

IN DEFENCE OF CAPITAL CONTROLS

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I. Introduction'

The story of the rise and fall of the Golden Age of modern capitalism is an oft told tale. But for all its familiarity, it is easy to forget that the Golden Age was, among other things, an era of effective national economic regulation. It was the age of the 'social contract' or capital-labour 'accord' (however loaded in capital's favour these arrangements might have been) under which the Keynesian state, with the acquiescence of capital, was to pursue full employment and build a stronger social safety network. Golden Age central banks fixed exchange rates and determined interest rates with only sporadic interference from a relatively small class of financial speculators. Such state regulation was made possible by the emaciated condition of the domestic rentier class, capital controls on international financial flows, and the as yet quite limited size and power of multinational corporations (MNCs).

The limited extent of globalization was hardly the only important determinant of the Golden Age, nor even its most important condition of existence. But the acceleration of the process of globalization of finance and capital investment and the increase in the openness of trade that took place as the Golden Age evolved does seem to have been an essential element in the dynamics of its demise. The continuation of the globalization process over the past two decades has created tenacious impediments to the restoration of a regime of sustained full employment and real wage growth.

In this essay we will argue that a set of policies to gain more control over the international flow of money and, perhaps, goods is an essential component of any serious package of **progressive** structural reforms designed to achieve sustained full employment and greater equality of income and wealth. In making this argument we are in a minority, but we are not alone. Indeed, in recent years there has been renewed support for capital controls, even among policy makers and mainstream economists.

Several factors help explain this growing interest. First, speculative

attacks against the EMS in 1992 drove Great Britain and Italy out of the exchange rate mechanism, generated enormous macroeconomic problems for Sweden, Spain and other countries, and forced a widening of the bands for countries that remained. A number of respected mainstream economists have wondered whether capital controls may be necessary to bring about the transition to European Monetary Union. (See, for example, Eichengreen, Tobin and Wyplosz, 1995 and the references there.) Second, the recent Mexican disaster frightened even committed **neoliberals**. In this sensitive environment, the International Monetary Fund, in a move that made headlines and generated a critical editorial in the *Wall Street Journal*, cautiously argued for the occasional desirability of controls on inward capital flows to developing economies (IMF, 1995).³ Finally, the continuation of devastatingly high unemployment in Europe and wage stagnation and increased inequality in the US has led to renewed interest in capital controls among progressives as a way of allowing countries to use macroeconomic policy to promote full employment. The surprise best selling book by *The Guardian's* Will Hutton, *The State We're In*, calls for capital controls as a way of promoting full employment. Other respected progressive academics who have recently supported controls as part of a restructuring programme include Juliet Schor, Fred Block, and Andrew Glyn."

However, even proponents of controls remain ambivalent about their feasibility. Is it possible to control capital when billions of dollars can move across cyberspace in a nanosecond? Can the international cooperation that may be required to control capital ever really occur? And, maybe globalization and the constraints that it imposes aren't all that important? For example, Andrew Glyn (1995), one of the economists on the left who has written most often and most perceptively and supportively on the economics of capital controls recently seemed to shift gears, arguing that the primary impediment to full employment at present lies in the fact that labour has failed to support a binding incomes policy that commits working people to non-inflationary wage and benefit demands at full employment. He believes that the costs, tensions and pressures of sustained full employment, magnified as they are in the current environment, should be 'explicitly counted and willingly shouldered by the mass of wage and salary earners' (Glyn, 1995, p.55). The problems of globalization complicate the issue to be sure, according to Glyn, but constraints on international mobility are not an essential element in its solution.

We share Glyn's belief in the need to constitute a new set of domestic political arrangements that will commit labour, capital and the state to egalitarian full-employment policies. The problem is this: *in the absence of the enactment, or at least the credible threat of enactment, of capital controls and trade restraints, what leverage can labour and the citizenry*

possibly use to force capitalists to even bargain seriously over these issues, never mind to persuade them to agree to any new political understanding other than one that delivers the total and complete surrender of all progressive social and economic values? There are a depressingly large number of costly adjustments that the working class would have to 'willingly shoulder' in such a new domestic deal as Glyn now advocates. The US, for example, suffers not just from excessive average unemployment, but from urban decay, public infrastructural disinvestment, a health care system that is not viable in the longer run, an emaciated social safety network, a growing underclass of low-paid, under employed workers, and so forth. Is the working class to voluntarily agree to pay all the costs involved in solving these problems? Under existing political conditions, it is certainly clear that the economic elites will refuse to do so. And are engorged rentier incomes to be guaranteed in this new deal along with adequate corporate profits? The point is that *world elites have no incentive at present to jettison their current economic and political agendas*. Capital controls or their threat are the means to create such an incentive.

Discussions among economists about the pros and cons of capital controls usually take place in a fairly narrow context. Would this or that control help country X maintain a moderately lower interest rate or a somewhat lower rate of unemployment? Given the problems of evasion, or the propensity of controls to induce or worsen corruption, or the inefficiencies assumed to follow any interference with market incentives, the case for controls is normally rejected more or less out of hand. We want to consider capital controls in a much broader context. We are concerned with the current and future implications for the quality of life of the majority of the world's people of the continued development and perfection of the neoliberal global economic regime. Sustained high unemployment is now taken for granted across Europe and in most of the world. Inequality is on the rise everywhere. The US, though celebrated for its less-than-very-high unemployment rate, is suffering from secularly falling real wages, rising poverty rates, massive urban decay, and rising racial tensions. Its social safety net, miserly by developed country standards, is being torn to shreds by an arrogant and ignorant Congress whose only accountability is to wealth and power. Of course, these problems cannot be contained within the economic sphere. Deep fissures in the social fabric are appearing everywhere, and the body politic is not immune to the poisons this regime is spreading around the world. Racial hatred, immigrant bashing, and neofascism have made their reappearance on the global political scene.

In this context, the key question is not whether this control or that is on balance cost effective. Rather, we need to consider whether or not capital controls can help alter the current configuration of class economic and

political *power* in order to facilitate the creation of new political commitments in support of full employment macropolicy, public investment, credit allocation and income redistribution. There are three ways in which capital controls can be helpful in this regard. First, such controls directly restrict the ability of rentiers and MNCs to threaten labour and the political majority by running away. Freedom to 'run' is one of the main sources of capitalist political power in the current neoliberal regime. Second, controls can facilitate the attainment of full employment, at least in the short to intermediate run, thereby strengthening labour's bargaining power. Third, the imposition of moderate controls and the *threat* to implement comprehensive controls (on trade and the movement of real and money capital) and more powerful state economic *intervention* in general may be the only way to get capital to consider supporting more progressive institutional arrangements because negotiations toward a political 'new deal' will be the only way they can protect themselves against the possible emergence of an overtly anti-rentier or even anti-capitalist regime or, alternatively, the development of political and social chaos.

Fortunately, the political feasibility of capital controls may be greater than is commonly believed. The current system of capital mobility, however profitable in the short run, is not operating in the long run interests of many of those capitalists engaged in producing goods and services. It is primarily the global rentier class that consistently benefits from the current system of capital *mobility*.³ While it is true that the rentier class has gained tremendously in size as well as economic and political power in the post-war period, their assets still constitute a small fraction of total capitalist wealth. Hence, the constitution of a coalition of interests between labour and fractions of industrial and commercial capital against the parasitic interests of rentiers might be attainable under the right conditions.

As for economic feasibility, the case is even stronger. Economists do not doubt that capital can be controlled. The only issue is at what cost. Neoliberal economists assume that the current economic system is operating virtually without flaws; thus any costs associated with interference in the system are automatically considered to be too high a price to pay. We agree that the costs of imposing controls must be compared with the costs of not imposing them. However, contrary to the dominant view, it seems clear to us that the costs of maintaining the current neoliberal regime are absolutely astronomical. Any reasonable estimate of the efficiency costs to the nation of a system of capital controls must pale in comparison with the costs of doing nothing. As we shall see in Part IV of this essay, a broad range of controls are possible; capital flight can be frustrated not only by international cooperation among states, but also by the appropriate sequencing of and the vigorous enforcement of various

controls by individual governments.

II. From the Golden Age to the Resurgence of the Global Rentier Class

We offer here a brief and selective chronology of events leading to the birth and death of capitalism's Golden Age in the 1950s **and** 1960s⁶ and then discuss the construction of the global neoliberal regime in order to draw attention to five key points. First, the systems of capital controls and credit allocation put in place after the war helped make the Golden Age possible. Second, the unravelling of these controls contributed substantially to the Golden Age's subsequent demise. Third, the alliance between industrial and financial capital that emerged in this period, as well as increased competition among nations for shares of the enlarging international financial market, were central to the dynamics of its demise. Fourth, the current neoliberal regime was created by global economic elites to facilitate their victory in a one-sided class war waged against working people around the world. Fifth, this regime has given capital such power over labour and society that no attempt to create a new progressive domestic policy coalition is likely to succeed unless accompanied by a direct assault on the foundations of that regime through capital and perhaps trade controls.

By the beginning of the 20th century, a globalized economy had become a reality. London, New York and Parisian bankers could move money to the far corners of the globe in no time at all, financing trade, public works, and speculation of vast proportions (Zevin, 1992). The free movement of money – anywhere, anytime – was the keystone of a liberal society and the basis for the accumulation of massive wealth by rentiers like Morgan, Rothschild, and Aldrich. Then came the calamities which destroyed the liberal order: the two World Wars and the Great Depression (Hobsbawm, 1994). If the Great Depression and War brought about an enormous reshuffling of national fortunes, it also dramatically reshuffled the pecking order of ideologies and classes. The sacred economic ideas of the day – the gold standard, independent central banks, and free international capital mobility – had all come to be seen as purveyors of calamity rather than pillars of stability. John Maynard Keynes was only the best known of many economists who discredited the idea that free international capital mobility and unregulated private finance were the *sine qua non* of economic progress (Crotty, 1983). Indeed, in many parts of the capitalist world, no group bore more blame for the economic crisis than the rentier class and its allies, the central bankers. Among the early casualties of the depression was the independent power of many central banks, including the Federal Reserve and the Bank of England, both of which were brought under the direct

control of their governments in the 1930s (Epstein and Schor, 1995).

The planning undertaken by governments to more effectively wage the Second World War hastened the maturation of a political process already in motion: the institution of financial controls and economic planning in much of the advanced capitalist world. When Harry Dexter White for the US and John Maynard Keynes for England met to begin negotiations to construct the post-war economic order, there were two things on which they agreed. Controls over international capital movements would be necessary to achieve economic prosperity in the post war world; and such controls would be most effective if countries developed comprehensive national regulation of all foreign exchange transactions and cooperated with each other in enforcement of these regulations? They wrote provisions which protected countries' rights to institute comprehensive controls into early drafts of the Bretton Woods Agreement; these provisions survived more or less intact. Keynes proposed voluntary international cooperation in his drafts, while **White argued** that such cooperation should be mandatory. In his 1942 draft, for example, White proposed that governments be required 'a) not to accept or permit deposits or investments from any member country except with permission of the government of that country, and b) to make available to the **governments** of any member country at its request all property in form of deposits, investments, securities of the nationals of that member country' (quoted in Helleiner, 1994 p. 38).

The early proposals of Keynes and White met with fierce opposition from New York bankers. Mandatory controls would interfere with the profitable business of accepting flight capital, as the New York bankers had done in the 1930s. And bankers opposed capital controls because they knew they would be used to support significant government intervention in post-war domestic economies. They eventually succeeded in removing the mandatory aspects of international controls enforcement. The 1943 version of **White's** draft stated that countries had to cooperate in enforcing controls 'only if the IMF had recommended it' (Helleiner, p. 47). In addition, countries were no longer required to repatriate flight capital at the request of the originating government, only to provide information about it. There was virtually nothing concerning nations' obligations to help each other enforce controls included in the 1944 Joint Statement. In the end, though, the Bretton Woods Agreement did reject the sanctity of unregulated private capital flows and the liberal, open, financial order with which it is associated.

It should be noted that one reason the New York bankers were not even more effective in striking controls from the Bretton Woods agreements was that industrial capitalists in the US and elsewhere rejected free capital mobility. In particular, those industrialists – largely from capital-intensive

and high tech sectors – who had provided Roosevelt with crucial business support in the 1930s strongly supported effective capital controls (Ferguson, 1984). In other important countries (such as Japan, Germany, France and Italy) both financial and industrial interests agreed on the need for controls.

Indeed, at the start of the post-war period virtually all the countries in the world, with the important exception of the US, had extensive capital controls on outflows, inflows or both. For many countries such controls were seen as necessary to protect modest foreign exchange reserves in the face of strong import demand and tempting financial investment opportunities in the US. But for others, controls facilitated the creation and allocation of credit and the regulation of trade that were important parts of government directed national development plans. Countries, such as Germany, for whom controls seemed an unfortunate necessity rather than an essential element of economic planning, began to remove their controls early in the post-war period. But virtually all such countries eventually reinstated controls in some form (Goodman and Pauly, 1993). The German Government 'while opposed to capital controls in principle, also resorted to them in practice' (Henning, 1994, p. 314). A coalition of bankers and industrialists committed to an export-led development strategy saw capital controls as essential for the maintenance of a stabilized and undervalued Mark. The German government therefore reimposed controls on inflows again from 1960 to 1969, in 1971 and as recently as in the early 1980s.

Japan, on the other hand, was more ideologically committed to the use of controls as part of its industrial development strategy. Its Foreign Exchange and Trade Control Law of 1949 brought 'formal prohibitions on capital transactions and restrictive licensing for financial institutions engaged in international business. There were also informal controls, such as administrative guidance of the foreign exchange positions of Japanese banks' (Henning, 1994, p. 314; Mathieson and Rojas-Suarez, p. 9). Capital and exchange controls allowed Japan to keep the cost of credit low, to channel credit to desired uses, and to stabilize the Yen at an undervalued level to promote exports. These policies were, as in Germany, the reflection of a coalition of interests between industry and finance. In France as well, a strong alliance between the state, finance and industry supported controls as part of an overall industrialization strategy. The French had used controls since 1915; in 1966 their post-war system of controls was significantly strengthened when a new law gave the government the right to control all foreign exchange transactions between France and the rest of the world, oversee the liquidation of foreign funds in France and French funds abroad, and prescribe conditions for the repatriation of all income earned abroad. Among the developing countries, South Korea used highly restrictive capital controls most effectively

(Nembhard, 1996). Controls on both outflows and inflows were a necessary adjunct to the industrial and credit allocation policies which made South Korea one of the first developing country 'economic miracles' in the post-war period (Amsden, 1989). Of course, controls were misused in some countries. But the point is that they played an essential role in creating virtually all of the great post-war secular booms.

In sum, the creation and reproduction of the Golden Age was facilitated by several key conditions. First, the rentier class was weak. Some economies were flush with liquidity after the war **years**, real interest rates were modest, and capital accumulation was primarily financed by the flood of internal funds created by growth and a consistently high rate of profit. This was an age in which the interests and needs of real capital accumulation dominated those of financial capital. Second, capital controls helped keep finance primarily national while domestic financial regulations and credit controls channelled funds to priority domestic uses. Both aspects were important: domestic rentiers had little power over the accumulation process and capital controls prevented them from augmenting their power by threatening to 'run away' if interest rates and inflation rates did not suit them. Largely because of controls, the overall flow of private cross border finance was quite low in the 1950s and early 1960s. **Rentiers** thus had yet to gain veto power over macropolicy. Third, though the dislocations and uneven destruction wrought by the war meant that trade had to be of some significance, it was less important than it was to later become, while direct investment across borders was inconsequential. Firms thus were forced to rely primarily on strong rates of growth of domestic aggregate demand for their own expansion and profit. Industrialists as a group were unable to resolve their cost problems by national policies of high unemployment without destroying the main markets for their own goods. And with political commitments made by capital to labour during the war to cement their allegiance to the war effort still in effect, conditions were ripe for the creation and maintenance of the political and economic arrangements that led to full employment and rising social wages across Europe and, to a somewhat lesser extent, in the US.

Unfortunately, the history of the postwar financial order is one that culminates in the ultimate triumph of rentiers and **MNCs** and the restoration of an open global financial and economic system. A major contributing factor to this victory was that as important segments of business became more international in orientation they joined the bankers in their support of a more financially open global economy. Thus united, they became too politically powerful for most governments to successfully oppose.

In our view, the contradictions and strains that brought the Golden Age to its demise in the late 1960s and early 1970s were primarily domestic.

The economic and political power of the working classes in the advanced countries was invigorated by sustained full employment and a rising social wage. This period saw an eruption of strikes, militant demands for better wages and working conditions, and a push by labour for more democratic control of the labour process. These challenges to capital created the cost side of the squeeze on the profit rate characteristic of this period. At the same time, industrial capital was trying to undercut labour's power by shifting production to nonunion sites either at home or abroad; foreign investment and its threat became increasingly **important** weapons in this conflict. Meanwhile, citizens around the developed world demanded a more generous social wage, creating strains on the public purse. (See Bowles, Gordon, and Weisskopf, 1990.)

Of course this is also the initial period of the resurgence of the global rentier class. The modern global rentier class evolved through an increase in the size and power of rentier interests in many advanced capitalist countries combined with increased openness of world financial markets. As it became larger, the rentier class began to form coalitions with segments of industrial and commercial capital, in some cases as the result of the creation of huge **financial/industrial** conglomerates, a veritable merging of rentier and industrial interests under one corporate roof.

The clearest early signpost of this new unity occurred in the 1960s in the context of the implementation of a capital controls programme in the US and the associated rise of the Eurodollar market. When the US government set up its voluntary capital controls programme in the **1960s**, it tolerated and even promoted the Eurodollar market in London in order to prevent the subversion of the programme by large US banks and multinational corporations. The Eurodollar market allowed both big banks and multinational industry to gain access to deposits and loans abroad without immediately hurting the US balance of payments. The push by British Banks and the British Government to restore London as a world financial centre, with a deregulated international financial market unhindered by capital controls, finally let the globalization genie out of the bottle.

The US had become decidedly hostile to international capital controls by the early 1970s. When the declining US trade position precipitated a run on the dollar and threatened the collapse of the Bretton Woods system, European and Japanese governments proposed extensive cooperative capital controls to help maintain the fixed exchange rate mechanism. The US government vetoed their proposal (Helleiner, 1994). Without the support of the US, the attempt to maintain international regulation of the emerging global rentier class was doomed to failure. By the middle 1980s virtually all advanced countries **were** in the process of loosening or even eliminating controls. Their general demise was the result of a combination of internal and external political pressures, the precise mix of which varied

from country to country. Much of the external pressure emanated from the US. As noted, the US had encouraged the development of the Eurocurrency markets in London in the 1960s. Euromarkets then became the site of the freest international capital market since the 1920s; this created pressure on other countries to dismantle their own capital controls so that their financial institutions could more successfully compete in the emerging global marketplace. In the 1970s, the US succeeded in changing the language of the IMF bylaws, for the first time giving the IMF the power to force countries to reduce or even eliminate capital controls. Finally, in the late 1970s and 1980s, the U.S. directly pressured a number of countries, Japan among others, to open their capital markets. Germany played a similar role within the EMS. Nevertheless, in most cases the primary cause of the demise of capital controls was probably domestic. Domestic industry and finance, having become more globalized and more outward oriented, eventually became more unified in their opposition to controls. They had also lost much of their commitment to the social contracts that originally made capital controls attractive to them. The accumulation of these international and domestic pressures to remove controls eventually overcame the resistance offered by various OECD governments.

Symptoms of the death of the Golden Age were easy to spot. Real wage growth slowed everywhere; in the US it vanished. Average industrial and commercial profit rates declined markedly. But the rentier class continued to expand in size as well as in its propensity to cross borders. The central events in this process of expansion revolved around the creation of an ocean of petrodollars recycled by the exploding Eurodollar market to the Third World. Petrodollar recycling represented a new evolution for global rentiers since loans to developing country had previously been modest in amount, and came primarily from governments and international lending agencies, not private financial institutions. The second OPEC price increase in 1978–79 accelerated this process. Inflation spiked again. Exchange rate instability skyrocketed. The Europeans tried to delink from the US dollar and form their own exchange rate system in an attempt to insulate themselves from this chaos. Capital controls in much of Europe were temporarily reintroduced.

In political terms, the 1970s can perhaps be best understood as a time of distributional struggle among and between classes over who would bear the costs of slower growth, rising rent extraction by oil producers, and increased economic instability and insecurity. The decade saw no clear cut winner. The rentier classes in particular fared poorly. Inflation adjusted equity prices dropped rapidly over the decade; indeed share prices divided by money wages fell dramatically all across the OECD. Meanwhile, inflation at times rose above nominal interest rates in the late 1970s, giving

rentiers negative real rates of return. By 1980 the economic elites in the developed world were seething with anger at their failure to win this distributional struggle. If the 1970s was their decade of discontent, the 1980s was to be their decade of revenge.

A run on the US dollar in 1979 kicked off the decisive phase of capital's war against labour and the social contract. US Federal Reserve Chairman Volcker proceeded to implement his attack on inflation and the US working class, precipitating the Third World debt crisis. Super-tight US monetary policy, along with like-minded policies implemented elsewhere in the OECD, raised world real interest rates, helping create a global recession. The global recession created an environment that permitted European elites, who were not in a political position to simply tear up the social contract, to violate it with some impunity. European unemployment rates, which had increased from about 3% to about 6% between 1973 and 1980, levitated to above 10% by the mid-eighties, never to return to their 1970s, let alone their 1960s, levels.

Thus, by the early 1980s all the pieces needed to implement the new political agenda of the more unified elites were in place. Rentiers wanted the devolution of all regulatory controls on the movement of money – within the country and across borders. They wanted inflation smashed quickly. Finally, they wanted low taxes on rentier income and on the rich. The agenda of industrial capital was generally consistent with rentier interests; only questions of the depth and length of the desired recession separated them. To raise profits and create greater managerial autonomy, they wanted to complete the job started in the 1970s and break the economic and political power of labour. They sought lower real wages and more freedom to organize work and workers as they saw fit; the weakening or even destruction of unions and the reduction of the social safety net were necessary conditions for achieving this result. They also wanted to loosen the government regulatory apparatus and cut business taxes even further. In the decade or so to follow, US rentiers and industrialists got almost all of what they wanted; their European counterparts had to settle for less.

The 1980s also saw the accelerated expansion of a deregulated financial sector swollen by high real interest rates, rapidly rising debt to income ratios in the business, household and government sectors, and speculatively driven financial asset prices. Since there had been no increase in world saving, the sustained secular rise in indebtedness, along with the rentier-dictated anti-inflation mania of central banks, kept constant upward pressure on real interest rates. The relation of the financial sector to the nonfinancial sector thus had changed-dramatically from the hey-day of the Golden Age. The financial sector now absorbed a vastly increased share of the income flows generated in the real sector which it used primarily to

fund its own self-expansion. Finance had become a parasite on and impediment to real sector growth.

Of course, governments everywhere became increasingly dependent on the rentier class. The post-1973 slowdown in economic growth reduced the rate of increase of tax revenues and raised demands for higher spending. Serious budget deficits first arose after 1973; they increased (relative to GDP) in the 1980s. Cuts in taxes on business and the rich further weakened the fiscal position of the state. Finally, the record high real interest rates of the period raised the cost of servicing the ever rising stock of government debt. Throughout the developed and the developing worlds, governments became burdened with their heaviest debts since WW II. With **rentiers** now inclined to boycott bonds issued by governments that tolerate inflation or run deficits that are considered irresponsibly large, raising their interest payments and punishing their exchange rates, fiscal as well as monetary policy had fallen under rentier dominance?

The political-economic strategies implemented by capital in the 1980s were astonishingly successful in settling the distributional struggle in capital's favor in the US and in much of the Third World, and reasonably successful in the rest of the OECD. Looking at the US, we can say that the elites have substantially destroyed the old social contract. Meanwhile, the economies of the Second and Third Worlds have become increasingly open to First World exploitation. Indeed, with the acceleration of globalization, with the increasing allegiance to neoliberal policies and ideology, with further privatization, and with legally binding treaties such as GATT and **NAFTA**, the very concept of nationalist economic policies is beginning to seem hopelessly naive.

The central point that needs recognition is how integral the process of globalization has been to the unfolding of this story. The proximate cause of the end of the Golden Age was the collapse of US international financial hegemony and of global financial stability brought on by a run on the US dollar in the early 1970s. And the proximate cause of the onset of global monetarist terror in the 1980s was the run on the dollar in 1979 that brought Volcker to power. The policies adopted in the 1980s then produced the speculative booms and financial fragility that further enlarged and empowered the rentier class. Indeed, the general environment of uncertainty that followed the Golden Age was fuelled by waves of global hot money flooding into and then out of different countries, dramatically raising exchange rate instability. This ocean of hot money has grown ever wider and deeper as financial sectors inflate, technological and organizational innovation accelerates, and, most importantly, the ability and the desire of governments to control these flows erodes. Unless and until we restore some reasonable degree of societal control over the 'freedom' to move goods, jobs and, especially, money across borders at will, attempts to

implement full employment macropolicies or to write domestic new deals will be doomed to failure.

III. Capital Controls as Prerequisites For Progressive Macropolicy

The crucial question in this context is whether capital controls (and perhaps also trade management) are necessary conditions for the implementation of full employment and egalitarian economic policies. There are actually two important sub-questions involved here. First, do unregulated investment, trade, and financial capital flows make the implementation of a long term or sustained policy of full employment difficult if not impossible? Second, do they significantly weaken labour's ability to force capital to agree to a new, progressive, egalitarian domestic economic regime? We believe that the answer to both questions is yes, and that, therefore, capital controls are an essential precondition for the reconstruction of a regime of sustained full employment and reduced inequality. Obviously, some countries face less binding external constraints on the implementation of progressive domestic economic policies than do others. But, in our opinion, capital controls would enhance the ability of a progressive political alliance in any country to successfully pursue sustained full employment and a more progressive income distribution.

How do trade openness and unregulated real and financial capital flows impede the ability of government to pursue high wage, high employment, egalitarian policies? To answer this question it is first necessary to ask how extensive capital mobility really is. On the one hand, the quantity of two-way short-term flows (so called gross mobility), has increased dramatically, and is now at astronomical levels. These are the movements of capital that most observers have in mind when discussing the 'hyper-mobility' of capital. On the other, the net transfer of long term capital from one country to another is still at a lower level relative to the size of economies than it was at the turn of the century. But things are changing. With the rise of neoliberal ideology, the increased power of the global rentier class and the strengthening of international protections for foreign investment embodied in NAFTA, agreements of the EU, and other international legal arrangements promoted by the IMF, World Bank and other institutions, the pace of long-term and net capital flows is dramatically accelerating. If the current pace continues, the level of international capital mobility even on a long-term and net basis is certain to eventually increase substantially over the early 20th century peaks. In sum, short term international mobility is already extensive; and if current trends continue, long-term mobility will continue its dramatic rise as well. (See Epstein, 1995 and Epstein and Gintis, 1992 and the references cited there). In this context, let us consider the following issues.

Direct Investment

Changes in technology and the prying open of Second and Third world economies to unrestricted foreign investment have made it easier for multi-nationals to invest anywhere and to produce an increasing variety of goods and services using a broader spectrum of relatively low cost foreign labour skills. While still modest relative to domestic investment in the advanced countries, foreign direct investment is not insignificant and is growing fast. Foreign investment can have two deleterious effects on the domestic economy: it can substitute for, and thus reduce, domestic investment; and it can affect the relative bargaining power of labour and capital in the negotiations that determine wages and working conditions, primarily in those industries experiencing capital outflow, but in related industries as well.

There are arguments on both sides of the question as to whether foreign investment by domestic corporations is a complement to or substitute for domestic investment by these same companies. But taking into account the increasingly wide range of labour skills available to advanced country MNCs abroad at a fraction of the cost of domestic workers, as well as the frequent absence of unions, environmental restrictions, health and safety regulations, taxes, and so forth in less developed countries, it seems reasonable to conclude that foreign investment in the advanced countries is on balance a substitute for domestic investment (Burke, 1996; Feldstein, 1994).⁹

Under virtually anyone's theory of wage determination, the loss of capital and technology in the domestic economy caused by foreign direct investment should lower productivity and therefore the real wage, at least in the short run. The magnitude of this effect should not be large, however, because the proportion of the potential domestic capital stock that has run away is not large. But if one accepts, as we do, the more realistic view that the division of the national product among the factors of production is mediated by a complex set of institutions and practices that determine the relative power of the contending parties, it is not at all clear that the effect on wages of runaway capital is minor. How many companies have to run away, leaving behind unemployed and underemployed workers and depressed communities and regions, in order to lend credibility to the threat by other companies to do the same? In an environment of substantial secular unemployment such as we have lived through in the past 15 years, even partial credibility can frighten workers into making major concessions. Until we find a reliable way to measure the growth of such threat-credibility, we will have no way of knowing for certain what we believe to be the case: that foreign direct investment has had a major effect on wage behaviour in the advanced countries in recent years.

Trade and Financial Capital Flows

Consider the situation confronting a nation that wants to implement a macropolicy designed to achieve sustained full employment. Assume this nation is completely open to trade and to real and financial cross border investment flows, and that trade is a significant component of GDP. The trade-related impediments to a full employment macro policy in such an open, trade-dependent nation are many and complex. Here we simply list four. First, increased income growth will induce a rise in imports that will lessen the impact of a given degree of policy stimulus on GDP (or will lower the policy 'multiplier'). Second, the rising trade deficit will, other things equal, precipitate a fall in the nation's exchange rate that, in current speculative currency markets, could be of substantial magnitude. Third, the fall in the exchange rate will cause a deterioration in the real terms of trade – the quantity of imports earned by a given volume of exports. If traded goods and services are a large percentage of GDP, this could lead to a large reduction in real wages and in the national income. Fourth, this surge in imports itself will cause competitive downward pressure on domestic real wages. As we shall see, these trade-related problems will interact with financial capital flows to sabotage the full employment policies that spawned them.

Those who do not believe that globalization is a major cause of the deterioration in economic performance over the past twenty years often point out that while dependence on trade did increase substantially since the 1960s, its rise has not been all that dramatic, and that while direct investment did increase by dramatic proportions, it remains small in absolute terms. However, no one can deny that financial capital flows have increased dramatically and have reached unprecedented relative and absolute levels. The daily turnover in the foreign exchange market, which was about \$15 billion in 1973 and about \$60 billion in 1983 is now approximately \$1.3 trillion, an amount perhaps sixty times the volume needed to finance trade, one that dwarfs the less than one trillion dollars available to the governments of the advanced countries for exchange rate stabilization purposes.¹¹

What impediments to our hypothetical full employment macropolicy might today's global rentier class cause? The primary problems are that the fall in the exchange rate caused by the higher trade deficit and lower interest rate associated with this policy will be larger, will take place sooner, and will be more uncertain or unpredictable in size. The term 'rational expectations' is an oxymoron in the world in which we live. We can 'predict' the future only through guesses, hunches, rules of thumb, and social conventions. And perhaps no important world market is more subject to the speculative instability and fundamental uncertainty endemic in the real world than the current global money market. Any significant

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movement of an exchange rate in either direction can start a stampede into or out of any currency in this market; herd behaviour is the norm (Crotty, 1994). Thus, as our new full employment policy – with its reliance on low interest rates and its promise of higher inflation and larger trade deficits – begins to be implemented, global rentiers will jump ship, touching off an exchange rate decline which could turn into a free fall. Knowing that they don't know how fast or how deep the drop will be, even investors who are not hostile to the longer term objectives of the host government may quite sensibly decide to play it safe by shifting their funds elsewhere, perhaps with the intention of returning when the exchange rate pressure has subsided.

These problems are greatest, of course, for small, trade-dependent developing countries. But even large countries will suffer when rentiers decide to run away from their currencies. The central bank may be forced to defend the exchange rate through high interest rates, striking a blow to domestic investment. Financial instability may rise as higher interest rates undermine the stability of banks dependent on short term deposits to fund their investment in long term loans and in bonds purchased earlier when rates were low. Higher interest rates may transform a difficult fiscal deficit into a fiscal **nightmare**: the government will pay much higher rates to finance its deficits and turn over its debt. Heavily indebted industrial and commercial corporations are subject to the same kinds of financial shock; greater financial fragility in this case means less capital investment. In short, substantial capital flight can generate tight constraints on policy. Unfortunately, vast inflows of capital can eventually prove to be almost as damaging. The crisis in Mexico in 1994–1995 is a case in point (Gabel, 1995; Danby, 1995; IMF 1995).

The main point is that the problems caused by the decline of the exchange rate are magnified and quickened. In essence, the problems which the new expansionary policy might have generated only slowly and in concert with its benefits, are now magnified and appear *before the benefits have a chance to even be experienced*. It is easy to see why the objectives of the new policy might be impossible to attain under these conditions. It is easy to see how **public support** for the policy could easily evaporate in this environment. It is also easy to see, given the logic of this scenario, why even well meaning governments – an endangered species – would shy away from anything resembling a policy of sustained full employment. With central banks universally opposed to such policies and rentiers ready to severely punish any government which tries one, it is easy to understand why the majority of the world's population has had to suffer the consequence of secularly high unemployment for the past two decades.

The virtual elimination of full employment macropolicies is not the only serious problem caused by financial aspects of globalization. The

existence of this ocean of hot money, subject as it is to fads and fashions, has helped create enormous actual as well as potential instability in exchange rates. This rise in exchange rate uncertainty potentially affects the decisions of all economic agents influenced by international prices and quantities; a group that grows apace with globalization. That is to say, the evolution of the global rentier class has substantially increased the deleterious impact of uncertainty on economic performance. Nowhere is this more important than in reducing the pace and changing the composition of capital investment spending. The current era is thus one in which productive accumulation is being strangled by financial capital – through debt burdens, high interest rates, fickle short-term finance, heightened uncertainty, and restraints on expansionary macropolicy. Freedom to cross borders at will has substantially enhanced the ability of the rentier class to enrich itself while impoverishing society.

IV. What is to be Done?

We have no doubt that existing impediments to the implementation of effective capital controls are many and are powerful. The main general problem is this: the most efficient potential solutions to our current economic problems are global in character, but there are no obvious democratic political mechanisms at hand through which to design and implement global institutional change of the kind we need. Such mechanisms as we do have are national or regional in character.

To see the potential superiority of global solutions, suppose that *all* governments decided to cooperatively pursue full employment through larger budget deficits and lower interest rates. Under such global cooperation no country need confront serious problems from rising trade deficits, or capital flight, or currency devaluation. Thus, the need for capital or trade controls would be substantially diminished. If this need did arise, cooperative agreements to enforce capital controls would make them much more efficient and harder to evade. Keynes was surely on the right track when he based Britain's 1940s proposals for a new international order on the concept of an international central bank empowered to expand the world's credit supply to accommodate and sustain global economic expansion. The bank was to assist countries that develop balance of payments problems through faster than average growth, and penalize surplus countries, forcing them to grow faster.

Clearly then, the most effective method for creating global full employment is cooperative macropolicy expansion, cooperative capital controls, an international central bank in the Keynes mode, and an international Social Charter enumerating and enforcing minimum wages and working conditions, minimum social and economic rights, and appropriate

environmental standards. Unfortunately, current prospects for attaining such comprehensive global agreements are dim. Governments everywhere are beholden to national and global economic elites who are either quite content with the status quo or who want to push the **neoliberal** agenda even further. Cross border labour and citizen alliances are developing, but they have not evolved to the point where they could have a serious impact on global economic policy. 'The focus on nation states derives primarily from a pragmatism born of a total inability to conceive, let alone construct, a meaningful political process at the global level' (Bienefeld, 1994, 122).

Thus, the best political prospects for major change exist at the national or regional levels, but here is where the economic impediments to the implementation of effective controls are greatest. Comprehensive controls in a single nation, if they remain in place for a long period of time, become increasingly difficult and costly to administer and, under the intentionally leaky enforcement procedures that normally prevail, increasingly easy for the economic elite to evade." The smaller (and more politically isolated) the country and the tighter its integration in and dependence on world markets, the harder the problem becomes. It is especially hard for a small, globally dependent country to unilaterally implement powerful comprehensive capital controls designed to thwart all the forces that will rebel against permanent, egalitarian full employment policies.

This is not to say that it cannot be done. If the government's economic plan is comprehensive and coherent and consistently implemented and if the controls enforcement mechanisms are powerful and vigorously, even ruthlessly, enforced, then the successful use of long term controls by smaller countries is possible – as South Korea and Taiwan, among others, have demonstrated. Nevertheless, the political units best able to unilaterally adopt a programme of capital controls in pursuit of expansionary egalitarian policies and the eventual achievement of a new social contract are relatively large countries (especially those, such as the US and Japan, that are not excessively dependent on trade), and appropriate regional alliances, such as the EU.

Let us assume that, with the possible exceptions discussed below, it is most reasonable to consider the possibility of controls for the case of large nations or appropriate alliances. What set of capital and/or trade and/or direct investment controls would best facilitate the achievement of a new progressive full employment programme? The first thing to realize is that the answer to this question is contingent on all those things that influence the relative power and the political perceptions of the main economic classes; freedom of capital to cross borders is just one determinant of capitalist class power. **Any combination** of domestic economic policies and cross border controls that can bring industrial and rentier capital to political negotiations willing to accept a progressive social contract, or that can help

unite labour and segments of industrial capital against rentier intransigence is satisfactory. In the best of circumstances moderate controls might suffice. Under more common, less propitious circumstances, it might take relatively strong capital controls accompanied by a believable threat that the refusal of capital to cooperate in bargaining will result in the rigorous control of trade, investment and financial flows and a generally more interventionist state.

There is no single policy with respect to controls that is optimal in all countries under all circumstances. Nevertheless, we present below a sample list of feasible national or regional capital controls to emphasize that, under the right conditions, including controls in any strategy designed to produce sustained full employment is a pragmatic political act. The claim that strong controls are not technically feasible or economically sustainable is, we will show, simply inconsistent with the facts. We cannot over-emphasize the point that the primary impediments to the successful use of capital controls are *political*, not technical. It is not support for capital controls, but the contrary belief that progressive economic **restructuring** can be achieved without at least the threat of such controls that is utopian.

V. Capital Controls and International Cooperation

What Not to Do

The first task facing those who want to rein in the domestic political power of MNCs and global rentiers is to stop any further liberalization of the rules governing international capital mobility. At regional as well as global levels, moves are afoot to further reduce the ability of nations to control international capital mobility. This is especially true with regard to foreign direct investment. For example, the United States is proposing an extension of the North American Free Trade Agreement to Chile and other countries in the Caribbean and Latin America. This so-called 'Free Trade' agreement is primarily an agreement to reduce the ability of communities to regulate, restrict or control foreign companies which invest there. This will only serve to diminish national policy autonomy. For its part, while the EU continues negotiations for its enlargement, the rules governing the outflow of direct foreign investment to lower wage areas must be carefully monitored and shaped so as not to further enhance capital's bargaining position.

At the global level, negotiations are continuing for an agreement on the international protection of foreign investment within the framework of the World Trade Organization. These protections, if ratified, would dramatically reduce the ability of national democratic forces to establish restrictions on foreign investment. These attempts must be resisted. Finally, we should continue to oppose conditionality requirements imposed

by the IMF and World Bank which trade access to credit in return for limitations on the ability of nations to restrict capital mobility. But we should not stop here: a good offence is the best defence.

Stand-by Controls on Capital Flight

Instead of using international institutions to promote capital mobility, they should be used to limit destructive capital flight. A system of international stand-by controls on capital flight could be negotiated that required countries to return capital that crossed borders in violation of any nation's laws (Block, 1993, p. 170–171). Such stand-by controls would be especially helpful to the enforcement efforts of smaller, poorer countries. While small countries can and do implement capital controls, the costs of unilateral enforcement can be high, especially if the country is very dependent on imports, exports or foreign investment. There is ample precedent for such agreements. As discussed earlier, Keynes and White saw such international cooperation as a key to any sensible international financial regime, and they tried to write such cooperation into the Bretton Woods Agreements.

International cooperation in monitoring and controlling the movement of funds is already occurring, and the tightening of such controls seems virtually inevitable. Already, law enforcement officials from around the world are desperately seeking better mechanisms to restrict the laundering of drug money. **For example**, Switzerland has reduced its bank secrecy laws as applied to drug-related and other illicit financial movements partly as a result of pressure from the US. Efforts to reduce tax evasion by multinational corporations is another pressure point; many governments have an interest in seeking international cooperation to better identify and control the international movement of corporate funds. What is needed, then, is an extension of these ongoing efforts at international cooperation on the restriction of financial **flows** to include mandatory cooperation in support of national capital controls – as originally proposed by Harry Dexter White.

An Internationally Coordinated Transactions Tax

Another globally coordinated measure which has received wide discussion among academics and some international organizations is the so-called **Tobin Tax**, named after Nobel Laureate economist James **Tobin** (Tobin, 1978, 1994). The **Tobin Tax** is a small percentage tax on all foreign exchange transactions. It is designed to discourage excessive short term speculation without discouraging longer-term, presumably more efficient flows of capital and uses of foreign exchange.

The tax would work like this. Say the rate of tax is 0.5 percent on all foreign exchange transactions, both when buying and when selling foreign

exchange. An investor who buys \$1 million in foreign exchange, invests it in a foreign bank for 1 month, and then sells it again (and does this every month), will pay $(.005) \times 12 \times 2 \times \1 million or a total of \$120,000 in tax (or a tax rate of 12% per year). If she buys and holds only for one day, and she does this every day, she will pay tax at the rate of 365% per year. Only a very large expected profit on speculative dealings could justify such foreign exchange churning. On the other hand, if she buys and holds a 1 year bond, she will pay a tax of 1% or \$10,000 on a million dollar investment.

Tobin points out that such a tax would have to be levied globally or at least in all major financial sectors. Otherwise, foreign exchange transactions would simply move to an untaxed locale. Implementing such a coordinated international tax would be relatively easy. Any of the international financial institutions, such as the IMF, BIS, or **WTO** could implement and enforce the tax with the help of local authorities. The international coordination of financial regulation is widening and deepening in any case. Moreover, there are relatively few technical obstacles to such a tax, since the same computer technology that facilitates capital flows could be used to monitor and tax them.

However, there are serious limitations to the **Tobin Tax** as a mechanism for dealing with the disruptions created by contemporary international capital mobility. A small tax would not discourage massive speculation based on the expectation of a one shot, immanent, large devaluation, as in the recent British or Mexican cases. Indeed, mainstream advocates of the tax see this as an advantage: they do not want to discourage speculation against what they see as unsustainable or ill-advised policies.

Implementing an internationally coordinated **Tobin Tax** would be a major step forward and we strongly endorse it. But it would not be sufficient to qualitatively alter the domestic political class balance of power. While such a tax might allow for a temporarily lower interest rate in one country undertaking an expansionary policy, it would not protect countries implementing longer term policies which dramatically differ from the international lowest common denominator. Deeper and broader controls would likely be necessary to bring about the results we require. And these deeper controls are, in the present environment, likely to be implemented only at the national or regional levels.

VI. Capital Controls at the National or Regional Levels

Controls on Direct Foreign Investment

Consider first controls on foreign direct investment. There is a wide range of experience with constraints on the activities of **MNCs**. With respect to inflows, many countries have restricted the purchase of domestic

companies by foreigners anywhere in the economy (South Korea) or in certain sectors (oil, Mexico). Other countries have allowed only the purchase of minority shares in companies, or in companies of particular sectors (the media, U.S.). With respect to outflows, countries have placed general restrictions on foreign direct investment (South Korea), or have controlled particular investments, (for example, the sale of sensitive high technology production processes to potential enemies). The general considerations outlined above apply here: the point is to get sufficient control over capital to create a qualitative change in the domestic political balance of class power.

Restrictions on Bank Lending to Non-Residents

A widely discussed measure which would discourage shorter-term flows is based on the recognition that speculators must first obtain a currency before they can sell it. Nonresident speculators often borrow domestic currency from financial institutions for future resale. To reduce the incentive for such speculation, countries or regions could place a tax on lending to non-residents, or a requirement that a portion of all such loans be put into a non-interest bearing account (Eichengreen, Tobin and Wyplosz, 1995). In the case of a deposit requirement, the size of the requirement could be proportional to the size of the loan. Because speculators receive no interest on these deposits, they function as a tax. The higher the interest rate, the higher the interest foregone, and thus the higher the tax rate. Hence, the higher the interest rate differential between home and abroad (and therefore the greater the incentive for speculation), the higher the rate of the tax.

These controls could eventually become quite leaky. Residents may begin to borrow from domestic banks in order to lend the money to non-residents, thereby circumventing controls. Advocates of such controls, therefore, see these policies as being effective only in the short term. For longer term controls on capital, stronger medicine is clearly required.

Using the Tar System to Reduce Capital Mobility

Perhaps the easiest and most efficient way to reduce destructive capital mobility is to use a well developed, politically accepted institution which all advanced industrial countries rely on: the tax system. The great advantage of reliance on the tax system where feasible is that it involves no new bureaucracy and, at least in the advanced countries, is reasonably cost effective.

Consider first the imposition of a 'Keynes' tax – a tax on the sale of any financial asset held for less than a target length of time, say one or two years. (See Baker, Pollin and Schaberg, 1995)¹² The Keynes tax is a natural complement to the Tobin tax because before large sums of 'hot' money can

flee the country, they must first be **harvested** through the sale of assets or by borrowing. Taxing the sale of the asset and taxing the foreign exchange transaction should have the same qualitative effect on the profitability of flight. And a Keynes tax can be applied unilaterally. Of course, since it penalizes domestic financial market 'churning,' a Keynes tax would also have a salutary effect on the stability of domestic financial markets. Similar results could be obtained through changes in the provisions of the capital gains tax: penalty rates (relative to ordinary income) applied to the sale of assets held for less than the target period could be very effective.

The tax system can also be used directly as a type of capital control by treating differentially income generated from foreign and domestic financial investment. For example, until this year the tax treatment of gains and losses on the foreign and domestic securities held by the very powerful Japanese insurance industry were set so as to severely limit the incentive to invest abroad. These tax laws were quite effective in achieving their desired results. Institutions such as pension funds and insurance companies hold large and rapidly rising shares of advanced country domestic financial wealth, and they are trading securities across national borders at an increasing rate. By taxing the gains from cross border investments at a penalty rate and by discriminating against the deductibility of cross border losses, governments could substantially reduce the propensity of money to move into and out of the country.

Another way to see the point that the tax systems can be used to control capital mobility is to note that in some cases tax systems already promote capital outflows. In the United States, for example, tax rules that govern multinational corporations' transactions (such as transfer pricing, deferral of tax payments and deductibility of taxes paid in foreign jurisdictions) have had the effect of promoting outward foreign direct investment. These rules could be changed to discourage such outflows.

Focusing on the tax system makes it clear that enforcing international capital controls need be no harder (and no easier) than imposing taxes. Taxes, like capital controls, are, to some degree, evaded. It costs money and takes effort to collect taxes as it does to control capital mobility. But where there is a will to collect taxes, they are collected; it would simply take a change in the tax law to extend this mechanism to reducing international capital mobility.

Dual Exchange Rates

Dual (or multiple) exchange rates can substitute for or reinforce the tax proposals discussed earlier. (See **Dornbusch**, 1989 and Glyn, 1995.) A major problem with capital flight, as noted above, is that it can significantly lower the exchange rate, **greatly** increase the cost of imports, and thereby substantially lower the standard of living. The destructive effects

of capital flight could be reduced if their impact on the cost of imports could be attenuated or eliminated.

That is what dual exchange rates attempt to do. Separate exchange rates are established for trade and capital transactions. The government stabilizes the rate used for trade, but allows the rate used for capital transactions to float. In this system, even if capital flight greatly depreciated the value of the exchange rate, businesses would be able to obtain foreign exchange from the government at the old rate in order to import products. Hence, the attempt by speculators to sell domestic currency need not increase the cost of imports. Such dual exchange rates have been widely used, particularly in developing countries. In 1975, three industrial countries used dual exchange rates, and 22 developing countries did so. By 1990, only one industrial country (South Africa) used them, but the number of developing countries using them increased to 34 (Mathieson and Rojas-Suarez, 1993, p. 5). Andrew Glyn (1994) has recently proposed using them in Great Britain.

A difficulty with dual rates is that people try to evade them by buying the cheaper currency from the government, then using it to purchase financial assets abroad. Hence, a strong enforcement mechanism may be required to reduce the likelihood that the country will run out of foreign exchange because of illegal capital flight. Eventually the government may find that it needs to implement quantitative controls.

Quantitative Restrictions

The most commonly used capital controls are quantitative in nature. There have been a dazzling array of controls used by different countries at different times. In 1975, 17 industrial countries and 85 developing countries had some types of quantitative restrictions on payments for capital transactions on the books. By 1990, 11 industrial countries and 109 developing countries had them.¹³ Of course, having them on the books and strongly enforcing them may be two different things. In the 1992 ERM crisis, for example, Ireland and Portugal implemented strong capital controls simply by enforcing and strengthening controls that were already law. To give the reader an idea of current practice, we list some examples of controls that have been used recently (IMF, 1995, ch. 5).

In Ireland in 1992: (1) all credits to nonresident Irish **pound-denominated** accounts in excess of 250,000 pounds had to be reported to the Central Bank unless the credit was trade-related; (2) residents were not allowed to make financial loans in Irish pounds for periods of less than one year to nonresidents without the permission of the Central Bank; (3) foreign currency accounts were available to residents but with restrictions: for example, deposits made with funds converted from Irish pounds had to be held for at least three months; (4) forward foreign exchange transactions

in Irish pounds for speculative purposes were prohibited – minimum maturity requirements of 21 days were imposed; and (5) as the crisis developed, the law was strengthened so that all currency swaps required central bank approval (IMF, 1995, p. 104). In Portugal during the same crisis, all short term local currency lending to non-residents was prohibited.

More comprehensive quantitative controls have also been used. These could be held out as a threat to bring capital to the bargaining table if milder controls don't suffice. For example, in Argentina, in April 1982, (as in many countries in the early post-war years) all sales of foreign exchange were prohibited except for imports and for principal repayments and interest payments on foreign loans. In Mexico in the summer of 1982, all foreign exchange transactions were made subject to control, with the Banco de Mexico (and its designated agents) being the only authorized foreign exchange supplier. A 5,000 peso limit was imposed on imports and exports of domestic currency and limits were placed on the amount of foreign currency that could be taken out of Mexico by each person. Insurance of payments and other transactions in pesos abroad by Mexican credit institutions was prohibited. Profit and royalty remittances associated with foreign direct investment in Mexico were limited to 15 percent of equity subject to foreign exchange availability (IMF, 1995, p. 106). And the list goes on.

As these examples suggest, there is a whole panoply of quantitative controls which can and have been used. These range from controlling a select set of transactions to controlling all uses of foreign exchange, including trade. There is no shortage of examples and experiences to either adopt or to use as a threat.

VII. Conclusion

Two questions immediately come to mind when assessing the case for **capital** controls. First, even if they worked would they be a good thing? Second, will they work, for how long and at what cost?

Even if one dismisses the notion that unfettered free market capitalism delivers the goods, one may still raise objections to capital **controls**. First, won't they reduce the flows of capital to poorer countries that badly need them (Block, 1993)? The best answer is that private capital markets are currently doing a poor job of transferring useful capital to most poor countries. In fact, the net flow of capital to poorer countries is much smaller than is commonly realized. There are substantial two-way flows, but little net transfer of funds; and much of what does flow is short term and unstable (Block, 1993; Epstein, 1995; Epstein and Gintis, 1992). The citizens of Mexico as a whole did not benefit from the huge flow of mutual

fund money that went their way (Danby, 1994; Grabel, 1995). What is needed is a much better public mechanism for capital transfers to poorer countries. not more unstable two way flows.

Second, won't controls drive financial business away from a country's financial centre and cost income, revenue and jobs? This threat is often highly exaggerated. Andrew Glyn argues that the City of London's dealings in sterling (as opposed to other business), actually brings in very little revenue to the UK. He notes that 'The City's contribution to the balance of payments is indeed invisible in more ways than one' (Glyn 1994, p. 196). But even if this financial business is lost, that may not be such a bad thing. Many financial sector jobs in the US and other financial centres are not by most accounts socially **productive**.¹⁴ These clerks and **MBA's** could be much better used elsewhere in the economy. Indeed, that is one point in favour of capital controls: they can facilitate policies that will achieve a more socially rational use of physical and human resources.

There is evidence based on statistical analysis and case studies that suggests that capital controls can be effective, at least in the short to medium term. Marston (1995) shows that capital controls on outflows were effective in keeping domestic interest rates in Britain, France, and Germany below international levels in the 1960s and 1970s, before they were dismantled. Grilli and Milesi-Ferretti (1995), in a study of 61 developed and developing economies, find that countries with exchange and capital controls tend to have lower inflation adjusted interest rates than those that don't. Epstein and Schor (1992) report econometric work indicating that in the 1970s and early 1980s countries with capital controls tended to have lower unemployment rates. Manuel Pastor (1987) and James Boyce and Lyuba Zarsky (1989) both report econometric studies which suggest that capital controls reduced capital flight in the 1980s in a number of developing countries. Most of these studies refer to controls on outward flows. The International Monetary Fund report (IMF, 1995) on the experience of many countries with inward capital controls during the last five years or so found that such controls have been effective in stabilizing exchange rates and interest rates.

The strongest and most convincing evidence that relatively strict capital controls are not only technically feasible, but can be used successfully as a crucial component of a national interventionist strategy to achieve long term growth and stability has already been presented. The so-called 'economic miracles' of late 20th century capitalism – including Japan, South Korea, Germany and Sweden – all used capital controls in conjunction with a whole set of interventionist policies to achieve **decades-long** prosperity. These cases provide compelling evidence that controls, when implemented properly and embedded in a coherent national economic-plan, can work **brilliantly**. Of course, progressive economists

have no desire to simply replicate the Japanese and South Korean development experiences. The design and implementation of an effective long term interventionist growth plan requires a prior political 'contract' or agreement that forces all major class strata to accept the roles and responsibilities given to them in the plan. In both Japan and South Korea, this political commitment was imposed by force on the weaker classes by the stronger. Japan smashed labour's political power in the late 1940s (with the help of US occupation forces) while Korea 'still enforces tough anti-strike laws that go back to the years of military rule' (Tsuru 1993; Wall Street Journal, Oct. 20, 1995, p. **A9A**). We hope to see the enactment **and/or** threat of controls used to help democratically create the political preconditions required for the constitution of an effective and progressive economic programme. Unless and until working people can substantially reduce the economic and political power of rentiers and globally oriented industrialists, no such progressive economic programme will be possible. Capital controls can help solve this political problem. Whatever their other flaws, the experience of the 'economic miracle' countries demonstrates conclusively that there are no economic or technical impediments to the successful use of controls.

But haven't things changed? Aren't Japan, Korea and the other 'success stories' dismantling their controls? To some extent, they are. But, as we have stressed, the **primary** reasons are political, not economic or technical. An extremely interesting study by Daniele Checchi (1992) suggests one reason why even countries that have used controls effectively are retreating from them to some degree. In a careful econometric analysis he found that in two out of three **countries** he studied (that is, in Great Britain and Japan, but not in Australia) more intensive use of capital controls was associated with a higher labour share of income. Hence, capital controls, possibly by contributing to lower unemployment and more rapid economic growth, may have enhanced labour's power vis-a-vis industrial capital and rentiers.

The evidence reviewed here supports our thesis that capital controls are technically feasible, and that even comprehensive controls can be maintained for long periods of time with very positive effects on economic performance. Thus, as we see it, it is a mistake for the debate about controls on the left to continue to focus on their technical feasibility. That is not really in dispute even on the right: as *The Economist* put it recently, those 'who demand that the trend of global integration be halted and reversed, are frightening precisely because, given the will, governments could do it' (Oct. 7, 1995, **p.16**, emphasis added). Indeed, as we noted at the beginning of this essay, it is not at all clear that even if progressives fail to support capital controls they will stay off the political agenda. It is virtually inevitable that another financial earthquake such as global rentiers recently experienced in Mexico will erupt in the future, perhaps next time

in the more dangerous form of a financial meltdown in a major country. One of these events is likely to trigger a demand for the reinstatement of controls by rentiers and industrialists. The left had best come to grips with the question of controls before they are unilaterally imposed on us by our political enemies.

It is often argued that the implementation of capital controls by a progressive government is self-defeating because capital will flee the country as soon as the policy is given serious political attention, before the controls can be implemented. There is some validity to this argument, but it applies as well to any serious policy proposal (such as low interest rates, higher taxes on the rich or tighter financial market regulation) perceived to be against the interests of rentiers. Should we abandon support of all progressive policies out of fear of such retribution? In any case, several considerations suggest that the problem may be manageable. If capital controls are part of a sensible, believable overall plan to raise the rate of economic growth and reduce economic uncertainty over the longer run, some holders of longer term real and financial assets might not see flight as their most profitable option. More important, the *sequence* in which various controls are introduced can affect the degree of severity of the problem. Suppose relatively moderate Keynes and Tobin taxes are introduced first. If more powerful controls are contemplated thereafter, they can be preceded by a substantial rise in the magnitude of these taxes. In the same vein, taxes on some transactions involved in the flight of capital can be applied retroactively, again limiting the gain from flight. And it is possible to enact *standby controls* in conditions where there is no immediate plan for their implementation. At some future time when more comprehensive controls are considered, the standby controls can be used without prior notice to prevent anticipatory capital flight. That is, under proper sequencing, the cost of flight can be raised just as the incentive to flee goes up.

In sum, these problems are indeed serious, but not in principle insurmountable. What remains most relevant is the potential contribution of capital controls to the economic success of a progressive full employment policy regime and their ability to change the political power of the contending classes.

Politically, the real question is whether it is likely to be possible for a democratically constituted majority coalition to wrest effective control over government economic policy in all its dimensions from rentiers and industrialists in the absence of controls or, at bare minimum, the credible threat of their implementation. That is, can the veto power over economic policy currently held by an increasingly powerful, arrogant and pitiless capitalist class be broken by working people without the use of controls? Is Andrew Glyn correct that the most effective way to solve the severe

problems of the current conjuncture is for the working class to unilaterally agree to pay any and all costs that arrogant capital might demand for its permission to move the economy closer to full employment?

Our answers to these questions are clear. We believe it will not be possible to restore the political and economic position of working people to anything resembling their Golden Age status (never mind improving on it) unless we can successfully challenge the domestic political power of capital. Since one of the crucial pillars of capitalist power is the unrestricted freedom of rentiers and MNCs to roam the world in search of economic profit and political dominance, constraints on this freedom in the form of capital and trade controls are a necessary precondition for the creation of a more favourable class power balance. Without a substantial structural rise in the power of labour relative to capital, the hoped for constitution of a 'new deal' committing capital, labour and the state to the pursuit of sustained full employment, greater economic equality and a more adequate social welfare system may turn out to be nothing more than a dream. And if that turns out to be the case, if the neoliberal regime continues to deepen and strengthen, the cost to humanity may prove to be incalculable.

NOTES

1. We are grateful to Leo **Panitch** and Ilene **Grabel** for helpful comments on an earlier draft.
2. The term 'social contract' is used in this essay in a metaphorical rather than a literal sense. It refers to the multiplicity of laws, formal agreements, and informal arrangements, conventions and practices through which capital, labour and the state, or various segments thereof, coordinated their actions in pursuit of agreed-upon economic objectives. When in the course of this essay we argue in favour of the use of controls over international economic flows as a means to force capital to 'negotiate' a progressive new 'social contract' or a 'New Deal' with labour and the citizenry, we do not mean to limit our political vision to some grand national convocation of labour, capital and the state. A new 'social contract,' should one eventuate, is more likely to evolve from a wide range of economic and political agreements negotiated at various private and public sites.
3. However, the report maintained the **IMF's** strong opposition to controls on outflows.
4. See also the excellent collection of articles in Michie and Smith (1995), especially the chapters by **Akyuz**, **Cornford** and **Kelly**.
5. By global rentier class we mean national rentiers with an interest in the free flow of capital across borders. While such rentiers do not, strictly speaking, constitute a class, they do have important economic and political interests in common. Moreover, these common interests are institutionally represented by the World Bank, the **IMF**, and most of the central banks of the world.
6. For other discussions of the rise and fall of the Golden Age and the Bretton Woods System, see Block, 1977 and **Marglin** and **Schor**, 1990.
7. The discussion here draws very heavily on **Henning** (1994), **Goodman** and **Pauly** (1993), and especially **Helleiner** (1994).
8. A growing proportion of this increasing pool of public debt is held by nonresident rentiers. And government bonds held by foreigners have a much higher rate of turnover than bonds held domestically. Thus, 'the opinions of international bondholders have become increasingly important in countries with big public-sector debts. In recent years

bond markets have passed votes of no confidence [in the fiscal policy of] several heavily indebted governments, including those of Canada, Italy and Sweden.' Moreover, 'when the global capital market dislikes an economic policy it moves fast' (*The Economist*, Oct. 7, 1995).

9. A recent *Wall Street Journal* article on the transfer of technology and high skilled jobs from the US to China by the Boeing Corporation noted that the cost to Boeing of equivalent labour in China and the US was \$120 and \$3,530 per month respectively (Oct. 10, 1995, p.1).
10. *The Economist*, Oct. 7, 1995. Glyn (1995, p. 48) reports that daily turnover is 'four times the total gross central bank intervention during the 1992 ERM crisis (\$270 billion).'
11. Since small country governments are often tightly controlled by economic elites, it is not surprising that they normally permit themselves modes of evasion of their own capital controls. Controls are not in principle unenforceable. Consider for example the case of South Korea, where 'violations of prohibitions on overseas capital transfers were punishable by a minimum sentence of ten years in prison and a maximum sentence of death' (Grabel, 1995, 28-9). Since the Korean government was serious about enforcement, its controls were quite effective for decades.
12. As Baker, Pollin and Schaberg note in their Table 1, numerous industrialized countries have financial transactions taxes, including the U.S., which has a .0004% tax on stock sales. As discussed above, since domestic currency can also be borrowed and then sold abroad, deposit requirements or taxes on borrowing may also be required to get maximum effectiveness from the Keynes tax. But since a large portion of the run away funds will come from the sale of domestic financial assets, the Keynes tax should be reasonably effective even on its own.
13. The total number of countries included in the sample increased from 128 in 1975 to 153 in 1990 (Mathieson and Rojas-Suarez, p. 5, Table 1).
14. See Crotty and Goldstein, 1993, on the allocational inefficiency of US financial markets. Robert Fitch (1994) has vividly described how reliance on global and domestic banking, real estate and insurance has helped bring the city of New York to its knees.

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