Lessons from Brazil's capital inflow tax
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Australia is not the only country facing uncomfortable upward pressure on its exchange rate. With the prospects of a two-speed world and sustained interest differentials between the slow-growth countries and the swift, there is the likelihood of continuing upward exchange rate pressures in many of the emerging countries, including our neighbours in Asia.

Already Brazil, facing the prospect of excessive capital flows bidding up asset prices, has imposed a 2 per cent tax on foreign portfolio inflows, which had the immediate effect of halting the rise in equity prices and the exchange rate, at least for now.

Brazil's action reflects just the latest manifestation of a protracted debate on international capital flows, still unresolved. Volatile capital flows were a central element in the 1997-98 Asian crisis, not fully recognised or acknowledged at the time. With exquisitely bad timing, the International Monetary Fund made a doomed attempt in 1998 to mandate free capital flows, giving them the same status as trade flows.

Ten years on, the global slump revealed new facets of this debate. US Federal Reserve chairman Ben Bernanke is just one among many who blame excessive international imbalances and the capital flows associated with them for causing the crisis. It is argued that the inflows bid down US interest rates and provided the funding for excessive credit.

But this argument sits uncomfortably with two of the building blocks of established US economic policy. It was the US that was behind the IMF's attempt, in 1998, to open up world markets for free capital flows. It seems inconsistent now to see these flows as a source of serious vulnerability for the largest economy, with the deepest and most mature financial markets.

Second, the Fed has a high degree of control over its interest rates. To argue that external events significantly altered interest rates beyond the control of the authorities would be to acknowledge a substantial weakness of current monetary policies.

In practice, the story for countries like the US is that capital flows are largely benign. The two macro-policy contributors to the slump were not directly associated with capital flows.

The first was that the Fed set interest rates too low for too long after the bursting of the tech bubble in 2001. This encouraged borrowers while at the same time tempting investors to search for yield through riskier investment. The second contributor was the near-zero household saving rate in the years leading up to the slump, so foreign funding was needed to finance the external deficit. Capital inflows were more a response to these problems rather than the cause.

For countries like Brazil (and most of the countries of East Asia), capital inflows present a different – and greater – challenge. Financial markets in these countries are small (so the inflows from world markets are overwhelmingly huge) and are not deep or resilient, so they cannot easily absorb the flows. Also, their exchange rates are less well anchored than the currencies of mature economies.

What should emerging countries do? First, let's see how the Brazilian tax works out. The IMF, true to form, has provided some tut-tutting commentary about the dangers of interfering with markets, but this can safely be ignored.

The Brazilian policy is a variant on an old theme. Over the years, many countries have imposed some form of tax on capital inflows.

Usually, foreign investors are required to deposit a proportion of the inflow funds in an unremunerated government account. Australia's Variable Deposit Requirement in the early 1970s was just one example. This worked so effectively it had to be rescinded because it choked even the stabilising elements of capital flow.

More recently, Thailand attempted to impose an unremunerated deposit requirement when faced by excessive capital inflow in 2006, but in this case the financial markets complained loudly enough to have the measure revoked.

Now, with the slump having shaken our faith in the market's price discovery capabilities, the Brazilians might be able to give it a fairer test.

The key to successful use of this sort of measure is to see it as a temporary counterweight or offset in response to excessive flows and excessive asset price movements (including the exchange rate).

The emphasis is on "excessive". Neither inflow taxes nor exchange rate intervention can stand in the way of the longer-term fundamentals. None of this will be comfortable for Brazil's tradeable sector, especially manufacturing. But its "sand in the wheels" of foreign capital inflow can address only the overshooting, not the fundamentals.

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