CIVIL SOCIETY FINANCING FOR DEVELOPMENT Mechanism

BRIEFER

Capital Controls to Manage Volatility and Systemic Risks

It is widely acknowledged that there are risks associated with cross-border capital flows, and that these risks grow with their volume, procyclicality, and volatility. In particular, short-term capital flows pose serious challenges for policymakers in Emerging Market and Developing Economies (EMDEs), as surges in capital inflows are frequently followed by large reversals ('sudden stops'), resulting in systemic financial crises.

Since the early 2000s, the magnitude and volatility of global capital flows have increased considerably, prompting EMDEs policymakers to recognize the important role of capital controls in mitigating systemic risks that cannot be resolved through macroprudential measures or the accumulation of large foreign exchange reserves, which are also costly to hold.

Capital controls may be viewed as a less expensive policy tool for mitigating volatility in capital flows. As detailed in Box 1, capital controls come in several varieties. Controls on capital inflows could potentially alter the composition of inflows towards longer maturities[1], thereby reducing financial vulnerability. Conversely, restrictions on outflows aim to prevent sudden capital outflows and currency depreciation, as witnessed in Malaysia (1998), Iceland (2008), China (2016), and Argentina (2019). Additionally, controls on outflows are considered to be particularly significant for smaller and weaker economies, as they often lack substantial foreign exchange reserves or access to currency swap lines and regional financing arrangements.

Box 1: What are Capital Controls?

Capital controls are regulations that restrict or prohibit the movement of capital across national borders. The regulatory measures are designed to govern the capital account of a country's balance of payments[2] and, therefore, include restrictions on the movement of capital into or out of a country.

Capital controls can regulate a wide range of cross-border transactions carried out by both residents and non-residents in a country. These transactions may include money transfers, direct investments, portfolio investments, bank loans, etc. For example, a tax applicable only on non-residents' investments in domestic bonds or equities qualifies as a capital control. Similarly, caps on foreign equity investment in specific sectors (such as banking and defense) or limits on overseas investments by residents are also classified as capital controls, because these measures regulate the inflow and outflow of capital in a country.

Capital controls can be a combination of official, legal and quasi-legal instruments, and can take a wide variety of forms, including taxes on cross-border flows, unremunerated reserve requirements, investment caps, minimum stay requirements, multiple exchange rate systems, credit regulations, and outright prohibitions on certain types of capital movements.

[1] In finance, maturity is the specific date when a financial instrument, such as a bond, loan, or certificate of deposit, reaches the end of its term, requiring the issuer to repay the principal amount and final interest to the investor.

[2] All international transactions that alter the assets or liabilities of a country's citizens or its government over a given time period are recorded in the capital account of the Balance of Payments (BoP). It covers financial flows such as international loans, banking capital, portfolio investments, and foreign direct investment (FDI). A surplus in capital account denotes net capital inflows, while a deficit indicates net outflows.

Capital controls can be broadly classified into three categories: quantity-based, price-based and regulatory controls. Quantity-based controls involve explicit limits or prohibitions on capital account transactions. Such quantity-based measures on inflows may include: a ban on investment in money market instruments[3]; limits on short-term borrowing; and restrictions on certain types of securities that can be owned. In India, for instance, there is a cap on the aggregate foreign ownership of rupee-denominated government debt. On outflows, quantity-based controls can take the form of an explicit moratorium. In September 1998, for instance, Malaysia imposed quantity-based controls on outflows to eliminate the offshore ringgit market.

Price-based controls seek to alter the volume of capital transactions by altering their costs, with the intention of discouraging a particular class of flows and encouraging another set of flows. Price-based controls on inflows can take the form of a tax on stock market purchases and certain foreign exchange transactions; or the imposition of unremunerated reserve requirements (URR) on certain types of capital inflows. The URR on foreign loans imposed in Chile during the 1990s (also referred to as encaje) is a well-known example of price-based controls. Under Chile's encaje, anyone borrowing money from abroad had to deposit a set portion of the loan for one year in a non-interest-bearing account at the central bank. Price-based controls on outflows can typically take the form of an exit tax.

Regulatory controls can be both price-based and quantity-based, and such a policy package usually treats transactions with non-residents less favourably than with residents and directly influences the volume of financial transactions.

Closely related to capital controls are macroprudential measures (such as limits on loan-to-value ratios or capital buffers — the mandatory capital that banks are required to hold in addition to other minimum capital requirements) that do not discriminate on the basis of residency of parties involved in a financial transaction, but can indirectly influence inflows through restrictions imposed on domestic financial institutions.

Source: Based on Kavaljit Singh (2019), What Are Capital Controls?, Policy Brief # 1, Madhyam, January 2.

Following the 2008 Global Financial Crisis (GFC), the topic of capital controls has garnered significant attention and moved to the forefront of international policy discussions on economic governance. Capital controls are now widely acknowledged as a legitimate instrument of the macroeconomic policy toolkit as several EMDEs used a variety of capital controls to manage capital movements during the post-crisis period. Available evidence[4] suggests that countries that imposed tight capital controls recovered more quickly from the 2008 crisis and subsequent economic crises than those with an open capital account, particularly among emerging market and developing economies (EMDEs) China and India, two major fast-growing Asian economies, consistently deploy capital controls on both inflows and outflows on a permanent basis.

[3] Short-term, high-liquidity, low-risk debt securities with maturities of up to a year are known as money market instruments. Some key examples of money market instruments include Treasury bills, commercial paper, certificates of deposit, and short-term loans (often overnight) between banks. These instruments facilitate quick, low-cost capital for banks, corporations, and governments.

[4] See, for instance, Apoorv Bhargava et al. (2013), Capital Controls in Times of Crisis – Do They Work?, IMF Working Paper, WP/23/67, International Monetary Fund, March.

A Brief History of Capital Controls

Contrary to popular belief, most economies have extensively used a variety of capital controls to restrict and regulate cross-border capital movements. The significant decline in the use of capital controls corresponded with the ascent of neo-liberal ideology in the late 1970s.[5]

From the 1980s forward, the removal of capital controls became a key policy initiative under structural adjustment programmes supported by the International Financial Institutions (IFIs). In particular, the IMF became a strong votary of full capital account liberalization, as part of its broader financial liberalization agenda. However, it is important to point out that the IMF did not have, and continues not to have, jurisdiction over members' regulation of international capital movements under its Articles of Agreement. Despite this, since the 1980s, the IMF has gradually but steadily assumed authority over capital movements as part of its continuing 'surveillance' functions and operations under the pretext of furthering its goal of preserving the stability of the international monetary system.

The IMF is still reluctant to endorse the use of capital controls for the accomplishment of a myriad policy objectives. A close reading of the IMF's Institutional View[6] (IMF 2012) and its subsequent Review[7] (IMF 2022) reveals that there has been no marked departure from its longstanding bias against capital controls.[8] The IMF continues to view capital controls as a measure of last resort, imposed selectively on capital inflows, and on a temporary basis. The 2022 Review does not recommend using capital controls on outflows on a pre-emptive and lasting basis. 'The IV's proposition that outflow CFMs should be used only in crises or imminent crisis situations remains appropriate', says the Review. The IMF appears to be lagging behind current thinking and practice on capital account liberalization.

Capital Controls as the Cornerstone of Monetary and Financial Sovereignty

Vested with a responsibility to maintain financial stability within their jurisdiction, national authorities ought to proactively deploy capital controls and other macroprudential measures. Indeed, their domestic actions should inform and accelerate international policy development on managing the capital account. Although the formulation of an international policy agreement is highly desirable and may require considerable time to develop, it is imperative that national regulators act domestically. The freedom of countries to regulate international capital movements is also acknowledged in Article VI (Section 3) of the Articles of Agreement of the IMF, which has remained unchanged since its adoption in 1945.

International cooperation is feasible if the source countries are willing to assist recipient nations in managing volatile capital flows. This is because there have been several instances where EMDEs have experienced sudden stops in capital flows due to developments in the source countries, such as the tightening of interest rates and increased risk aversion among portfolio investors. Thus far, the two G20 working groups (International Financial Architecture and Framework Working Groups) under the finance track have not proven to be effective in enhancing international cooperation on managing capital flows.

[5] For a detailed analysis of capital controls, see Kavaljit Singh (2000), Taming Global Financial Flows: Challenges and Alternatives in the Era of Financial Globalization, Zed Books and Madhyam Books. Available at: https://www.madhyam.org.in/books-six-2/.

[6] IMF (2012), The Liberalization and Management of Capital Flows: An Institutional View, Policy Paper, November 14. Available at: https://www.imf.org/external/np/pp/eng/2012/111412.pdf.

[7] IMF (2022), Review of The Institutional View on The Liberalization and Management of Capital Flows, Policy Paper No. 2022/008, March 30. Available at: https://www.imf.org/en/Publications/Policy-Papers/Issues/2022/03/29/Review-of-The-Institutional-View-on-The-Liberalization-and-Management-of-Capital-Flows-515883.

[8] Kavaljit Singh (2022), Deciphering the Review of the IMF's Institutional View on Capital Flows, Briefing Paper # 52, Madhyam, April 5. Available at: https://www.madhyam.org.in/deciphering-the-review-of-the-imfs-institutional-view-on-capital-flows/.

However, several countries limited their policy space on capital account management because of restrictive clauses within bilateral and plurilateral trade and investment agreements. Going forward, it is recommended that countries revisit any agreements that prohibit the use of capital controls. Countries should strive to incorporate adequate balance of payment and prudential carve-outs that enable the use of these measures irrespective of commitments on transfer of funds, market access, and national treatment in the treaties. Likewise, it is suggested that the list of exceptions in the Treaty on the Functioning of the European Union and the OECD Codes of Liberalisation of Capital Movements ought to be augmented for reasons of preserving macroeconomic and financial stability.

Which Multilateral Way Forward?

A new multilateral agreement on capital account management, to be discussed and negotiated under the auspices of the United Nations, has also been advocated by civil society organizations. Such an agreement could provide the political consensus to reaffirm national sovereignty on capital accounts, encourage international cooperation, facilitate the renegotiation of trade and investment agreements, and clarify the mandates of international financial institutions.

The Role of an International Financial Transaction Tax

An international financial transactions tax (IFTT) could also assist in taming short-term volatile capital flows and generating additional revenue to support the financing of the SDGs and other global initiatives.[9] The successful implementation of various financial transaction taxes in India (as detailed in Box 2) demonstrates that the primary obstacles of its implementation are political in nature, rather than technical or administrative.

Box 2: Financial Transaction Taxes in India

(i) Securities Transaction Tax

In 2004, India introduced the Securities Transaction Tax (STT) in domestic equity markets. The STT is a kind of financial transaction tax levied on every purchase and sale of securities listed on Indian stock exchanges. Securities covering the STT include equity, equity futures and options (F&O), and units of equity-oriented mutual funds. In the case of F&O contracts, an STT is levied on all sell transactions. For the purpose of STT calculation, each future contract is valued at the actual traded price, whereas each option contract is valued at a premium.

The STT was introduced to raise tax revenue, curb tax evasion by market players, and reduce excessive speculation in the Indian equity markets.[10]

Over the years, the government has modified tax rates depending on market conditions. For instance, the government substantially increased the STT on options trading in 2023 in an effort to limit retail participation in the derivatives markets after a study by the market regulator — Securities and Exchange Board of India — showed that nine out of ten individual traders in the equity F&O segment incurred losses in 2022.

[9] Kavaljit Singh (2011), Why We Need a Financial Transaction Tax: A Proposal for the G20, Briefing Paper # 5, Madhyam, October. Available at: https://www.madhyam.org.in/wp-content/uploads/2014/07/Why-We-Need-a-Financial-Transaction.pdf.

[10] For a detailed discussion on the STT in India, see Kavaljit Singh (2001), Tax Financial Speculation: The Case for a Securities Transaction Tax in India, ASED-PIRC Briefing Paper, January. Available at: https://www.madhyam.org.in/tax-financial-speculation-the-case-for-a-securities-transaction-tax-in-india/; Kavaljit Singh (2004), Equitable Equity: India Introduces Securities Transaction Tax, Commentary, Madhyam, July 16. Available at: https://www.madhyam.org.in/equitable-equity-india-introduces-securities-transaction-tax/.

Table 1: STT rates for Different Types of Trades

Order Type	Tax Rate
Intraday	0.025% on the sell side.
Delivery	0.025% on the sell side.
Options	0.125% of the intrinsic value on options that are bought and exercised. 0.0625% of the premium for options that are shorted.
Futures	0.0125% on the sell side.

The STT has produced significant tax revenues since it was introduced in India. In the fiscal years 2023-24 and 2024-25, the Indian government collected INR337777 million (US$4.1 bn) and INR521968 mn ($6.1 bn) respectively through this tax. The STT collections for the current fiscal year (2026-27) are estimated to reach INR73700 mn ($8.2 bn) by the Indian government due to continuing buoyancy in the Indian equity markets, driven by both domestic and foreign investors, as well as an increase in the tax rates on F&O contracts. In the Indian context of resource mobilization, these are not insignificant sums.

Unlike other direct taxes, the STT is a simple, direct tax to implement. The tax is collected by stock exchanges from the brokers and passed on to the exchequer, thereby enabling the government to raise tax revenue in a neat and efficient manner. The Indian experience with the STT clearly shows that the main obstacles to its implementation are political, not technical, in nature. Some of the apprehensions expressed by market players and stock exchanges at the time of the introduction of STT have proven to be erroneous. The STT has not brought Indian markets to a standstill, nor has it dried up liquidity in equity markets.[11]

Nevertheless, there is an urgent need to tweak the tax rates to curb excessive speculative activities carried out by day traders, arbitrageurs, and 'noise traders' in equity markets. For instance, the STT rate for intraday securities trading should be higher than that for delivery-based equity transactions.

In addition, Indian equity markets are heavily tilted towards derivatives trading, especially high-risk options trading. In 2023, nearly 85 billion equity options contracts were traded in India, accounting for 78% of the total options contracts traded worldwide. In Indian equity markets, the ratio of the notional value of derivatives to the underlying cash trading is 422 times, the highest in the world by a large margin. While this ratio of Germany stands at 36, Brazil at 13, South Korea at 12, the U.S. at 9, and the Eurozone at 2.

The boom in options trading in India has been facilitated by a number of factors, including the widespread usage of trading apps and online trading, the lower ticket size of lots, and the introduction of weekly options contracts. As a result of a light-touch approach towards stock market regulation, options trading in India has shifted from hedging to pure speculative purposes, with retail investors holding an options contract for less than 30 minutes on average. Most of the retail investors are youngsters in their early 20s. They do not own much capital, but borrow money from friends and family to place speculative bets in the derivatives segment. Consequently, household savings are being diverted into these speculative bets, rather than going into productive economic activity.

More than a higher STT rate, strong regulatory measures (such as scrapping the weekly expiry of stock and index options) are needed to tame the speculative mania that has emerged in the options trading segment.

[11] Kavaljit Singh (2004), Securities Transaction Tax Disproves All Fears, Commentary, Madhyam, November 3. Available at: https://www.madhyam.org.in/securities-transaction-tax-disproves-all-fears/

(ii) Commodities Transaction Tax

In 2013, India also introduced a Commodities Transaction Tax (CTT) on the trading of commodity derivatives contracts.[12] Primarily designed with the intent to curb speculative activities in poorly regulated commodity derivatives markets, CTT is applicable only to sellers of commodity derivatives contracts. Buyers of contracts are not subject to CTT. CTT is only applicable to contracts related to non-agricultural commodities (such as gold, silver, crude oil, aluminum, and copper), while agricultural commodities are exempted from this tax. CTT is taxed at 0.01% for futures contracts, 0.05% for options contracts, and 0.0001% for agricultural commodities options contracts when exercised.

(iii) Tax on Crypto Assets

In July 2022, India imposed a 1% tax on all crypto-asset transactions exceeding INR50000 (US$620). A 1% tax in the form of a tax deduction on source (TDS) is imposed whenever a crypto asset (such as cryptocurrency, NFT, and tokens) is transferred from one owner to another.

In P2P transactions, the buyer will subtract the 1% tax amount when paying the seller for the transfer of crypto assets, and the TDS amount will be transferred by the buyer to the exchequer. If a transaction is conducted on an exchange, the exchange deducts this tax from the seller and transfers the TDS amount to the exchequer. For crypto-crypto transactions, a TDS of 1% is applicable to both buyers and sellers.

While the Reserve Bank of India is pushing for a blanket ban on trading crypto assets in the country, the government has opted to regulate crypto space with a heavy taxation regime to make cryptos less attractive asset classes. The 1% TDS, along with a 30% tax (plus 4% cess) on gains from investment in crypto assets, are key elements of this approach aimed simultaneously at tracking transactions and preventing tax evasion.

[12] Kavaljit Singh (2013), Decoding the Commodity Transaction Tax, Briefing Paper # 10, Madhyam, March. Available at: https://www.madhyam.org.in/wp-content/uploads/2014/07/Decoding-the-Commodity-Transaction-Tax.pdf.

CIVIL SOCIETY FINANCING FOR DEVELOPMENT Mechanism

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