MANAGING CAPITAL INFLOWS TO REDUCE
RESOURCE TRANSFER FROM DEVELOPING
TO DEVELOPED COUNTRIES

Increased financial integration has heightened the vulnerability of developing countries to global financial cycles. In response, many have sought to accumulate foreign exchange reserves, usually in the form of short-term United States dollar-denominated bonds, as self-insurance to prevent a sudden capital inflow reversal or contain the adverse effects of such a reversal. However, such assets bring low returns relative to the costs of servicing the volatile capital inflows that developing countries receive. In the period 2000–2018, the ensuing resource transfer from 16 major developing countries amounted on average to roughly $440 billion per year or 2.2 per cent of the combined gross domestic product (GDP) of these countries. This policy brief argues that capital controls can provide a more effective way to control financial vulnerability, but that supportive measures will be needed at the international level.1


Closer financial integration of developing countries creates a resource transfer from these countries

Financing the 2030 Agenda for Sustainable Development requires resources to be mobilized from many sources. Private foreign capital is increasingly perceived as having the potential to narrow the resource gap in developing countries. However, capital inflows do not come with a guarantee that opening the capital account and establishing an investor-friendly environment will attract the kind of inflows needed to strengthen a more inclusive and sustainable development path. Large capital inflows may actually diminish financing options for developing countries.

The debate on financial integration often juxtaposes the expected advantages and risks of capital flows. However, persistent capital flows also increase the size and alter the composition of the stocks of foreign assets and liabilities. The income stream associated with such increased stocks of foreign assets and liabilities is typically negative for developing countries, resulting from a mismatch between the return characteristics of their external assets and liabilities. A large part of the external assets of developing countries consists of relatively low-yield and safe dollar-denominated securities,
often accumulated as a form of self-insurance to prevent a sudden reversal of speculative capital inflows or contain the adverse effects of such a reversal. The external liabilities of developing countries tend to consist of relatively high-yield and risky portfolio instruments and tend to be related to volatile short-term speculative capital inflows that are driven by global financial cycles and determined by the level of interest rates in developed countries, the level of commodity prices and the risk aversion of financial investors. As a consequence, changes in the valuation of external assets and liabilities, related to changes in asset prices and exchange rates, can adversely affect the external balance sheets of developing countries.

The total rates of return on the gross external assets of developing countries are lower and those on their gross external liabilities higher than those of developed countries (see figure). In the period 1995–2018, on average, developing countries earned about 2 percentage points less on their gross external assets and paid about 2 percentage points more on their gross external liabilities than did developed countries, implying a total return differential of about -4 percentage points between developing and developed countries. Such return differentials between safe external assets held to insure against risky external liabilities create a resource transfer from developing countries which, in the period 2000–2018, among the 16 developing countries examined in the Trade and Development Report 2019, amounted to roughly $440 billion per year or 2.2 per cent of the combined GDP of these countries.

Policy options for reducing resource transfer from developing countries

There are two broad policy options for reducing the resource transfer from developing countries associated with balance sheet asymmetries.

One option is to reduce the need for developing country self-insurance in the form of holding low-yield foreign assets. This could be achieved through a reform of the international monetary system, to ensure a predictable and orderly supply of international liquidity and, in particular, of the short-term finance required to compensate for sudden liquidity shortages. To date, the difficulties experienced in the design and implementation of the various reform proposals – such as creating a world currency, moving towards a system based on special drawing rights or establishing a global network of central bank foreign currency swap arrangements – have done little to dissuade developing countries from pursuing the self-insurance option.2

The alternative option is to use capital controls to manage speculative capital inflows and reduce the stock of high-yield external liabilities. The recognition of capital controls as an essential part of the macroeconomic policy toolkit would help to make them comprehensive and long-lasting regulations on cross-border finance, rather than simply temporary and narrowly targeted measures. Capital controls can be effective tools for altering the composition of flows, to ensure a close match between gross external assets and liabilities, as well as for countercyclical management.

IMF is moving, somewhat cautiously, in this direction. IMF has acknowledged that capital controls form a legitimate part of the policy toolkit, stating that, in addition to their potential benefits, capital flows carry risks and that full liberalization is not always an appropriate goal. IMF recognizes that capital account liberalization should be sequenced, gradual and not the same for all countries at all times, yet still treats capital account liberalization as a policy goal, despite the lack of a strong correlation between capital account liberalization and economic growth, in particular in developing countries.3

More importantly, developing countries need multiple instruments to integrate effectively into the global economy, without preconditions for their use. Such instruments should combine macroeconomic policies that secure economic growth and sustainable macroeconomic and external conditions with macroprudential measures, comprehensive and lasting capital controls.

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Total rates of return on gross external assets and liabilities, selected developing and developed countries (Percentage)


Notes: Data for 2017 and 2018 are partly estimated; group numbers are medians; the group of developed countries includes Germany, Japan, the United Kingdom of Great Britain and Northern Ireland and the United States of America; the group of developing countries includes Argentina, Brazil, Chile, China, Egypt, India, Indonesia, Malaysia, Mexico, Morocco, Pakistan, the Philippines, the Republic of Korea, South Africa, Thailand and Turkey.
and other regulatory measures that insulate domestic conditions from externally generated destabilizing pressures. Such insulating measures, including capital controls, need to be country-specific, determined by the nature and degree of a country’s financial openness and by the institutional set-up of its financial system.

Many developing countries currently lack the institutional set-up required for the effective monitoring of capital controls. They may also have concerns that the adoption of capital controls might be perceived by international financial markets as a signal that an economy’s underlying problems are worse than anticipated. By contrast, having legislation in place that provides for comprehensive and long-lasting capital controls allows policymakers to act quickly and avoid lengthy debates and procedures, in particular during surges of capital inflows when the build-up of macroeconomic and financial vulnerabilities is greatest and when the political forces against regulation tend to be strongest. Two factors could significantly facilitate the task of policymakers in this regard, as follows:

- Gaining the backing of domestic economic agents such as exporters that are more interested in a competitive exchange rate than in access to global finance, as well as members of the general public, who may have a collective memory of the adverse impacts of past boom and bust cycles of capital flows in developing countries, whether their own countries or elsewhere.

- Designing capital controls in the context of prudential measures, such as by casting them in the accepted discourse of the new welfare economics of capital controls and the need for macroprudential regulations. This could appease decision makers in global economic governance institutions such as IMF and the World Trade Organization, as well as international financial markets, thereby alleviating fears, in particular in countries with chronic current account deficits, that controlling capital inflows could impede long-term access to international capital markets.

To enhance the effectiveness of domestic policies, two supportive measures appear to be indispensable at the international level.

The ability of policymakers to use capital controls requires keeping capital account management out of the purview of regional and bilateral trade and investment agreements or at least establishing safeguards in such agreements that allow countries the right to regulate capital flows without conflicting with their contractual commitments.

In addition, capital controls would be significantly more effective if capital flows were controlled at both ends. This could be achieved through multilateral endorsements of specific cooperative mechanisms, which would assist in particular recipient countries with limited capabilities to enact capital controls, either due to a lack of institutional capacity or due to legal constraints such as from trade and investment agreements. Source-country Governments may wish to regulate outflows, in order to enhance the effectiveness of monetary policy by steering credit towards productive investment in their economies and preventing the leakage of monetary stimulus into financial investments abroad. The coordination of capital controls might achieve greater stability in capital flows with relatively lower levels of restrictions at both ends rather than stricter controls at one end.

The recognition that such changes could be essential in achieving the Sustainable Development Goals may provide additional motivation for their enactment.

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4. Capital controls discriminate against non-residents and target capital flows, that is, they are intended to regulate the volume of cross-border capital flows and/or to change their composition towards less risky forms. Macroprudential measures apply to regulated financial institutions and intend to contain the adverse impacts of capital inflows on the stability of domestic financial systems. The two types of measures overlap when they concern, for example, capital requirements and limits on currency mismatches. Important differences include the following: macroprudential measures only cover the balance sheets of resident financial institutions and not the foreign exchange operations of non-resident investors or of resident non-financial investors; and capital controls only cover cross-border transactions and not foreign exchange operations in domestic markets. However, neither of these instruments fully covers foreign exchange derivatives, a capital flow category that has increasingly also been used in developing countries with advanced financial markets.