Why not limit capital inflows?

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Because this policy goes against the neoliberal fundamentalist principles that the economists learned in their schools.

Last week, in view of again another appreciation of the Brazilian currency real, my wife, who is not an economist but a psychoanalyst, said to me that this come-and-go was very harmful. Using her common sense, she asked me why the capital inflow and outflow was not limited. I answered that the capital inflow is not limited, because this policy goes against the neoliberal fundamentalist principles that the economists learned in their schools, and because it is not in the interest of the rich countries that the developing countries should have competitive exchange rates. On the other hand, as far as the capital outflow is concerned, it is another story: it should not be limited, because it is a sign of the country's financial fragility, it is a sign that the country did not control its public deficit and accepted the "good" advice of "growing with foreign savings", therefore allowing the country to be inundated with dollars, euros and yens.

Should the markets work the way their fundamentalists assume they do, the exchange rate would be the floating price, keeping itself reasonably stable and guaranteeing the balance of the current account of the country. However, given that the market, even being an excellent coordinator of the economy, is not able to accomplish this specific task, the exchange rate fluctuation in developing countries slopes towards the appreciation, which, if not corrected by the government, ends up in a balance-of-payment crisis. Such trend has structural causes, associated with the Dutch disease and with the greater profitability of the investments, to which the conventional orthodoxy policies of growing with foreign savings, exchange rate anchor and high interest rates are added.

Due to the existence of such volatility and mainly of such trend to overvaluation, the successful developing countries manage their exchange rate by preventing the overvaluation from occurring. Formerly, this effect was achieved through the fixed exchange rate regime, but it has become gradually evident that it was better to let the national currency float in the market, while managing it. Such was the practice recommended by Keynes that is what the common sense tells us. Yet the neoliberal orthodoxy calls this practice "dirty fluctuation", despite all contrary evidence insists that the market is a good exchange rate coordinator, and still against all evidence states that it is impossible to manage the exchange rate, and at last condemns to the flames of hell those who defend the inflow control whenever the capital inflows are very strong. Only "populist" economists could do this.

The problem is not simply ideological. It is in the best interest of the financial traders to have exchange rate fluctuations in developing countries, because this is one of the sources of their gains. And it is particularly in the best interest of the rich countries that convey to us this “economic truth” to have an exchange rate that tends to be high in developing countries. Thus their disadvantage in international markets caused by higher salaries is compensated by the overvalued exchange rate in developing countries, especially in middle-income countries, which are their great competitors.

The biggest evil faced by developing countries is the international financial fragility. If the country adopts a correct macroeconomic policy, based upon a balanced public budget, moderate interest rates and competitive exchange rates, the country will not need to control the capital inflow, except in special moments. If it listens to the fundamentalism, it will be always at the edge of a crisis, and asking for help from its wealthier competitors.