Countervailing Monetary Power

Emerging Markets and the Re-Regulation of Cross-border Finance

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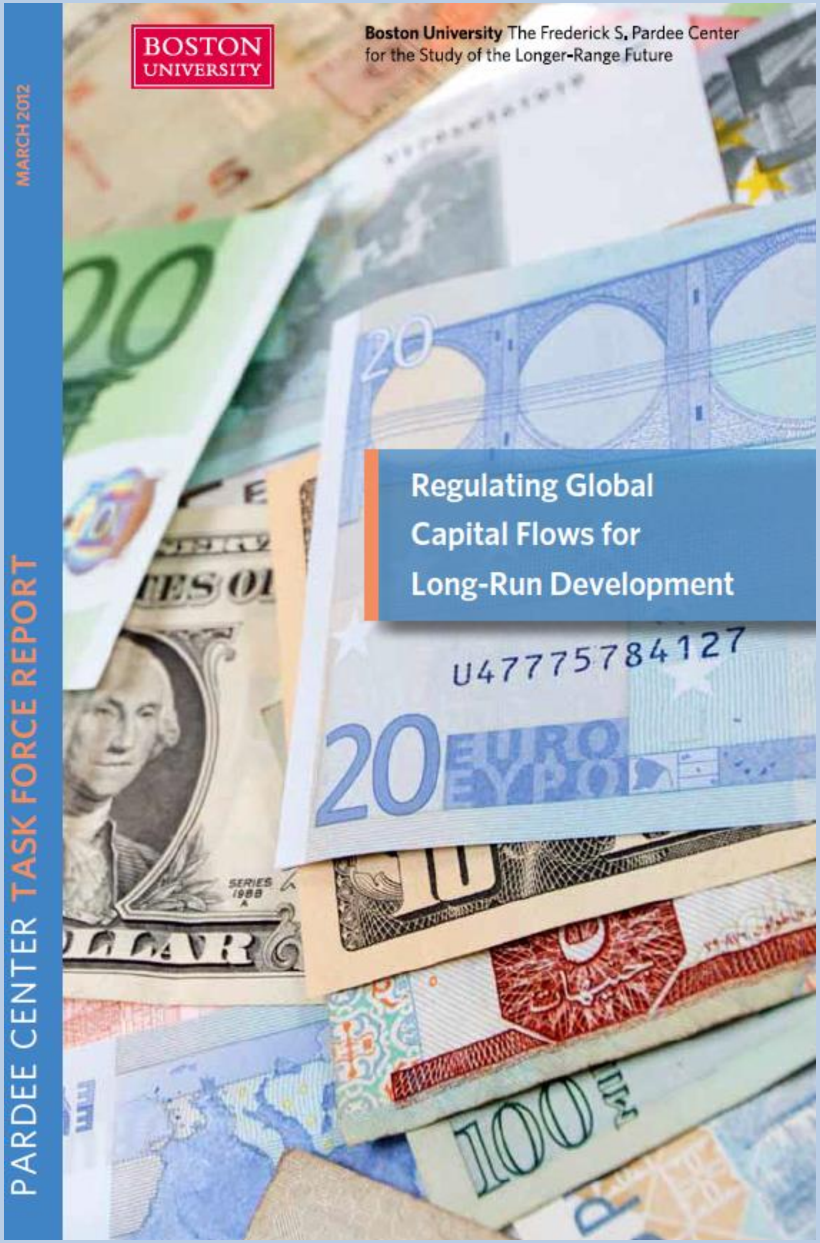

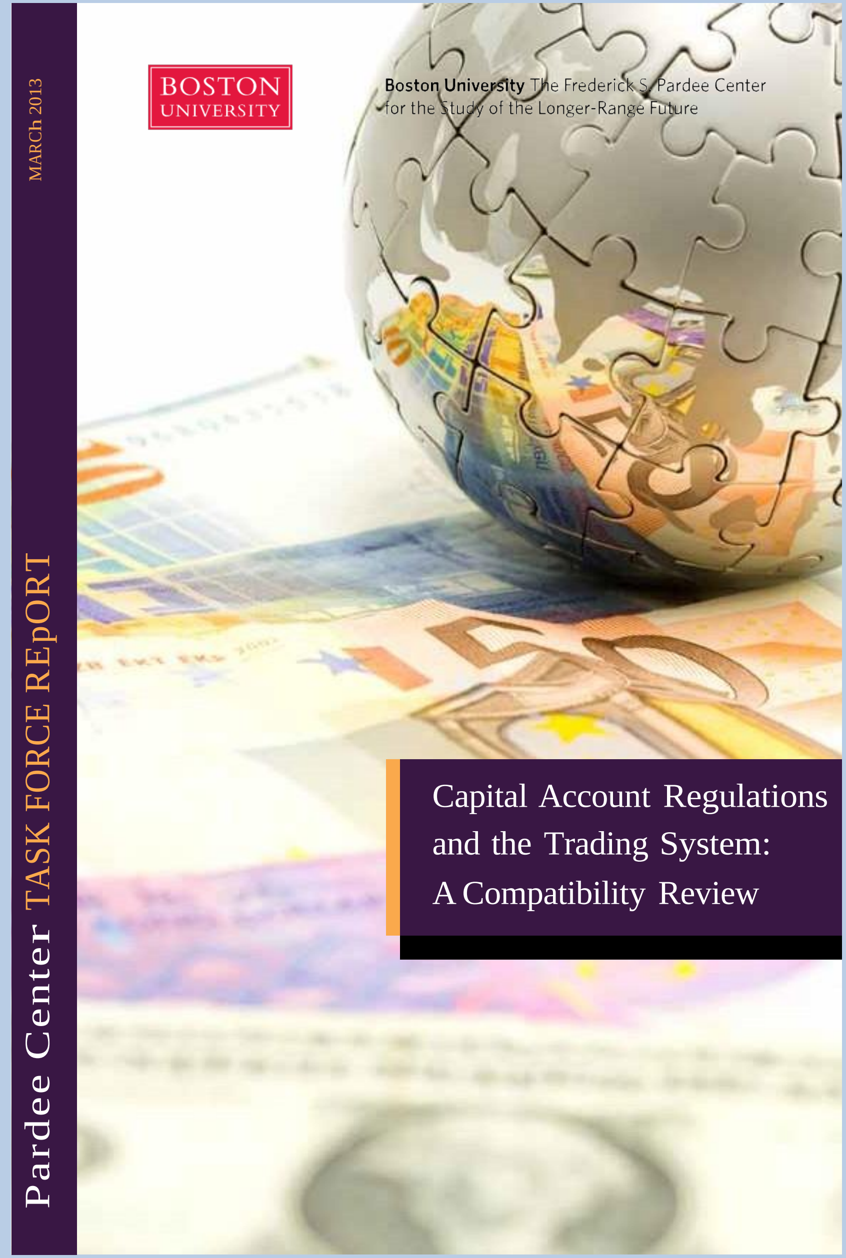

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Outline

1) Capital flows and the crisis:

- ‘new’ economics of capital flows.
- ‘global financial cycle’ and the post-crisis period.

2) **(Some) EMDs are re-regulating cross-border finance:**

- Many EMDs re-regulated capital flows to some success.
- EMDs overcame key political economy hurdles.

3) **‘Productive incoherence’ in Global Economic Governance:**

- IMF new ‘institutional view’
- G-20 ‘coherent conclusions’ vs. ‘investment protectionism’
- WTO (may be) more open
- US FTAs and BITS more constraining, hotly contested

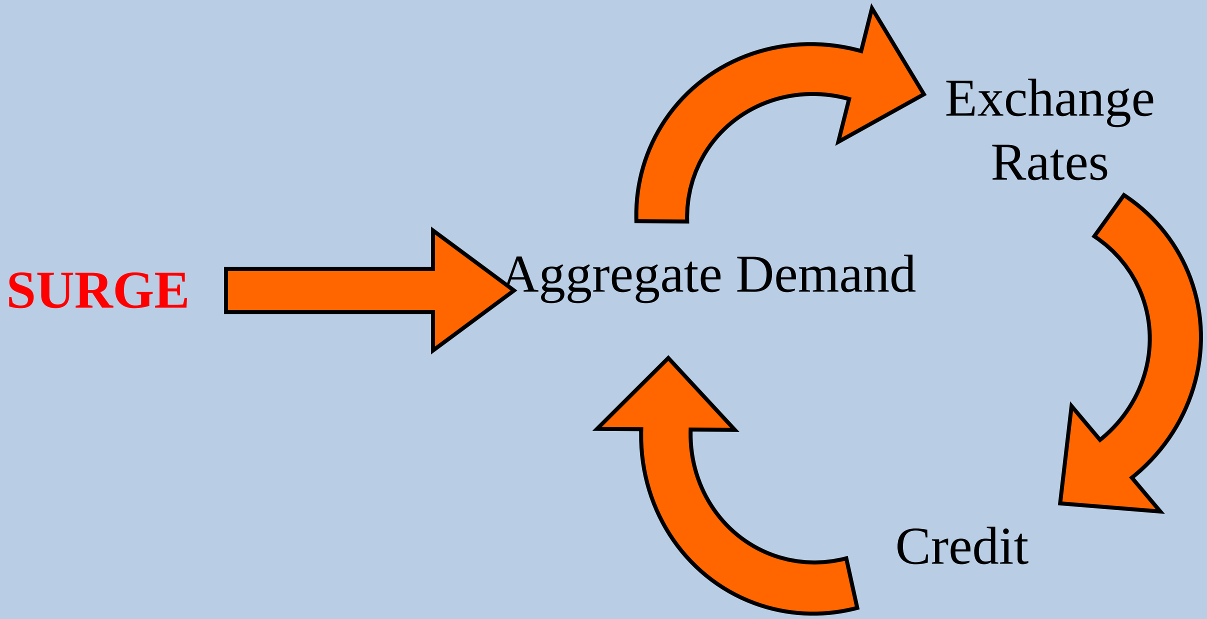
4) Need stronger effort at ‘both ends’

1) Capital Flows and the Crisis:

Capital Flows and Financial Fragility

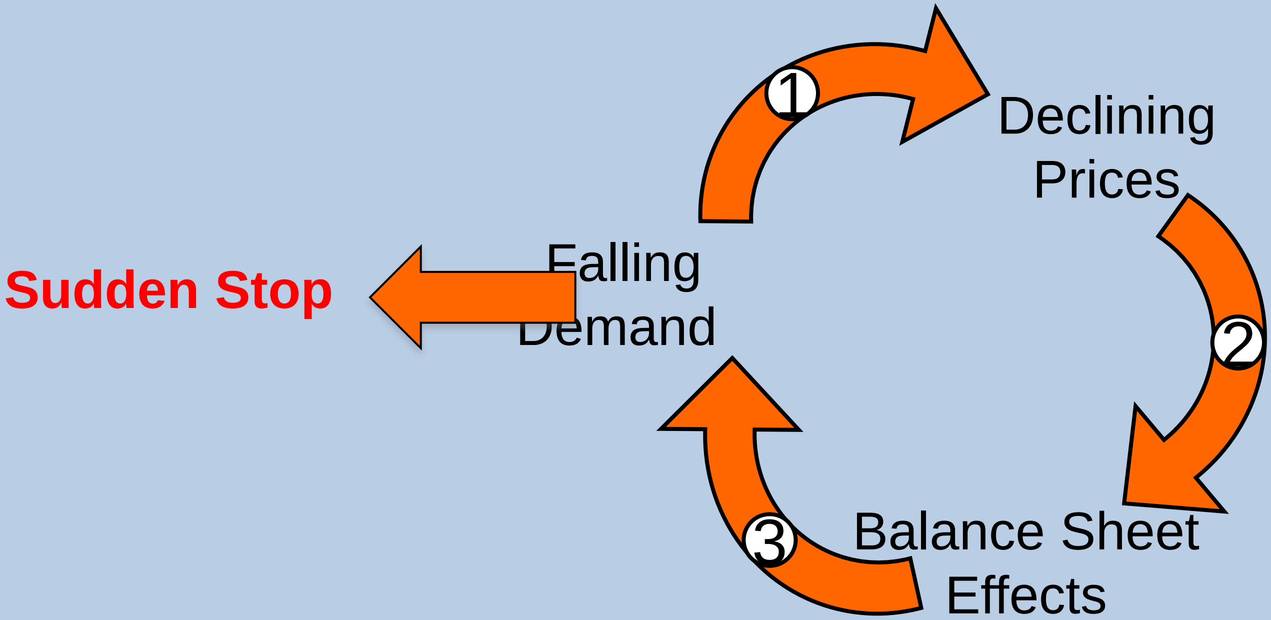
- Surges of inflows associated with buildup of foreign debt and appreciation of currency, rise in domestic asset prices and thus an increase in the internationally acceptable collateral on the basis of which domestic agents can borrow abroad.
- Sudden stops lead to capital outflows which cause depreciation of exchange rate and decline in asset prices. Amplified by inability to repay foreign creditors in domestic currencies and given that the value of domestic assets has depressed (severe currency mismatch issues).

Financial Amplification Effects



Source: Korinek, Anton (2011), "The New Economics of Prudential Capital Controls: A Research Agenda," IMF Economic Review, V 59, N3.

Financial Amplification Effect:

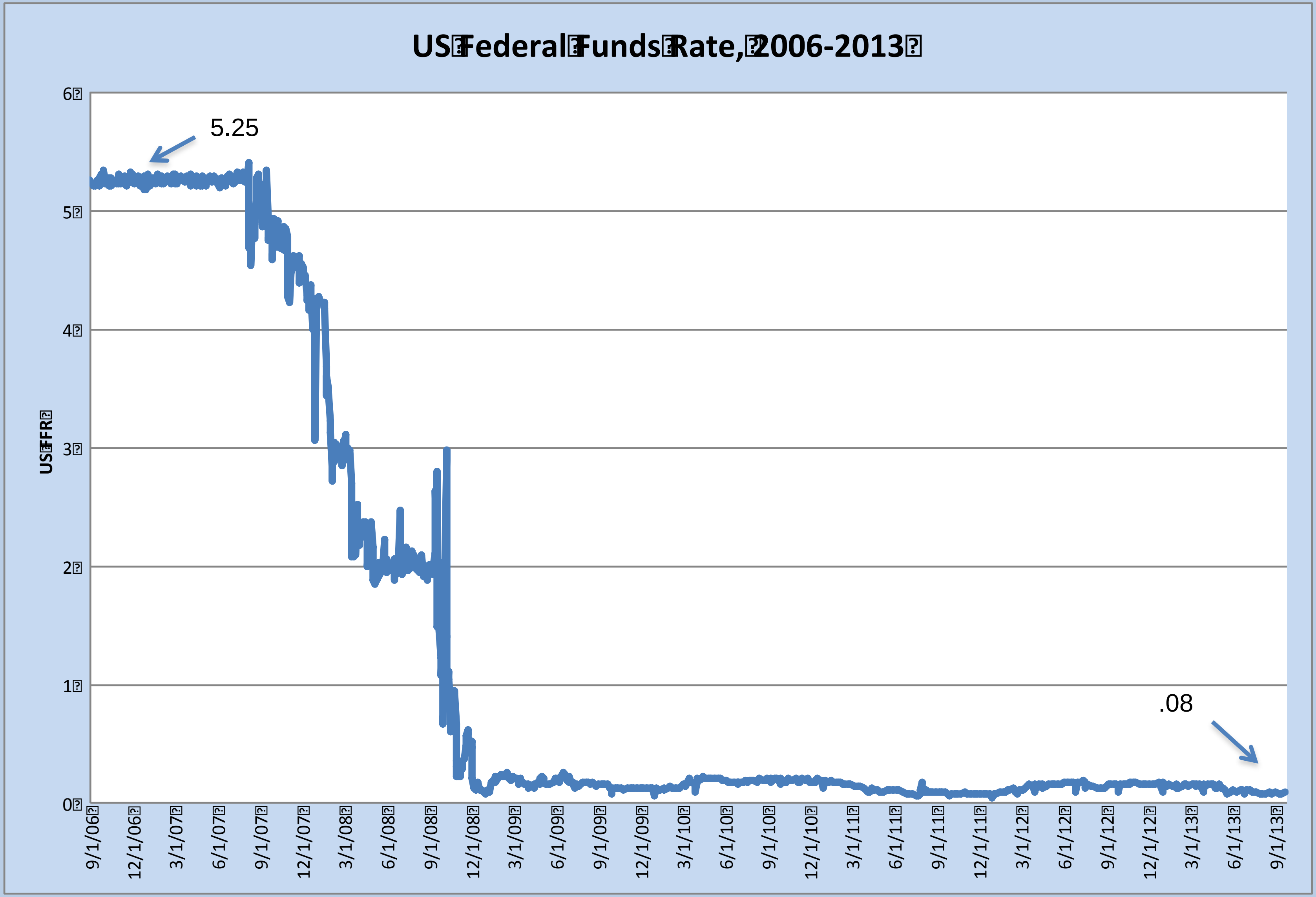


Korinek, Anton (2011), The New Welfare Economics of Capital Controls: A Research Agenda, IMF Economic Review.

Prudential Capital Account Regulation

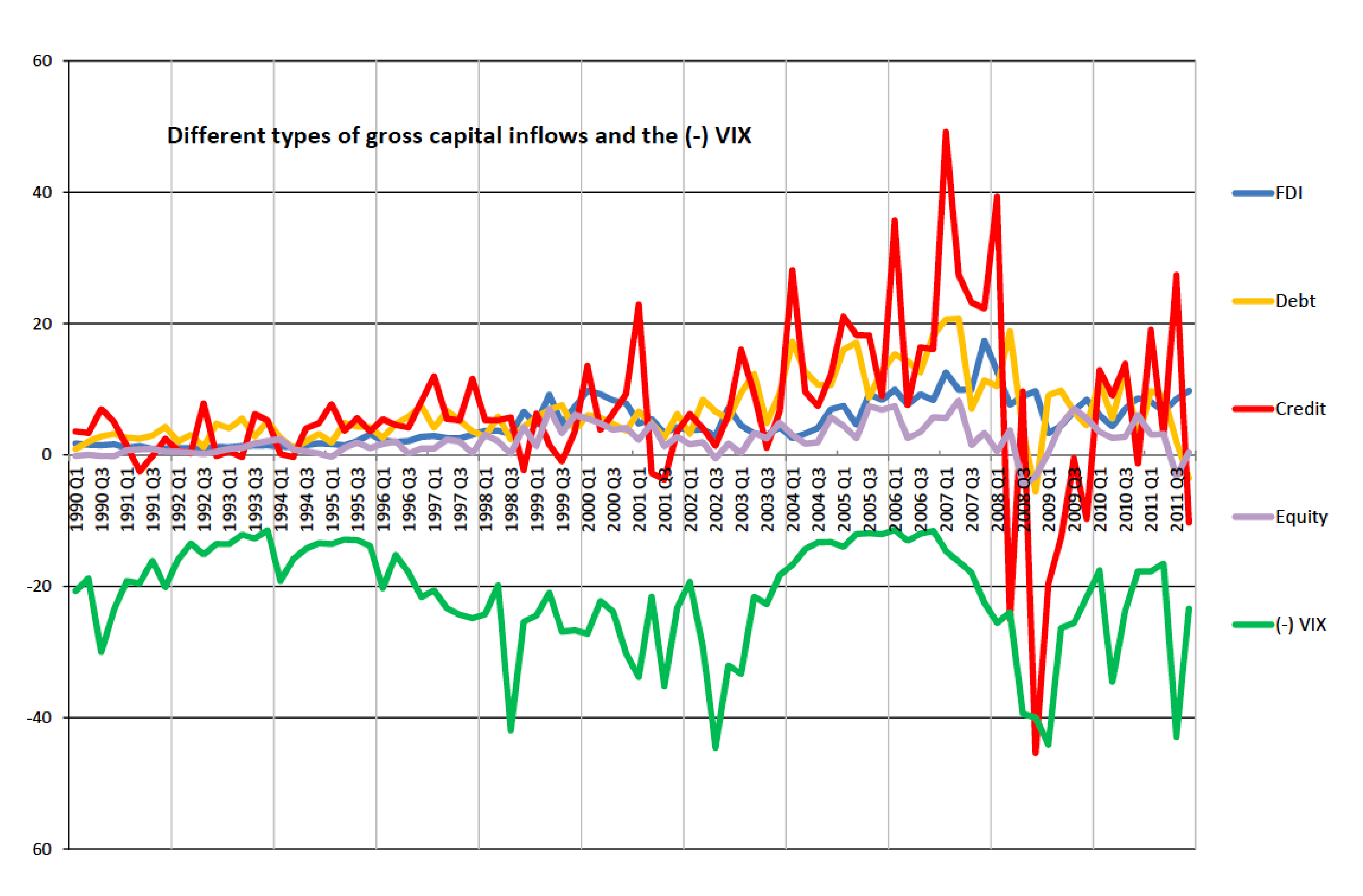
- Individual rational agents do not internalize their contribution to aggregate systemic risk when they design their balance sheets to achieve combinations of risks and returns.
- Individual participants do not take into account their JOINT impact on the degree of financial fragility.
- Classic ‘externality’ where the cost of systemic risk needs to be internalized with Pigouvian tax.

Capital flows and the crisis



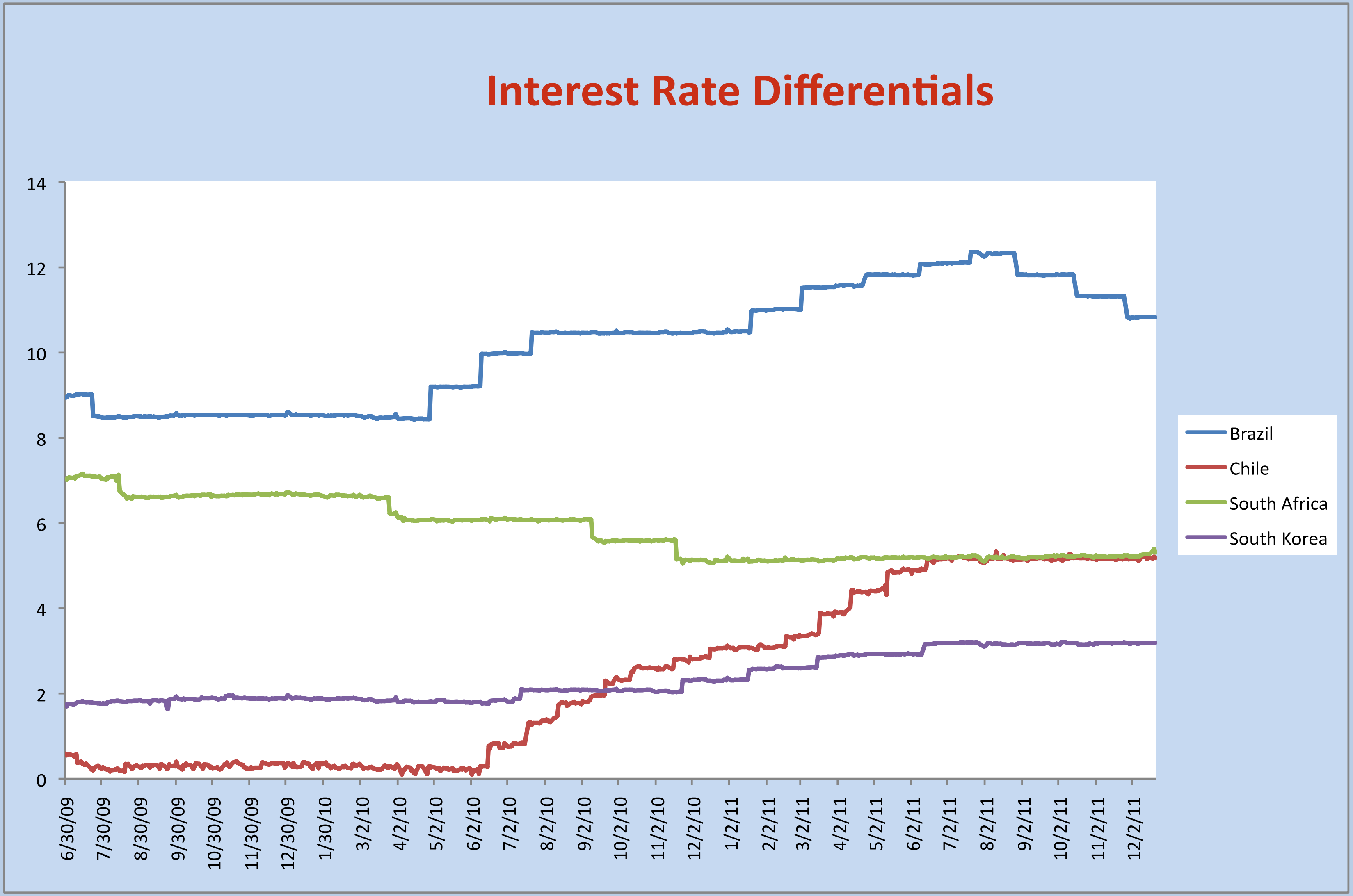
Source: Federal Reserve Bank of New York

Global Financial Cycle



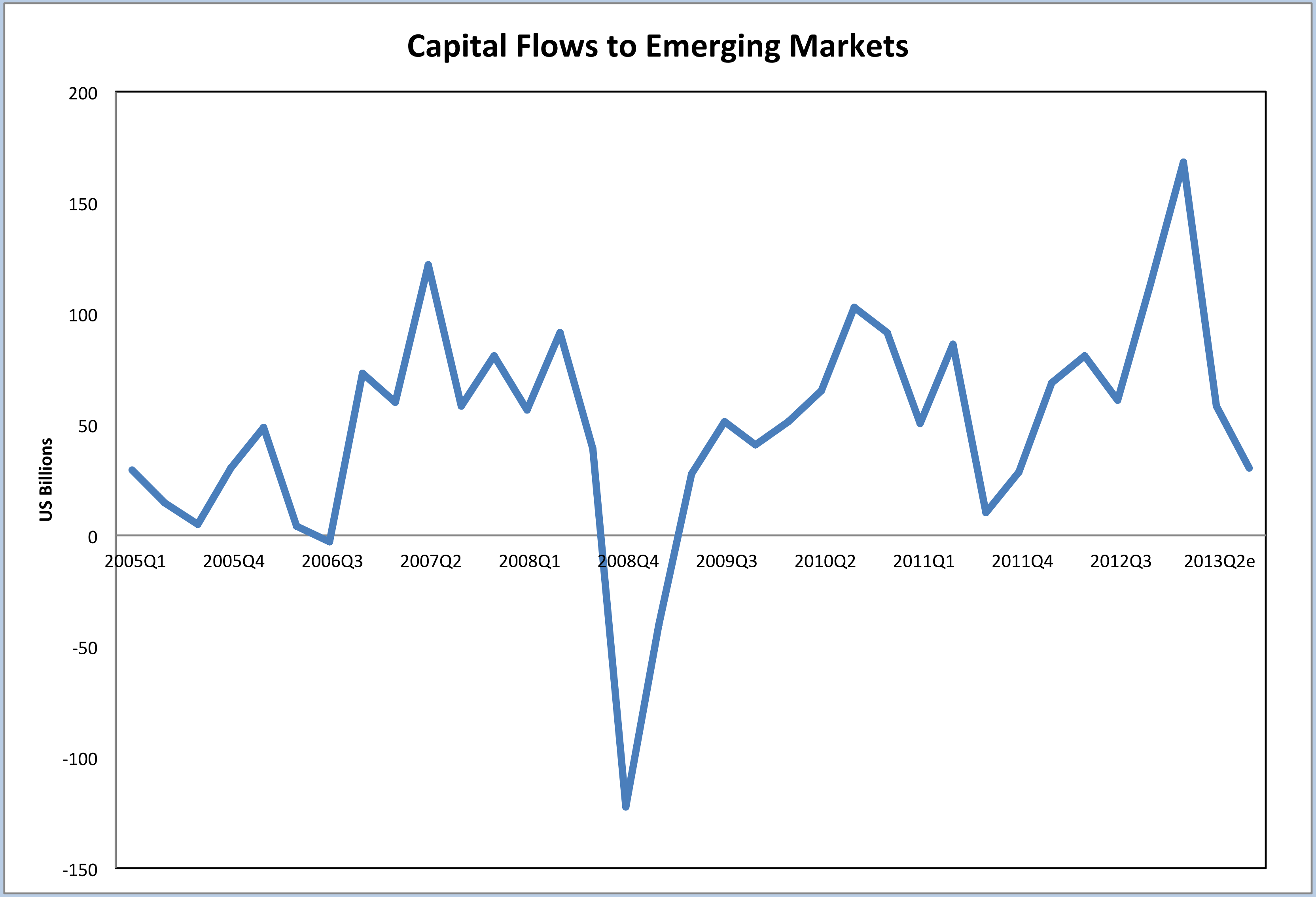
Source: Helene Rey (2013) "Dilemma not Trilemma" Jackson Hole Symposium

Getting Carried Away

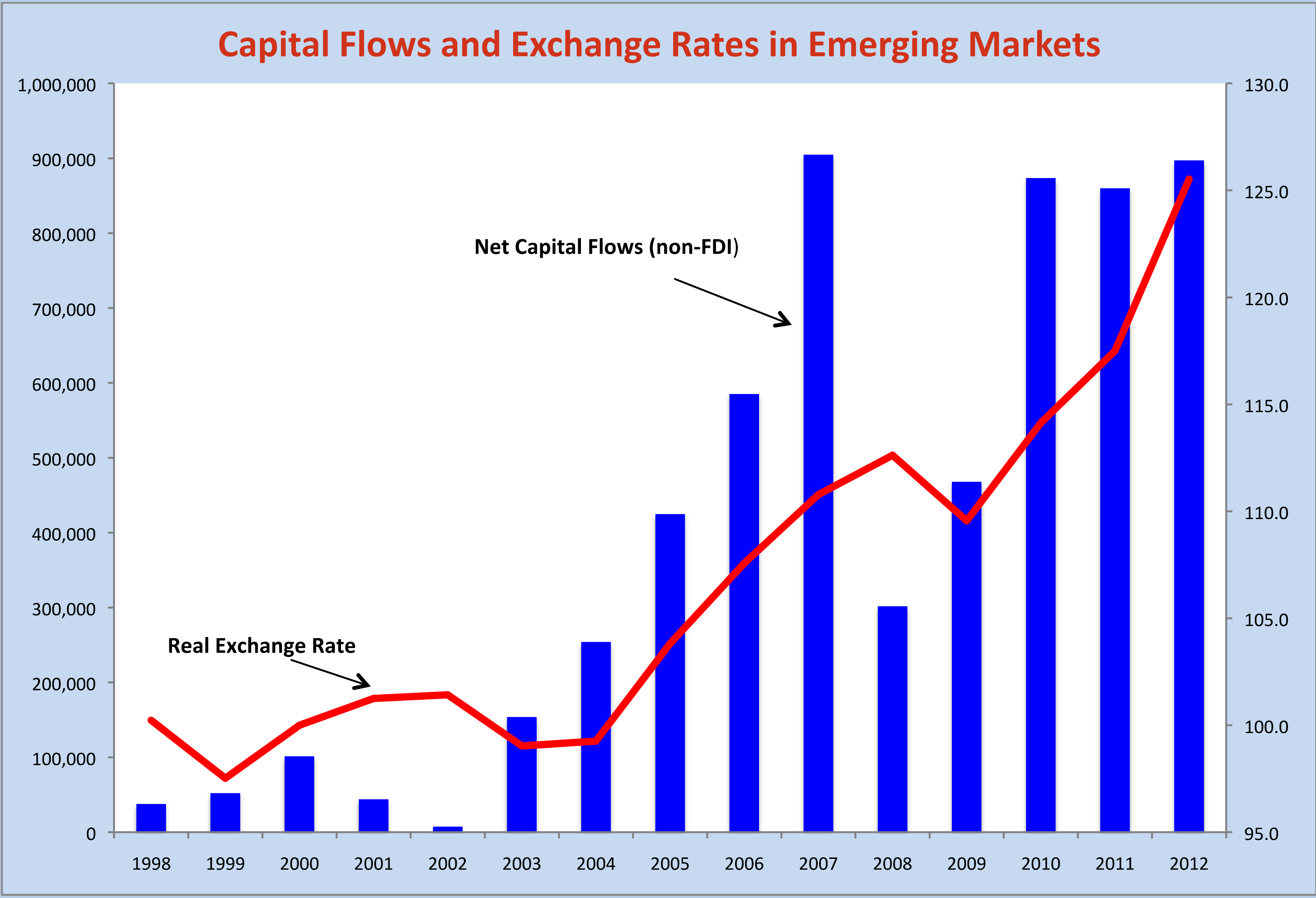


Source:Thompson Data Stream

Capital flows to EMS



Source: IIF 2013



Source: Institute for International Finance, Capital Markets Monitor, 2012 (million USD)

2) **(Some) EMDs re-regulate cross-border finance**

Three Generations of EMD Cross-Border Financial Regulations

Country	First Generation *(quantitative controls)*	Second Generation *(price-based controls)*	Third Generation *(FX regulations)*
China	outright bans or limits on the entry of certain investments		
India	Direct limits on USD-ruppe trades		margin requirement on dollar-rupee forward trade increased to 100 percent
Brazil		taxes on portfolio investments	non-interest reserve requirement on bank's short dollar positions in FX spot market
South Korea		witholding tax on non-resident holdings of treasury and monetary bonds	numerous restrictions on bank's FX derivatives positions
Peru		taxes on portfolio investments	position limits on FX short dollar trades and reserve requirements for all FX deposits
Indonesia	one month holding period on central bank bills		
Thailand		taxes on non-resident purchase of public bonds	

Source: Gallagher, 2014

Political considerations (domestic)

- *Backed by an export sector that is more concerned about the exchange rate than about their access to global finance*
- *Backed by workers more concerned about employment than short-term consumption upswings*
- *A 'politics of memory' exists regarding the severity of past volatility and crises*
- *Have legislation that enables finance ministry and/or central bank to use counter-cyclical regulations*
- *Regulation more successful when re-framed as 'macro-prudential' measures to reduce risk*
- *Have the policy space under global economic commitments*

Capital Account Regulations in Brazil and South Korea

Brazil

Effective Date	*Event*
20/10/09	IOF tax of 2%
19/11/09	ADR tax of 1.5%
05/10/10	Increase of IOF tax to 4%
19/10/10	Increase of IOF tax to 6%, increase of tax on derivatives
06/12/10	Increase in reserve and capital requirements
04/04/11	Reserve requirement on USD positions
29/03/11	IOF tax of 6% on foreign bond sales and loans
07/04/11	Modified IOF tax on foreign bond sales and loans
27/07/11	IOF tax of 1% on FX derivatives
01/03/12	Modified IOF tax on foreign bond sales and loans

South Korea

Effective Date	*Event*
19/11/09	Measures on banking sector
14/06/10	Measures to curb banks' currency derivatives
01/07/10	Restriction on foreign currency loans to overseas use
19/10/10	Increase bank regulation on foreign curreny derivatives
01/01/11	Withtholding tax on earnings of foreign investors from government bonds
01/08/11	Levy on banks' non-deposit foreign exchange liabilities
01/06/11	Lowered limits on banks' foreign exchange derivatives
26/04/11	Probe on lenders' trading of foreign-exchange derivatives.

Measures relatively successful

Cross-sectional studies

- **Less contraction** (Ostry et al, 2010)
- **More growth** (Ocampo and Erten, 2013)
- **Increased monetary autonomy** (Ocampo and Erten, 2013)
- **Exchange rate stability** (Ocampo and Erten, 2013; Ahmed and Zlate, 2014)
- **Changed level and composition of flows** (Ocampo and Erten, 2013; Ahmed and Zlate, 2014)

Country case studies

- **Changed level** (**Brazil**, (Forbes et al, 2011; de Silva and Harris, 2013)
- **Changed Composition** (**Brazil,** Baumann and Gallagher, 2012a; South Korea, Baumann and Gallagher, 2012b)
- **Increased monetary autonomy** (**Brazil**, Baumann and Gallagher, 2012a; **South Korea**, Baumann and Gallagher, 2012b)
- **Exchange Rate Stability** (**Brazil**: Chamon and Garcia, 2013; Baumann and Gallagher, 2012a**; South Korea**, Bruno and Shin, 2009)

3) Changes in Global Economic Governance

New IMF Guidelines

Capital Account Liberalization

•Capital account liberalization should be done in a sequenced manner

Managing Capital Inflows

•Allow the exchange rate to appreciate, accumulate reserves, tighten fiscal policy, increase capital requirements

•Use **capital flow management measures (CFMs)**

CFMS on Capital Outflows

• CFMs on capital outflows can be considered in crisis or near crisis conditions.

Multi-lateral Aspects of Managing Capital Flows

•Nations on both ends of capital flows should be conscious of the multilateral aspects of their policies

•Nations should strive for reciprocity when macro-prudential policies are being deployed

•Many trade and investment treaties are at odds with CFMs

IMF Articles of Agreement

"Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions"

G-20 one step forward, two steps back

G-20 'Coherent Conclusions'

"Capital flow management measures may constitute part of a broader approach to protect economies from shocks. In circumstances of high and volatile capital flows, capital flow management measures can complement and be employed alongside, rather than substitute for, appropriate monetary, exchange rate, foreign reserve management and prudential policies."

Source: G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences

G-20, they are talking

<u>G-7/G-8, 2013</u>

- "We, the G7 Ministers and Governors, reaffirm our longstanding commitment to market determined exchange rates and to consult closely in regard to actions in foreign exchange markets. We reaffirm that our fiscal and monetary policies have been and will remain oriented towards meeting our respective domestic objectives using domestic instruments, and that we will not target exchange rates."

<u>G-20, 2012</u>

- "We commit to monitor and minimize the **negative spillovers on other countries** of policies implemented for domestic purposes."

G-20: Little Coordination on Reform

- Derivatives reform coordination lacking
  - FX swaps and forwards exempted from Dodd-Frank
  - Cross-border applications may be exempted
  - Volcker rule only in US
- "Investment Protectionism" reports contradict 'coherent conclusions'
  - OECD-UNCTAD reports single out cross-border financial regulations in Brazil, South Africa, etc.

The World Trading System

WTO:

- free to regulate unless commitments under GATS
- BOP exception
- Prudential exceptions 'may' leave room to regulate
- Disputes are 'state-state'

US FTAs and BITS:

- All transfers must flow 'freely and without delay'
- No BOP exception
- Prudential exception too narrow for capital account regulation
- Disputes are 'investor-state'

IMF on FTAs and BITs

•**these agreements in many cases do not provide appropriate safeguards or proper sequencing of liberalization**, and could thus benefit from reform to include these protections (IMF 2012a, 8)."

•"In particular, the proposed institutional view could help foster a more consistent approach to the design of policy space for CFMs under bilateral and regional agreements. Recognizing the macroeconomic, IMS, and global stability goals that underpin the institutional view**, members drafting such agreements in the future, as well as the various international bodies that promote these agreements, could take into account this view in designing the circumstances under which both inflows and outflows CFMs may be imposed within the scope of their agreements (IMF 2012b, 33).**

International Monetary Fund (2012a), Liberalizing Capital Flows and Managing Outflows, Washington, IMF.

International Monetary Fund (2012b), The Liberalization and Management of Capital Flows: An Institutional View, Washington, IMF.

Some Political Considerations: Gaining and Preserving Policy Space

- As EMs gain more market power they obtain more conducive policy outcomes.
- Coalition building has been important, in institutions where voting power less more equal or by consensus.
- EM coalitions can leverage the fragmented global economic governance system to their benefit.
- EMs can temper the concerns of investors and West by re-framing regulation under a ‘macro-prudential framework’

Summary

- Cross-border financial regulations justified now more than ever.
- EMDs have a new generation of regulations that have promise.
- There are opportunities to gain political space for new policy.
- EMDs are gaining more policy space as they gain market power, form coalitions, and leverage alternative institutions.
- US policy: Monetary and trade remains big threat

Toward a More Coordinated Approach

- Permanent but counter-cyclical regulations on cross-border finance.
- Institutions to diversify the economy and sources of finance.
- Evoke the collective memory of financial crises.
- Re-frame the need to regulate at home and abroad.
- Push for quota reform at the International Monetary Fund.
- Continue EMD coalition building.
- Build alternative institutions (and leverage them at IFIs).
- Reform the incompatibilities between trade and financial regimes
- Coordinate regulation at ‘both ends’.

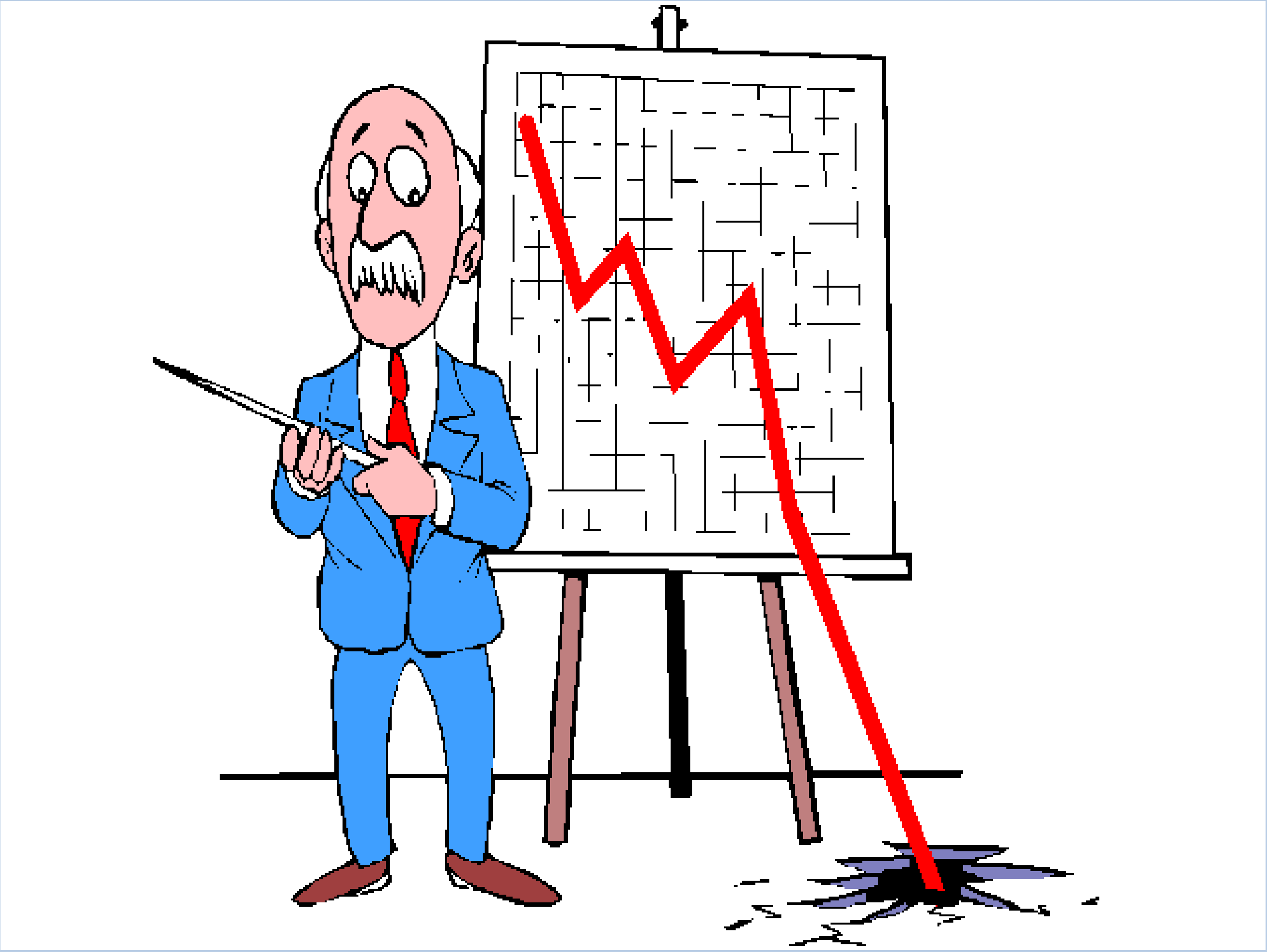
Little Counter-cyclical Lending in US

Table 1 US commercial bank cash reserves relative to bank liabilities and GDP during six economic recovery periods

	Commercial bank reserves (billions $)	Reserves as pct of bank liabilities	Reserves as pct of GDP
1973 following 11/70 recession trough	27.1	3.6%	1.9%
1977 following 3/75 recession trough	26.9	2.9%	1.3%
1985 following 11/82 recession trough	28.6	1.4%	0.7%
1993 following 3/91 recession trough	35.0	1.2%	0.5%
2004 following 11/01 recession trough	24.0	0.4%	0.2%
2011 following 6/09 recession trough	1595.9	15.3%	10.5%

Note: Figures are for two years into economic recoveries.
Source: Flow of Funds Accounts of Federal Reserve System.

3) (New?) Economics of Capital Flows
Mainstreaming Minsky

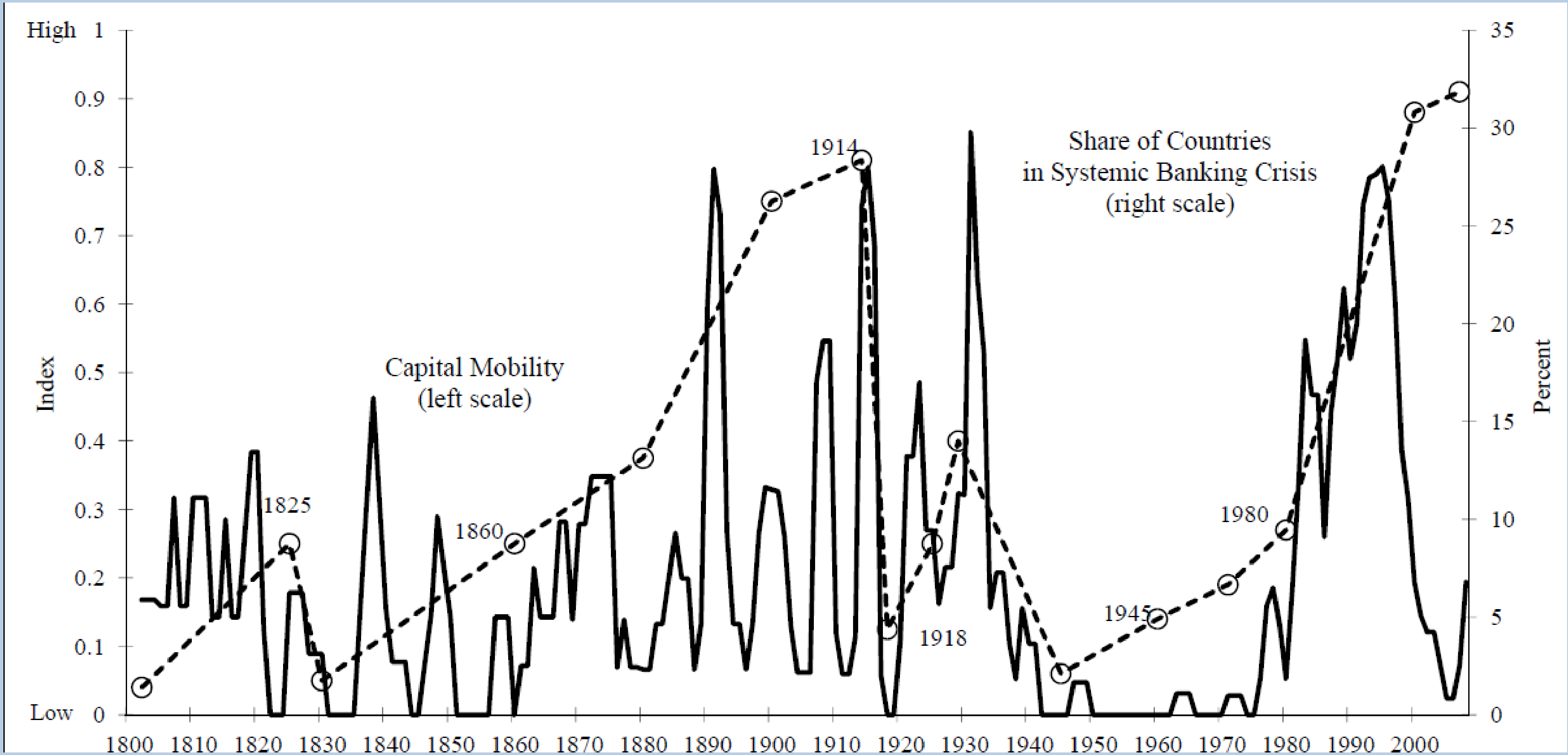


Capital Account Liberalization not Associated with Growth and Stability

- “the international community should not seek to promote totally free trade in assets—even over the long run—because free capital mobility seems to have little benefit in terms of long run growth and because there is a good case to be made for prudential and non-distortive capital controls.

Source: Jeanne, Olivier, Subramanian, Arvind and John Williamson (2012), Who Needs to Open the Capital Account? Peterson Institute for International Economics, Washington.

Capital Mobility causes Banking Crises

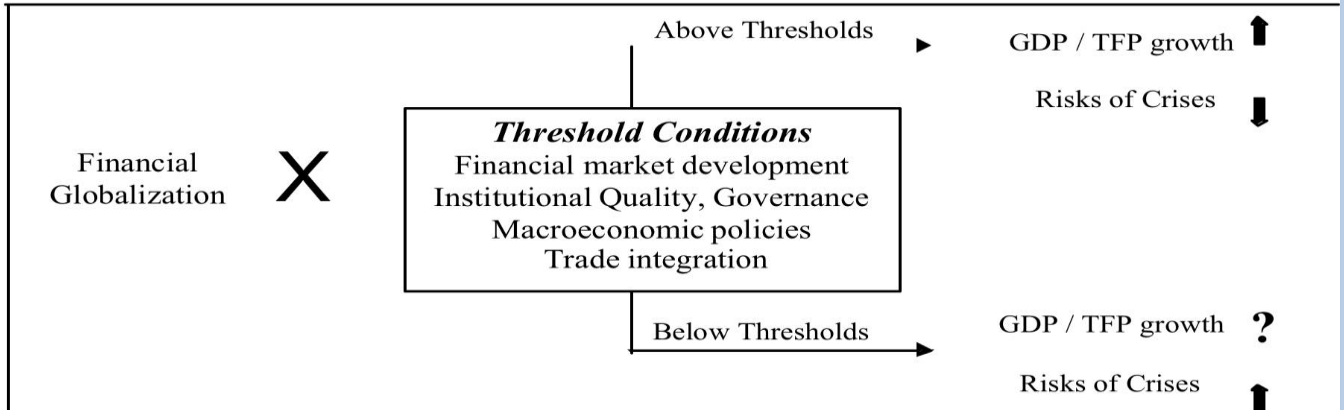


Source: Reinhart and Rogoff (2010), This Time is Different, Princeton University Press.

Thresholds

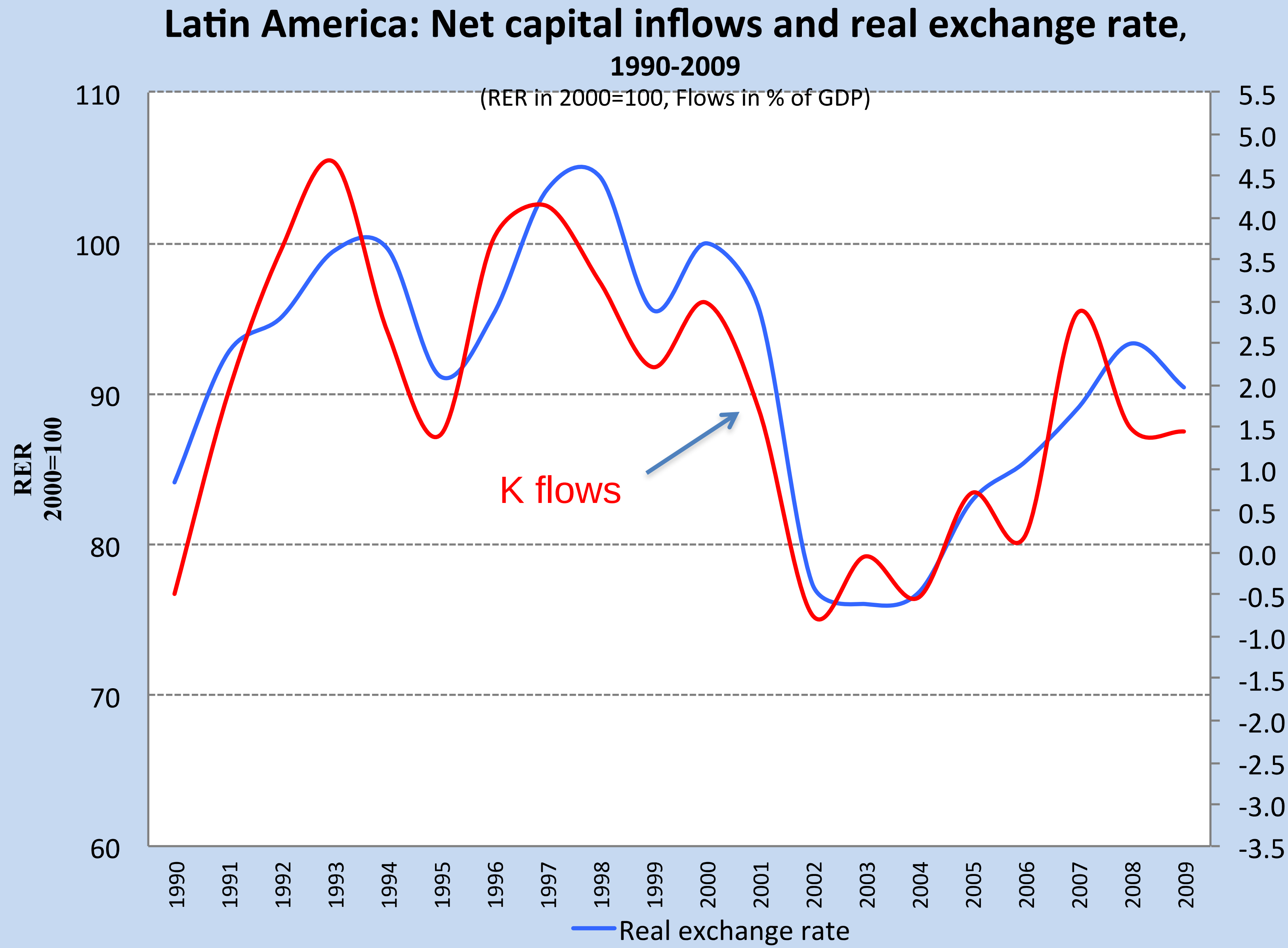
Box 2. But There Are Thresholds

But There are Thresholds



Financial globalization leads to better macroeconomic outcomes when certain threshold conditions are met. This generates a deep tension as many of the threshold conditions are also on the list

Kose, M. Ayhan, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei. 2009. "Financial Globalization, A Reappraisal." IMF Staff Papers 56, no. 1 (April): 8-62.


Latin America: Net capital inflows and real exchange rate,
1990-2009
(RER in 2000=100, Flows in % of GDP)
RER
2000=100
110
100
90
80
70
60
5.5
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K flows
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2004
2005
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2007
2008
2009
Real exchange rate

NBER

Magud, Reinhart, and Rogoff (2011)

- "In sum, capital controls on **inflows** seem to make monetary policy more independent, alter the composition of capital flows, and reduce real exchange rate pressures"
- In Malaysia **outflow** controls "reduce outflows and may make room for more independent monetary policy."

Magud, Nicolas, Carmen Reinhart, and Kenneth Rogoff (2011), "Capital Controls: Myths and Realities," Cambridge, National Bureau of Economic Research Working Paper 16805.

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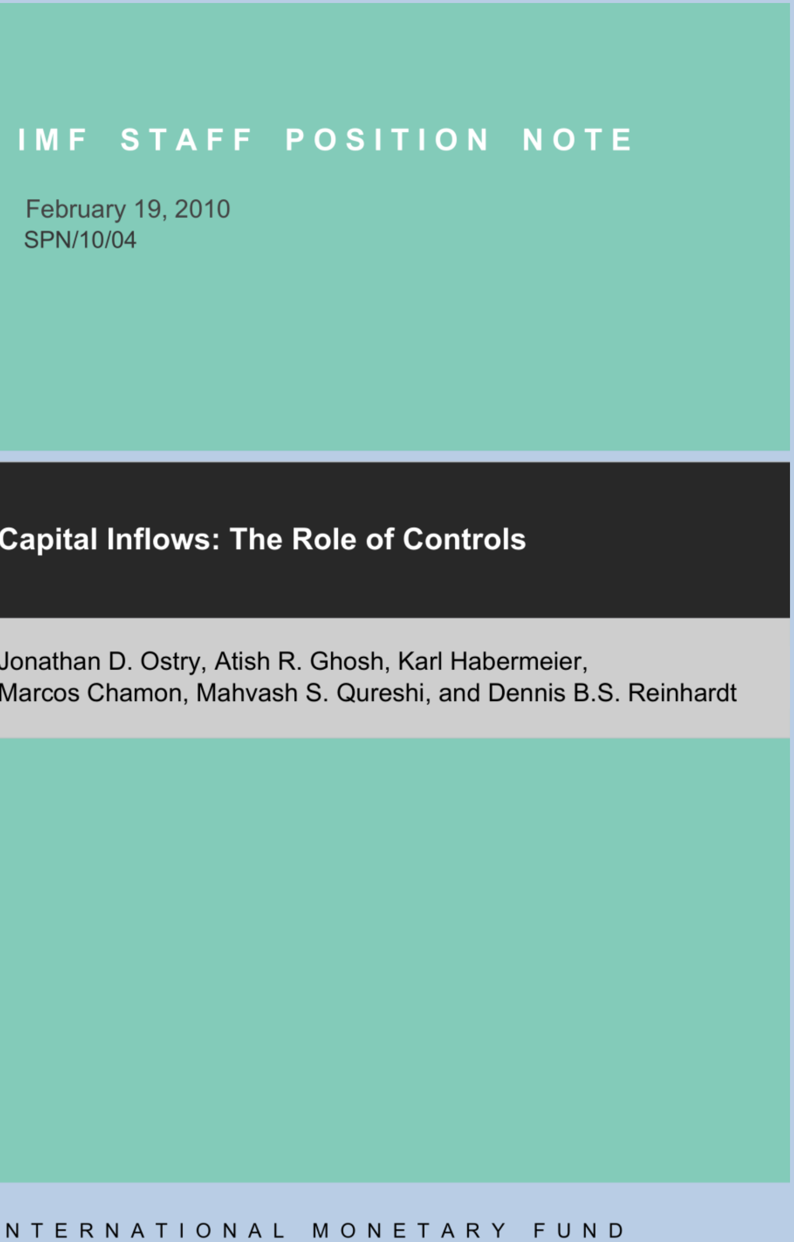
IMF STAFF POSITION NOTE

February 19, 2010
SPN/10/04

Capital Inflows: The Role of Controls

Jonathan D. Ostry, Atish R. Ghosh, Karl Habermeier,
Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reinhardt

NTERNATIONAL MONETARY FUND

IMF: February 2010

- Capital controls and crisis: **"the use of capital controls was associated with avoiding some of the worst growth outcomes associated with financial fragility"**
- capital controls are thus: **"justified as part of the policy toolkit to manage inflows."**