Workshop on Capital Account Regulations and Global Economic Governance

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REPORT[1]

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Introduction

This report summarizes the presentations, discussions and lessons from the workshop "Capital Account Regulation and Global Economic Governance", which took place on 3-4 October 2013 at UNCTAD and the WTO, Geneva. The workshop was organized jointly by UNCTAD and Boston University's Global Economic Governance Initiative (GEGI), with support from the Ford Foundation. It brought together policy makers, negotiators and experts to assess the rationale for and recent experience with capital account regulations and discuss what changes in global governance structures might be needed to facilitate re-regulation of cross-border finance.

Richard Kozul-Wright, Head of the Unit on Economic Integration and Cooperation Among Developing Countries of the United Nations Conference on Trade and Development (UNCTAD), and Kevin P. Gallagher, co-director of the Global Economic Governance Initiative (GEGI) in Boston University, opened the workshop and briefly introduced the issues to be discussed.

Cross border capital flows constitute a key economic phenomenon in understanding the roots of the 2008 financial crisis that affected many advanced economies and the turbulent economic environment emerging economies have been facing since then. In response to the surge in private capital inflows in the aftermath of the crisis policy makers in emerging countries have increasingly made use of capital account regulation (CAR) and unlike in the past decades, the richest countries could not prevent its implementation.

The analysis of capital flows cannot be disentangled from other international phenomena, like trade and financial stability issues. Moreover, individual country experiences have become an important input to enrich reflection on capital flows regulation. These two reasons make international organizations a suitable forum to host this workshop.

UNCTAD is especially concerned about capital account regulation. It has been engaged in this debate for over a decade, analyzing the costs implied by the free movement of capital flows and the role of international institutions in promoting financial stability. One of the most relevant issues to be discussed in this regard is how much available policy space there is for capital account regulation under the current international trade and investment legal framework. It is sensible thus for this debate to take place in Geneva, and have a panel session organized in the head office of the World Trade Organization (WTO).

Panel 1

The first panel put forward an overall perspective about the role of CAR in emerging economies. The first panelist, Yilmaz Akyüz, explained why capital inflows create a risk to financial stability and why CAR can be usefully employed to address this concern. According to him, international investment in emerging markets has followed a cyclical pattern of booms and busts after the Second World War. The first episode of capital flow euphoria, during the seventies, ended in the eighties' debt crisis. The second one, during nineties, led to the Asian crisis. The third episode was marked by the collapse of Lehman Brothers and the last one, which began in 2009, is now fading out. During the booms, monetary stimulus in advanced countries has been the common driving force, whereas liquidity tightening together with the worsening of economic performance in emerging countries and increased investor risk aversion explain the bust episodes.

Strong capital inflows may have different destabilizing effects, ranging from foreign exchange appreciation, which may led to current account deficits, maturity and currency mismatches in agents' balance sheets, domestic credit expansion or the formation of assets bubbles. Three policy tools have been traditionally recommended to deal with these problems, but none of them can simultaneously fix all the possible imbalances.

The first tool is macroeconomic adjustment, including both monetary and fiscal policy. However, these policy tools, which have always been the favorite option of the International Monetary Fund (IMF) are not sufficient to address simultaneously movements in the exchange rate, the balance of payments and euphoria on the assets and credit markets. The new Institutional View of the Fund on capital account regulation does not necessary imply a fundamental change in this regard.

The second tool is foreign exchange intervention to reduce exchange rate appreciation, implying reserves accumulation. The sterilization of the intervention may be carried out to avoid expanding the monetary base, but this can be very costly. Finally, the third macroeconomic tool consists of liberalizing capital outflows, which can also be very problematic since it could raise the risk assumed for the economy –depending on the investment made- and does not necessarily help to mitigate the currency mismatches that inflows could generate. Moreover, if the capital inflow euphoria ends abruptly, nothing seems to suggest that domestic capital will flow back to the country of origin and contribute to restore equilibrium in the capital account; quite the opposite may occur if domestic outflows accelerate.

The previous policies have demonstrated to be insufficient most of the time and that explains why countries are showing renewed interest in regulating capital flows. It is worth noting that CAR is not the same as macroprudential policies, although both policies overlap. Both can have effects on incoming financial flows, but the latter affects exclusively those movements intermediated by banks. The policy space that countries rely on to apply CAR is being threatened by bilateral and multilateral commitments to liberalize trade and investment.

Following the recovery from the Lehman Brothers collapse, many emerging countries started to attract capital flows. Brazil adopted quite soft measures to mitigate the vulnerabilities that inflows could generate, with limited success. South Korea has been more effective in this regard even though as a member of the OECD the country faces constraints to use capital controls. During the latest boom episode of surging inflows to emerging economies firms have accumulated important imbalances, and it remains to be seen what the final outcome will be, now that the euphoria is starting to fade out.

Yilmaz Akyüz concluded with three main points. Emerging economies need a strategic integration in international capital markets, which implies using as many policy tools as possible to tackle all potential imbalances that capital flows may entail. These include, but are not limited to, designing a permanent and flexible framework for regulating capital flows.

Experience has shown that administrative restrictions and strong sanctions should be part of such a framework if it is to be effective. The second conclusion is that the policy space for countries when resorting to capital account regulation should not be conditioned either by multinational institutions or bilateral agreements. Finally, increased policy space for regulating capital flows is only one necessary part of the story. The real challenge, however, is to redesign the entire international financial architecture, including the foreign exchange rates system and the reserves regime.

The second panelist, Rogério Studart, focused his intervention on how economic thought surrounding capital account regulation has evolved over the last sixty years. The design of the international monetary system that emerged from the Bretton Woods consensus in 1945 was clearly influenced by the disastrous experience of the thirties' crisis, when practically unrestricted capital flows accelerated contagion during the financial turmoil and made tariffs the only tool available to fight against the competitive devaluations of the exchange rate all countries were undergoing. In order to rebuild the trade links between nations, the Bretton Woods system guaranteed the possibility of restricting capital flows, so that countries could pursue internal macroeconomic balance without having to resort to trade restrictions. The support for capital account regulation was almost unanimous.

Since the seventies, once the system of fixed exchange rates collapsed, fast liberalization of the capital account was promoted as the best policy option for developing countries. The debt crisis during the eighties made it clear that the currency mismatch was one of the main risks faced by an economy opening to international flows. Financial innovations seemed to promise an effective way to hedge against this and other risks, but the Asian crisis in the late nineties showed that in the increasingly open international financial system crises seemed to be unavoidable.

Mainstream economic theory concluded that there was nothing substantial to be rethought about financial openness. It was still considered inherently positive for developing countries and only one caveat was added to the model. Free capital flows allow investors to easily "punish" countries applying economic policies that are perceived as not sufficiently sound or consistent. According to this view, financial crises caused by international capital flows was a problem of the "periphery", and the recipe to avoid future financial turmoil consisted of applying "serious" macroeconomic policies from that point on.

But Lehman Brothers collapsed in 2008 and it was in the United States (US). The IMF has since arrived to the conclusion that some kind of redesigning of the international financial system is needed. Even when sound macroeconomic policy is applied, financial flows could be problematic and there is a rationale for their regulation in certain circumstances. However, the problem behind the financial crisis is deeper than just a matter of one country regulating or not capital flows crossing its borders. There is a structural problem in that unrestricted capital mobility is bound to be destabilizing in a world lacking an effective governance structure to rein in its dynamics. Finance has become globalized to an extent that governance has not. The financial governance is still mainly national, whereas capital flows are global.

Three alternative scenarios could be considered at a theoretical level at this current stage. First, financial globalization could be reversed, which would lead the world economy to a second version of the Bretton Woods system. It seems very unlikely that this may happen, and the same could be said of the second scenario - the achievement of full globalization, including full liberalization of finance, trade and labor, with a new global governance structure able to regulate and monitor different forms of flows. What is most probable to happen over the coming years is the third scenario: developing countries widening their own policy space by increasingly deploying national capital controls. This seems to be the only viable option, in the medium term, in order to achieve an acceptable degree of stability.

After the presentations, some comments and new ideas were brought into discussion. One was related to the initiatives that emerging economies have launched in order to reduce their dependency on traditional multilateral institutions. One example is be the Contingency Reserve Arrangement, which BRICS countries have agreed to create, with a 100 billion USD facility toe help manage liquidity shortages and support financial stability. This kind of initiative is reflects gaps in the system of international liquidity provision as well as a wish by the BRICS countries to reduce their dependence on the northern countries' emergency mechanisms. So far, countries with short term liquidity needs have basically resorted to institutions from the richest countries like the FED.

As a final consideration, the discussion about how to respond properly to a surge in capital inflows in emerging economies may well be an issue of the past, given that the last inflows boom seems to be almost over. Thus, maybe more attention should be paid to the question of how to react when capital outflows start to increase. This is what is likely to become quite relevant for emerging countries in the near future.

Panel 2

The second panel contained three presentations about recent country experiences in capital account regulation. Daniela Prates, ithe first panelist, compared the experiences of Brazil and South Korea. These countries have all experienced a common problem arising from the increase in capital inflows: exchange rate appreciation against the US dollar (USD). They are submerged in a currency war, trying not to lose too much competitiveness with respect to the richest countries and other emerging economies. Moreover, they currently are also experiencing slowdown in economic growth and inflationary pressures.

Authorities trying to stabilize the macroeconomic scenario are facing a dilemma. A restrictive monetary policy to address inflationary pressures could attract more capital inflows, thus further contributing to further currency appreciation and asset price booms. This situation calls for capital account regulation in order to tackle these imbalances simultaneously. This is what has been done in Brazil, Peru, Korea, Indonesia and Thailand, most of which have also introduced new domestic prudential policies at the same time. Among this group Brazil and Korea are especially interesting examples due to the weight of their FX derivatives markets and their relevance in understanding currency appreciation pressures.

Korea is the only OECD member who has applied capital account regulation on inflows after the global financial crisis. But the appreciation of its currency was reverted mainly thanks to the implementation of prudential regulation affecting FX derivatives transactions. Since the counterparts in most of these transactions were domestic banks, prudential regulation measures were enough to curb the volume of these operations.

Brazil could easily introduce CAR on inflows in October 2009 because it had not undertaken any commitment that restricted its policy space in this regard. Appreciation pressures continued, due to the fact that FX derivatives transactions were not affected. The reason is that they are non deliverable and thus liquidated in domestic currency, so they are not cross border transactions and are not affected by CAR. Likewise, domestic prudential measures would not have been completely effective, as FX transactions involve not only domestic banks but also domestic non-financial agents. Only specific regulation could affect FX derivatives transactions. As a consequence, only when the three types of legislation -CAR, prudential measures and specific regulation of FX derivatives transactions- were active (July 2011) appreciation was contained and partially reversed.

According to Prates, as there is no effective global economic governance to punish excessive currency speculation, the main lesson to learn from the recent inflow episode is the need to maintain countries' policy space to regulate capital flows. The regulation should be adapted to each particular country and its financial markets, and should also be flexible to respond to macroeconomic changes.

The second panelist, Sabri Öncü, described the India's experience with regulating capital flows. Compared to Brazil, India's experience is quite different, because the country has a long history of imposing capital flows regulation that was originally established by the British in 1942. India started to open its economy in 1991 and speeded this process up after 2000, but it has always been very cautious. For example, debt inflows have been always discouraged, especially with regard to short-term debt. Even the Government has rarely resorted to external borrowing. Nevertheless, equity flows have been encouraged, creating sizeable risks to the Indian economy. The current legal framework in India leaves space for both quantitative and price based regulation, although the specific implementation measures have evolved over the last decade. Before the Lehman Brothers collapse some steps were taken to discourage inflows and promote outflows. During the post-Lehman boom of capital flows the policy applied did not change until 2013, when some steps were taken to curb outflows. But what did change after the Lehman collapse was the degree of sterilized intervention in FX markets that was dramatically reduced in comparison with the pre-Lehman period.

In the light of India's experience, two main recommendations were made. Firstl, domestic production and consumption should rely only on the domestic credit markets, and should not depend on capital inflows. Second, in order to avoid the problems that exchange rate movements against the USD can create, it would be useful to start exploring the possibility of agreement schemes that promote trade in local currencies.

Robert Wade was the third panelist, focusing not on inflows but the challenges of controlling outflows instead, by drawing on the experience of Iceland with CAR, following the banking collapse the country was exposed to in 2008. After a fast liberalization process during the late nineties, in 2000 Iceland started to attract capital inflows, which helped finance large current account deficits. Inflows were attracted by interest rate differentials and high returns promised by the three largest banks, which used these funds to invest abroad and boost domestic consumption and investment in the real estate sector. Two bubbles in both stock and housing markets grew until the banks' balance sheets became 10 times as big as Iceland's GDP, with a huge amount of private debt denominated in foreign currency. Alarm calls from different sources, including the IMF, were systematically disregarded. The collapse was inevitable when the banks were not able to refinance their short-term foreign currency liabilities. A "perfect storm" had broken out. The currency immediately lost half its value and the GDP suffered the biggest fall among OECD countries between 2007 and 2010.

Shortly after the banking collapse, strong restrictions on foreign exchange transactions were applied to avoid the exhaustion of the Central Bank's reserves. When the IMF launched its Stand By Agreement with Iceland, the restrictions on current account payments were lifted, but the ban on capital outflows account remained in place. The temporary emergency tool became a permanent legal framework that is still in force almost five years later. Capital account regulation implies cheaper funding for the public budget and a stable exchange rate, which favors price stability and avoids further deterioration of private balance sheets.

However, some actors advocate the withdrawal of the CAR because it arguably hampers portfolio diversification, discourages investment and makes it difficult for companies to hire foreign employees. But removing this regulation could destabilize the whole economy. According to IMF estimations, the capital that could flow out after lifting the ban is equivalent to 100 per cent of GDP. Such capital outflows would exhaust reserves and cause massive exchange rate depreciation, with the subsequent impact for private agents servicing foreign currency debts.

The precondition to remove CAR is to diminish the threat of capital flight by attracting long term investors to "substitute" for those agents trapped behind the controls and willing to exit as soon as possible. But so far no major investment has arrived. The new political environment adds even more uncertainty. The agrarian party that won the elections in April 2013 promised a considerable write-off of the outstanding housing debt. The problem is that the plan to achieve this is in some way contradictory. First, the Government would buy the shares of the restructured banks from their foreign owners applying a haircut but offering the possibility of escaping the CAR after the transaction. It would require the CAR to be in force in order to make the Government's offer attractive. Secondly, the Government would sell those shares to some other investors at higher prices. The profits would be used to cover the housing debt write-off. But the presence of capital controls is a serious obstacle to finding interested investors to buy the shares. Summarizing, there is still uncertainty around when and how CAR will be removed, and regarding the economic consequences of this decision.

After the three presentations, the first point made during the debate that followed is that banks require special attention as they are important actors in the economy, due to being the center of the payments system, and therefore it is worth carefully analyzing their specific roles in each situation.

With respect to Brazil's experience, it was stressed that currency mismatches have not been significant so far, which means that the intense depreciation that could take place if capital started to flow out is not bound to cause serious problems. At the same time, it was recalled that Brazil has had important current account deficits despite having enjoyed a favorable context for its exports. This means that firms' balance sheets could be strong, but the aggregated balance of payments could show signs of vulnerability, which should be a cause of concern.

Some final remarks were also made regarding Iceland. Iceland has not undertaken any liberalization commitment that could erode its policy space to apply CAR. In particular, it has not signed any treaty with the US, the most demanding country as to liberalization requirements. Belonging to the European Economic Area does not imply similar policy space limitations, either. This means that there were no legal obstacles to prevent regulation of outflows after the banking collapse. In fact, this policy has been explicitly supported by the IMF and also validated by the European Free Trade Agreement (EFTA) Court. But the same applies to the previous period of financial boom between 2000 and 2008 when Iceland could have taken the necessary steps to stop the inflows tide by applying CAR.

A final point made was that, in practice, Iceland is using a double exchange rate system. Besides the ordinary one there is a special -depreciated- exchange rate to sell foreign currency to investors that have been allowed to take out their capital from Iceland. This happens when some other new investors with foreign currency have acquired long term investment assets offered by the Government in domestic currency. This is the strategy that has been used to diminish the threat of capital flight and the volume of such operations but using the depreciated exchange rate has been quite limited so far. At the same time, it was emphasized that maintaining multiple exchange rates is forbidden by the IMF.

Panel 3

The third panel included four presentations and tried to address the issue of the availability of policy space for regulating capital flows under different bilateral and multilateral agreements on trade and investment liberalization. The first panelist was Annamaria Viterbo, who focused on the General Agreement on Trade in Services (GATS) from the WTO. This legal framework was designed when both the US and the EU strongly advocated in favor of economic openness. The countries undertaking the GATS can define a list of sector services to be liberalized. Even though the GATS does not contain a general limitation for CAR, specific commitments do restrict the space to apply such a regulation.

Firstly, when a financial service sector is liberalized under the so called "Mode 1", there are no restrictions for a firm located abroad to provide that service inside the country. If such a commitment is assumed, all kinds of capital controls that obstruct the provision of the service are forbidden. Secondly, when any kind of service sector is liberalized under the so called "Mode 3", foreign providers are allowed to establish commercial presence within the country to provide that service. In this case, regardless of whether the service is financial or not, the agreement implies that no restrictions can be implemented that obstructs the capital flows needed for providing the service. Thirdly, capital flows regulation could also imply a breach of GATS if it discriminates according to the investor's residence.

Three safeguard clauses give some space to introduce CAR, though. Firstly, CAR is allowed when requested by the IMF. Secondly, in case of a balance of payments crisis outflows regulation could be accepted but it is unclear to which extent it applies also to inflows regulation. Finally, countries are allowed to introduce prudential measures, which could give room to inflows regulation depending on what is understood as "prudential" and to which extent this concept overlaps with capital controls, a debate that is far from being closed.

The second panelist, Sarah Anderson, analyzed Trans Pacific Partnership Country Agreements, which are bilateral liberalization treaties on trade or investment signed between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam and United States. These treaties sometimes hamper the policy space to apply CAR, but the importance of this constraint varies remarkably among them. Most treaties do not totally forbid capital flows regulation, but all treaties include some limitation to it.

The most common situation among the TPPCA is a general banning of capital flows regulation but with some safeguard clauses in case of balance of payments problems or due to prudential reasons. It is remarkable that the US has excluded these kinds of clauses in all free trade and investment treaties signed since the 1994 NAFTA. At the same time, there are also treaties that promote financial liberalization as a general rule, but which refer in practice to national laws and regulations, which can be understood as a softer restriction over CAR.

The US is preparing a new model of TPPCA, trying to maintain their traditional position towards full liberalization, although with some degree of flexibility. However, the policy space that this new generation of treaties may concede may not be very significant. For example, it seems that the way the prudential safeguard is written could make it legally useless in practice. Also, this safeguard would apply to microeconomic vulnerabilities only, which narrows the space for applying CAR, since this policy often tries to address macroeconomic imbalances. In the same sense, taxes on certain kinds of inflows may be allowed, but they cannot discriminate on the basis of the investor's residence, which is quite common in CAR measures.

In order to guarantee the policy space for the signatory countries, the best option would be undoubtedly to avoid any limitations regarding CAR, as treaties between China and Germany or US and Israel have done. If the treaties include some limitations, safeguard clauses should be more operational in practice, both for balance of payments crises and prudential reasons.

Xavier Carim, the third panelist, explained the South African experience with bilateral investment treaties. This country has carried out a deep review of all the investment treaties signed during the early post-apartheid era, before the new Constitution of 1996. These treaties have granted great security to investors but, altogether, conform a legal framework that is neither consistent nor perfectly aligned with the Constitution.

The revision of these treaties has led to important findings. Firstly, there is no clear correlation between the existence of a treaty with a country and investment coming from that country. Secondly, the treaties suffer some deficiencies that could create uncertainty to investors, for example inconsistencies in definitions or problems with the arbitration mechanisms in case of conflict. In light of these findings, South Africa has decided to finalize or renegotiate the existing investment treaties, to define a new treaty model to be used from now on and, finally, to clarify the status of foreign investors' protection in a new law better aligned with the Constitution.

With regard to capital flows, old treaties had almost unrestricted clauses for protecting funds repatriation by the investors. The new treaties will contain clauses to combine this essential investor right with some limitations to be applied under delicate circumstances, such as balance of payments crises. It does not mean that there is the intention to apply CAR and it is not a first step in planning its implementation either. The goal is to guarantee that the policy space is available, in case a need arises. The position of South Africa as to financial services liberalization is based on the GATS framework. Two possibilities are under consideration to solve conflicts in the new treaties' framework: a resolution system between states or to maintain the conflict within South Africa. Finally, even if a treaty is terminated, the protection clauses that guarantee the repatriation of funds will still be in force for at least one more decade.

The last panelist, Erivaldo Gomes, detailed the experience of Brazil dealing with capital account regulation, and investment and trade liberalization agreements. Brazil is mainly an open country for business, more than Australia and the US, according to the OECD regulatory restrictiveness index. Outflows are unrestricted but some temporary prudential measures affecting capital inflows are in force. None of them are quantitative restrictions. Their overall goal is to contribute to the macroeconomic stability in a context of potentially destabilizing capital inflows. Specifically, they are intended to reduce the excess of short-term inflows that affect the exchange rate, contribute to current account deficit and spur assets bubbles.

The prudential measures adopted include taxes on certain kinds of inflows, capital requirements, LTV ratios, FX intervention and FX bank exposure regulation. This policy mix has been effective in curbing credit expansion and short-term borrowing. It was designed taking into account the characteristics of the Brazilian financial markets, which has a very developed derivatives market. In Gomes' assessment, the authorities have been quite successful in avoiding the circumvention through FDI channels, even though fighting evasion means to continually adapt the regulation.

Brazil has undertaken few commitments under international treaties as to financial services liberalization, as noted earlier. The reason is that these treaties have traditionally given much protection to investors and few guarantees to regulators. As a consequence, little protection was granted to consumers. Brazil pursues a balanced equilibrium between these interests. The country's position regarding investment liberalization treaties is to negotiate only with regard to FDI, and with respect to financial services Brazil advocates deferring to international financial institutions' requirements, undertaking particular agreements only when there is parallel cooperation on fiscal or regulation policies.

Summing-up, the principle inspiring the Brazilian position is to protect trade and direct investment, but not speculative capital flows. Regulators need enough policy space to protect consumers' rights, to ensure that markets work with fairness and efficiency and, finally, to reduce systemic risk.

After the interventions of the four panelists, the debate offered further clarifications and remarks. With respect to the GATS, a critical point made was what services countries accept to liberalize. The more restricted the list is, the wider the policy space becomes. In that sense, some in the debate argued that northern countries and the financial lobby want the developing countries to assume commitments on as many sectors as possible. Thus the GATS could be seen in the current global scenario as a tool used to thwart emerging countries' regulatory response to turbulent capital flows.

Once some commitments have been undertaken, it is quite difficult to change them; although the policy space does not entirely disappear, it is certainly diminished. If the CAR affects any liberalized service, the application of the safeguard clauses may or may not not make such regulation accepted, since it depends how and by whom these clauses are interpreted, implying a narrower and more uncertain policy space. Ecuador requested an official interpretation of the GATS prudential safeguard but its demand was not accepted by the WTO. The European Union (EU), nonetheless, has adopted a more proactive attitude. In 2013, after introducing new legislation affecting short selling, credit default swaps and OTC derivatives markets, the EU notified the WTO that they had put into force that legislation on the understanding that it was acceptable under the prudential safeguard clause. It is too early to know how this mechanism will work. A final issue is that a Financial Transaction Tax would not be problematic as far as the GATS is concerned, because it contains a clause that specifically protects direct taxes.

Concerning the investment treaties, what could be stressed is that some of them offer no policy space at all for regulating capital flows. This is why the pre-signature negotiation process could make the difference. If a country has a well-established and sound legal framework regarding capital flows regulation, its position gets stronger and it becomes easier to request the inclusion of a clause referring to the national legislation, thus guaranteeing the possibility of regulating capital flows. Moreover, a permanent legal framework has advantages in itself, as it gives room to a continued but flexible countercyclical regulation and increases predictability regarding what will be done if the financial situation becomes threatening.

Two conceptual issues arise as well. First, it is analytically difficult to distinguish foreign direct investment and portfolio investment. But the main issue when talking about a particular investment treaty is which transactions are regulated and which are not according to the agreement, regardless the terminology. "Macroprudential" is another concept that gives rise to different interpretations. There is a standard definition used by the BIS, IMF and G-20 according to which macroprudential measures and CAR, even though they can overlap in their effects on capital flows, are clearly different as for their primary goals: the former tries to curb systemic risk whereas the latter aims to affect capital flows. However, many developing countries do not accept this standard, as policies affecting capital flows would only be acceptable under GATS or other treaties if it could be argued that they intend to reduce systemic risk.

Panel 4

The fourth panel contained three presentations addressing to what extent the current global governance of the international financial system works properly. In the first presentation Daniela Gabor analyzed the new IMF Institutional View about capital account regulation. The first conclusion is that the change represented by this Institutional View is only cosmetic in comparison with the previous IMF's position. The policy advice is basically the same as it has always been and the regulation of capital flows is considered a “last resort” measure that should be only used when all conventional policy tools have been exhausted. Moreover, some limitations are recommended when using CAR: to regulate inflows more strongly than outflows and to use non-discriminatory measures if possible.

The second conclusion is that the IMF analysis lacks an adequate perspective on real financial actors and their connections. This can be seen by observing the sequential steps that form the roadmap recommended by the Fund when facing a surge in capital inflows. The first advice is to let the exchange rate adjust in response to capital flows. The non-explicit hypotheses behind this are that an equilibrium exchange rate exists and that we can get to know its value. But this theoretical framework, based on the notion of equilibrium, completely ignores carry trade, a relevant phenomenon in explaining capital flows and currencies fluctuations.

The second advice is to reduce interest rates, which could be problematic if there are inflationary pressures. But the most questionable advices from the point of view of this interpretation are the third and fourth, about precautionary reserves accumulation and its sterilization “at all cost”. Again there is no sound framework defining the adequate level of foreign reserves. Above all, intervention and sterilization means that, to some extent, the Central Bank loses its capacity to manage liquidity in the domestic economy and simply becomes a counterpart in the carry trade circuits used by international banking actors.

The advice of the IMF should be based on analyzing actors, their cross connections and the vulnerabilities that their action entail for the economy, as well as the CAR that can fix the different problems that may arise. Instead of this, its Institutional View keeps on recommending as a first option a macroeconomic policy kit that, in a complex financial context that the IMF does not consider, could be more harmful than beneficial. Analyzing CAR as a real policy tool requires an overhaul of central and private banking models.

The second panelist, Kevin P. Gallagher, explained how the international financial architecture has performed after the crisis. An adequate international financial system would be expected to provide five public goods, according to Kindleberger's approach, none of which have been effectively provided. First, the activity connected with maintaining the markets open has been mainly focused on trade. Second, last resort lending has been very limited in aggregate terms. Third, countercyclical lending has not even existed. For example, cheap money was pumped into US banks but they invested it abroad, hardly giving any support to the US economic recovery. As far as emerging countries are concerned, the inflows they have received have been strongly pro-cyclical. Fourth, the exchange rate has been nowhere near stable, and the term “currency-war” is now commonly used. Fifth, there has been virtually no macroeconomic coordination.

Reforming the international financial system would especially require such a coordination effort. If only the G-20 put in force a common regulation on margin requirements and limited agents' leverage and positions, FX derivatives markets would be under certain control. This would inhibit the carry trade with emerging countries’ currencies, which has actually been the main channel through which the US crisis has propagated its effects on the emerging world in the form of unstable capital flows. The efforts of southern countries to counteract this liquidity tide have not been resolute enough, and thus they have not been completely effective.

Some suggestions are derived from this analysis. Emerging countries should apply stronger capital account regulation when needed, and focus strongly in FX derivatives markets. At the same time, they could improve the way these policies are explained. “Macroprudential measures” are seen far more favorably than “capital controls” by investors, even though they could in fact be the same. Just a change in terminology could in practice widen policy space.

Industrialized countries should go beyond easing liquidity conditions when stimulating the economy. They could apply the necessary regulation on FX derivatives to ensure that the liquidity created actually stays within the country and is not massively invested abroad. In the multilateral arena, the IMF should reform its quota system. It could also be more helpful in the enforcement and coordination of capital account regulation and, when analyzing industrialized economies, it should pay attention to the spillovers their policies have on emerging countries. Finally, the IMF should go beyond acceptance of the CAR already applied and explicitly back emerging countries efforts in this regard.

In conclusion, it is true that emerging countries have regulated capital flows and this time industrialized countries have not been able to stop them, unlike they did during the nineties. But this change cannot hide the failure of the financial architecture in protecting countries from the risks they are exposed to by volatile capital flows. Much more coordination and bigger efforts on both source and target countries are needed to address these deficiencies.

Rogério Studard, the third panelist, focused on the governance structure of the global economy, whose modification is necessary as well as difficult. The current multilateral institutions were created in Bretton Woods to maintain and reinforce the status quo that emerged after the 2nd World War with the US as the leading power. Every governance structure tries to perpetuate itself. Bretton Woods' institutions are not an exception and they show a strong resistance to evolution. They also count with the support of mainstream economics which is, actually, to a great extent, a product of the power structure represented by the Bretton Woods hierarchy. Dominant institutions and mainstream economic thought tend to reinforce each other.

But mainstream economics has an important handicap when trying to understand the current global economic situation because it never takes into account the power relations between actors. Their microeconomic framework takes human beings as individuals interacting freely with the only distortion coming from the state, which through its coercive power moves away resource allocation from optimality. According to this framework, capital flows move guided by profit differentials reflecting the relative scarcity of savings and efficiently allocate the world's resources. The role of the governments is to apply good and consistent enough policies not to disturb this result. Every other action is bound to be, in the long term, detrimental to the economy.

The increasing financial integration since the eighties and, above all, the Lehman Brothers collapse made two things clear. First, it is no longer valid, if it ever was, that financial markets will work perfectly if governments just let them function at full capacity while applying sound policies. As power relations do exist, the optimal outcome is not at all guaranteed. And second, the problems created by dysfunctional global financial markets are unavoidably common to all countries, so policies trying to fix them need to be common as well.

A common regulatory effort requires mutual consistency and coordination, and this means to change both the multilateral institutions' way of doing things and the mainstream economic thought that is embedded in them. It is going to take a long time to achieve this, but the renewal of the multilateral architecture is essential to properly manage the globalized economy.

The debate that followed started with a reflection about capital flows during the last decade, whose cyclical boom and bust patterns would indicate that they do not move according to soundness of the target countries' economic policies, as the mainstream theory predicts. With regard to coordination, it is emphasized that it is not reasonable to have a financially integrated world lacking an institutional framework to coordinate it and make it work properly. Coordination would also be important to analyze global financial actors' behavior. Their portfolio decisions are behind the capital movements and understanding them could only be the result of a shared effort.

There are some attempts to build an alternative institutional framework led by emerging countries. An example would be the BRICS Bank, still under negotiation, with a voting system that is likely to be based on the principle of one vote per country. This is still not a serious threat to the institutional monopoly of the Bretton Woods system, but it does put some pressure on traditional players like the IMF, explaining to a certain extent its current efforts to renew its governance structure.

It was pointed out that the IMF should be more active in preventing global financial imbalances instead of just letting them grow and then fixing only some of their symptoms. The IMF pays close attention to the areas in which advanced countries should work regarding economic growth and financial reform, but nothing is said about the consequences that these actions would entail for emerging countries. As a practical example, when the IMF analyzes the US economy, it barely says anything about the global implications of the Dodd-Frank Act exemptions for FX derivatives transactions, when the FX market has been the channel through which liquidity flowed away from the US towards the emerging world. When analyzing emerging economies, the IMF does insist on the vulnerabilities and inconsistencies that they suffer as a consequence of being target countries for capital flows from developed economies. Only the end-side of the global capital flows chain is considered, forgetting the push factors that are fueling potential global imbalances in the countries where flows are originated.

Another remarkable fact is that the Dodd-Frank Act, particularly the Volcker rule, has been considered by Canada as a breach of the NAFTA treaty, as it would pursue financial stability in the US making it increasingly difficult for Canadian financial institutions to effectively manage their risks. Again, the liberalization trade framework could help to explain the reluctance of regulators to extend the applicability area of this law.

As to the quantitative easing (QE) measures in the US, it is difficult to assess their overall effect on emerging economies. They have promoted destabilizing capital flows, but at the same time helped the US economic to recover with a subsequent positive effect on emerging countries' exports. But the point is not to judge QE in itself. It was needed to back the economy, even more so in a context in which the fiscal policy was blocked as a countercyclical tool. But the QE should have been accompanied by regulatory measures to make the liquidity remain in the US, which would have made it more effective and could have avoided collateral effects in the form of capital flow surges to the south.

In relation to the WTO, it seems reasonable to fight against trade protectionism, when the effects that the protectionism wars had for all countries after the Great Depression are remembered. But it does not seem reasonable that financial regulation, which aims to fix dysfunctional markets, be considered protectionism. Thus using the WTO legal framework to obstruct these regulatory initiatives is not justifiable.

Conclusions

The main conclusions have been organized according to different topics. The first area regards the role UNCTAD has played in promoting the debate around CAR. Richard Kozul-Wright underlined that having the necessary policy space to regulate capital flows is essential for the economic development of developing countries, and therefore it should be included in the debate about the post-2015 development agenda. However, so far this agenda has focused mainly on social and environmental issues. UNCTAD has actively promoted the analysis of capital flows and their regulation, but developing countries could enhance even more this role by requiring the UNCTAD to give them policy advice in this area. Otherwise, only institutions like the G-20 or the FSB will address this issue, using a less analytical approach. This would not favor knowledge accumulation in this field.

Along the same lines, Robert Wade pointed out that the civil society has also a role to play in recognizing the UNCTAD as a qualified institution to focus on this topic.

The policy space for the emerging world has undoubtedly been a central concept in this workshop. Two divergent perspectives arise in this regard. Yilmaz Akyüz reasons that policy space does exist and the problem is that emerging countries do not make the most of it. During the good times, they apply policies that could have been promoted by the Washington Consensus advocates two decades ago. They do not worry much about potential risks and open their economies with few caveats. The current CAR in emerging countries is a timid and individual response that is not likely to avoid the danger of a future balance of payments crisis in the emerging world as soon as liquidity gets scarce in the advanced countries and capital starts to flow out from the south. The real problem is that emerging countries as a whole do not share a common vision about global financial issues and they have no interest in fixing the structural problems of the system.

With a distinct perspective, Kevin P. Gallagher sees as very promising the fact that developing countries are more active than ever in trying to regulate flows and promoting institutional reforms at the multilateral level. The most relevant discussion then would not be how few changes have already occurred, but the varied and numerous initiatives aimed at inducing such important transformations. A constructive debate may well focus on how to guarantee as much policy space as possible, and the main conclusion would be that it is crucial to have a permanent legal framework that would allow flexible countercyclical policies to be applied, and adapt them to the changing macroeconomic conditions. As a part of a proactive agenda for the developing world, Sabri Öncü recalls that a strong strategy should be designed for southern countries to gain decision power in international financial institutions.

The language used to explain the legislation to be implemented is also relevant to define the policy space available in practice. Kevin P. Gallagher points out that it does not matter how a policy is called, but what it consists of. If the capital account regulation can be labeled in a more acceptable way, let us do it. The measures will be better accepted, the policy space will be widened and the policies applied will probably be more successful.

With respect to coordinating macroeconomic policies, very little coordination efforts have taken place after Lehman Brothers collapsed. Looking ahead, the most important task could be to maintain a surveillance attitude in relation to the spillovers that advanced countries' policies have on the developing world.

The trade liberalization legal framework has been deeply analyzed. As Kevin P. Gallagher synthesized, it seems that the best option to guarantee the policy space is to undertake as few commitments under the GATS Mode 1 or Mode 3 as possible. Brazil would be an example of this attitude. If some commitments are assumed, a reasonable way to introduce new and potentially problematic regulation could be what the European Union has done: notifying the WTO about the new legislation, reasoning that it has been put in force given that it was considered acceptable under the prudential safeguard clause.

Another reflection made by Sarah Anderson is connected with this and points to the institutional design of Government departments dealing with trade negotiations. They are usually not connected with the national financial regulators and this is a problem. The staff that could be aware of the constraints that a trade treaty may imply for the policy space regarding CAR do not often take part in the negotiation process to build the agreement.

The investment liberalization treaties have also been analyzed. Again, according to Kevin P. Gallagher, the most suitable option for a developing country, when possible, seems to be to sign as few treaties as possible that restrict its policy space for applying CAR. In this regard, it was underlined that a key advantage in negotiating a treaty could be to have a wide and permanent legal framework on financial regulation. It should not be forgotten that there are always alternative options once the treaties are signed, though. South Africa is an example of a serious and autonomous revision process of the previously signed treaties, aimed at rebuilding them by rebalancing the link between the investor and the host country.

The institutional change in the IMF has been addressed as well. In this regard, Ricardo Gottschalk recalls Rogério Studart's presentation and remembers that it takes a long time for institutions to transmit changes from its top to the basis, for reasons related to the institutional culture, the bureaucracy and the inertia. Thus, we should be ready to be patient with this process.

The last reflection is about the kind of countries this workshop has focused on. As Ricardo Gottschalk noted, relatively open economies dealing with volatility of capital flows have been at the center of the stage. But the developing world is varied and countries that are small or with a relatively closed capital account may well be facing different problems to those discussed; for example the consequences of dollarization due not to CAL but to aid flows, how to open the capital account, at which speed and to which extent. Kevin P. Gallagher adds these countries could draw on accumulated knowledge on how to manage capital flows. It would be valuable to learn as much as possible from the larger developing countries that have already liberalized their capital account before they eventually end up opening their own economies. It is emphasized that every country's roadmap to dealing properly with financial integration might be different and the policy space to follow it should be guaranteed. Some countries will probably open their capital account less and more slowly than Brazil or South Africa have done. What is worth remembering is the relevance of the policy space that is secured, along with the specific integration pattern by individual countries.