The case for and experience with capital account regulations

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The 'excessive' exchange rate volatility associated with capital flows that the world has experienced in recent years points towards an essential leg of international monetary reform: capital account regulations. It is useful in this regard to recall that a major agreement during the recent crisis was that deregulated financial activities can be a source of major macroeconomic disruptions. The G-20 thus led a major effort to re-regulate finance, mainly at national level. However, *cross-border* finance was left almost entirely out of the agenda, as if it did not require any regulation—or indeed as if it was not part of finance. A particular twist of terminology is also involved in discussing this issue: domestic financial regulations are called by that name, but if they involve cross-border flows, they are called 'controls'. We would refer to them by their appropriate name: capital account *regulations*.

The essential problem here is that capital flows, like finance in general, is pro-cyclical. Agents that are perceived to be risky borrowers are subject to the strongest swings in the availability and costs of financing. These riskier agents include small firms and poor households in all domestic markets and emerging markets and, more generally, developing country borrowers in global markets. There is overwhelming evidence that capital flows to developing countries are pro-cyclical and have become one of the major determinants (and perhaps *the* major determinant) of business cycles in emerging economies (Prasad et al. 2003; Ocampo et al. 2008). Furthermore, the cyclical supply of finance is increasingly driven by portfolio decisions in industrial countries which may be entirely delinked from demand for capital by emerging and developing countries. These countries face further problems: their domestic financial markets are significantly more 'incomplete' and are plagued by variable mixes of currency and maturity mismatches,

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and their capital markets are shallower and small relative to the magnitude of the speculative pressures they face.

It is important to emphasize that the cyclical behaviour that characterizes capital flows goes beyond volatility of short-term flows. Even more important are the *medium-term* cycles in the availability and costs of financing. Since the mid 1970s, we have experienced three full medium-term cycles—from the mid 1970s to the end of the 1980s, from 1990 to 2002, and from 2003 to 2009—and we are at the beginning of a fourth one. The major problem with these cyclical swings is their strong effect on major macroeconomic variables: that is, on exchange rates, interest rates, domestic credit, and asset prices. As a result of this, pro-cyclical capital flows exacerbate major macroeconomic policy trade-offs, significantly limiting the space to undertake counter-cyclical macroeconomic policies. For example, during a boom, countries may float the exchange rate to maintain some degree of monetary policy autonomy, but this merely displaces the effects of pro-cyclical capital flows to the exchange rate. The resulting deterioration in the current account allows these countries to 'absorb' the increasing flows but experience indicates that it also increases the probability and costs of crises. More exchange rate volatility generates, in turn, disincentives to invest in export and import-competing sectors. If there is hysteresis associated to dynamic economies of scale (e.g., if productivity tomorrow depends on production today), there may be permanent losses in production structure during booms, and therefore adverse effects on growth.[1]

Since a restrictive monetary policy would only exacerbate appreciation pressures, an alternative for authorities to reduce the expansionary pressures generated by capital inflows is to adopt a contractionary fiscal policy. But this makes fiscal policy hostage to capital account volatility. Fiscal policy may lack the flexibility to respond rapidly to variations in capital flows, and there may not be political backing for doing so. Authorities may also try to stabilize the exchange rate by accumulating foreign exchange reserves while sterilizing their domestic monetary effects. But such sterilized accumulation generates quasi-fiscal losses that are particularly costly in countries with

[1] See the review of the literature in Frenkel and Rapetti (2010).

high domestic interest rates. When foreign exchange reserves are already high, as they are in many emerging and developing countries, these costs are hard to justify. Such interventions also destroy the rationale for capital inflows in the first place, which is to transfer resources to the country. To the extent that such reserves are a way to counterbalance the risk of future reversals of capital flows, they destroy the additional rationale for capital account liberalization, which is to diversify risks. In fact, experience indicates that they are rather a source of additional risk.

During boom periods, capital account regulations can therefore be justified as a way to help authorities manage booms while avoiding exchange rate appreciation, the risks associated with rising current account deficits and/or useless foreign exchange reserve accumulation. During crisis, they may also be used as a way to avoid or mitigate capital flight, which has the opposite macroeconomic effects. More generally, these regulations can play a dual role: they can be a complementary macroeconomic policy tool and help reduce the risks associated with liability structures tilted towards reversible capital flows. As a macroeconomic policy tool, they provide some room for counter-cyclical monetary policies. During booms, they increase the policy space to undertake contractionary monetary policy while reducing exchange rate appreciation pressures. In turn, during crises, they can create some room for expansionary monetary policies. Viewed as a liability policy, capital account regulations recognize the fact that pro-cyclical behaviour and, particularly, reversibility varies significantly according to the nature of capital flows: foreign direct investment is more stable than portfolio and debt flows and, among the latter, short-term debt flows are particularly volatile.[2]

Capital market regulations obviously *segment* domestic from international markets, but this recognizes the fact that markets are already segmented. Indeed, the basic flaw of capital account liberalization is that it does not recognize the implications of this basic fact. As with prudential regulations, capital account regulations can be either quantitative (or administrative) or price-based, but there are more complex typologies (see, for

[2] See, for example, Reddy (2010: ch. 21). The classic treatment of the riskiness of short-term capital is Rodrik and Velasco (2000).

example, IMF 2011).[3] The former include, among others, prohibitions or ceilings on certain capital flows, derivative operations or net exposure in foreign currencies; minimum stay periods; and restrictions on foreign investors taking positions in domestic securities or rules on what type of agent can undertake some capital transactions (residents versus non-residents, and corporate versus non-corporate). In turn, price-based regulations include unremunerated reserve requirements on capital inflows, taxes on inflows or outflows, and larger reserve requirements for external liabilities of net balances in foreign currencies. Furthermore, they can be partly substituted by domestic prudential regulations when they involve domestic financial intermediation, though not when they entail access to external capital markets by non-financial domestic agents.[4] They thus belong to the family of what have come to be called 'macroprudential regulations', including particularly of counter-cyclical prudential regulations (for an early analysis of this link, see Ocampo 2003).

The concrete analysis of experiences with the use of capital account regulations leads to several conclusions.[5] First, regulations on either inflows or outflows can work (though the more orthodox literature is sceptical of the effectiveness of the latter), but the authorities must have administrative capacity to manage them, which includes acting on time to close loopholes and respond to 'innovations' by private agents aimed at circumventing regulations. As a result of the link with administrative capacity, permanent regulatory regimes that tighten or loosen the norms in response to external conditions may be the best choice rather than improvising a system in the face of shocks. Second, regulations help generate a mix of increased monetary autonomy, reduce exchange rate pressures and alter the magnitude of flows, with greater scepticism on the latter effect by several authors. Some of these effects may be temporary, largely due to greater circumvention of regulations as time passes, and in this sense regulations may act as

[3] There are also terminological differences. IMF (2011) coins the term 'capital flow management measures', and Epstein et al. (2003) have suggested the term 'capital management techniques'.

[4] In the latter case, price-based regulations can also be substituted by tax provisions applying to foreign-currency liabilities (see, for example, Stiglitz and Bhattacharya 2000).

[5] See, among others, three papers by the IMF and IMF experts (Ariyoshi et al. 2000; Ostry et al. 2010; IMF 2011), Magud and Reinhart (2007), Kawai and Lamberte (2010) and my own work (Ocampo 2003, 2008).

‘speed bumps’[6] rather than permanent restrictions; this implies that further reinforcement may be required to maintain their effectiveness. Third, capital account regulations on inflows help improve debt profiles and thus act as an effective liability policy that reduces external vulnerability. Finally, and perhaps most importantly, regulations are a complement to sound macroeconomic policies, not a substitute for them.

Overall, the evidence is therefore that capital account regulations are a useful and effective complementary instrument of counter-cyclical policy management (IMF 2011). There is also evidence that countries using regulations on capital inflows fared better during the recent global financial crisis (Ostry et al. 2010), and that the new regulations put in place by some countries since 2010 have been at least partly effective (Gallagher 2011; IMF 2011).

Debates on this issue since 2010 have emphasized some *global* dimensions of these regulations that must be at the center of attention. The first and essential problem is the asymmetry generated between the strength of several emerging economies and the continuing weakness of most industrial countries. This situation, which is likely to continue, implies that the latter have to maintain expansionary policies, but the former are gradually moving towards more restrictive policies, though partially constrained for doing so by massive capital inflows. In short, the ‘multi-speed’ character of the recovery creates a need for a mirror asymmetry in monetary policies, which would be very difficult to manage without some restrictions on capital flows.

A second problem is that monetary expansion may be largely ineffective in industrial countries but can generate large externalities on emerging markets. This is particularly problematic when it involves the country issuing the major global reserve currency. Indeed, expansionary monetary policies in the USA, including now quantitative easing, has had at best mixed effects in generating a reactivation of credit, the major transmission mechanism of monetary expansion to domestic economic activity, but the low dollar interest rates associated with that policy are inducing massive capital flows to emerging

[6] This is the term used by Palma (2002) and Ocampo and Palma (2008).

markets, where they are generating appreciation pressures and risks of asset price bubbles. They may also be contributing to the weakening of the dollar, with negative effects on trading partners.

A third problem is that unilateral actions by countries also have negative externalities on other countries; that is, regulations by some countries may generate even stronger flows towards those not doing so. This is also true, of course, of interventions in foreign exchange markets.

So, cross-border capital account regulations are an essential part of global monetary reform. Actually, the basic principle that should guide actions in this field is the 'embedded liberalism' under which the IMF was built: that it is in the best interest of all members to allow countries to pursue their own full employment macroeconomic policies, even if this requires blocking free capital movements. It is therefore positive that the Fund has recognized that capital account regulations can play a positive role, as part of the broader family of macroprudential regulations, and has taken the step to openly discuss this issue and has suggested a possible 'policy framework' for discussion (IMF 2011). Furthermore, this is the first step taken to include cross-border capital flows within ongoing efforts at strengthening prudential regulation worldwide.

Such policy framework should start, however, by designing mechanism to co-operate with countries using these policies, helping in particular make those regulations effective. In fact this may require eliminating provisions in several free trade agreements (particularly those signed by the USA) that restrict the use of such regulations. This type of co-operation is excluded from the IMF guidelines even while recognizing that capital account volatility is a negative externality inflicted upon recipient countries.

The guidelines try to identify 'best practices' in this area. As indicated, such best practices include the recognition that they are a complement and not a substitute for counter-cyclical macroeconomic policies. However, the guidelines tend to view them as interventions of 'last resort' (or a second, third or fourth line of defence), to be used once other macroeconomic policies have been exhausted: exchange rate adjustments, reserve accumulation and restrictive macroeconomic policies. This is a limited view of their role, as they should actually be part of the counter-cyclical package, which should include avoiding excessive exchange rate appreciation and reserve accumulation in the first place.

Also, the guidelines tend to view them as temporary measures. This goes against another IMF recommendation, which calls for 'strengthening the institutional framework on an ongoing basis'. This implies that regulations should be part of the permanent toolkit of countries, which are strengthened or weakened in a counter-cyclical way. Also, and again against the guidelines, almost by necessity they require some discrimination between residents and non-residents, which reflects the segmentation that characterizes financial markets in an international system: as different moneys are used in different territories, residents and non-residents have asymmetric demands for assets denominated in those currencies.

In any case, any guidelines in this area should recognize the fact that there is no obligation to capital account convertibility under the IMF Articles of Agreement—an issue that was settled in the 1997 debates—and therefore countries have full freedom to manage their capital account. In the words of the Group of Twenty-Four (G-24 2011: par. 8): 'Policy makers of countries facing large and volatile capital flows must have the flexibility and discretion to adopt policies that they consider appropriate and effective to mitigate risks'. So, although the IMF has made a positive contribution by bringing the issue of capital account regulations into the global debate, it can only be taken as a first step in the necessary task of including this issue in the efforts to re-regulate finance and avoid global macroeconomic imbalances.

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