

The Foundations and Role of Capital Account Regulations

By Martin Guzman and Joseph E. Stiglitz



The foundations and role of capital account regulations

by Martin Guzman and Joseph E. Stiglitz

April 2026

Martin Guzman: Professor, Columbia University School of International and Public Affairs; co-President, Columbia University's Initiative for Policy Dialogue.

Joseph E. Stiglitz: University Professor, Columbia University; co-President, Columbia University's Initiative for Policy Dialogue.

Brief prepared for: the Foreign Policy's Roundtable "Managing Volatility: Rethinking Capital Flows in a Fragmented Global Economy", at the IMF/World Bank 2026 Spring Meetings.

The foundations and role of capital account regulations

1. The perfect markets benchmark, also known as the Arrow-Debreu framework, describes the conditions under which a free-market solution is Pareto optimal – implying that any state regulation would be inefficient.
2. That benchmark assumes perfect information, absence of externalities, every agent of the economy is a price-taker, technology is exogenous, and there are complete markets, itself implying that there are perfect insurance markets.
3. In the real world, none of those assumptions hold. For analyzing the role of capital account regulations, i.e. regulations for cross-border capital flows, it is important to recognize that the global economy is characterized by incomplete markets (including imperfect insurance and credit rationing), imperfect information, and externalities, including the macroeconomic externalities well-established in the literature.
4. Planet Earth is a closed economy, hence the sum of the capital accounts of all the countries in the world must be equal to zero – i.e. by definition global capital flows are acyclical.
5. The empirical evidence shows that private capital flows are countercyclical for advanced economies and procyclical for developing countries. In times of abundant global liquidity, capital flows to the developing countries, that are inherently riskier due to their less developed (and less diversified) structures of production. In times of increased global uncertainty, capital flows back to the safety of advanced economies.
6. This cyclical pattern of private capital flows acts as a stabilizing force for advanced economies and an amplifier of volatilities in developing economies. It makes the advanced countries safer, the poorer countries riskier. That cyclical pattern of capital flows reduces the volatility of government debt yields in the advanced economies, increases it in developing countries.
7. The disparity in volatilities translates into a self-reinforcing disparity in yields and access to finance. The higher interest rates that developing countries have to pay would make their bonds riskier, even if all else were the same. But perhaps more importantly, in a world where countries may not have access to credit, poorer countries may lose access, and they often lose access precisely at moments when the benefits of access to credit are larger.
8. Under unregulated capital flows, arbitrage implies that this result holds both for foreign-currency and local-currency debt in developing economies.
9. Thus, that pattern increases fiscal policy space in advanced economies and reduces it in developing economies.
10. Similarly, that pattern decreases monetary policy autonomy in developing economies, as central banks face pressure for interest rate hikes to contain capital outflows right at the time when counter-cyclical policies have more value.
11. Moreover, the pro-cyclical pattern of capital flows increases the volatility of the exchange rate in developing economies while making the currencies of advanced economies more stable.
12. Because of imperfect insurance markets, the volatility of real exchange rate cannot be fully hedged, leading to a further decrease in risk-adjusted returns of investments, beyond that associated with the higher average interest rates developing countries have to pay. Hence, that cyclical pattern is detrimental for investment in developing countries and favors investment in advanced economies.

13. Private decisions concerning borrowing and lending do not take into account any of the macro-economic externalities associated with the effects we have just described. For developing countries, regulating the inflow and outflow of capital (and there are multiple ways by which this can be done) stabilizes capital flows relative to what they would be in unfettered markets, with impacts on interest rates and their term structure and access to capital (e.g. potentially reducing the likelihood of sudden stops).
14. Thus, the cost/benefit ratio of unregulated capital flows is markedly different across economies with different risk patterns and hence different supplies of safe assets.
15. Unsurprisingly, governments from advanced economies are more prone to favor unregulated or less regulated capital accounts. They benefit while developing countries lose.¹ From the viewpoint of developing economies, an appropriate design of capital account regulations that discourages the highly volatile short-term portfolio capital could simultaneously encourage more patient foreign direct investment, lower volatility of the exchange rates, lower volatility of government yields, and a more robust development of local capital markets (which would be of benefit in its own rights).
16. An analysis of the toolkit for the implementation of capital account regulations in developing economies is offered by Guzman, Ocampo, and Stiglitz (2018).
17. Capital account regulations also provide more autonomy of fiscal and monetary policy, which is also of benefit in its own right, since even a global shock presents itself differently in different countries. The fiscal and monetary autonomy is part of a broader political autonomy: open capital markets have often resulted in financial markets in advanced countries having undue influence over the outcome of democratic elections in developing countries.

References

Guzman, Martin, Jose Antonio Ocampo, and Joseph E. Stiglitz. "Real exchange rate policies for economic development." *World Development* 110 (2018): 51-62.

¹ The losses of developing countries may be greater than the benefits accruing to developed countries.