



A FRAMEWORK TO INTERPRET CAPITAL FLOW MANAGEMENT MEASURES AND MACRO-PRUDENTIAL MEASURES IN AN ERA OF FINANCIALIZATION

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Plan of the talk

- The International Monetary Fund (IMF) views on the role of capital flow management measures (CFMs), both capital control measures (CCMs) and of macro-prudential measures (MPMs). Following Forbes et al. (2015), CFMs are seen as comprising CCMs and MPMs.
- Critique of the IMF approach and alternative framework based on the case studies presented, with particular emphasis on the Latin American case.
- Policy proposals associated to the current crisis that follow the study cases and the alternative framework developed (not included in this preliminary version).

IMF institutional view

- Most of the discussion of IMF views are based on the paper “The Liberalization and Management of Capital Flows: An Institutional View,” and tries to explain the Fund’s theoretical underpinning of the relationship between policies related to capital flows and macro-prudential measures.
- For the Fund, policies that affect capital flow management (CFMs), including capital controls (CCMs) and macro-prudential measures (MPMs), both aim to address systemic financial risk, and are to some extent complementary, but address slightly different problems and are not substitutes.
- CCMs are designed to limit capital inflows while MPMS aim at reducing systemic financial risk. The fundamental idea is that CCMs should be used only in special circumstances to preclude the volatility associated with large changes in financial flows, while “[s]ystemic financial risks that are unrelated to capital flows are better addressed by macro-prudential measures (MPMs), which are targeted specifically to deal with such challenges” (IMF, 2012: 18).

CFMs

- It is important to note that the IMF views on capital mobility have not changed significantly, in spite of the debate about the changes in the institutional position (for an optimist view of the change see Grabel, 2018; for an older and more pessimistic view see Vernengo and Ford, 2014).
- In the paper that lays out their new institutional view, the IMF says: “CFMs should not substitute for macroeconomic policies that are needed for warranted external adjustment, domestic macroeconomic stability, and effective operation of the international monetary system... Even when CFMs are desirable, their likely effectiveness remains a key consideration. CFMs’ effectiveness may be limited, especially if they are not accompanied by the needed macroeconomic adjustment” (IMF, 2012: 19).

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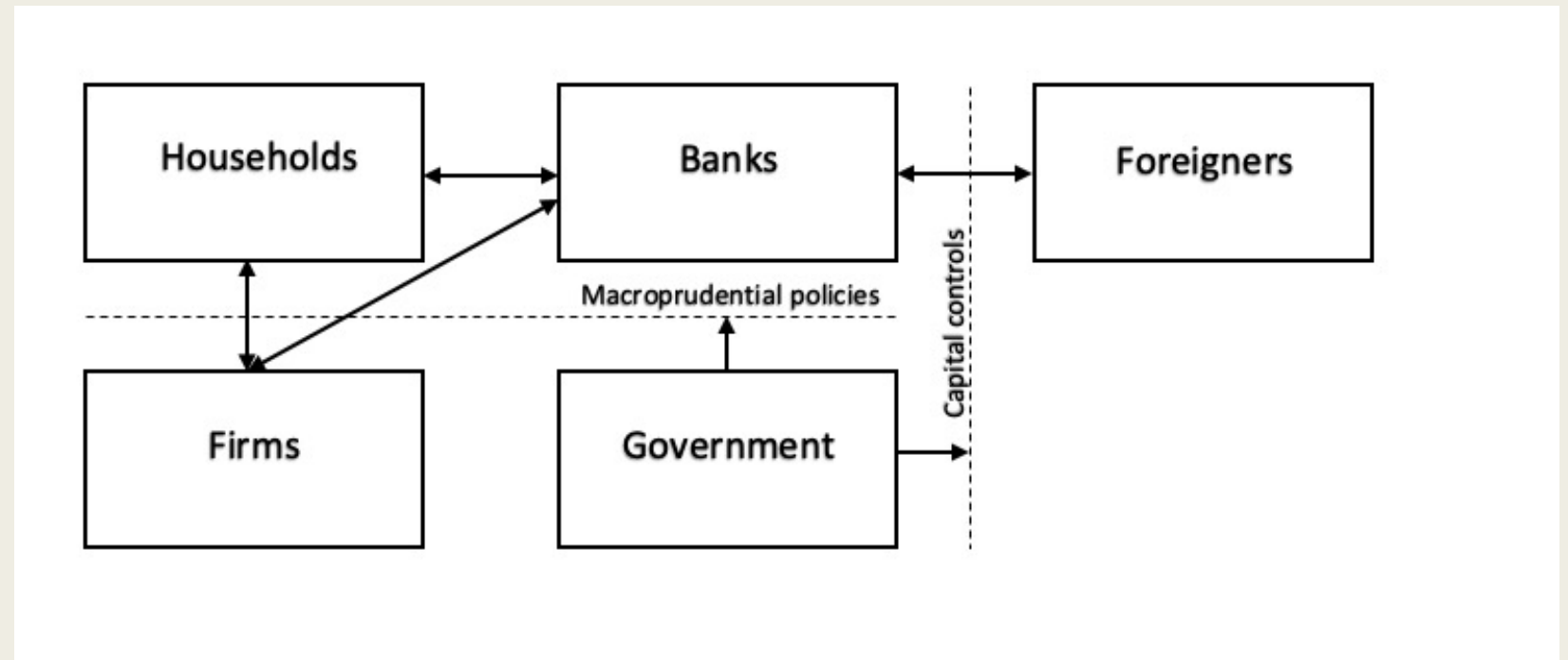
- The logic of the need for capital mobility remains the same that was defended, since the 1950s, even when the Fund's mandate was explicit about the desirability of the use of capital controls.
- Article VI, section 3 says that countries can: “exercise such controls as are necessary to regulate international capital movements”, however, the IMF reminds that: “members’ right to regulate international capital movements is not unlimited” (IMF, 2012: 30), and remains in favor of capital account liberalization, if in a more subdued way. They argue that:
 - *“Capital flow liberalization refers to the removal of CFMs. Liberalization does not rule out the maintenance of prudential measures nor the temporary re-imposition of CFMs under certain circumstances, if capital flows pose risks to macroeconomic or financial system stability” (Ibid.).*

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- In their words:
 - *“There is no obligation to capital account liberalization under the IMF’s legal framework. However, there is agreement that the flow of capital may entail important benefits for the country concerned as well as the global economy, provided that important preconditions for successful capital account openness, including in particular a robust regulatory and supervisory framework, are sufficiently met. An important long-term goal for G20 countries should be to put in place, domestically and internationally, through enhanced cooperation, the conditions that allow members to reap the benefits from free capital movements, while preventing and managing risks that could undermine financial stability and sustainable growth, and avoiding financial protectionism” (IMF: 2012: 39).*
- It seems that MPMs are necessary to some extent to reduce the need of CCMs, since one of the preconditions for “successful capital account openness” is “a robust regulatory and supervisory framework,” which is often associated with macro-prudential measures.

CCMs and MPMs

- The figure shows an schematic framework to understand the IMF's views on CCMs and MPMs.
- Essentially, CCMs affect the relation of domestic economy with the world, while MPMs manage the risks of the financial sector.



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- The IMF admits that sometimes it is impossible to disentangle CCMs and MPMs. They argue that:
 - *“There are situations, however, when CFMs [sic; CCMs in our terminology] and MPMs overlap. To the extent that capital flows are the source of systemic financial sector risks, the tools used to address those risks can be seen as both CFMs [sic] and MPMs. An example could be when capital inflows into the banking sector contribute to a boom in domestic credit and asset prices. A restriction on banks’ foreign borrowing, for example through a levy on bank foreign exchange inflows or required reserves on banks’ foreign exchange liabilities would aim to limit capital inflows, slow down domestic credit and asset price increases, and reduce banks’ liquidity and exchange rate risks” (IMF, 2012: 21)*

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- The non-exhaustive list provides examples of both CCMs and MPMs.

Types of Capital Flow Management Techniques

Capital controls	Macroprudential Measures
<ul style="list-style-type: none">• Quantitative limits on foreign ownership of domestic companies' assets• Quantitative limits on borrowing from abroad• Limits on ability to borrow from offshore entities• Restrictions on purchase of foreign assets, including foreign deposits• Special licensing on FDI and other financial transactions• Minimum stay requirements for new capital inflows• Taxes on capital inflows• Reserve requirements on inflows of capital (e.g. unremunerated reserve requirements)	<ul style="list-style-type: none">• Reporting requirements and limitations on maturity structure of liabilities and assets• Restrictions on off-balance-sheet activities and derivatives contracts• Limits on asset acquisition• Limits on banks' FX positions• Limits on banks' lending in FX• Asset classification and provisioning rules• Taxes on FX transactions• Capital requirements on FX assets• Differential reserve requirements on liabilities in local and FX currencies

A critique of the IMF institutional view: CCMs

- The conventional argument for capital account liberalization rests in both its aggregative and intertemporal versions on the notion that capital flows are to some extent stabilizing forces that help reduce imbalances, even if at the expense of short-term exchange rate instability. Arguably the notion is that capital flows are stabilizing, running in the correct direction and help correct balance of payments imbalances, an idea that harks back at least to David Hume's price-specie-flow mechanism.
- In the conventional theory, capital should flow from the capital abundant advanced economies, to the capital scarce developing nations, since in the canonical model, the former would have lower rate of remuneration for capital than in the latter, after risk adjustments. In this sense, capital mobility should not only increase growth, and employment in the periphery, but provide a higher rate of return on savings in industrial countries. The fact, that capital seldom flows from rich to poor countries has been termed the Lucas Paradox, following Lucas (1990).

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- The modern literature on capital account management suggests that the main reasons for the introduction of capital controls are associated to externalities and market failures, while the arguments for free capital mobility have moved away from relatively naïve stories about allocative efficiency in a world with perfect markets and emphasized political economy arguments.
- While these developments are certainly noteworthy, but a more systematic critique of the conventional case for free capital mobility and financial deregulation would go beyond the imperfectionist argument.

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- The literature on global financial cycles, in general, suggests that capital controls are second best tools, since they do not address the fundamental causes of excess elasticity of financial markets, and that microprudential regulation should be utilized to constrain booms. They might be necessary only before the domestic financial market becomes more developed.
- Rey (2013: 315) is explicit about it, suggesting that: “it is really excessive credit growth that is the main issue of concerns, capital controls should be viewed more as partial substitutes with macroprudential tools.” Her argument is in the context of the use of capital controls as temporary instruments, rather than permanent tools for managing capital flows. The logic of the temporary use of capital controls is well explained by Eichengreen (2004: 279) who suggests that emergency situations call for emergency solutions.

Critique of the IMF's views on MPMs

- In the same way that conventional views suggest that capital flows are ultimately positive and that, under certain conditions, capital account liberalization (the elimination of CCMs) should be encouraged, the consensus on the functioning of the financial sector is that it facilitates the expansion of the real economy, and that, under certain institutional circumstances, very often associated to limited regulatory and legal frameworks, they are neutral and do not affect real outcomes.
- The conventional notion that the economic system is self-adjusted with a tendency to full employment, in which money is neutral, is complemented by the idea that financial markets are stable, help facilitate the functioning of the economy, and are not the main source of crises. This view leads to the notion that regulation of financial markets is at least limited to the existence of imperfections.

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- Asymmetric information, the fact that borrowers always have better information about their ability or willingness to repay a loan than creditors, leads to market failures, as banks might not extend loans to creditworthy clients. This sometimes leads to suboptimal results (e.g. adverse selection and moral hazard).
- Imperfections in a world of interconnected balance sheets may lead to crisis. For example, the costs of credit intermediation change during the cycle. In a recession, when firm's balance sheets deteriorate, banks might demand a higher interest rate to compensate for risk, leading to a reduction in credit when firms need it the most, intensifying the business cycle.
- To the extent, that capital outflows intensify the problems associated with a deterioration of domestic agents' balance sheets, then a combination of CCMs and MPMs are seen as acceptable, at least in the short run.

An alternative framework

- Hyman Minsky argues that the conventional theory that suggests that the financial sector can only disrupt the functioning of an otherwise stable economy is equivalent to a barter economy, while the capitalist economies discussed by Keynes and his followers corresponded to what he refers to as the Wall Street paradigm. In other words, the relevant framework is that of a capitalist economy in which the objective is the accumulation of capital in monetary form.
- Minsky analyzes the financial structure of corporations and suggests that there is an in built tendency for the financial system to become increasingly fragile and prone to crisis. The central idea in Minsky's FIH is that the normal functioning of the capitalist economy would lead to a financial crisis. In other words, stability is destabilizing.
- This view, is in accordance with the so-called critical macro-finance (CMF) approach that argues that global finance is organized on interconnected, hierarchical balance sheets, increasingly subject to time-critical liquidity (see, for example, Bonizzi and Kaltenbrunner, 2020, and Gabor, 2020).

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- In this framework, the simple dichotomy between CCMs, designed to limit capital inflows when imperfections make them destabilizing, and MPMS, to reduce systemic financial risk, is untenable. Economic agents accumulate in a global economy where balance sheets are interconnected, and the balance sheets of economic agents in peripheral economies are to some extent integrated into the global financial networks that are dominated by institutions, and agents from central countries.
- Flows of capital that affect the valuations of the balance sheets of domestic agents in the periphery cannot be disentangled from the domestic systemic risks associated with the financial sector, neither could be the latter be simply associated with excessive liquidity.
- In this regard, the central position of the dollar, as the key reserve and vehicle currency in the global economy, puts the United States, and the so-called IMF-Wall-Street Complex (Bhagwati, 1998) at the center of the transmission mechanism of global financial cycles (Miranda-Agrippino et al., 2020).

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- The surge in capital flows, in particular in gross flows, which suggest that centrality of capital and financial account rather than current account movements in explaining volatility, has been dealt in a variety of ways, as the three regional studies have demonstrated.
- Some have relied almost exclusively on macroeconomic policies, such as the maintenance of a high or low interest rate (depending on the circumstances), or the use of foreign exchange market intervention, again to promote currency appreciation or depreciation according to the necessities. In other cases, macroeconomic policies have been accompanied by CFMs, both CCMs and MPMs, such as taxes on certain types of inflows, introducing holding periods on central bank bond purchases, or imposing leverage caps on banks' derivatives positions.

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- This has made some traditional measures of financial vulnerability less reliable. And the risks of a financial crisis, in particular associated to changes in the valuation of balance sheets considerably more difficult to assess.
- For example, all countries in the Latin American study show current account deficits and a negative Net International Investment Positions (NIIP), and had, for the most part, adopted Basel III regulatory standards. Yet, as noted by Forni and Turner (2020) the surge in “dollar bonds issued by emerging market economy (EME) corporates seemed most at risk.” As the BIS Global Liquidity indicators show, Dollar credit to emerging market and developing economies (EMDEs) expanded by 7% year-on-year, surpassing the \$4 trillion mark(BIS, 2020).