international and national capital controls[1] to limit so called hot-money flows (short-term capital flows) in order to prevent financial crises. Thus, the paper will analyse and evaluate capital controls as a way to reduce the risk of financial crises (i.e. to reduce volatile short-term capital flows and as support of structural reform programs).[2]

The main thesis of this paper is that national short-term capital controls are desirable - and consequently should be supported by the IMF - in countries with weak and underdeveloped financial markets and in countries, which undergo severe economic and political reform periods. However, short-term capital controls alone are not sufficient to prevent financial crises. Moreover, a bundle of measures is needed. The paper also aims to show, which measures and steps should be implemented to reduce the risk of financial crises. It will be argued that contrary to temporary national capital controls, international capital controls, such as the Tobin tax do not belong to this bundle of measures since they are neither economically desirable, nor is there enough governmental support for their implementation.

In the first part of this essay, some of the factors, which fostered the internationalisation of finance, will be described. Subsequently, it will be argued that the internationalisation of na-

[1] It is necessary to distinguish between national and international capital controls. National capital controls can be divided into prudential capital controls and capital controls implemented during a crisis in order to prevent massive capital flights. Furthermore, national capital controls can be divided into capital inflow controls and capital outflow controls. One form of capital inflow controls are taxes on capital inflows. One form of capital outflow control is a speed bump, which works by having investors commit to stay for a minimum period. This prevents investors to quickly pull their money out of a market in a panic. Furthermore it provides incentives for investors to base their investment on risk assessment.

[2] Other arguments for capital controls are: 1. the retention of domestic saving and 2. the maintenance of the domestic tax base.

tional financial markets has been accompanied by the development of greater risks and uncertainties and several severe financial crises such as the Mexican and the Asian crisis.

In order to answer the question whether or not these crises are a call for capital controls, the second part of this paper will investigate the causes of financial crises, in particular of the Asian crisis. If financial crisis were primarily caused by market failure, i.e. the lack of information, irrational behaviour of investors, etc., the conclusion would be that short-term capital flows should be reduced by introducing international capital controls such as a Tobin tax. If one assumed that financial crises are primarily caused by government failure, i.e. by corrupt governments or wrong fundamentals, one would prefer implementing reforms, such as reforming the banking sector or implementing international prudential agencies. The main argument in this part is that most financial crises are caused by government as well as market failure. Following this argumentation, national reform and prudential supervision as well as temporary capital controls are necessary in order to prevent such crises from happening.

Consequently, the third part of this paper will analyse which measure and steps should be taken to reduce the risk of financial crises. It will be investigated which forms of capital controls should be implemented. The main argument of this part is that short-term national capital controls are desirable in countries in transition and newly developed countries with underdeveloped financial markets. Long-term national and international capital controls, on the other hand, are neither economically desirable nor politically feasible.

Since short-term capital controls alone are not sufficient to prevent financial crises, other risk reducing measures, such as increasing the accuracy of information and measures to reduce the moral hazard problem, will also be presented in the last part of this paper.

2. The Internationalisation of Finance

In recent years, foreign exchange transactions have expanded explosively. Important factors which led to the growth of the international financial system are: 1. technological development, which reduced the costs of cross-border transactions, 2. the restoration of market confidence in the late 1950s, 3. the rapid expansion of market demand for international financial services, 4. the depositing of enormous surplus funds in intentional banking markets by OPEC countries in the 1970s, 5. the unravelling of conservative inward-oriented financial cartels in the 1970s and 1980s and 6. the dismantling of capital controls (Helleiner 1994: 165).

The dismantling of capital controls was pushed by various economic arguments which influenced government behaviour and by a series of international and national developments. Thus, in the 1970s, government economic policy was influenced by a series of economic considerations and arguments: The traditional argument for opening the capital account is closely related to trade theory (comparative advantage and the Stolper-Samuelson theorem). Thus, the opening of the capital account will lead to capital inflows, increase the supply of capital and the national capital stock, lower the rate of return, and make investments cheaper, i.e. spur economic growth. Furthermore, it is argued that unregulated and free international capital flows will lead to an optimal allocation of capital. The increased efficiency in the allocation of investment will lead to higher growth rates world-wide. Last, it is being argued that free international capital flows make risk spreading easier so that costs, caused by financial economic risks, can be lowered, which is again said to foster economic growth.

Apart from these economic arguments a series of other factors and developments have lead governments to remove national capital controls. According to the domestic comparative and domestic interest explanation, the international move towards free capital flows was fostered by countries, which removed their capital controls due to their strong financial interest groups and highly developed financial markets. Thus, the countries, which saw their comparative advantage in the financial sector and in financial services, fostered the liberalisation of international capital flows. Furthermore, it is argued that countries, which strongly depended on capital export, removed their capital controls relatively early. Additionally, in countries, in which the link between the industry and banks was rather weak, banks supported free capital flows over exchange rate stability. Since the owners of capital (banks, funds, multinationals, private investors, etc.) are highly influential in many countries - more influential than the trade sector - they cannot be ignored by the government and capital controls were removed. Last, countries, which moved early from the manufacturing sector to the service sector favoured capital mobility. This partly explains the removal of capital controls in the US in the 1970s.

Since the US and some other countries such as Germany were very interested in free international capital flows and consequently removed their own capital controls, they created a competition situation. To prevent falling behind in the international competition for capital, other countries followed the US-American example and also liberalised their capital account. Thus, according to the state interest/competition explanation, the liberalisation of capital flows was fostered by international competition from the 1970s onwards.

Another cause for the liberalisation of international capital flows was – according to the institutionalist explanation – the breakdown of the Bretton Woods system with its fixed exchange rates which had made capital controls necessary.[3] After the fixed exchange rates and the existing capital controls had been undermined by the growing international capital flows (for example capital flight from the US into the Eurodollar markets) and after the consequent breakdown of the fixed exchange rate system, capital controls became unnecessary. Closely related to this explanation is the crisis explanation, which, after also naming the breakdown of the Bretton Woods system as one reason for the removal of capital controls names the stagflation in many countries as a reason for the policy change and reforms towards more openness. Furthermore the oil shock and the growing Eurodollar markets are often named as a cause for the liberalisation of international capital flows.

In the late 1980s and 1990s the capital account liberalisation in many developing countries was particularly fostered by the demands made by the IMF, i.e. by the IMF conditions linked to its credits. Thus capital account liberalisation was one element of the so-called Washington consensus. This explanation emphasises ideas and ideologies as cause for the international liberalisation of capital flows. Closely linked to this explanation is the argument that international capital flows were liberalised due to an ideological shift away from demand side economics towards supply-side economics and from a regulative to a de-regulative approach in economic policy.

Due to the removal of capital controls and the developments described above, global daily turnover rose from $18 billion in 1977 to $230 billion in 1995 or $1,300 billion if futures and options are included (Braunstein 1999: 114). Net flows to developing countries increased from roughly $50 billion a year in 1987–89 to more than $150 billion in 1995–97 (Eichengreen 1998: 1).

In addition to the increasing international capital flows, there have been several important changes within the national financial markets such as decompartmentalisation (the removal of restrictions on geographical and hierarchical limitations within a financial sector, between different sectors and between different functions within sectors), disintermediation (the slower growth of the supply of bank credits), securitisation (the faster growth of negotiable securities issues and trade) and financial innovation such as futures, option, swaps (Cerney 1993: 56).

[3] Since free capital flows, national sovereignty in monetary policy and fixed exchange rates cannot be achieved simultaneously, one of the three has to be restricted or given up. During the Bretton Woods period, countries favoured national sovereignty and stable exchange rates over free capital flows. Thus capital controls prevailed and were even strengthened in the 1960s. Examples for this are the "voluntary capital export restraints" and "interest equalisation tax" of 1963 and 1965 in the US and capital inflow controls in Germany in the 1960s.

Additionally, the international financial system today can no longer be seen as consisting simply out of separate national financial markets, linked together only by trade and intercurrency exchange. Moreover, it is a collection of national systems while at the same time being a single global financial system unevenly and incompletely integrated but basically functioning as a single interacting unit.

Together with the internationalisation of national financial markets, there has been an increase in the degree of financial instability and systemic risks, i.e. the possibility of a contagious spread of losses across national boarders and an acceleration of financial crises such as the financial crises in Mexico, East Asian and Russia, which threatens to harm the real economy. Thus, large banks, security firms and insurers have been increasingly involved in derivative markets, which includes forwards, options and swaps. There is a concern that the growth of the derivative market poses an increased systemic risk. The main concern is that the collapse of a major deal in derivatives could cause heavy losses for other financial institutions and lead to a contagious loss in confidence in the entire financial system. As financial institutions become more involved in international financial transactions, it becomes increasingly difficult to monitor the safety and soundness of these institutions. Financial institutions engaged in international transactions face tree kinds of risks: 1. foreign exchange risk, 2. transfer risk (the risk that residents of a foreign country will be unable to pay a promised amount of money because of restrictions of the central bank on currency exchange or outflows, 3. international settlement risk (transfers are not quick enough). Furthermore, the complexity, opacity, and the speed in which market positions can be shifted, make it difficult to evaluate whether market risks are being adequately managed. Additionally, the activity of non-banking institutions can lead to systemic underestimation of financial risk.

Financial instability can be very costly. It affects government budgets and changes asset prices, which in return affects people's wealth, their standard of living and consumption. Furthermore, it affects business and consequently investment and employment. Short-term and potentially reversible capital flows pose the risk of sharp reversals, which can result in losses of output, investment, employment and lead to poverty. Thus the prevention of financial instability and crises is very important.

3. Financial crises: market failure or government failure?

In order to determine whether or not the current financial instability and financial crises are a call for capital controls, it is necessary to investigate if the crises were caused by the liberali-

sation of the financial markets and irrational investor-behaviour, i.e. market failure, or by structural problems such as crony capitalism, i.e. government failure. In the case of the former, there would be a need for capital controls while in the latter case the answer to the problems would be the implementation of international and national financial supervision and prudential regulation as well as the improvement of national institutions and fundamentals. These arguments will be analysed more closely in the following part.

Supporters of the liberal exchange market argue that the international financial markets operate efficiently. Thus information is rapidly absorbed into prices. It is argued that arbitrage through foreign exchange dealings brings about an equalisation of national interest rates and that a thicker market encourages a speedier return to the equilibrium and thus to an equalisation of interest rates nation-wide. Thus the equalisation between onshore and offshore interest rates on similar assets denominated in the same currency is seen as a sign for the good performance of the international capital market (Krugman 1997: 674). Furthermore, greater international capital flows and liberalised international financial markets bring important benefits. Thus saving and investment are allocated more efficiently. Furthermore poor countries with low saving rates will be increasingly able to finance their investment on the international capital markets. Additionally, savers can take opportunities, which offer the highest returns around the world. Furthermore, risk will be diversified as investors can spread their portfolio more widely. This means that investors can divide their wealth between a wider spectrum of assets.

Believers in the international financial market see the causes of a currency crisis in government failure. Thus Krugman argued that currency crises derive from poor domestic policy-making. In his view, government profligacy is the main cause of the crises. If a country with fixed or pegged exchange rates finances its budget deficit by printing money and thus creating inflation, investors will expect that a devaluation of its currency is inevitable. Consequently they will leave the currency. Thus foreign exchange reserves will fall[4] (Economist 1998: 66).

Another structural explanation, closely related to Krugman´s "fundamentals" model but tailored to the Asian crisis is the "exceptionalism" explanation, which was strongly supported by Alan Greenspan and the IMF. Both argued that the underlying causes of the crisis were structural and an integral part of the Asian model of capitalism. Thus, deeply rooted patterns of

[4] This explanation does not fit the East Asian case with relatively balanced budgets and relatively high-sustained growth rates.

corruption, unsustainable real estate speculation, wasteful government spending and misguided government policies led to the crisis (Singh 1999: 18).

An explanation closely related to both models is the domestic banking and moral hazard explanation put forward by Krugman in the aftermath of the Asian crisis. Asian banks and finance companies operated with implicit government guarantees. These, together with poor regulation, distorted investment decisions and encouraged bankers to lent on risky projects in the expectation that they would enjoy the profits, while the government would cover the losses. Investors' decisions were thus not based on risk assessment but on returns in ideal circumstances. This lead to over-investment and to increasing asset prices. The bubble existed as long as the government guarantee was maintained. As soon as one company went bankrupt, banks faced great problems. Believing that the government would not be able to bail out all banks in trouble, investors started to leave the country and the currency, setting off a currency crisis (Economist 1998: 66).

According to these models, which see the causes of the crisis in government failure, national reforms, getting rid of crony capitalism and installing prudential regulation are needed in order to prevent financial crises.

However, another explanation of financial crises is market failure. Supporters of this explanation argue that asymmetric information pervades financial markets, which greatly undermines their efficiency in allocating resources. Because geography and cultural distance complicate the acquisition of information, asymmetric information is particularly prevalent internationally. Consequently, international markets are prone to sharp investor reactions and unpredictable market movements (Eichengreen 1998: 3). In addition to the problem of asymmetrical information, irrational investor's behaviour poses a great threat to financial stability. A study by Richard A. Meese, and Kenneth Rogoff, showed that day to day investor's decision making is not entirely based on fundamentals of a country. Exchange rate movements are an example for this. Thus a “random walk” model based on the exchange rate today to predict the one of tomorrow performs better in the short run than statistical forecasting models of exchange rates based on standard fundamentals (Krugman 1997: 678). Moreover, conventions and perceptions play a great role. Investor behaviour can be described by two phenomenon: the beauty contest and herd behaviour. Thus investors will not choose the funds and assets which they view as the most promising but the ones they believe everybody else will invest in because this will increase the price and thus the investor's returns. According to the phenomenon of herd behaviour, an investor who sees others investing in a particular project will also invest in

it because the rising prices will lead to greater profits for him. He will invest, even if he has knowledge about fundamentals in a particular country, which would demand curtsey. Since a great percentage of the investors will behave like this, prices will rise further, which can lead to an europhoria among investors, to over-investment and the creation of bubbles. As soon as some investors become uncertain and hesitant, investors will start pulling out of the market, which can lead to a panic. As a result of panics and market reactions, which are not justified by current available information, foreign exchange markets have become excessively volatile and thus unstable.

Based on these assumptions of investor's behaviour, the "self-fulfilling crisis" is another explanation of currency crisis. Pegging the exchange rate requires governments to use monetary policies in order to maintain the currency's value. However, as rising interest rates will slow down the economy, it is believed that pegging becomes more and more costly for the government. If the markets doubt the government's commitment to the peg and expect a devaluation, they will attack the currency even if the government did not plan to devalue its currency. Investors will exit the market, which will eventually lead to the currency crisis they prophesised. These self-fulfilling attacks create a channel for contagion. Thus a crisis in one country can lead investors to believe that a whole region or a certain type of countries will have economic and financial problems which will lead them to attack their currencies as well. This can be seen in the Asian crisis (Wyplotz 1999: 163). According to these explanations, market failure is the cause of these crises. This theory is strongly supported by James Tobin, Joseph Stiglitz and Ajit Singh. Ajit Singh argues that the Asian crisis is mainly a crisis due to market failure and the liberalisation of financial flows. Singh claims that the crisis was the result of the private's sector excessive reliance on hard currency denominated foreign loans and the failure of governments to control portfolio investment inflows. The liberalisation of capital market allowed excessive short-term foreign currency denominated lending and encouraged extensive foreign portfolio investment. As soon as equity investors suspected that the exchange rate was about to fall, they sought to protect their funds by selling out. This, however, drove the exchange rate down, increasing the burden of foreign debts, pushing East Asia towards insolvency. The prospect of corporate bankruptcies prompted foreign investors to continue to bail out. At the same time the supply of credit evaporated, reducing economic activity and creating even more reason to exit. This created a vicious cycle. Because investors are often not rational and driven by herd behaviour, this vicious cycle is not an exceptional phenomenon but could happen anywhere where confidence vanishes (Grabel 1999: 48).

The authors believing in the market failure explanations support the regulation of the international finance and the implementation of capital controls to slow down and limit the amount of "hot" capital flows.

It can be argued that most financial crises are a cumulating of both market and government failure. Thus the Asian crisis, which was not a crisis due to macroeconomic fundamentals, was on one hand a banking crisis, which developed into a currency crisis. On the other hand, the Asian crisis was a consequence of over- and misallocated investment as well as a self-fulfilling crisis.

In the next part of this paper, it has to be asked - following the above arguments - how financial crisis could be prevented. According to the government failure argument, there would be a strong call for the implementation of reforms, such as reforming the banking sector or implementing international prudential agencies. According to the market failure hypothesis on the other hand, the conclusion would be that short-term capital flows should be reduced by introducing an international capital control such as the Tobin tax. If on assumes that financial crisis are a cumulation of government failure and market failure, a mixture of crisis prevention instruments have to be implemented. These will be presented and analysed in the following part.

4. Measures to prevent financial crises

4.1. National Reform

Assuming that financial crises are often caused by a combination of government market failure, a bundle of measures has to be implemented. First – following the government failure argument – national reforms should be enacted. Thus, the national institutions have to be strengthened, i.e. the national financial/banking sector has to be stabilised, banking regulation and prudential supervision have to be implemented and an independent central bank should be installed. Furthermore, national property rights should be enacted and government corruption should be reduced. These are measures, which had not been fostered and supported by the IMF as condition linked its loans until the Asian crisis. The credit conditions, which are often described as Washington Consensus, emphasised good fundamentals, i.e. spending cuts, low taxes, low inflation, low government deficit etc., but not a strong financial sector. This changed after the Asian crisis, which showed how important a strong banking sector was. Consequently the IMF is now fostering national institutional reforms. The IMF stated: “Recent events clearly demonstrate the crucial importance of strong financial institutions operat-

ing in accordance with established principles of sound banking and rigorous transparency. In this context the emerging markets have to move as quickly as possible to adopt the core principles of banking supervision“ (IMF 1997: 45).

To foster national reform, the IMF should help countries through economic advice and consultations, as well as through educational programs. The IMF can also increase the incentives for governments to enact reforms by linking loans to institutional reform. However, it should be regarded, that the reforms have to be accepted by the national government, i.e. they have to come from “within” and not from “above”, in order to be successful. If the reforms are not accepted but opposed by the government and the people, their prospect of success will be very small. Consequently educational programs and economic advice as well as co-operative programs are very important.

4.2 National capital controls

It is important to note that reforms cannot be implemented over night. Thus national institutions such as the banking sector will remain weak and prone to crises for a longer period of time. However, strong and stable national institutions are necessary for the liberalisation of capital flows. Consequently, the prompt liberalisation of capital flows would severely shake the national financial system and could lead to over-investment or massive capital flights. Thus, countries with insufficient prudential regulation and risk management should be able to implement capital controls to discourage excessive surges of short-term capital flows (FAZ 1999: 18). As Wyplotsz (1986) and Sachs (1987) have pointed out, effective capital controls can prevent self fulfilling currency crisis. They can also prevent speculative attacks on foreign exchange reserves and balance of payments crisis when a government is pursuing monetary and credit policies that are inconsistent with the exchange rate peg (Alesina 1992: 4). These capital controls are short-term, installed for the time in which reforms take place and have a prudential character, i.e. they are ex-ante capital controls to prevent financial crises. After the national reforms have been implemented and the national institutions have been stabilised, capital controls should be lifted and the capital account should be liberalised. This is also often called “sequencing”.

It has to be emphasised that capital controls are only effective in the short run as a prudential measure. Long-term capital controls can foster reserve depletion. Reserve depletion can take place through the current account channel in the long run. Capital can be moved relatively freely by overinvoicing imports and underinvoicing exports. Furthermore, technology has

undermined the significance of geo-political boundaries. As a result, financial corporations can avoid regulation by moving to a more congenial regulatory domain. In recent decades some national tax and regulatory initiatives have been more effective in shifting the location of financial activity than in accomplishing its objectives. An example for this is the attempt by the US to implement an interest rate equalisation tax to discourage foreign borrowing in dollar capital markets, which created the Euro-dollar market in the 1960s. Furthermore, long-term capital controls can undermine the reputation and credibility of a country. The longer capital controls have been imposed, the more porous they will be (Hanson 1995: 390).

While prudential short-term capital controls installed by countries with a weak financial sector can be helpful, it should be noted that short-term capital controls can also have negative effects. Thus they can also undermined the reputation of a country, lead to a capital flight or hinder capital inflows, which can slow down the economy. Thus the controls can be circumvented by the unbundling and renaming of flows.

The ex-post / crisis capital controls, i.e. the instalment of capital controls during a crisis, can lead to a panic and to an illegal outflow of capital, which can hardly be prevented. On the other hand, it is argued that the crisis, ex-post capital controls can be very helpful as well and stop the capital flight temporarily as the Asian crisis has shown.

Having established this theoretical argument, which is neither a clear argument in favour nor against national capital controls, (but seems to be slightly in favour of short-term, prudential capital controls) it is now important to investigate whether there is empirical evidence for the effectiveness and benefits of capital controls. Chile is often named as a success story for the implementation of ex-ante capital controls. Thus the Chilean monetary authorities installed speed bumps. In 1991, it introduced a one-year mandatory non-interest bearing reserve requirement on all foreign borrowing. This meant that anyone who borrowed money abroad had to put 30% of the amount borrowed into the Central Bank without earning interests. The Chilean government also insisted that only firms and banks with a credit rating as high as that of the government could borrow aboard. The reserve requirement did reduce the share of short-term capital inflows but the measure was costly. Thus interest rates were higher than they would have been without the controls. Furthermore, the capital market was divided between big firms, which could borrow broad and small firms, which did not have the capacities. It has been argued that this slowed down economic growth.

Another example for a country, which implemented capital controls is China. The Chinese long-term capital controls were very restrictive - more than the Chilean controls - and led to a

massive capital flight. Thus, they undermined the credibility and fostered an illegal capital outflow. Furthermore, the US capital controls installed in the 1960s did not stop capital outflows but even increased the capital flows from the US to the flourishing Euro-dollar markets. The capital inflow controls, established by Germany in the 1960s, are another example for short-term capital controls, which were equally ineffective as the controls established by the US.

The Asian crisis (and here especially Malaysia) is named as an example for a situation in which ex-post, crisis-reaction capital controls seemed to be successful. Malaysia imposed exchange controls in September 1998 in response to speculative attacks and depletion of its foreign exchange reserves. These controls were emergency measures, implemented after the crisis. The controls were to enable the government to keep interest rates relatively low to expand demand and keep up growth without sending its currency through the floor (Wade 1989: 49). The rapid recovery of Malaysia was seen as sign for the beneficiary effects of capital controls by the proponents of capital controls. It has been argued that the controls have allowed Malaysia to recover faster, with less social cost, than it would have otherwise. However, today there are smaller inflows of capital into Malaysia. Consequently, it can be argued that the controls undermined Malaysia's credibility and now slow down economic growth. Furthermore, it is also important to note that other countries in this region such as Korea also recovered. Consequently, the recovery of Malaysia does not have to be a proof for the efficiency of capital controls.

In conclusion, and according to Jeffrey Shafer, it is not possible to estimate with any reliability the effects of capital controls on net capital flows because of the many ways capital controls can be circumvented (Shafer 1995: 137). Thus it is not really clear, if there is sufficient empirical evidence for beneficial effects of capital controls. All in all, nation capital controls should only be supported and fostered by the IMF as support of structural reform programs.

4.3 International measures to prevent financial crises

According to the market failure argument, the measures named above, i.e. national reform and temporary capital controls, are not enough to prevent financial crisis because they do not solve the problem of irrationality, moral hazard. One measure of crisis prevention is the improvement of the availability and accuracy of information. Another measure is to intensify international banking regulation. Thus already existing international standards such as the Basle Accord should be extended, new standards concerning the activity of non-bank finan-

cial institutions and non-traditional banking business (swaps, options, futures) should be developed and effective international co-ordination has to be established, including the possibility of a new international regulatory authority.

Moreover, the IMF should encourage private sector burden sharing, notably by introducing collective-action clauses in G7 sovereign bond contracts and by requiring that any new sovereign bond contract issued and traded in G7 markets has such clauses. This "bailing in" of investors can reduce the moral hazard problem and make investors more careful in their decision-making. In order to reduce the moral hazard problem on the state side, the IMF should lend less freely. If the Fund stood ready to lend great funds to countries in trouble, these countries are less likely to adopt difficult measures of reform. The prospect of smaller IMF loans on the other hand would make countries more cautious and increase the incentive for implementing reforms.

4.4 The prospects and desirability of implementing an international capital control

While the measures described above might improve investment decision-making, it is not clear if they will reduce irrationality, such as decisions based on the "beauty contest" or the herd behaviour of investors. Thomas Palley argues that short-term capital flows should be reduced altogether. One way to achieve this is by installing an international Tobin tax on short-term capital flows. Tobin proposed in his 1972 lecture at Princeton a tax on foreign exchange transaction as a way of limiting speculation and enhancing the efficiency of macroeconomic policy in the process while raising some tax as a by-product (Palley 1999: 103).[5] This tax is to reduce short-term capital flows and to strengthen the autonomy of national policy makers. It is also argued that the implementation of a Tobin tax would slow down international finance without forcing countries to implement national restrictions, which would damage their competitiveness and their reputation.

However, there are various objections that can be raised against the Tobin tax concerning its desirability and feasibility. Hence, some argue that it can have distortionary effects. The distortionary effect arises from the discouragement of some potentially beneficial trades that would have taken place otherwise. Thus it will hinder the optimal allocation of capital. On the other hand, it is argued that a Tobin tax is ineffective in the first place because technological advances have facilitated the unbundling and repackaging of individual financial services. Consequently, regulation that prohibits one kind of activity can easily be circumvented by a

[5] Tobin estimated revenues over $1.5 trillion a year for a 0.5% tax

product redesign to produce a close substitute. These unbundling and renaming of financial services and other “tricks” to circumvent the international tax, can again increase the distortions and financial instability by making prudential regulation and risk assessment more difficult.

According to Eichengreen, Tobin and Wyplosz this problem could be solved by installing universal and uniform transactions taxes, which would apply to all jurisdictions while the rate would have to be equalised across markets (Eichengreen, Tobin and Wyplosz 1995: 165). This however, creates a great co-ordination problem. It would require the co-operation of all countries with significant foreign exchange dealings. However, a typical collective action problem prevails here. The implementation of a Tobin tax as well as its monitoring is time consuming and complicated. The monitoring of the system to ensure that investors will abide to the rules and to prevent substantial illegal capital flight will be very difficult. Thus the tax creates new costs for countries. From a rational point of view, it would be more beneficial for countries to free ride in a system of stability, instead of participating and bearing the costs actively, i.e. implementing the tax, monitoring the tax system etc. Since all countries prefer to free ride instead of bearing the costs, they will not co-operate and come together in order to install the tax. Moreover, it is not very likely that countries, such as the US, which have preferred an open international financial system and unregulated capital flows since the 1970s will support such a tax. Not only in the US but also in countries such as Germany or Great Britain, there is a very strong lobby group/interest group, i.e. the financial sector, which opposes such a tax. Thus the financial sector prefers unrestricted capital flows and will lobby against the restriction of international capital flows. Since the national governments today are no longer able to ignore the demands of the banks and the important investors, they will also opposes the implementation of such an international tax. Without the support of the US, however, such a Tobin tax would never be implemented. Moreover, according to Kenen, an international Tobin tax would not be efficient without the participation of the EU, Japan, the US, Singapore, Switzerland, Hong Kong, Canada and Australia (Grieve Smith 1999: 245).

In conclusion, it can be said that even if an international capital control such as the Tobin tax was desirable, which is highly questionable, the implementation would be impossible due to the lack of support.

5. Conclusion

In conclusion, it can be said, that financial crisis are often caused by a number of factors such as by wrong macroeconomic fundamentals, weak national institutions, national structural problems, government corruption, over- and misallocated investment, sharp detorations in confidence, and irrational investor behaviour. Thus market as well as government failure play an important role. Consequently, the IMF and other international institutions such as the Bank for International Settlement should implement and use a mixture of measures and instruments in order to prevent financial crisis: First, before removing restrictions on capital account transactions, major problems in the domestic financial system have to be addressed such as inadequate accounting, auditing, and disclosure practices in the financial and corporate sectors that weaken market discipline; implicit government guarantees that encourage excessive, un-sustainable capital inflows; and inadequate prudential supervision and regulation of domestic financial institutions and markets, which open the way for corruption. Countries in which these problems are severe run the risk of serious financial crises when they open up the capital account in a big bang. Therefore, countries should first eliminate these distortions. Moreover, less leverage for speculation against the currency of a country exists when the fundamentals of a country are right and the institutions credible. Consequently, these institutional reforms should be supported and fostered by the IMF.

Secondly, in such a transition and reform period, national capital controls will be necessary. After the transition period, capital controls should be lifted again. Long-term capital controls should not be supported by the IMF because they can undermine the country's credibility, lead to an illegal outflow of capital, reduce the national capital stock and consequently reduce the rate of investment and slow down economic growth. Under the assumption that long-term national capital controls can be circumvented and lead to substantial illegal capital flight as well as create various opportunities for rent seeking activity, they are not desirable.

Another important factor in preventing financial crises is fourthly the improvement of the accuracy and availability of information about countries. Yet, this alone will not lead inves-tors to behave more rationally. Hence, the risk of self-fulfilling currency crisis will remain as long as investors are guided by the beauty contest and the herd behaviour. This, however, is not a justification for long-term national or international capital controls, considering the costs involved with long-term national and international capital controls. Moreover, the IMF should not support long-term international capital controls such as the Tobin tax. A Tobin tax can have distortionary effects and prevent risk diversion. Furthermore, a Tobin tax can lead to a

series of “tricks”, such as the unbundling and renaming of financial services, in order to circumvent the international tax. This can result in greater financial instability, by making prudential regulation and risk assessment more difficult. Consequently, while short-term national capital controls can be very beneficial, as has been shown in section three of this paper, long-term international capital restrictions are not desirable. Moreover, the implementation of an international capital control such as the Tobin tax would not be possible due to the lack of support by governments as well as important international private actors such as MNCs.
To conclude, a certain risk of financial crisis will always remain. However, this risk can be severely reduced by implementing the measures named above.

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