Transcript of the Questions and Answers of the Session "Capital Flows Management Measures and Systemic Risk"

Panel: Stephany Griffith-Jones (Chair), Paulo Nogueira Batista, Jose Antonio Ocampo, Yu Yongding, Kevin Gallagher

Questions to the Panel

Aaaron Mehrotra (BIS Hongkong) : I want to ask about the sort of possible international spillovers of capital flow management measures that I think were not very much discussed yet in the panel. So I was wondering whether these exist and whether countries that actually use CFM measures need to take these into account. I mean one could think about a possible policy spillover whereby one country that puts in place capital flow management measures, then leads to another country also putting in place such a measure or possibly some asset price bubble in a small open economy could be diverted to another economy that could have quantity spillovers. So I was wondering about your views on that.

Manuel Agosin: Just a comment about the Chile-US Free Trade Agreement. I think you got it wrong there Kevin. The agreement has a one year safeguard for capital account measures to protect against capital surges renewable to two years. The Chilean delegation on wanted to have a carve out like it had with Canada but it was not able to get that but it did get a safeguard.

I have a question for Yu Yongding, I didn't really understand why in this arbitrage operation with Hong Kong, the exchange rates don't rapidly equalize as this is a huge market I assume and pretty liquid, so you ought to have a movement towards disappearing spread on the exchange rates.

Joseph Stiglitz: I thought all the presentations were fascinating. I have a question on BITS mainly for Kevin, about Chile. When I was down there when the flood of money was coming in, to Chile, I met with all the senior people in the government including the President. The sense I got was that even though there is this limitation of one year, there seemed to be an ambiguity of the consequences if there was any transgression and that was certainly a serious concern. There were a couple of remarks; one of them was that BITS also imposed limitations on the ability to restructure debts after you have a crisis. For instance, Argentina is now being sued under an Italian BIT. One of the important aspects to realize is that companies are totally mobile so that while the BITS were originally intended to protect foreign companies, an American company can become a foreign company and sue, or put it like this an Indian company can become a citizen of any other country with a BIT and come back and sue. So you set up a subsidiary, and you do the investment with the subsidiary so what these agreements are doing is totally

undermining the ability of countries to regulate not only the financial markets but every other aspect of regulation.

The second point I want to raise is that the cost of these restrictions on ability to regulate can be much greater than the trade benefits of these trade agreements. The final question is with respect to BITS. In the aftermath of the crisis, with a democratic administration that is supposed to be sensitive to these kinds of concerns, how could it be that the Obama administration is pushing an agenda that is so anti-good performance of the economy and could increase instability hurting the middle income and poor, whom the Obama administration is supposedly helping?

In the context of China, is there a discussion on the cost of these capital market and financial market liberalization and what is the political economy in China on this? You would have thought that there are many groups who would be worried about the external orientation and would want the reforms that would be associated with keeping the current controls in place. Why has this gone as far it has gone?

Adair Lord Turner: I have a question to Yongding. I find that there is actually a sort of internal circular contradiction that we are opening the current account because it will force us to internationalize the RMB, and we are going to internationalize the RMB because it will force us to open the capital account. The motivation stated for opening the capital account was to remove the upward pressure on the RMB exchange rate and therefore the upward pressure on the accumulation of reserves. If that was your objective surely the logical thing to do would be to remove some of the outward limits on capital export in a controlled quantity fashion and not to internationalize the RMB. To the extent that you internationalize the RMB, you will create a set of demand for corporates to hold operational balances in RMB and that would lead to appreciation of the RMB. Am I missing something or is the argument just missing something?

Answers by the Panel
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Kevin Gallagher: I am sorry, Manuel, if you look at the law, you are not interpreting the US-Chile agreement right. You are right that Chile got a carve out with Europe, it got a carve out with Canada, it tried with the US, and we said no. So we have an Annex to investment chapter that says, if Chile puts in place the INCAHE on inflows starting on January 13, 2014, then Yong Ding's Company cannot sue you for that action for a year, but they can sue you for the action you did on Jan 13. It is not that you can do

anything you want for a year; it's that they can't file a suit to World Bank under the Investor Trade Dispute Resolution until a year. So that is what the Chilean government is trying to rectify that under the TPP. They are pushing really hard to get the same carve out that they got with the Canadians, and now that Canada is actually in the TPP, it is a problem for the US.

Manuel Agosin: That is what I understand, exactly what you said, you have safeguard up to one year and not for ever. It is up to one year as safeguard.

Kevin Gallagher: You can still be sued after a year, but it is not that you can put the measure in place. If on Jan 13, 2014, you put in place an unlimited reserve requirement on inflows, that is illegal; you can go ahead and do it, but after the one year grace period, a US firm can sue the Chilean government without going through the US government for the damages that they incurred because of the measures. They can get damages for the period before the suit is filed.

To address the question on sovereign debt restructuring. I wrote a paper that is called the "new vulture culture - mission creep in trade treaties", that was published here in India and available on my website. In old investment law, the core component for foreign direct investment is to prevent expropriation. Once you include sovereign debt and derivatives, bonds and so forth in the definition of investment, a haircut is legally the same thing as expropriation. So we have the first case of $ 3 billion worth of bond holders from Italy suing Argentina. Just last year, **EXIT (?)** ruled that they have a jurisdiction over that. Right after that, currently there is a case against the Troika for the Greek restructuring where a number of Slovakian investors in Greece are suing Greece for the restructuring due to the Slovakia-Greece bilateral investment treaty, by the same law firm that is conducting the program in Argentina. Now there are also Greek bond holders that are suing Cyprus. The trade agreements never were supposed to be about this stuff and it is something that is really a concern.

The third question was why is the Obama administration, a democratic administration, whose party railed against the Bush administration during the Chilean and Singaporean negotiations, specifically pushing for this. I was appointed to the bilateral investment treaty: to Obama's credit that he wanted to revisit these issues after he got elected and so he put together a panel. I was appointed to it and there were about 20 of us on the panel and about 14 of them were financial services roundtable and legal counsels of the biggest banks in the country. Then there were the trade unions in the US and some environmental groups and myself. The environmental groups and the trade unions have a whole set of other things that they were concerned about with US trade policy that was really not part of the

discussion here. I am sorry I am not that tough, it was me versus the US financial commission that was completely against it. Now the lawyers, USTR and treasuries are also concerned about it because of precedent. We have hundreds of these treaties, 30 FTAs but lots of bilateral investment treaties. If we changed it now, then there is a doctrine in law that you go by the most recent one. So **EXIT t**hen could rule on the US for want of treaty 7 years ago based on the thinking that is on our latest negotiation. They were worried that we would unravel all our commitments with other countries. We organized an economists' letter signed to put pressure on USTR to change its way about this and that had no impact. There are a number of Congress people that are pushing for it. But the one key issue is that USTR always tells us and Treasury always tell us is what they are concerned about this is that the American public and many other people in the administration are so concerned about the Chinese exchange rate. There is a difference between capital controls as a part of exchange rate regime and prudential capital controls or macro-prudential capital controls. US is willing to be a little more open on some of these capital management techniques but there is a huge constituency for a whole set of reasons that is concerned about Chinese exchange rate policy and the policies that go there. It is legally hard to slice out the difference between the two because even Chinese regulations impact short term capital flows they just can't go there. It is completely disappointing but we have not given up. There is lot pressure on Congress plus from non-governmental organizations and we have this economists group who are doing it, and in the end it is actually going to be the Chileans and Malaysians in the TPP that push hard on this stuff. When you look at these treaties there is so much more about than foreign direct investment and textiles, it is also about sovereign debt and cross-border financial services.

Yu Yongding: Yes, if there is no capital control then perhaps arbitrage will lead to equalizing these two exchange rates. The problem is that China still has lot of capital controls. So even though CNH will impact on CNY but because of capital control, the cross-border flow is limited. So capital flow from in and out of Hong Kong to China is limited, is not big enough to make the risk equalize. About political economy, I hope Joe will find time to go to China again. I don't know whether you receive such warm welcome if you insist on your opinion in China. For many years Friedman was the most popular economist in China, because Americans influence education and so on, we believe in market mechanism. The key phrase in this third plenary is that we should allow market to play decisive role in resource allocation. This is regarded as the core, the fundamental guiding force in this whole plenary decision. My question is that where is the market in China? If the distortion is so serious, how can this market play decisive role to guarantee rational allocation of resources. So I think there are two problems. One is political economy, the vested interest, if I am engaged in financial sector, which is

actually very influential, then we will like certain ideas and so on. This is one part of the story. Another part of the story I think is sort of understanding education because lots of the economists in China still believe, I think I will not say market fundamentalism, but believe in markets very deeply. I think there is a reason because market-oriented reform changed China dramatically, it played very important role for the progress of China. Also we have not suffered any serious financial crisis yet. So we talk about this kind of idea of liberalizing, we haven't suffered from this yet. So perhaps we need one or two small crisis. I think it is better for people like you to come to China to exchange views with the Chinese officials and economists. I think most Chinese economists are really sincere. They are hoping that the country will be stronger and stronger but at the same time they buy almost 100 per cent of ideology from your country.

About Adair's question, I entirely agree with you. Actually, I wrote three papers on this RMB internationalization. I just said we have mainly four objectives. Number one is to reduce exchange rate risk but actually most transactions are invoiced in US dollar rather than RMB. So if you use dollar to do the invoicing then how can you avoid this exchange rate risk. So investing countries that we are talking RMB to settle transaction. You assume that you must use RMB as invoicing currency. That is not the case, and I think this is very important. So very few people are talking about reduce exchange rate risk in China than they are talking about internationalization.

The second reduce increase in foreign exchange reserves. The results are opposite. Just like you said, more capital inflows is very simple. We have USD 1 billion, we spent USD 1 billion, increase in foreign exchange reserves is zero but we earn USD 1 billion, we spent RMB 8 billion buying things so we have USD 1 billion left. So what can we do? Buy treasuries. So the result is RMB internationalization increases rather than decreases foreign exchange reserves, other things being equal.

Thirdly, yes competitiveness and perhaps there is some positive things but I think perhaps Hong Kong benefited greater than Shanghai.

And fourth, reduce transaction cost of the trade. I think that is right. I think it is fair to say that there are some positive aspects of RMB internationalization but on the whole I think risk is very big. So we can continue with the RMB internationalization but be careful. In China the trick is that lots of people use RMB internationalization as a way to disguise the intention of capital account liberalization. The true purpose is capital account liberalization, not RMB internationalization. Over the past several years, lots

of people argue with that. We have to fully liberalize capital account otherwise we cannot push RMB internationalization further. So this is a very important argument.

Now we step further. We just forget about RMB internationalization, we just talk about capital account liberalization. Why do we need capital account liberalization? The single most important argument used recently is to push domestic reforms just like we join WTO then we have to abide by lots of international rules and so on, so China make quite significant progress. I think that is true. But how about capital account liberalization, I think it is really very dangerous but unfortunately I think most Chinese economists still believe that by opening up, the external force will shock Chinese economy. You will force Chinese to make lots of reforms, reform in exchange rate, reform in interest rate, reform here and there and so on. But I cannot understand. For example, one of the most important things in Peoples Bank of China is exchange rate. We failed to make exchange rate more flexible. So if you want to make reform it is not that difficult, we just stop exchange rate intervention, and we have a flexible exchange rate. It has nothing to do with capital account liberalization. Why you have to use capital account liberalization to force yourself to liberalize your control for exchange rate. Of course whether we should liberalize exchange rate is another issue we can debate but anyway to use capital account liberalization as a sort of pre-condition for reform is totally wrong.

Paulo Nogueira Batista: I would just address briefly the question that came from the gentleman from the BIS on spillovers from capital flow measures. Capital flow measures on inflows are often a response to the spillovers of monetary policies of advanced economies, but do they have spillover themselves on other countries? That is question? For example Brazil adopts a tax on inflows of capital, does this divert capital to Mexico? Depending on how you view the balance of costs and benefits, the spillover can be positive or negative. If you believe that these capitals inflows are mostly beneficial, Brazil's action would benefit Mexico and would be a positive spillover and the opposite if you believe that the balance is negative.

A great deal was made about these spillovers from capital flow management measures for example in IMF staff documents in recent years. But going through these documents, our chair noticed that mostly this was based on conjecture, this was based on vague references to market perception. It was a bit funny because at the same time the effectiveness of these controls were challenged; there was expression of concern about the spillovers it would create on third world countries. Why was there this insistence on the part of the IMF? A country like Brazil which as Kevin showed is one of the countries that have the most marginal manoeuver in this area; it hasn't signed a BIT with the United States; it is

not member of the OECD, it is not a member of the Euro area, so it is under Article 6, it is a member of the Fund of the Articles agreement. Countries like Brazil can adopt any regulation that it sees appropriate on capital flows. So the argument is yes, there is Article 6 but even countries like Brazil and many others have to take into account certain disciplines on their policies to the capital account because of the spillover effects on other countries. So when we noticed this trend on the part of IMF staff, we repeatedly asked them where the evidence is. They tried and tried but didn't manage so far to come up with any relevant empirical evidence that these effects are significant or even existent. So very recently the IMF staff did recognize that there is no sufficient evidence to make this major concern in practical terms.

Jose Antonio Ocampo: I want to discuss one point that Kevin said that it is a positive of the institutional view of the IMF which is the recognition of the inconsistency in the global rules relating to capital flows, and actually in the sense that macro-prudential regulation, if capital account management is perceived as it is by the IMF as belonging to the family of macro-prudential regulation. So they point out that there is a growing inconsistency in the rules that should be corrected, and I think the view is that should be corrected on the side of prudential regulation.

Kevin Gallagher: I would just want to add one thing about the spillovers. One man's trash is another man's treasure. If Brazil puts in place regulations and that causes asset managers and portfolio managers to shift their allocations to places like Mexico, it actually depends on what the composition of their capital is? Extra investment into Mexico might not have financial amplification effects. So that is one piece. The other piece is that if Brazil is preventing financial crisis in their country by their regulation, the benefits are preventing contagion to Mexico far away may cause some negative capital flows going to a place like Mexico.

Stephany Griffith-Jones: Thank you all panelists.