UNCTAD/ECLAC's Expert Workshop on "Financial stability, macroprudential regulation and international capital flows"

Comments by Juan Carlos Moreno-Brid and Lorenzo Nalin, May 10, 2021

History shows again and again that emerging market economies (EMEs) -even when they have solid macroeconomic fundamentals- may suffer acute balance of payments cum fiscal crisis whose origin lies either in fully developed economies or in other regions of the developing world. Equally, the evidence is abundant that EMEs´ macroeconomic busts may also be rooted in internal phenomena, with roots in episodes of economic mismanagement, uncontrolled exuberance in certain markets or even political tensions that explode in civil unrest, inter alia. In brief, the pattern of recurrent crisis cum acute instability has both endogenous and exogenous roots of systemic risk; an intrinsic phenomenon of financially integrated economies, as put forward by Minsky (2008). International capital flows are an important component in building up such fragility in a dynamic process. Though they may have positive effects on financing development, they inherently play a potentially severe destabilizing role, as recognized in the economic development literature and emphasized recently by the IMF in its *Integrated Policy Framework* (IPF) (IMF, 2020). Indeed, stressing the importance of such role, the IPF has come to accept capital flow management policies as a legitimate tool in the macroeconomic policy tool kit.

All in all, there is abundant theoretical evidence supporting an active capital flow management (CFM) in EMEs as it would serve to improve the country's resiliency against the growing financial turmoil. Whether they should be seen as a standard, say, all-weather protective instrument or exclusively as a fire extinctor, to be used only in case of emergency, is a point where consensus is still in the process of being cemented. In our view in any given country the debate on how to manage/administer international capital flows -over and above the technicalities- in order to foster development and economic stabilization should pay attention to the following key issues:

1. History matters. What, if any, is the previous experience of the country in question in the application of controls on capital flows? What is the current perception on what were their effects, their pros and cons, their achievements and their limitations in their design and implementation??

Despite their recent and more than justified revival as a tool of macroprudential strategies, capital flow management is still viewed with considerable suspicion and misgivings, by a number of academics, analysts and policy makers linked to Central Banks and officers in credit rating institutions. In this regard, for any given country, its particular history regarding macroeconomic stabilization policies in the face of external shocks is crucial when assessing the legitimacy, the political or technical appeal of CFMs. If its key actors tend to have memories that associate such controls with periods of economic -more specifically, balance of payments´- crisis, such past experience may turn into a political fore that hinders, or even fully blocks, the open discussion of CFMs not to mention their design and implementation except, perhaps, in periods of extreme balance of payments crisis associated with massive capital flight. For instance, memories are often linked to the interwar periods when massive American banks' lending (domestically and abroad) led to the collapse of the financial system in 1929, pressuring the gold standard in a context where acute capital flight led to debt unsustainability in several European countries (i.e. Austria, Germany, and Eastern European). This was followed by a period of high macroeconomic instability, currency devaluations, reduction in global trade, foreign exchange restrictions and controls to limit capital outflows. It should be noted that, in addition, these measures were adopted in the midst of social discontent and the surge of authoritarian regimes. Even worse, those measures did not lead to positive outcomes neither for economic prosperity nor for social welfare or peacekeeping.

In general, there is a tendency in the popular literature on CMF to stress negative experiences and ignore the positive ones. Among the latter, in the region stands out the case for Chile. Indeed, its use of "prudential" measures helped to contain foreign capital inflows for quite some time, until the financial liberalization program in the early 1980s. There is consensus that the removal of such measures led to massive capital inflows, real exchange rate appreciation and a credit boom that ultimately resulted in a crash. A most entertaining and illuminating description of this episode can be found in Diaz Alejandro´s 1985 article: "*Goodbye financial repression, hello financial crash*".

2. Political economy matters. Even though CFMs may benefit the economy´s stabilization and growth prospects as a whole, its impact at the micro level may be more favorable to some groups. In fact, for some key sectors, CFMs may be seen as a hindrance. Which political interests will prevail? Is uncertain and of utmost importance as, most likely, the perception on the short and long term costs and benefits of CFMs may differ widely among some key political and economic agents.

The political economy of capital management is as important as the historical experience with them. For example, restrictions on foreign capital flows may reduce expected profits and alter the business climate for the financial sector and certain foreign direct investors, affecting certain sectors, groups and even regions in very different ways. This would inevitably create tensions among the business community and political actors. An historical example, decades ago, is the say last-minute intervention by New York bankers in the final version of draft of the IMF´s Articles of Agreement aimed at watering down all proposals regarding CFMs proposals put forward by Keynes and White.

Recall too that, as mentioned by Keynes, CFM would not be effective unless applied "at both ends"; that is, unless foreign capital flows are administered from their source of to their point of destination. Intervening only on one "side" of such flows is bound to be ineffective as "players" will more likely find way to circumvent any such controls. An illustrative example is the development of the FOREX market in England. Despite imposing controls on capital outflows, the 1950s and 1960s saw the birth and boom of

the Eurodollar market in London partly as a result of a “loophole” in the regulations that permitted transactions on the forward exchange market (Schenk, 1998)
Yet, coordinating both ends and avoiding all incentive to break such controls is complicated, especially if international cooperation on these matters is not particularly welcome. Lack of cooperation from one side could severely undermine CFMs and lead to rather disastrous situations. For instance, during the Bretton Wood golden era, the United States -being the major recipient of international capital flows- declined to cooperate in enforcing other countries’ restrictions on capital outflow. It was only when its balance of payments began go show signs of fundamental instability and its current account began to show red numbers, that it began to see with favorable eyes some measures of CFMs, including an outright prohibition of net direct investment outflows to continental Europe on top of interest equalization taxed (IET) on foreign issuance in its domestic market (Ghosh et al, 2018).

3. A country´s productive structure and financial architecture matter. How are its domestic private and development banking sectors related to foreign financial intermediaries? What is the role of these intermediaries in financing fixed capital formation and in speculative asset purchases?

The financial architecture of the country should be also considered when evaluating the need and convenience of introducing some form of CFM. Some developing countries with sound domestic banking sectors may not find it particularly troublesome to mitigate the impact of the reduction of foreign capital inflows as source of financing for development, others with no strong presence of development banks capable to mitigate the reduction of foreign capital, may be find it impossible without facing acute shortages of financial resources, especially in hard currency. Thus, it is crucial to analyze which type of investment projects will be most likely affected by the introduction of CFMs. If foreign capitals are mainly devoted to finance speculative asset purchases, CFMs may be more easily acceptable. In any case, there should be an evaluation of how CFM might harm fixed capital formation One such case arises when their implementation leads credit rating agencies to downgrade the country´s sovereign debt. In this sense.

4. The country´s long-term development agenda matters. Whether such development agenda exists, whether it has significant internal support of key actors, and which is the role of the financial sector in alleviating (or aggravating) the balance of payments constraint are all leu questions that must be tackled when assessing the possibility of putting in place CFM?

The effectiveness of CFM depends on the existence of a consistent, long-term domestic development agenda, its fiscal and financial sustainability, and -as mentioned- the political support it receives. It would be desirable that such agenda clearly identifies the specific role of foreign financial capitals -indirect and direct investors- as sources of development finance. factor. CFM may have enormous benefits if considered as a legitimate tool of macroeconomic policy in the context of a long-term development agenda. For instance, quests for export-led growth strategies seem to be less prone to

success when associated with full financial liberalization, as exchange rate volatility linked to portfolio reshuffling is persistently, say, affecting the real exchange rate and thus harming the investment climate, particularly on the tradeable sectors. China is a well-studied case of the positive implication of exchange rate controls as an instrument of a long-term development agenda based on exports´ dynamism.
CFM may be very positive for macroeconomic resilience to the extent that it may help to avoid infamous stop-go cycles. For this to occur, CFM should not be merely considered as an emergency measure to stop capital flight at times of balance of payments or fiscal crisis. On the contrary, they must be conceptualized as a tool of a broad long-term development strategy. Such development-oriented CFM should identify which kind of flows –and from which sources- should be more carefully monitored and controlled to minimize the possibility of destabilizing effects. Additionally, in our view, the debate on CFM is too often restricted to financial markets, with no consideration whatsoever to their relation with FDI. Yet, in many emerging markets, there is strong links between the trajectories of both forms of capital flows; direct and indirect. In such cases, tight restrictions such as those inherent to CFM may severely affect -for good or bad- FDI´s short and medium-term prospects.

5. Finally, the regulatory or legal institutional restrictions whether in a regional, multilateral or international perspective matters.

The institutional sphere is a key element to consider in the discussion on CMF. Whether the country has signed, has joined international agreements that impose restrictions on such CFM is a key question; as many such agreements discourage or even prohibit any policy intervention to restrict foreign capital outflows or inflows, or even of measures seen as exchange rate interventions to favor depreciation of the currency and, in their view, provide unfair commercial advantage. Mexico, which recently signed the USMCA agreement with U.S. and Canada (replacing the original NAFTA signed in the mid-1990s is an example. Despite having a sophisticated financial system –including a deep forex market and the second most traded currency in the developing world– it has been lately suspected of currency manipulation by the US. Actually, the U.S. Treasury placed it on its foreign exchange monitoring country list. In other words, from now the Mexican government and its central bank will be monitored to assess if they are undertaking such manipulation to promote its commercial interests. If found, say, guilty of currency manipulation, application of pecuniary sanctions may proceed. Within the USMCA, proposing CFM would be rather difficult, not to say impossible.