Comments on the paper `Innefective controls on capital inflows under sophisticated financial markets: Brazil in the nineties´ by Bernardo Carvalho and Márcio Garcia

It is perhaps important to insist on the persistent relevance of the issue in Latin America as populist strains of economic policy prove to be extremely resistant in several economies and a backlash does not seem out of the question in the more extreme cases. Only last Monday Brazilian newspapers carried an article by a former Finance Minister who feigned surprise to find out that there were still economists who proposed a deepening of the liberalization of capital controls in Brazil.

Carvalho and Garcia´s paper is structured in three parts. There is a perhaps too short history of capital controls in Brazil, followed by a detailed discussion of cases of circumvention of capital controls between 1993 and 2000, and a vector autoregression analysis testing whether controls on capital inflows in Brazil have been effective in reducing the inflow of financial capital.

It would be interesting to have a bit more material and also more precision on the historical aspects on capital flows. It does not ring true that exchange rate controls did not apply to foreign direct investment in the past. Recurrent wrangles about how reinvestment should be treated both in the early 1950s and in the early 1960s had to do with registration of reinvestment as foreign direct investment and so with capital controls even if in a roundabout way. Still clearer is the relevance of circumvention of desincentives of foreign

direct investment inflows implied in the incredibly complex multiple exchange regimes adopted in the 1950s. The possibility of importing capital goods without going through the foreign exchange market was a vital discretionary element in the attraction of foreign direct investment coupled with all sort of subsidies, absolute protection and carefully controlled right of establishment.

The treatment of a long list of techniques used to circumvent capital inflow control is extremely interesting. But perhaps too many circumvention cases are examined in detail in the paper with a resulting loss of focus. It would be useful to have such cases classified under some taxonomy. Focus could then be centered those circumvention techniques which are less-country specific and/or relatively more sophisticated. Good candidates would be short-term capital flows disguised as foreign direct investment (case 1), labeling fixed investments as equity investments (cases 2 and 3) and investing through box operations with options for earning fixed income returns (case 4). And also swaps of blue chips and CC-5 (non-resident accounts) positions (case 10) and trade in international derivatives markets (case 11). The other cases – privatization currency (case 5); ACC (foreign forward currency arrangements) (case 6); BACEN Resolution 63, so-called Caipira, operations (case 7); Siderbrás debentures (case 8); bond issues with options to exceed the minimum loan terms (case 9) – seem all to be of relatively secondary interest and too specifically focused on Brazilian recent experience. It would have been good to get a clearer picture of the relative actual and potencial importance of such circumvention techniques even if based on rough estimates of market size.

The econometric analysis depends crucially on measures of the importance of capital controls. The indices for capital inflow and capital outflow controls are derived from the accummulation of specific measures introduced by the Brazilian authorities updated to 2004 [from Cardoso and Goldfajn, IMF Staff Papers, 1998]. These indices are a rather crude proxy to measure restrictions imposed by capital controls as recognized in a specific footnote. But the acknowledgement is perhaps not enough to reassure us. Very significant measures are deemed to have had the same impact as rather minor ones. For instance, for the period before 1995, minor changes in travel foreign exchange allowances and major changes in the taxation of foreign borrowing. It would perhaps pay to go beyond counting and look more closely into specific measures and assess their relative importance so as to capture their different intensity.

It is slightly disturbing that indices purporting to measure the impact of capital controls inflow do not somehow reflect the paper´s essential idea which is that capital controls lose power over time. The paper´s conclusion would seem to imply a criticism of the index used to measure capital controls.

In any case a list of measures which were considered relevant in 1995-2004 would be welcome and complete extant lists for the former period [Cardoso and Goldfajn, IMF Staff Papers, 1998].

The vector autoregression analysis testing whether controls on capital inflows in Brazil have been effective in reducing the inflow of financial capital covers only the 1995-2001 period. Does the number of observations

warrant too strong conclusions based on the vector autoregression analysis? Zero impulses are included within intervals of confidence in all four exercises based on different capital inflow measures. These problems should have been explicitly discussed.