COMMENT

CHILE SHOWS THE WAY

Allende's Chile is a closed chapter. Nor does Chilean literature evoke much passion among new generation radicals. But Chile continues to attract attention of developing countries for its bold attempts to control capital inflows. For many third world countries otherwise under the dominating sway of foreign capital, the situation created by unregulated capital inflows, is simply suffocating. Wage earners are literally on the edge and they simply don't know how to fight back. Movement of capital is good news for local capital managers but 'problem of plenty' is no less harmful than 'paucity of funds'.

The idea of taxing capital movements was first mooted by Nobel Laureate Professor James Tobin in the seventies. He suggested that cross-country capital movements could be taxed by IMF or World Bank and the revenues used for poverty alleviation in the developing countries. This could not be implemented for lack of consensus, especially on how to share the revenues and which transactions must be exempted. But countries like the United States, Israel and Chile have imposed unilateral taxes on capital flows at various times. The experience of Chile is particularly relevant for India at the present time.

Chile was facing large capital inflows in the early nineties as India is facing today. The Chilean Peso was rising. A report by Third World Network titled 'Regulation of foreign capital flows in Chile' explains : ''In June 1991, the authorities imposed a stamp tax on external loans at an annual rate of 1.2% on operations of up to one year. Also, external credits were subjected to a non-interest-bearing reserve requirement of 20%. The reserves had to be maintained with the central bank for a minimum of 90 days and a maximum of one year. This deposit had the same effect as a tax.''

The result appears to have been good. A study by Sebastian Edwards of University Of California, Los Angeles on the Chilean experience reports that immediately after the implementation of the policy, flows with less than a year maturity declined steeply relative to longer term capital. However, with the exception of a brief decline in 1993, the total volume of capital inflows into the country continued to increase until 1998. Chile's short term debt as a proportion of total debt declined from 19% in 1990 to less than 5% in 1997. The policy also helped reduce stock market instability.

The message for India and other developing countries is loud and clear. Imposing some type of 'entry tax' upon foreign investors will help reduce capital inflows. This will save Indians from various unwanted consequences such as rise in rupee leading to problems for exporters, increasing cost of sterilization, rising of domestic interest rates, etc. What is urgently needed is to impose such a tax without any delay.

The University of California study has criticized this policy saying it was not able to isolate Chile from the financial shocks stemming from East Asia in 1997-1999. It also led to an increase in the cost of capital. The controls on inflows also failed to stem the appreciation of the Peso. The real exchange rate appreciated by approximately 30% during the 1990s. But, the Chilean policy cannot be discredited on this ground. Its effectiveness has to be assessed by looking at the scenario that would have prevailed in absence of imposition of the tax. This policy is not a panacea for all evils. Its positive impact on restraining capital inflows is unquestioned. Maybe a higher level of tax or some other stratagem would have succeeded better. One should, therefore, build upon it rather than discredit it.

It is now felt that quick transfer of large amount of money can lead to excessive volatility in the financial markets. The US crisis was made by excessive inflows into the US economy to avail of the high rates of interest available on US Treasury Bonds. Such rapid inflows at one time forced an upward valuation of the dollar. Then, when the crisis deepened, a rapid reverse flow took place and that led to the collapse of the US banking system. Such rapid flows are presently possible because no tax is payable on such transfers. The proposed tax will make such rapid transactions costly and discourage the same. This will bring stability to the global economic system. □□□