

# Capital Controls, New IMF Policies and the Practice of Turkey

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**Abstract** In parallel with the phenomenon of globalism, especially portfolio flows have become in a way to be carried in a distant of a computer button from one country to another; in this respect, the portfolio investments have constituted the most unstable part of global financial flows. In the forthcoming days, a clearly visible rise in portfolio or hot money flows has increased with discourses and practices supported especially by IMF. For this purpose, since the early 1990s, it has been seen that favorable solutions towards removal of capital controls have been brought to the agenda. However, opinions towards the fact that full liberalization doesn't always result in positive consequences have gained importance just after the crisis of 2008. Consequently, this study aims to question the fact that IMF, which used to support financial openness up until yesterday, has become in a way to support controls with a controversial discourse after the crisis of 2008 and the efficiencies of capital controls based on the experiences of Turkey.

**Keywords** Globalism, Capital Controls, IMF Policies, Liberalization, Crisis

## 1. Introduction

“Globalization” refers to the growing interdependence of the countries resulting from their increased economic integration via trade, foreign investment, foreign aid, and international migration of people and ideas. However, the important fact is the expansion in the volume of international investment and the extent of the financial flows, which are highlighted by the concept of globalization. Considering that the financial flows are practiced through the main channels such as foreign direct investment, private capital or portfolio flows, remittances from migrant workers, debt flows and official development aids, the significance of the portfolio investments in this classification becomes more prominent [42].

Controlling capital flows is one of the most difficult issues that policymakers have to face in the developing economies. Thus, the complexity of capital flows and the problems surrounding the control of them make it difficult to present the most suitable choices regarding these policies. In parallel with the globalization process, apparently, the rise in the capital flows and especially hot money flows have increased with the discourses and practices supported especially by IMF. In this regard, since the early 1990s, it has been seen that favorable solutions towards abolishing capital controls have been brought to the agenda. Therefore, it is uttered that

while rising capital flows, which have been helping to close the saving gaps in the developing countries, investments will increase and the countries will develop faster as a result of decreased interest rates. According to the people who agree in this idea, the capital flows to these countries will be increased as a result of increasing capital returns in the developing countries. The interest rates will drop down, because the rise of the capital is more than the rise of labor force; thus, the growth rate of the poor countries will be higher than the rich countries and these poor countries will reach them sooner or later. Although the ones who support the opposite opinion accept that financial globalization presents broad opportunities between those, who supply funds and for those who demand funds; experiences until today show that at the same time, speculative capital flows result in some macro-economic problems such as financial crisis, balance of payments deficits, debt crisis and exchange rate overvaluation. In this respect, it is also seen that there are various techniques and practices on the agenda towards the control of capital flows [1, 15, 18].

## 2. A General View of the Capital Controls

Capital control means all restrictions and arrangements that are imposed by governments to domestic residents and non-residents in order to restrict its mobility during the transfer of “capital” in the country or out of the country. It has been observed that until the 20<sup>th</sup> Century, capital controls were practiced occasionally; however, it has gained more importance in many countries over time. After World War II,

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it is seen that only Switzerland, Canada and USA accepted open capital regimes (considerably). Despite this fact, it is understood that other rich countries still continue to have strict controls and during the period of 1960-1970, they insisted on these political practices [8].

The main reason for this insistence is the Bretton Woods system, signed in 1944 in the town of Bretton Woods, in New Hampshire, which has defined the exact rules to be obeyed regarding international payments, structures “international money system” [17]. Within this system, independent nation states leagued together and accepted the Bretton Woods system (fixed exchange rate regime) in order for realizing global trade and wealth after the war, and signed the treaty, which reigned during the period of 1945-1971. The aforesaid treaty is known as the one which established International Monetary Fund (IMF) [30]. However, along with the end of the Britton Woods system in 1971-1972, the aforesaid structure started to change. Continents and countries such as developed North America, Europe and Japan switched to floating exchange rate from fixed exchange rate. This case has led the capital accounts to be liberalized and brought functionality to cross-border flows of financial investments [5]. Thus, it is possible to make a dual classification of world economy regarding financial regimes as Bretton Woods Period and Free Capital Period. According to this, while “the Bretton Woods Period” is generally refers to the structures based on fixed exchange rates and capital controls in terms of international financial regimes, it is a period in which this kind of practices are confirmed by IMF. Nonetheless, “Free Capital Period” has become very popular

since mid-1970s that refers to a period, in which fixed exchange rates were abandoned and floating exchange rates were accepted in terms of international financial regime, and the capital has gained free mobility by releasing controls of governments [25].

In parallel with these improvements, it is seen that capital controls, which are practiced by the developed countries, have started to change in the early 1980s, and the present controls were either removed or minimized. The main reason for the removal of capital controls in the developed countries can be classified under two headings. The first one is that the capital controls have become out of the date as a result of proliferation of market practices worldwide, and the second one is that the financial providers and investors have become experts on finding solutions by using various methods instead of the controls. This process was also seen in the developing countries in a similar way. Especially in Latin American and Asian countries (such as Argentina, Indonesia, Mexico, Turkey, Thailand and Malaysia), the common capital controls were loosened during the late 1980s; and in 1990s, the liberal practices towards removal of capital controls have been accelerated [8].

According to Rawi Abdelal, this financial liberalization process is an extension of political and financial hegemony, which is imposed by the developed countries, and aforesaid process was supported constantly by international organizations such as IMF (International Monetary Fund) and OECD (Organization For Economic Cooperation and Development) [29].

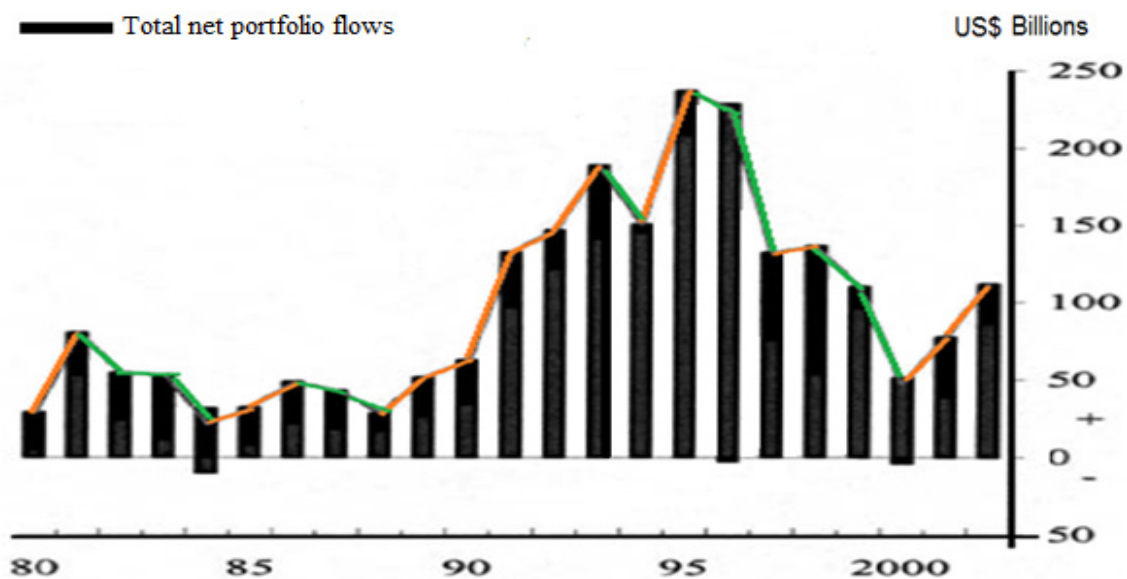
**Table 1.** Country Sample: Overview

Industrial Countries	Emerging Market Countries		Others
Australia	Argentina	Bangladesh	Belize
Austria	Brazil	Botswana	Bolivia
Belgium	Chile	Colombia	Ivory Coast
Canada	Ecuador	Egypt	Costa Rica
Denmark	Hungary	India	Cyprus
Finland	Indonesia	Israel	Dominican
France	Malaysia	Mauritius	Republic
Greece	Mexico	Pakistan	El Salvador
Iceland	Peru	Philippines	Fiji
Ireland	Poland		Grenada
Italy	Romania		Guatemala
Japan	Singapore		Guyana
Netherlands	South Africa		Honduras
New Zealand	South Korea		Jamaica
Norway	Sri Lanka		Madagascar
Portugal	Thailand		Malta
Spain	Trinidad and Tobago		Nepal
Sweden	Turkey		Panama
Switzerland	Uruguay		Paraguay
United Kingdom	Venezuela		Zambia
United States of America	Zimbabwe		

After financial deregulation and the removal of capital controls, in parallel with the rivalry phenomenon experienced in almost all the industrialized countries, cross-border capital mobility increased considerably. Because of low interest rates in their own countries, the developed countries have canalized their investments to the emerging market economies, which offer higher security conditions. While this situation was turning back to developing countries as growth and low interest rates, also it enabled the occurrence of a “respectable asset class” swiftly in the developing markets. The hot money flows canalizing to developing countries have contributed significantly to provide necessary funds in terms of having macro-economic stability and maintaining structural adjustment programs. On the other hand, commercial and financial deregulation decreased the risk perception that had existed in the developing countries up until yesterday, and this situation made a great contribution about reducing the external debt burdens. The renewed feeling of trust and confidence in the international scale has turned economical perspective into a positive direction in many developing countries. This situation revealed itself in a form of a dramatic rise in the capital flows by conducting investors to be deceived. As a result, while total explicit capital inputs were flowing into the developing countries in 1983, the capital flows almost reached to a level of explosion between the years of 1990-1994. In 1993, the capital or hot money flows have peaked with an amount of 155 billion dollars, which is equal to the total amount in the former five years period [31]. A general classification containing developing countries (emerging market economies) and sample countries, which need to be evaluated in another category along with developed countries, was carried out by Glick and Hutchison given in Table 1 [37].

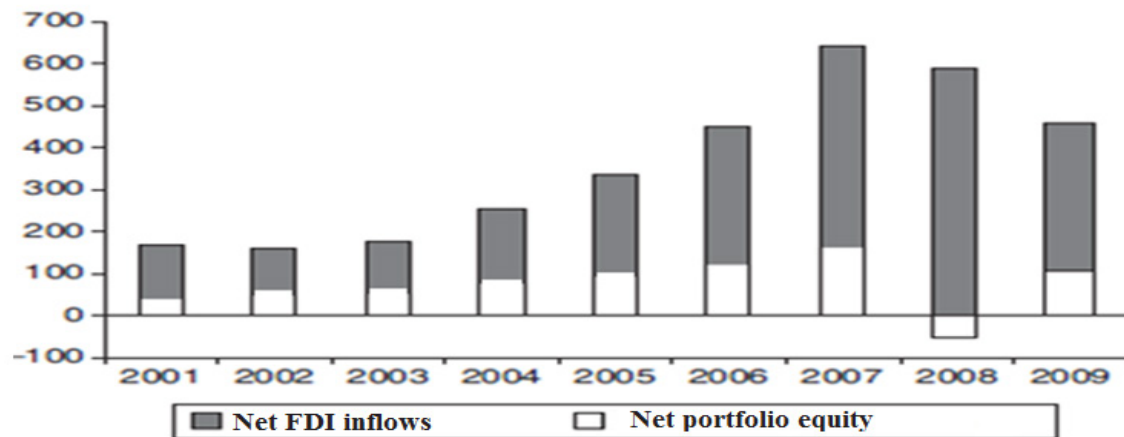
It has been observed that there was a sudden and radical change emerged, which had never happened before, in international capital markets in the 1990s. Significant increases in international hot money or short term capital flows (free funds) created inconsistencies especially at payments balance, current account and capital account items, which also resulted in significant growth in budget deficits. The results of the crises experienced in Mexico (1994/1995), South-Eastern Asia (1997), Russia (1998), Brazil (1999 and 2002), Turkey and Argentina (2000-2002) also confirm this situation. While crises have important impacts on the policymakers, the problems emerged show that a more severe deterioration occurs at the capital account compared to the current account. As apparent in Figure 1, the highest level that capital flows have reached was experienced in 1996 with 250 billion dollars. In 2002, it is pointed at a capital input which is less than half of this amount [20].

According to World Bank Report (Figure 2), net capital inflows (direct investments and total of portfolio investments) peaked with an amount of 643 billion dollars in 2007. After the global economic crisis happened in 2008, firstly, capital flows regressed at an amount of 534 billion dollars; and then, in 2009, they regressed to the level of 462 billion dollars with 13% decrease compared to the previous year. Considering the situation in terms of portfolio investments that rapidly left developing countries just after the crisis happened in 2008; although there was a revival of bond issue, the clear decrease in stocks and short term bond flows (bono) caused a net capital outflow with an amount of 53 billion dollars. Hot money flows increased to an amount of nearly 108 billion dollars by achieving a positive recycle in 2009. The financial crisis of 2008, which brought global financial system to a point of collapsing, has constituted the main motive for the escapes at portfolio investments [45].



Source: (Haldane, 2004)

Figure 1. Capital flows to emerging markets

**\$ Billions**

Source: (The World Bank, 2011)

**Figure 2.** Net equity flows to developing countries, 2001-09

The significant rises in bad debts of banks besides higher risk appetite resulted from dangerous high debt-equity ratio of leading financial institutions (investment banks) like Lehman Brothers are considered among the main reasons for the financial crisis of 2008. Especially, the fact that banks supply reserve to the market by collateralizing their assets resulted from subprime mortgage caused an artificial bubble to be formed in the market. Along with the decrease in house prices, this bubble was collapsed and the value of marketable assets, released into the market by big financial institutions, has become to be priced on its real estate value. While individual and collective effects of aforesaid shocks dominated the global economy after the crisis in 2008, it was stated as the biggest financial crisis since 1929 [2].

After these incidents, IMF presented a study named “The Liberalization and Management of Capital Flows: An Institutional View” dated October 14<sup>th</sup>, 2012. Within this study, it was seen that IMF presented a different point of view to the international capital flows after 2008. In contrast to the views of IMF supporting full liberalization in capital mobility for years, it is important that this study contains the views supporting that the capital controls can be helpful. In the meanwhile, the approach of IMF, which stands contrary to the previous discourses of IMF and denies itself, is also meaningful since it emphasizes that the current capital flows may carry risks for countries. Within this study, while the necessity of capital flows in global financial system is emphasized, the importance of improving these flows was also indicated. Besides, it was emphasized that liberalization should be well scheduled and planned. Thus, it was noted that the benefits being expected from capital flows exceed the costs. However, it was also stated that there are no presumptions indicating that full liberalization is an appropriate goal for all countries at all times. Additionally, it was assumed that fluctuation in rapid capital inflows and outflows can cause political problems. In this context, the

policymakers in all countries, including countries that generate large capital flows, should take how their policies may affect global economic and financial stability into account. Furthermore, the fund management states that it can provide advice and counseling services to the countries [23].

### 3. Types of Capital Control

Short term capital inflows, which constitute a significant part of international capital mobility and occur as a reflection of international financial liberalization in a way, can rapidly flow into a country and at the same time, they can leave the economies at the same pace. This emerging financial volatility may cause territorial and regional crisis, and also may penetrate all global markets by means of contagion effect as it was the case during Asian crisis. This situation forced especially the developing country governors to take the initiative over the economy of the country. As a result of these efforts, it was seen that real practices towards taking control of short term fund flows came into force in Malaysia in September 1998, just after the Asian crisis. In order to prevent the destructive effects of international capital flows; firstly, strong domestic precautionary measures were put into force and by this way, it was aimed to restrain uncontrolled inflow or outflow of capital into the country or out of the country, respectively [36]. In particular, after the global financial crisis of 2008-2009, free mobility of international capital has caused an increasing amount of concerns regarding not only countries drawing foreign capital but also the developed economies, and this situation has urged countries to take more intense measures in the subject of the capital controls [39].

Capital controls are considered as a tool for both preventing panic attacks caused by international capital flows and removing destabilized actions, which countries may experience in practice [20]. Basically, it is aimed to

interfere to free international exchange in financial assets [14]. In Table 2, the control methods, which were implemented on capital processes of domestic and foreign residents, are displayed. The mentioned control methods are classified as direct and indirect methods [40].

Controls on cross-border capital flows include various and mostly country specified measures to be taken.

These impediments to capital movements and restrictions have generally two common forms as follows: (1) "Administrative" or direct controls and (2) "Market-based" or indirect controls. Considering many cases in this area, capital controls have been applied consecutively with other measures of the policies, which are used to deal with episodes of heavy capital flows, instead of applying in isolation. Administrative or direct controls usually involve in either an approval procedure (often discretionary) or outright prohibitions in terms of cross-border capital transactions, since they are designed to have a direct effect on the volume of cross-border financial transactions. These controls force to have some administrative mandatories to be obeyed on the banking system of the countries in order to control the flows of capital. On the other hand, market-based or indirect controls make particular capital movements more costly, which result in discouragements. These control measures may be in different forms including dual or multiple exchange rate systems and explicit or implicit taxation of cross-border financial flows [3].

The multiple exchange rate system is one of the indirect control methods that contain government regulations with an aim of putting limitations to outflow of the funds from a country [41]. There are two values of a currency identified separately for different sets of monetary transactions in this method. A floating rate can be used for capital account transactions while a fixed exchange rate can be used for

normal commercial transactions. Two-tier foreign exchange markets have been founded, in which the government have regarded high short-term interest rates to impose unacceptable burden on domestic residents, and to split the market for domestic currency by either instructing or requesting domestic financial institutions to not to give money to those borrowers that are responsible of speculative activities.

Foreign exchange transactions associated with foreign direct investment, equity investment and trade flows are excluded from the limitations. In short, the two-tier market attempts are needed to establish a net short domestic currency position by raising the cost to speculators of the domestic credit, while allowing non speculative domestic credit demand to be satisfied at regular market rates. In addition, this system may prevent an overshooting exchange rate for current account transactions by accommodating excessive inflows. This kind of systems attempt to have impact on both the price of capital transactions and the quantity [3, 38].

One another indirect method is explicit and implicit taxation method created for restraining international capital inflows and outflows. In the explicit taxation method; it is rendered as less profitable for domestic investors to invest on foreign financial assets and foreign investors to invest on domestic financial assets. While taxation costs are increasing, net earnings are reduced. The most well-known example of this topic is the "Tobin Tax". The main rationale of Currency Transaction Tax, which is generally known as Tobin Tax, makes it possible to prevent instabilities in economies caused by capital mobility by levying a tax less than % 1 on foreign currency transactions. By this way, long term investments are reinforced and continuance of short term investments is provided [32, 11].

**Table 2.** Types of capital controls

Index	Type of capital flow controlled	Index	Type of capital flow controlled
Inflow controls	Local share purchases by non-residents	Backflow controls	Local money market instrument sales by non-residents
Backflow controls	Local share sales by non-residents	Outflow controls	Money market instrument purchases abroad by Residents
Outflow controls	Share purchases abroad by residents	Inflow controls	Money market instrument sales abroad by residents
Inflow controls	Share sales abroad by residents	Outflow controls	Commercial credits from residents to non-residents
Inflow controls	Local bond purchases by non-residents	Inflow controls	Commercial credits from non-residents to residents
Backflow controls	Local bond sales by non-residents	Outflow controls	Financial credits from residents to non-residents
Outflow controls	Bond purchases abroad by residents	Inflow controls	Financial credits from non-residents to residents
Inflow controls	Bond sales abroad by residents	Outflow controls	Outward foreign direct investment
Inflow controls	Local money market instrument purchases by non-residents		

Source: (Shagi, 2011).

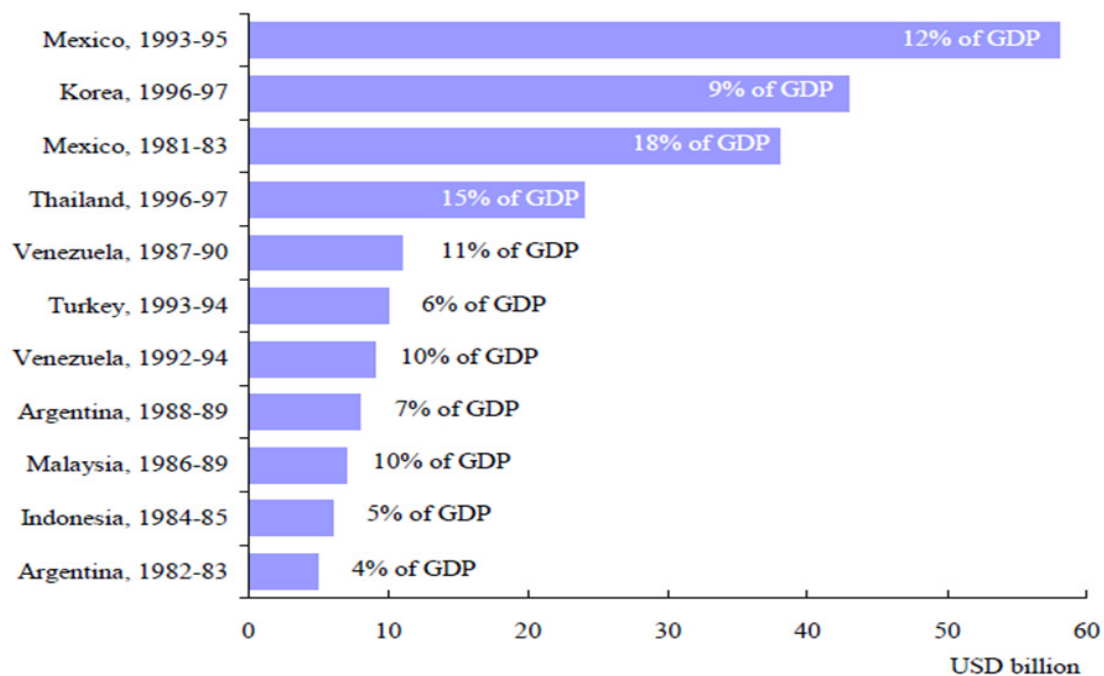
In implicit taxation, the most common practice is non-interest-bearing compulsory reserve / deposit requirements. In this method, it is compulsory for banks and other financial institutions to deposit a certain amount of their capital transactions to central bank as either domestic or foreign currency in the form of noninterest-bearing deposit. Thus, within this method, it is provided for short term capital flows to spread to long term flows and by this way, it is aimed to remove negative effects of the speculative capital flows to some extent. Other indirect regulatory controls have the characteristics of both price and quantity-based measures and involve discrimination between different types of transactions or investors. Such controls include provisions for the net external position of commercial banks, asymmetric open position limits that discriminate between long and short currency positions or between residents and nonresidents, and certain credit rating requirements to borrow from abroad. While there is not a regulatory control in the strict sense, reporting requirements for specific transactions have also been used to monitor and control capital movements [3,21].

On the other hand, some views supporting that capital controls can be harmful were also introduced. Hot money flows make positive contribution to the economies of the countries and they are also used as an important tool for financing and saving gaps of the countries. This situation allows countries to borrow money from other countries under more favorable conditions. While cross-border fund flows are making positive contribution to finance current account deficit, they also have curative effect on the balance of payments. In this extent, interest rates have been dropped down and asset prices have been more valuable.

Consequently, it is accepted that the mentioned flows have made important contributions to the macro-economic and political stability of the developing countries. Therefore, it is often stated that any restrictions on capital flows have negative effects on “economic growth and well-being” of the countries [13,25].

Those who support the necessity of capital controls indicate that financial markets have become more fragile with financial liberalization, and this situation provides a basis for the occurrence of financial crisis. In particular, when short term portfolio investments are drawn back abruptly from economies, they cause shock breaks, permanent destructions and negative effects; and in general terms, they cause even money and banking crisis [35,27]. Thus, in contrast to long-term capital inflows such as FDI, short-term capital flows are often volatile and disruptive. They can cause overheating pressures and their sudden reversal can wreak financial havoc. Short-term inflows can also lead to sharp currency appreciation, thereby eroding a country’s competitiveness. Capital controls against volatile short-term inflows can safeguard macro-economic stability and facilitate the transition to more flexible exchange rates due to this reason or similar reasons [36].

On the other hand, in addition to the institutions like IMF, which emphasizes the contribution of capital controls to financial stability [10], the studies conducted after the crisis of 2008 have underlined the necessity of capital controls for financial flows to show full performance [34]. Within this scope, the claims arguing that regular controls on capital mobility will be beneficial in both developed countries and developing countries are included in order to minimize the risks caused by financial crisis [31].



Source: (The Bank of England, 2010).

**Figure 3.** Large reversals in capital flows

#### 4. Practices for Control of Capital Mobility and New IMF Policies

In parallel with the development in the volume of world trade, private capital movements have gained considerable speed. Especially the increase in capital mobility, which is seen at emerging market economies, is significant. There have been two great fluctuations of private capital flows in this time period. The first one of these flows has begun in the early 1990s and ended all of a sudden with Asian crisis, which took place in 1997-98. The second or the last fluctuation have started in 2002 and peaked in the late 2006. The first global fluctuation was dominant in Emerging Asian and Latin American countries (Figure 3), whereas the last fluctuation emerged in Emerging European countries and other emerging market countries and later in the USA, and its effects are still believed to be continued [12, 4]. While the first fluctuation caused Mexican, Asian, Turkey, Venezuela, Russia crises [20], the second big fluctuation caused mortgage crisis in the USA in 2008 and then, contagion effects caused a global economic crisis spreading all over the world initially in European countries [17].

Considering the mentioned crisis, although most economists accept cross-border portfolio flows as a potential source of investment capital; at the same time, they emphasize that they can be harmful as a potential destabilizing and the countries should take necessary precautions about this matter [9].

At this point, it is not possible to consider only a monotype precaution or practice. Therefore, capital controls may be applied on a *selective* or *comprehensive* basis; they could be applied to *outflows* or *inflows*; they could be *temporary* or *permanent*; they could be applied *unilaterally* or *universally*; and they could use direct *quantitative* controls designed to frustrate the wishes of market participants or the *price mechanism* via explicit or implicit taxation to influence their choices [36].

The selected country samples in the world related to capital controls are at below. Accordingly, selected capital flow management measures are also given [23, 33, 28].

##### a) Measures designed to limit inflows

Brazil (2009): Introduction of a 2 percent tax on portfolio equity and debt inflows, (*Effectiveness: not effective*).

Colombia (2007-2009): Dynamic provisioning, marginal reserve requirement (MRR), and limits on banks' gross derivative positions in conjunction with the URR (*Effectiveness: No strong effect on credit growth*).

Indonesia (2011): Imposition of a six-month holding period on central bank bonds and of a limit on short-term foreign borrowing by banks to 30 percent of capital, (*Effectiveness: partially effective*).

Korea (2011): Restoring withholding taxes on interest income and transfer gains from foreigners' treasury and monetary stabilization bond investment, leading to equal treatment for both foreign and domestic investors, (*Effectiveness: Insignificant effect on FX lending to*

*households, but reduced credit growth. Banks' foreign borrowing dropped following the introduction of the cap*).

Peru (2010): Increase of fee on nonresident purchases of central bank paper to 400 basis points (from 10 basis points), (*Effectiveness: Slowed down credit expansion and lengthened the maturity of capital inflows*).

Thailand (2010): Imposition of a 15 percent withholding tax on nonresidents' interest earnings and capital gains on new purchases of state bonds, (*Effectiveness: partially effective*).

##### b) Measures designed to limit outflows

Argentina (2001): Establishment of Corralito, which limited bank withdrawals and imposed restrictions on transfers and loans in foreign currency.

Iceland (2008): Stop of convertibility of domestic currency accounts for capital transactions, (*Effectiveness: still continues*).

Malaysia (1998): Imposition of 12-month waiting period for nonresidents to convert proceeds from the sale of Malaysian securities, (*Effectiveness: effective*).

Thailand (2008): Imposition of limits on forward transactions and introduction of export surrender requirements, (*Effectiveness: effective*).

Ukraine (2008): Introduction of a 5-day waiting period for non-residents to convert local currency proceeds from investment transaction to foreign currency. Besides, as a result of the last demonstration against the government, the restrictions that central bank put on outflow of foreign currency (*Effectiveness: partially effective*).

Apparently, it is not possible to say that the controls, which are emerged in order to deal with the destabilizing effects of capital flows, are practiced similarly and the same results are obtained in all countries. First of all, current controls have to be structured in accordance with the circumstances of the country. As IMF stated, in order to eliminate the negative effects of financial openness, it is necessary to strengthen the banking system, avoid from excessive indebtedness, decrease interest rates, create a collateralization structure, which is more sensitive to moral hazard, establish a strong growth, low inflation and high foreign reserves, increase the direct foreign investments and consequently, the macro-economic policies should be at acceptable levels. It is uttered that the capital flows will be meaningful as an intervention tool within this way. In the areas, where financial stability and macro-economic policies and arrangements are lost or have become insufficient, it is predicted that capital controls can be used as an exit gate in order to prevent systematic hazards that may emerge. Hence [33, 24]:

1. Capital controls should be arranged according to domestic macro-economic policies. This requires a consistent exchange rate with its multilateral medium-run fundamental level; that fiscal and monetary policies are consistent with internal balance. In addition, the case of official reserves should be assessed carefully.



2. In order to eliminate the fluctuations caused by capital mobility, the appropriate mix of prudential regulations and capital controls should be put into force. Because, qualified capital inflow can also be blocked along with the unwanted money inflow.
3. Prudential regulations should evaluate possible risks very carefully. If capital flow is provided on regulated financial sector; in this case, it is necessary to get macro prudential regulations instead of expanding capital controls. Whereas, if capital flows bypass financial sector and prudential regulations become insufficient, capital controls may be the best tool to prevent a surge in risky external liabilities.
4. While preparing policies regarding capital controls, country-specific factors should be taken into account. First of all, if capital inflows increase macro-economic concerns, the controls should be done price-based largely. However, if financial stability is prioritized, in this case, the most risky capital flows should be taken into account. When the controls are used for the purpose of financial stability, administrative measures including prohibition of certain flows should be considered.
5. In addition, capital controls shouldn't contrast with obligations sourced from international, regional, or bilateral investment agreements signed by countries.

Considering the huge volume that both capital inflows and outflows reached in recent years (i), in order to prevent the situation, which damages competitiveness of the tradable sector by eliminating volatility in foreign exchange rate, it seems reasonable to practice controls in terms of reaching payments balance to stability (ii). At the same time, careful liberalization of capital flows can provide significant benefits, which countries could usefully work towards realizing over the long run. This situation allows country sources to stay in the country and also makes it possible to generate an income from national financial structures by taxation. (iii) Having said that the last global financial crises showed that if the developed countries and developing countries have insufficient financial inspection and regulations, they have to face negative consequences. As it was seen in the crisis of 2008, along with the collapse of asset bubbles financed by cheap external financing, capital escapes can happen, and it seems necessary to practice controls cautiously for the purpose of preventing abrupt entrances and exits sourced from financial flows. Moreover, use of the controls should be limited and temporary. While aforesaid controls are helping the financial institutions for their operations and market discipline, they should be designed in a way that won't cause the problem of moral hazards [22, 23].

## 5. Practice Process in Turkey for Capital Controls

Since the idea of Bretton Woods has been disappeared, international financial markets have encountered financial

crises for many times within the last 30 years. It was emphasized that financial liberalization could be helpful in many areas from reducing the savings gap to moderating burden of debt and then GDP growth especially in the developing countries; however, the negative consequences based on aforesaid capital flows have been almost ignored [17].

For example, during the free capital period since mid-1970s, while capital mobility has been rapidly mobilizing, GDP growth in OECD countries has reduced by nearly half. The growth rate has reached 2.8% after 1970s, which was 4.8% during the Bretton Woods period. Moreover, interestingly, further data show that the high rates of growth of investment in OECD countries in the Bretton Woods period were replaced by much lower figures in the free capital period. Thus, in the developing countries, intense capital flows can cause some side effects such as overvaluation of national money, increase in loan volume-leverage ratios and foreign deposit accounts, growth in asset prices and imports, negative effects on domestic industry, deficit in payment balance, increase in debt and interest rates. Considered in general terms, financial fragility is rising [25] and this situation shows similar consequences in the practices of Turkey.

Considering the financial liberalization period in Turkey; with Law Regarding the Protection of the Value of Turkish Currency dated back to 1930, there was a transition to exchange controls and financial markets, which were isolated from the outside world. In 1954, Law on Encouraging Foreign Investments, which was one of the most liberal regimes, was prepared and put into force in order to get more benefit from foreign resources. However, due to extremely rigid exchange rate regime, capital inflows didn't reach the level desired. In 1962, with the decision No. 17, restrictions and controls on the exchange and capital movement were concentrated in extreme ways [26].

Therefore, there were closed economy model practices in Turkey before 1980. During this time, import substitution industrialization policies were followed. Domestic production of imported goods was encouraged and the domestic industry was protected. It was necessary to import the industrial goods to sustain the domestic industry based on assembly. However, the depressions and especially oil crises, experienced in the 1970s, have increased the cost of exported goods and made the process more difficult. External debts have reached the limit, and due to scarce foreign exchange resources, economy of the country almost reached to a standstill level.

In order to eliminate such problems and provide financial sustainability, the state has formed additional measures. For this purpose, "24<sup>th</sup> of January, 1980 Economic Stabilization Decisions" were put into force, and it has targeted the liberalization of foreign trade and opening of Turkish economy to foreign countries [26]. Within the decisions made, it was aimed to bring inflation under control, close foreign financial gap, and reach a more extraverted and market-oriented economic system. Significant subsidies



were obtained by encouraging export oriented growth, and depreciation of Turkish Lira was allowed in real terms. These moves were important in re-gaining trust of international credit institutions. IMF stand-by and World Bank adjustment loans were scheduled rapidly and the payments were made. As a result, (i) loans, which are obtained from foreign countries, have increased the importation of intermediate goods and pressures on public finance were lessened; strong encouragements, which are given to the firms, carried exportation to significant levels (ii), although the depreciation of Turkish Lira was high, sustainability was maintained (iii) by reducing domestic demand significantly, a financial environment was prepared for strengthening exportation [43, 14].

The Capital Market Board was founded in 1982; the banks and other finance institutions have become subject to the supervision of the Board about their activities since the establishment day of the institution. In the same year, commercial banks were allowed to have foreign exchange position. In 1983, Saving Deposit Insurance Fund was formed. Exchange rate regime was liberalized to a large extent with the Decree No. 30 dated July 7<sup>th</sup> in 1984. In 1986, Istanbul Securities Exchange has begun its operations as second hand government debt securities market. In August 1988, Foreign Currency and Effective Markets were established within the body of Central Bank and daily sessions determining the rates have begun. Liberalization practices of capital mobility in Turkey were completed by Decree No. 32 in conjunction with economic and financial reforms carried out in 1980 [43].

With the decision no.32, entry to the country and exit from the country of securities and other capital market instruments, their export to abroad and their sale to foreign countries were liberalized. With this decree, it was legalized for residents in Turkey to get a loan from foreign banks and to invest in any country or a free zone. Turkey has applied to IMF in the year of 1990 and asked them to register Turkish Lira as a convertible sort of money [26].

Thus, Turkey's economy has started a period of integration with the world after 1980 and during this period, the routing of economy was left to the market mechanism. At market economy, prices route the economy. In order to reach the desired economic targets, there should be a balance among "goods prices", "exchange rates", "interests" and "wages". The financial crises emerge in the failure of delivering these balances [26].

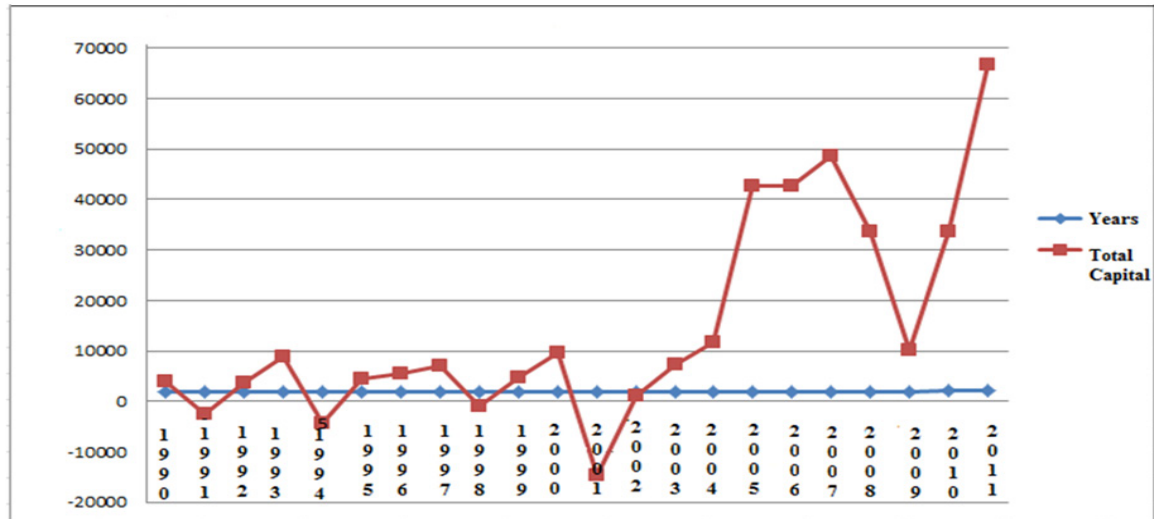
### 5.1. The Effects of Capital Movements in Turkey

After the liberalization of capital movements in 1989, (except the Gulf Crisis of 1991, the Financial Crisis of 1994 and the Russian Crisis of 1998) Turkey has provided more foreign capital inflow than its need for financing current account transactions during 1990s. Although the purpose, expected from financial liberalization, was stated as integration with international capital markets, the

determinative points was reducing financial constraints based on increasing public expenditure in practice. After liberalization, there have been important changes in the structure of capital flows, which work for financing balance of payments, short term loans that have taken the place of medium and long term loans.

Along with the Gulf War in 1991, economy of Turkey has experienced an important constriction resulted from external shocks. Then, Turkey has faced a serious financial crisis in 1994. A combination of uneven liberalization, large fiscal deficits, and a reliance on short-term, unhedged foreign currency loans sparked the initial 1994 crisis. While Turkish Lira was losing half of its value during the first three months, the reserves of Central Bank regressed from 7 billion dollars to 3 billion dollars. GDP was reduced at the rate of 6%, and the inflation numbers have reached three digits. The full blown crises, experienced once again in 2000-2001, have shown that how inadequate the measures taken were; and Turkey has failed to address the underlying problems with both its economy and its banking system [5, 7]. After the period of 2000-2001, structural reforms, which provided the removal of volatility towards banking sector that played an important role in the emergence of crises, have become the engine of the economic growth and the key to exit from the crisis [6]. After the crisis of 2008, Turkey's post-crisis adjustment under the AKP administration traces the steps of many developing countries, which are dependent upon foreign capital and conditioned to adopt or maintain contractionary policies in order to secure "investor confidence" and "international credit worthiness" [2].

There is an analogy between the outflow of capital from the country and financial crises shown in Figure 4 at below. In the early 1990s, capital flows, which began with the Gulf Crisis, have caused the emergence of many crises at important levels parallel to the ones happened in Turkey in 1994 and 2001, in Russia in 1998 and global crisis in 2008 at a later time. This situation is important in terms of seeing the effects of internal and external shocks. Considering the case in terms of direct investments, investments were considerably low in the period between 1990 and 2001. In 2000 and in the following years, improvements provided by political stability and structural reforms, development provided by legal arrangements (taxational-judicial), the distance covered in privatization practices have been significant. In terms of portfolio investments, they saw the lowest points in their history after Russian crisis in 1998 and they experienced the second biggest break as a result of the crisis happened in 2001. Portfolio flows, which entered the country in parallel to the expansion, have experienced in global liquidity circumstances after 2002 and they have reached significant levels. Thereafter, short-term funds (stocks-bonds), which exit as a result of 2008 global crisis that caused narrowing in our country as it had done around the globe, have developed increasingly in the following years (Table 3).



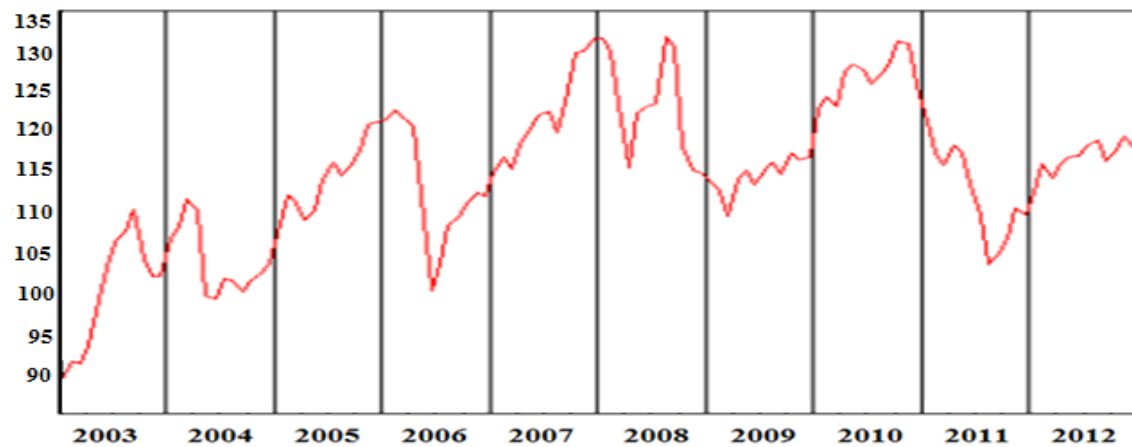
Source: TCMB, EVDS, Balance of Payments, 2014. The data of the study was compiled by us [43].

**Figure 4.** Total Capital Flow for Turkey (1990-2011)

**Table 3.** Total Capital Flow for Turkey (1990-2011 Net-Million TL)

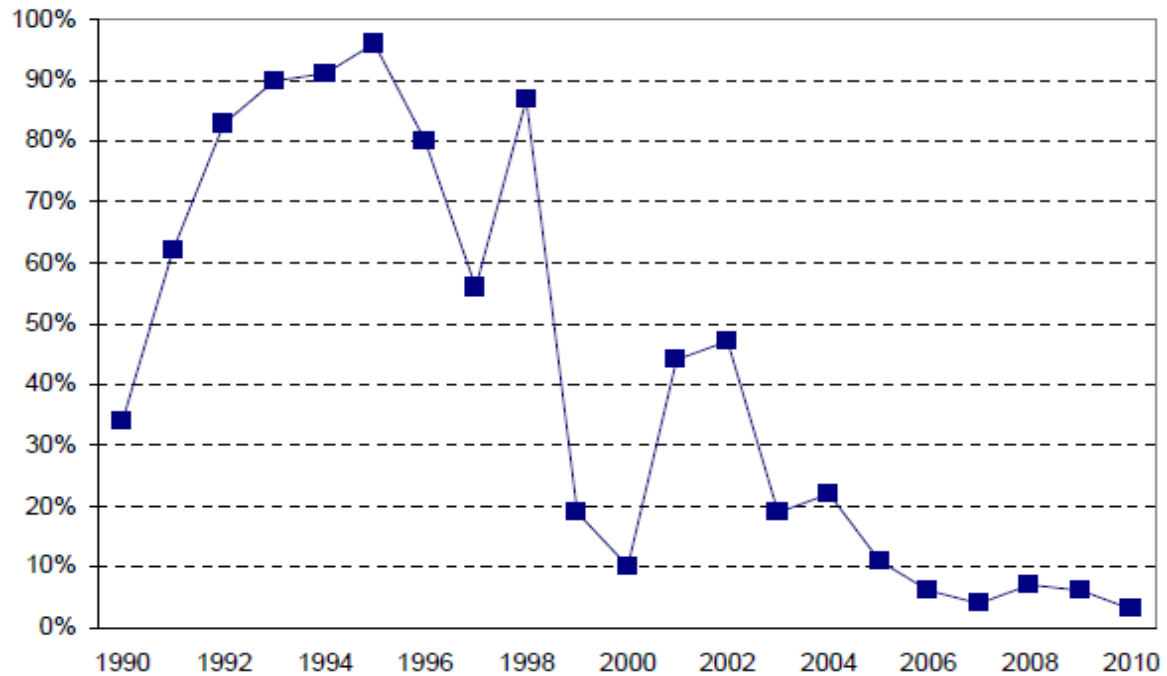
YEARS	Direct investments	Indirect investments	Other investments	YERAS	Direct investments	Indirect investments	Other investments
1990	700	547	2790	2001	2855	-4515	-12897
1991	783	623	-3803	2002	939	-593	826
1992	779	2411	458	2003	1222	2465	3475
1993	622	3917	4364	2004	2005	8023	7674
1994	559	1158	-5974	2005	8967	13437	20281
1995	772	237	3556	2006	19261	7415	16013
1996	612	570	4301	2007	19941	833	28513
1997	554	1634	4781	2008	16995	-5014	22766
1998	573	-6711	5298	2009	6858	227	2980
1999	138	3429	1262	2010	7574	16093	35262
2000	112	1022	8450	2011	13406	21986	31202

Source: TCMB, EVDS, Balance of Payments, 2014. The data of the study was compiled by us[43].



Source: TCMB, EVDS, Real Effective Exchange Rate, 2014. The data of the study was compiled by us [43].

**Figure 5.** Real Effective Exchange Rate (Consumer Price Index-based /2003=100/monthly)



Source: Undersecretariat of Treasury

**Figure 6.** Short-Term Domestic Debt / Total Domestic Debt

In this regard, one of the most important factors that should be considered in terms of applicability of capital controls is “Real Effective Exchange Rate”. As it is seen in Figure 5, with positive contributions of global liquidity, Turkish Lira continued to increase in value with the entrance of important short term capital flows during the period after 2003. As it is apparent at the graphic regarding real effective exchange rate, which was created based on the year 2003, Turkish Lira has continued to increase in value during the period after 2003.

On the other hand, it is seen that the borrowing structure has changed significantly in this period. It is also seen that the per cent of short term domestic borrowing in total domestic debt was higher during the 1990s (Figure 6). Although the per cent of short term borrowing increased again with the crisis of 2002, recently the proportion of short term borrowing has decreased significantly. As a result, compared to the debt structure in 1990s, it is estimated that debt maturity will cause less problems in the capital controls that Turkey can implement in the future. Sudden changes, which can be caused by controls in capital flows, result in less volatility in economy as a result of longer dated debt structure [16].

Nonetheless, another important factor in terms of the practice of capital controls is the size of current account balance to gross domestic product. This ratio will determine the importance of capital inflows regarding the country. Current account deficit in economies shows insufficient savings. Therefore, economies, which cannot provide enough money to finance their investments, have to attract foreign capital. Thus, in a country, in which current account deficit is higher, the practice of capital controls will be

highly difficult even for a short time period. When the CAB/GDP ratio of main developing countries, which practiced capital controls and the ratio of Turkey has been compared, it will be seen that Turkey is among the countries, which have the highest current account deficit compared to GDP after Croatia. However, considering the fact that Croatia is not in the same category with Turkey in terms of the size of its economy, it is seen that Turkey has the problem of financing current account deficit more than the countries practicing capital controls, and this situation creates constraints regarding the capital controls that are planned to be implemented in the future [16].

Considering Turkey in general, the struggle to pay off internal and external debts has been important; due to the effect of hot money flowing into the country, overvaluation of the domestic currency increased consumption and importation, and reduced the export values. As a result of current account deficit, foreign currency requirement and devaluation expectations caused overgrowth of demand to foreign currency, decrease in reserves, and consequently financial crises [32]. It is very obvious that two of the most important basic financial elements of current account deficit in Turkey are (i) portfolio investments and (ii) the amount of money with unknown entrance caused by net errors and omissions in the balance of payments. Consequently, this unhealthy structure and functioning that aroused in the finance of current account deficit has a feature that can obstruct the practice of capital controls.

Nevertheless, it seems partially successful to achieve “control of capital flows” in the areas such as controlling the credits that caused an explosion in automotive trade, restraining the increase in foreign currency deposit or

controlling public borrowing. However, in countries like Turkey, where current account balance problems obstruct the growth of the country, it is important to find the main solution. This situation makes it necessary for countries to solve their problems with their own potential and thus internal reforms are to be accomplished as soon as possible [19]. Because, as it is not possible to save a marriage with the help of the neighbors which doesn't have inner peace; it is also not possible to accomplish economical sustainability of a country, which couldn't overcome structural problems, with the help of foreign countries.

## 6. Conclusions

After the crisis happened in 2008, in many countries like Korea, Indonesia, Brazil, Colombia, Thailand, Iceland and India, capital controls are implemented on short term capital movements; and it is understood that similar policies are also discussed in EU countries as well as in most of the developed countries. However, it seems that the control practices implemented in EU are some arrangements aiming to realize macro-economic targets in EU, which are in the content of directives instead of controlling capital flows. In Turkey's economy, where there are significant savings gap, capital control practices contain difficulties, and this situation brings along economical volatilities caused by short term capital flows.

Capital flows in the developing countries have played an important role in the growth of economies in addition to the contributions they make in the finance of domestic investments. For example, telecom systems in Mexico, the roads in Thailand and similar services in many other countries are considered as a return of foreign capital and the added-value; because these services create jobs for human capital. However, hot money flows, which create positive effects while entering into the country but leave it abruptly at any speculative attack, can cause social, economic and political destructions as in the case of Latin America. While this one and similar examples highlight the views that full liberalization doesn't always result in positive consequences, they also bring along the arrangements towards the control of capital movements.

First of all, according to Rajan (2011), there is a need for practicing "market-friendly" capital controls. Furthermore, according to a limited number of the studies conducted in the literature, capital controls are more effective in moderating capital inflow surges than capital outflows, and they can be considered as more useful in lengthening the maturity of capital inflows instead of reducing the actual volume of the flows. Any dampening effects would be transitory on the volume of inflows at best as people find ways to circumvent the controls. The empirical evidence that show the influence of capital controls on currency swings suggests that they are depending on manner and type of the controls introduced. In the literature, most of the empirical studies were conducted on Chilean and Colombian experiences so far, which

imposed unremunerated reserve requirements (URR) to manage capital inflow surges and price booms. If they are applied appropriately, URR seems to be effective prudential and counter-cyclical tools that may generate much interest with one caveat, may also result in negative unintended consequence, while it can disproportionately raise the cost of credit for small and medium sized enterprises.

It is extremely important to convert short-term financial flows into long-term or institutional investments in the speculative capital. In terms of providing the functioning in the practice of capital controls, taxational arrangements like transaction tax are among the precautionary methods in practice. In order to be protected from negative effects of capital movements, it is important that governments should put inspection, criminal sanction and effective design of financial sector especially banking system into force in a way that doesn't contain any moral danger as IMF stated earlier. According to Moschella (2010), the efforts spent for creating an early warning system under IMF supervision are remarkable. By this way, it is aimed to send detailed warnings about capital inflows and outflows in a country by creating an effective data network regarding market structures in addition to the economic and financial circumstances of the member countries. Meanwhile, it is considered to block the use of funds coming from IMF resources by countries, which are imposed to continuous fund flows and do not discharge their responsibilities properly. Thus, while member countries are encouraged to act more cautiously about capital inflows and out flows, it is also possible to consider this system as an indirect capital control method.

In this context, it is stated that a reform, which can be realized for arranging international financial flows, will be beneficial for global welfare. However, the reasons such as the presence of countries, firms or stakeholders, which generate a high income by this way, restrict the practices for capital controls and the possibility to govern aforesaid flows considerably. Nevertheless, as Keynes has stated earlier that "the functioning of the markets is such a sharp area that it can't be left to the initiatives of private capital owners, who run after their personal benefits". Thus, it is highly necessary to provide a multilateral international cooperation in this area. Otherwise, no country will be able to benefit from international liquidity, which is growing rapidly and very changeable; and the current controls will not be able to go beyond having only a limited effect.

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