Making capital controls work

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A commentator called Milano asked yesterday:

Given today's highly interconnected plumbing (gilt repo, FX swaps, CCPs, non-bank leverage) and the fact that Thatcher's government first used an Order in Council in 1979 to switch off exchange controls and then, in 1987, repealed the Exchange Control Act itself so there's no longer any off-the-shelf legal framework, introducing measures like this would obviously require a very strong and determined government.

What do you think the first practical steps would be in terms of legislation, the Bank of England's remit, and PRA/FCA rules to introduce capital controls that actually work in the system we have now? I'm aware there's a growing literature on this, but in everyday discussion this is the question people most often use to dismiss or undermine any proposal for radical change, a bit like Rory constantly asking "yes, but how would you actually do it in practice?". I'd be really interested in how you'd answer it in concrete, worked-through terms.

Keeping myself to the 400-word limit allowed for comments on this blog, I answered as follows (although I admit I have edited this very lightly):

You are right to say that Thatcher did two things: first, she used an Order in Council to switch off exchange controls in 1979; then, eventually, she scrapped most of the legal framework.

She also removed the "Corset" (Supplementary Special Deposit Scheme), which was the Bank of England mechanism designed to restrict the growth of the broad money supply between 1973 and 1980 by penalising banks that lent too much, as well as relaxing hire purchase rules and deregulating Building Societies to allow them to lend more. Thatcher's changes were widespread.

Ever since, those who benefit from an open-door system have pretended that this history makes capital controls impossible. It doesn't. It just means we have to legislate again.

First, we would need a new Capital Management Act. That would give the Treasury powers to require registration and reporting of cross-border financial positions, to impose quantitative limits or charges on classes of flows (for example, short-term wholesale funding), and to direct the Bank of England and the regulators to use their tools to achieve those aims. The old Exchange Control Act is a precedent: it shows Parliament has done this before.

Second, the Bank of England's remit would have to change. Alongside price and financial stability, it must have an explicit duty to maintain external and capital-flow stability. It would then be required to use macro-prudential tools, such as counter-cyclical capital requirements on foreign exposures, reserve requirements on short-term foreign liabilities, and limits on FX mismatches, to pursue that goal. Access to sterling liquidity could be restricted to institutions that comply.

Third, the PRA (Prudential Regulation Authority) and FCA (Financial Conduct Authority) rulebooks would need to be revised. All sterling payment, clearing and repo activity for UK residents should take place in supervised entities that disclose their beneficial ownership and meet new reporting standards on FX, derivatives and securities financing. Time-varying regulatory charges (otherwise known as a Spahn tax), which are the equivalent of a transactions tax, could be applied to destabilising, short-term financial flows. Highly leveraged non-banks reliant on foreign funding could face tighter liquidity and leverage rules as a result.

Finally, we should not underestimate the importance of transparency. A public register of major cross-border positions, linked to company accounts and trust disclosures, would itself change behaviour.

None of this is technically challenging: banks already track these positions. What is missing is not the how, but the political will to say that managing capital flows is a normal function of a state that wants an economy which serves its people.

I now believe that this is an essential direction of travel.

Comments