

## CAPITAL ACCOUNT REGULATIONS AND GLOBAL ECONOMIC GOVERNANCE: THE NEED FOR POLICY SPACE<sup>1</sup>

Since the global financial crisis, a consensus has emerged around the need to regulate capital flows in order to reduce the chances of future crises and to mitigate their damage if they do occur. Many emerging economies have already introduced measures to reregulate cross-border finance. However, these economies are concerned that some of the global and regional agreements they have negotiated over the last two decades may unduly constrain their room to deploy effective measures. There is thus a need for more policy space so that developing countries can adopt effective capital account regulation (CAR) to deal with both excessive capital inflows and sudden outflows. At the global level, there is a need for comprehensive reform of the entire financial architecture and more coordination on macroeconomic policy whereby both source and recipient countries are targeted.

### Background: Global boom–bust cycles in capital flows<sup>2</sup>

Since the collapse of the Bretton Woods system, four boom–bust cycles in capital flows to developing countries can be clearly identified (see figure). The last of these cycles followed the Lehman collapse. A quick recovery occurred in the second half of 2009 which is now ending

due to the diminishing appetite for risk of global investors and the uncertain prospects surrounding exit from ultraeasy money in the United States of America.

Each cycle shares some basic features. Rapid credit expansion, together with low interest rates in the main reserve issuing countries, and increased global risk appetites have been the main factors behind the booms. Subsequent

### Key points

- A number of developing countries have reregulated cross-border finance in the post-crisis period, but global and regional agreements may constrain room to deploy effective tools.
- The recent record in managing capital flows has been mixed due to, among other things, adoption of ad hoc measures, with walls that are neither high nor wide enough to mitigate threats.
- Capital controls are most effective when permanent and adjustable in order to operate in a countercyclical manner.
- There is a need for comprehensive reform of the international financial architecture and more macroeconomic policy coordination to target source countries.

Net private capital flows to emerging economies  
(Percentage of gross domestic product)



Source: Y. Akyüz (2013).

<sup>1</sup> This number of the Policy Brief series is based mainly on presentations, discussions and lessons from the workshop entitled "Capital Account Regulation and Global Economic Governance", which took place on 3–4 October 2013 at UNCTAD and the World Trade Organization (WTO), in Geneva, Switzerland. The workshop was organized jointly by UNCTAD and the Global Economic Governance Initiative (GEGI) of Boston University, with support from the Ford Foundation. See presentations at <http://unctad.org/en/pages/MeetingDetails.aspx?meetingid=404>.

<sup>2</sup> This section and the subsequent sections on policy options, the International Monetary Fund (IMF) and architecture benefit from inputs by Y. Akyüz (2013).

busts typically follow rising interest rates and a strong dollar associated with tightening financial conditions in reserve issuers. Deteriorations in macroeconomic conditions in recipient countries can be an additional factor, but these are mostly due to the effect of capital flows rather than policy shifts. With currency appreciation, domestic credit expansion and rising asset prices fuelling domestic demand in the upswing, currency and other risk mismatches emerge and financial fragility grows, increasing the vulnerability of the economy as capital flows out.

Although exchange rate risk has fallen in the most recent cycle – 70 per cent of foreign liabilities in developing countries are now denominated in local currency – the impact of capital flows on credit and asset markets has been heightened. Even a strong balance of payments position and large international reserves do not protect against adverse spillovers from financial shocks, as seen in Asia after the Lehman collapse. Moreover, and despite the much discussed policy “trilemma”, the threat appears independently of the exchange rate regime, as a floating regime does not necessarily insulate a country from adverse effects or allow much autonomy of monetary policy.

Emerging economies are currently facing considerable risks on several fronts: their external debt is growing, interbank lending to these economies is at an all-time high, and off-shore corporate bond issues exceed those from advanced economies. The risks are amplified by the heightened sensitivity of credit flows to monetary conditions in the United States, and because creditors are highly leveraged in their carry trade activities. With risk aversion increasing, the prospects for a reversal of capital flows are growing at a time when many emerging economies are facing rising capital account deficits despite slowing growth. While international reserves provide some insurance, they can run out quickly (particularly when these reserves are borrowed rather than earned). Furthermore, if previous crises are any guide, international liquidity on an appropriate scale is unlikely to be forthcoming while there are still no multilaterally agreed mechanisms for a debt standstill and exchange controls.

### **Policy options for managing capital inflows**

Four main options might be considered to deal with volatile capital flows: macroeconomic adjustment, currency market intervention and sterilization, the liberalization of resident outflows and outright regulation of capital flows.<sup>3</sup> These options, however, are not equally effective in addressing simultaneously all the problems associated with volatile flows.

The use of countercyclical monetary, fiscal and exchange rate policies should be a permanent part of the economic management regime of countries at all levels of development, along with various measures including bank capital requirements and foreign exchange intervention; but these tools are unlikely to be sufficient when dealing simultaneously with currency, balance of payments, credit and asset market movements resulting from volatile capital flows. Currency market interventions by the central bank followed by sterilization can prevent appreciation of the domestic currency and capital account deterioration; they can also provide a buffer that can be used for mitigating the impact of future capital outflows. Full sterilization is however often difficult, leading to liquidity expansion and overheating. Moreover, these operations are costly, do not prevent mismatches in private balance sheets and can heighten risk-taking. Liberalizing resident outflows can ease pressure on the currency. However, these outflows do not prevent currency mismatches and there is no guarantee that money allowed to exit in good times will come back in bad times, as the outflows may also operate procyclically, mimicking the behaviour of capital flows by non-residents rather than countervailing them. Capital controls, including prudential rules for the domestic financial system (limits, special loan-loss provisions, liquidity, reserve and capital requirements), are often a more effective instrument because they can be targeted and fine-tuned and carry stronger sanctions. Moreover, by targeting foreign exchange positions and transactions, prudential regulation can help mitigate and discourage maturity and currency mismatches. However, the latter may still not be sufficient, particularly where inflows are not intermediated by banks.

### **Recent experiences**

The post-crisis period saw a strong recovery of capital flows to emerging economies, with carry trade operations standing out among financial flows, creating concerns over impacts on emerging economy currencies and policy dilemmas, such as whether to adopt a restrictive monetary policy to address inflationary pressures, but with the risk of attracting more capital flows and aggravating exchange rate misalignments (Prates, 2013). Responding to these policy dilemmas, a number of emerging economies have adopted capital controls and prudential financial regulations. The recent record in managing these inflows has been mixed, oftentimes because of deficiencies in the wider macroeconomic policy regime, with less impact in traditional inflation-targeting countries such as Brazil, South Africa and Turkey, but greater impact in Asia where countries have been

<sup>3</sup> Often referred to as “capital controls,” “capital account regulations,” “capital management techniques” and, most recently by the IMF, “capital flow management measures.” These refer to a range of measures used to restrict specific forms of capital that flow in and out of a country.

more successful in stabilizing their currencies and balance of payments. A common fault has been to adopt ad hoc measures, with walls that are neither high nor wide enough to mitigate the threat.

Brazil and the Republic of Korea attempted traditional capital controls and prudential regulations with only limited success. These countries went further by creating a new generation of cross-border financial regulations that target the foreign exchange derivatives market. Only after adoption of a wider range of tools did Brazil succeed in curbing speculation and halting appreciation of the domestic currency (Prates, 2013). Brazil has also been careful with its commitments under the General Agreement on Trade in Services (GATS) and has not ratified any bilateral investment treaties or free trade agreements (FTAs), unlike many developing countries around the world. The Republic of Korea, despite its membership and participation in the Organization for Economic Cooperation and Development and GATS, has been able to adopt prudential regulations.

While Brazil and the Republic of Korea are two examples of the use of cross-border financial regulations to address surges of capital inflows, Iceland's experience with capital controls at the onset of the global financial crisis stands out as a case addressing the opposite challenge: the imminent threat of sudden outflow of capital in the midst of a deep financial crisis. In the early 2000s, three large private Icelandic banks borrowed heavily from abroad and acquired assets both abroad and domestically. By the end of 2006, their combined assets reached almost 10 times the country's gross domestic product. When the three banks collapsed in early October 2008, the IMF stepped in and adopted an emergency strategy that included capital controls on outflows and repatriation of foreign exchange earned by exporters, a strategy that was maintained and reinforced by the Government of Iceland as it kept tightening controls through raising penalties and strengthening enforcement (Wade, 2013).

The Icelandic experience demonstrates that, in critical situations, the IMF may favour controls and act decisively, partly because it has learned tough lessons from its controversial role in the East Asian crisis. However, it is yet to be seen whether Iceland was a one-off case or whether the IMF would provide direct technical advice to developing countries facing emergency situations on how best to impose capital controls.

## **The International Monetary Fund and capital controls: A change of mind?**

At the end of 2012 the IMF retreated from its call, made just before the 1997 East Asian crisis, to change the IMF Articles of Agreement to promote full capital account liberalization and moved towards a new institutional view, recognizing the risks of capital flows to macroeconomic and

financial stability and thus accepting that capital controls "can be useful" (IMF, 2012). However, the IMF views capital controls as measures of last resort, to be used only in situations when a balance-of-payments crisis is already evident and once macroeconomic and financial policies (monetary, fiscal, exchange rate management) have been exhausted. The problem with such an approach is that it does not recognize the macroprudential role that controls can play in preventing such a crisis in the first place. In addition, the IMF view is that these controls should be temporary, with equal treatment for foreign and domestic investors and a focus on capital inflows rather than outflows. This view contrasts with country-based evidence of controls being most effective when part of a permanent framework embedded with sufficient flexibility to target specific forms of flows and financial actors and the controls can be adjusted to operate in a countercyclical manner.

The IMF recognizes that cross-border coordination can help reduce the risks of capital flows, and that source countries should recognize that their policies have possible spillover effects in other countries. However, the IMF's own role in the area of coordination, for instance through multilateral surveillance to address systemic risks, is limited by its lack of leverage over the reserve currency issuing countries, so what it recommends is not followed through (Gabor, 2013).

## **Trade rules and capital account regulation: The need for more policy space**

Developing countries nowadays do not face multilateral constraints to adopt capital controls to deal with a surge of flows.

However, countries that have made commitments under GATS and others that have entered into bilateral investment treaties and FTAs may lack the necessary policy space to adopt capital controls. The restrictions they face vary across different agreements, but these tend to be tougher in FTAs. Thus, the reality is that today trade rules impinge on the ability of developing countries to draw on capital account management tools to address macroeconomic challenges arising from volatile capital flows.

There is a certain irony in the fact that while some observers bemoan the absence of multilateral rules in the international financial system along the lines of the trading system, it is precisely trade rules, particularly at the bilateral and regional levels, that appear to make it difficult to effectively employ capital controls. Under GATS, countries may still have the leeway to adopt capital controls, albeit relying on exceptions clauses that as yet are untested in the Dispute Settlement Understanding. The level of ambiguity in GATS rules certainly

leaves ample room for different interpretations, though weaker countries lacking resources and bargaining power to implement such controls or to avoid litigation might find their use the most arduous (Viterbo, 2013).

Looking at the entire spectrum of approaches to CAR across different bilateral investment treaties and FTAs, one can find at one extreme total prohibition of controls, with broad coverage (including derivatives) and no exceptions for crisis; at the other extreme, capital account liberalization is encouraged, but with deferment to national laws and regulations (Anderson, 2013). Unlike WTO-based agreements in which disputes are between nation States, these agreements as they currently stand allow private

investors to file claims against Governments regulating capital flows (Gallagher, 2013).

In the face of the growing number of bilateral investment treaties and FTAs, developing countries may wish to revisit the terms of these agreements in the area of finance.

This and other country-level actions, however, are not sufficient to address a problem that is global in nature. At the global level, there is therefore a need for a reform of the entire financial architecture, including regulation of systemically important institutions, temporary standstills, crisis lending and debt workouts, and reserves and exchange rate systems in order to discipline financial markets and policies in key reserve issuers.

### Policy recommendations

- Capital controls should be part of a permanent regulatory framework that can be activated in times of need and can operate countercyclically.
- Countries that have already fairly open capital accounts should take a measured re-examination of their experience with capital account liberalization, rolling back specific liberalization measures which have been harmful, and seek strategic integration into the global financial system to ensure a more sustainable growth path.
- Developing countries that still have relatively closed capital accounts should learn from other countries that have liberalized “too fast, too far” and maintain a cautious approach towards the liberalization of their capital accounts.
- Developing countries should be cautious about entering into bilateral investment treaties and FTAs or making specific commitments under GATS that may severely constrain their ability to reregulate capital flows. Like South Africa, they may wish to reassess their bilateral investment treaties and FTAs to avoid limitations regarding CAR or at least ensure that clear safeguard clauses are included.
- There might be a case, too, for greater clarity in GATS provisions, so that small countries with few resources and little capacity do not become prey to unfavourable interpretations that might imply constraints on capital controls and lead to litigation by counterparties.
- At the global level, there is a need for comprehensive reform of the entire financial architecture, including the reserves and exchange rate systems, regulation of systemically important financial institutions, temporary standstill, crisis lending, debt workouts and more macroeconomic policy coordination whereby both source and recipient countries are targeted.

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