

# Capital Controls. Inflation. An Eerie Calm

Asset markets are coiled as tight as a spring, mostly wound up by the spread of quantitative easing of central banks the world over from the US fed to the ECB to the BoJ. Competitive easing is equivalent, or at least has as a collateral strategy, to competitive devaluation. In depressionary economies QE doesn't create the kind of inflation one might expect from the wholesale debasement of currency. However, inflation is already rising even in the weak economies of Europe and Britain. Only in the US is inflation low, suppressed by the shale oil, fracking boom that keeps energy costs, no small part of the CPI, low. Emerging markets are overheating as capital created in the developed markets flows elsewhere. At some point, countries in emerging markets will realize that open capital accounts render them vulnerable to the self interested yet collectively destructive policies of the West. The case for capital controls may once again arise.

For emerging markets with rampant inflation and asset bubbles, capital controls may not be a bad thing. Rising inflation often takes on a political flavor and it would be unfortunate if developed world policies end up influencing emerging market politics through an indirect and unintended route.

Strategically, it is in the interest of debtor nations to create inflation, particularly in creditor nations. Creating inflation domestically is of little interest. It is socially and politically destabilizing and it is economically undesirable. Creating inflation in one's creditor nations, however, debases the real value of the debt, while placing the cost of that debasement with squarely upon the creditors. In the longer term, this will, however, result in a weaker currency and more expensive imports. Not that a 30 year history of the widening trade deficits has made a stronger currency. The hope is that the current account and trade deficits will be reversed just as the weaker currency supports exports.

It's been a poor bargain for the sweatshops of the world. They got paid in a currency that is depreciating almost monotonically, they provided vendor financing in that currency as well, and the efforts of the developed market central banks and treasuries seem determined to devalue currency and inflate away debt.

Capital controls are without doubt a bad thing. However, this assumes that all players in the game are behaving responsibly. It now appears that the emerging markets will pay the price for the selfish and irresponsible policies of the developed markets. Under these circumstances, emerging markets facing high inflation and deteriorating trade balances may at some point decide that capital controls are necessary to impose some discipline in global economics. The world has already been in a currency war for a couple of years, a war hidden by the ineffectiveness, or effectiveness, depending on your point of view, competitive devaluation policies. The Yen's recent breakdown has been a brief victory in the ongoing conflict. When does this war escalate into capital controls?

Much has been written about the unfair treatment of savers in favour of debtors. The same finds an analogue between countries. People in the emerging markets are becoming impatient with their governments. Their governments are not as much in control than many believe. The blame for inflation clearly lies elsewhere. Governments simply have not the vision to envisage the unthinkable. Slamming the door on hot capital. In the meantime, on a parallel track, debtors print money to debase, and creditors print money to ensure that the ratio of good money to bad is maintained. Its not just a race to the bottom, its a race to the drainhole.