“Capital Flows Management Measures and Systemic Risk”

<u>Transcript of the comments by José Antonio Ocampo, Co-President, *Initiative for Policy Dialogue*</u>

Among the several documents that were sent us to us to prepare for this conference, there is a very interesting one by Dr. Duvvuri Subbarao that underscores the significant changes that have taken place in the views on capital account regulations during the still ongoing crisis. Paulo Nogueira Batista has already presented his caveats on the IMF debates. In a paper we published with Kevin Gallagher last year in the *Economic and Political Weekly*, we analysed the IMF's institutional view. Our assessment was that it went far with respect to previous IMF conceptions, but not as far as we wanted. But there is no question that there have been significant changes in this area relative to the world in which we lived five or six years ago. For those of us who have worked on this issue for a long time, and who have practiced regulations (as it is my case), these are welcome news. Let me summarize my own reflections on the theoretical and empirical analysis of this topic.

The major issue is, of course, pro-cyclicality. It is a well-recognized fact that emerging market economies face pro-cyclical capital flows. I understand why the US does not need capital account regulations, as it actually receives counter-cyclical financing from the rest of the world. But for the rest of the world, particularly for those countries that face pro-cyclical financing, it is an important policy tool. I must say in this regard that the evidence on pro-cyclicality is compelling. An IMF's *World Economic Outlook* dealt with this issue a couple of years ago and actually concluded that capital flows has actually become *more* volatile in recent decades, and that the differences in volatility between different forms of capital flows has narrowed down, including foreign direct investment, which has become more pro-cyclical essentially because it has become financialised. In other words, FDI is becoming a financial investment rather than fixed capital in the traditional sense of the term.

For this essential reason, I am among those who have claimed that regulations in this area are essential. Furthermore, I have pointed out that the terms capital account regulation or management are better than controls, which is a pejorative term that is never used for prudential regulation, only for the management of the capital account.

Regulations in this area have two objectives. The first is financial stability. This is the macro-prudential dimension of these regulations. For this reason, I have found astonishing that the Financial Stability Board has not taken this issue on board, almost implying that cross-border finance as it was not finance. It should have been dealt with it, as it is a major source of financial risk. I would even say it is *the* most important source of financial risk for emerging economies. So the issue of capital account management is part of the broader financial stability agenda.

The second objective of these regulations is macro-stability. It is associated with the fact that boom-bust cycles of cross-border finance are associated in most, particularly emerging economies, with the intensity of domestic business cycles. For this reason, regulations or management of capital flows should be part of a menu of options of counter-cyclical macroeconomic policy. My major criticism of the IMF's institutional view is that it still tends to look at these regulations as sort of macroeconomic "interventions of last resort". In the essence, it implies that countries should do everything else and, if they fail, then they are blessed to manage the capital account. This is a fundamental mistake because it is difficult to do macroeconomic policy that way, and because different interventions have different objectives and effects.

This becomes clear when we look at individual tools. For example, if countries are having booming capital inflows, the IMF argues then they should adopt restrictive fiscal policies, which is correct, but also restrictive monetary policies. But the latter worsens the problem, as it attracts even more capital flows. Boom-bust cycles of external finance actually pressure countries to adopt pro-cyclical monetary policies if they want to reduce capital inflows during booms and reduce capital outflows during crises. But this is certainly not the appropriate macroeconomic policy framework. Counter-cyclical monetary policies thus require additional tools.

The same thing is true of exchange rates, which tend to appreciate during booms and depreciate during crisis, and authorities are generally forced to allow market forces to generate that result. But in most emerging economies the private sector has net liabilities in foreign currency. So, appreciation during booms generates wealth gains, and depreciation during crisis a wealth losses. So, the wealth effects of exchange rate movements are also pro-cyclical. The effects on current account movements may be counter-cyclical, but there is an extensive literature that argues that they may also be pro-cyclical. Particularly, exchange rate appreciation during booms tends to increase real wages and thus domestic consumption, and depreciation during crises generates a reduction in real wages that has contractionary effects. So, under many circumstances exchange rates movements have pro-cyclical effects. The need for additional policy instruments is again clear.

Accumulating foreign exchange reserves during booms and using those reserves during crises helps avoid these problems and it is thus a desirable component of the macroeconomic policy package. But it has costs, as it implies that countries respond to foreign capital inflows that have returns of 5-

7% per year with reserves that central banks invest in very liquid investments, such as US Treasury securities, that have very low yields. So, from the point of view of countries, these interventions have significant costs.

The major contributions of capital account regulations to macroeconomic policy is, therefore, to support counter-cyclical monetary policies, avoid the pro-cyclical effects of exchange rate movements and help countries reduce the costs of foreign exchange reserve accumulation. For all these reasons, they should be seen as part of the toolkit that countries include from the very beginning as part of their policy packages rather than interventions of last resort.

Furthermore, I have been argued for more than a decade that capital account regulations should be seen as part of the macro-prudential family. Actually, I wrote a paper back in 2002 on how to link capital account regulations with counter-cyclical prudential regulations, which is how I called macro-prudential policies at the time, arguing that they are complementary tools. They should be seen as part of a family of interventions which starts with purely domestic macro-prudential regulations, which refer to domestic assets and liabilities in domestic currencies, but also includes regulations on the domestic use of foreign currency, and regulations on cross-border flows. Some of the most interesting innovations in capital account management have taken place in the intermediate area –that is, the domestic use of external capital—, which is by now the area where emerging and developing countries intervene more frequently.

In this regard, an interesting case is the Peruvian intervention system, which according to the IMF analysis is one of the most effective. What do they do? Peru has a semi-dollarized financial system, and authorities actively use differential reserve requirements on deposits in dollars versus those in the domestic currency. So when there is a capital inflow, they essentially increase reserve requirement on foreign exchange deposits. Actually at one point they decreed a 100% marginal reserve requirement, which essentially implied that any capital that came in could not be lent to any domestic agent; in turn, when the capital flow subsides, they reduce the reserve requirement.

So, there are intermediate forms of regulations that are interesting and actively used. That is why for some time I have been thinking that perhaps we should regulate foreign capital inflows with the same type of reserve requirement that use in the domestic financial system. This means, for example, that if countries require 10% or 20% reserve requirement on deposits in domestic currency, they should also require 10 or 20 % reserve requirement on all external liabilities.

Reserve requirements would then be on the stocks, not on the flows of external capital, as they have traditionally been in the so-called system of unremunerated reserve requirements (URRs).

How do I read the literature on effectiveness of these regulations? There is broad-based agreement that they have positive effects on the composition of capital inflows, tending to lengthen the maturity of external debt obligations. Second, there is relatively broad agreement that they increase monetary policy independence, in the sense that regulations on inflows allow countries to increase domestic interest rate during booms, and particularly to adopt contractionary monetary policies that have no effect on the exchange rate. This means that capital account regulations can actually separate the interest and exchange rate effects of capital flows.

There are more question marks in other areas, particularly on effect of regulations on overall capital inflows and on exchange rates. My work with Bilge Erten has tried to correct one major problem in the literature. Most papers look at the effects on total flows and exchange rates as separate effects, but in fact they are complementary. We develop a new index, which we call the "foreign exchange pressure" generated by capital flows, which can be reflected either in reserve accumulation or in exchange rates. When we mix these two variables, we actually find out that the effects of regulations are stronger.

There are also interesting real effects. This first analysis of this issue came with the work of the Jonathan Ostry and his team at the IMF. They show that countries that had capital account regulations before the recent crisis were able to mitigate the contraction of GDP during the crisis. There are more years in the dataset that we worked with Bilge Erten, and so could also analyse the recovery. We found that having had capital account regulations actually avoided overheating during the recovery. If we mix this with the previous result, it means that capital-account regulations are a good counter-cyclical instrument: they help countries mitigate the real effects of both booms and busts, and thus smooth out the business cycle.

There is also an extensive literature on the types of instruments. Let me present some of my conclusions on this topic. The first relates to the effects of regulation on inflows versus outflows. There is a significant bias in the current debate against regulating outflows. But actually the literature, including an excellent research document produced by the IMF back in 2000, actually argues that regulation of outflows have stronger effects. In our work with Bilge Erten, we also found that regulations of outflows are more effective than regulations of inflows. In this regard, there is also the related issue that central banks issue their domestic currency but not dollars. This is of course essential for foreign exchange interventions, but also for capital account regulations. So, in the first case, central banks issue domestic currency when they accumulate reserves to avoid the exchange rate from appreciating, but cannot issue dollars to smooth out exchange rate depreciations –only use the reserves they accumulated during the previous boom. And, of course, if they start losing dollar reserves, the capital flight may actually speed up. For those reasons, under those circumstances countries could be advised to regulate capital outflow.

On price versus quantity-based regulation, I should start by saying that I have been a practitioner of price-based regulations, in particular URRs. They have the particular advantage of generating less distortions. But again the evidence in the literature, including IMF research, is that quantity-based regulations are generally more effective. In fact, simple quantity based regulations –in particular, prohibition on certain transactions— are also used in domestic prudential regulation, with no stigma associated with them.

On temporary versus permanent regulations, the major issue is whether countries have the institutions in place, that is permanent regulatory systems. Improvising institutions to manage either booms or crises generates poor results. For this reason, the best is a permanent institutional framework that countries manage in a counter-cyclical way. For example Brazil has a tax of capital flows that they increase during booms but reduce, even to a zero rate, during crises.

On residents versus non-residents, the IMF's view is that countries should not discriminate between residents and non-residents. But this may not be reasonable and may in fact be impossible, as residents and non-resident have a significant difference in their demand for the domestic currency. Non-residents obviously demand it less than residents, and probably in a more unstable way. For that reason, it may make sense to discriminate between them. Thus, although I agree that countries should try to focus their regulations on currencies rather than residency, even regulations that focus on currencies discriminate between residents and non-residents because they have different demands for different currencies.

The issue of whether there should be different regulations for different type of flows has been dear to Indian regulators. I agree that it makes sense to do so, although if we believe the conclusion of recent IMF research that volatility has tended to be more similar through time for different types of flows, it probably is less important today than it used to be.

Finally, a basic reflection on international cooperation: effectiveness will be significantly increased if there is cooperation, for example, information by source countries on capital flows. And let me remind you, as a historical note, that the US negotiator in Bretton Woods, Harry Dexter White, actually proposed that such cooperation be an essential element of the post-war arrangements. At the time, the British negotiator, John Maynard Keynes, was actually surprised to see that the US was willing to make that offer. It may be the time to bring it back into the agenda, indeed as part of broader international cooperation on financial regulation.