UNCTAD-ECLAC Experts Workshop on Financial Stability, Macroprudential Regulation and International Capital Flows

15-16 April 2021

Part I: General overview and main takeaways

1- Framework underpinning capital flow management and macroprudential policies

One of the main features that stands out from the case studies presented in the UNCTAD-ECLAC Experts Workshop on Financial Stability, Macroprudential Regulation and International Capital Flows is that the empirical evidence does not support capital account liberalization as a means to achieve economic development. By contrast, in general, the countries that have adopted this approach have experienced increasing vulnerability and external fragility, which has threatened economic stability and has impacted the real economy. Throughout the seminar, several aspects that underlie this fact were discussed.

An important point that should be taken into account is the global context and how financial international flows have been changing over time. In this sense, the ways in which the financialization of the global economy affects cross-border transactions in the most recent decades are not the same as in previous ones. There have been numerous transformations in emerging countries' regulation that reshaped their exposure to external flows. Among these, some of the salient elements include the liberalization of foreign direct investment (FDI) regimes; opening up of local bond and deposit markets to enable borrowing in local currency for non-residents; allowing residents to realize capital account transactions, thereby integrating them into the international markets as investors and borrowers; and opening the banking sector to foreigners and enhancing dollarization. The adoption, influence and impact of these characteristics differ across countries. Nevertheless, in general, the fact that non-residents can directly acquire domestic assets in local markets has dramatically affected the structure of external balance sheets and become a new source of vulnerability.

In parallel to this transformation, and particularly after the global financial crisis (GFC) of 2008, there has been a renewed debate on how to manage capital flows. In this sense, given the crucial role that the International Monetary Fund (IMF) plays in the global economy, the institution's view on this topic has been deliberated. Capital control measures (CCMs) and macro-prudential measures (MPMs) are embedded in the broader set of capital flow management measures (CFMs), with the overall aim of containing systemic financial risk. While it is sometimes difficult to untangle the differences between the last two -since in practice concrete policies could fall under both categories- MPMs are more prevalent than CCMs. The reason is that the former target the risks of the financial sector within the country, thus assuring a stable macroeconomic environment. Moreover, CFMs are seen as complementary to macroprudential policies and should be applied temporarily rather than permanently to provide a buffer in specific contexts in which there are large capital inflows. Overall, there is the underlying assumption that capital account liberalization, by enhancing capital flows, has a positive impact on economic growth and development so it should not be discouraged.

From the case studies, it was noted that there appears to be a *path-dependence* related to the strategy adopted when liberalizing capital flows. In countries that went for a rapid and full liberalization of the capital account, administrative measures such as exchange rate management were used to mitigate vulnerabilities in periods of stress, while countries that only opened moderately maintained stricter measures to control capital flight.

Nonetheless, the structural change evidenced by the external balance sheets and the high interconnection that they imply, bringing in new transmission channel mechanisms, represent a major divergence in comparison to previous times. Consequently, traditional solutions or policy responses to manage a crisis or financial turbulence might not be suitable within this new scenario. In addition, given the unprecedented financial integration, it is not possible to isolate developing countries from external shocks. Therefore, implementing some degree of capital controls cannot be completely ruled out.

2- Evidence from the case studies: the great integration

In the case of selected Asian countries, three different phases of capital account liberalization were distinguished. The first one took place in the early 1990s up to the Asian financial crisis in 1997; the second started in the early 2000s to the GFC; and the last one from 2011 to 2018, interrupted by the Taper Tantrum in 2013. An important aspect to consider is the variety in economic development and the kind of international trade integration across the different countries. There have been notable disparities in terms of growth and intensity of capital account openness. However, a progressive trend towards liberalization is identified in most cases. Therefore, capital management has in general relied more on market-based and macroprudential policies rather than on administrative or more structural capital controls. The policies implemented involved mainly exchange rate management, domestic asset price inflation management and bank resilience. These policies have a limited degree of success and had contributed to increased vulnerability. Moreover, a salient feature that emerges from this experience is the decrease in investment rates, even though savings rates remained high. Still, the case of Taiwan is of particular interest since it used to have a quota system for capital inflows in the early 1990s that was successful, but was lifted afterward. Finally, despite capital account liberalization, not all countries were effective in attracting important amounts of capital flows, such as the Philippines and Pakistan. A remarkable fact is that even in contexts of lower levels of inflows, an increasing volatility was observed.

In Africa, it is worth noting that there is a sharp variability in terms of economic structure and exposure to external capital. However, a common feature is that all countries highly depend on the price of commodities, which are extremely volatile, reflecting in shocks in the current account; thus, signifying a first ingredient for vulnerability. In general, African countries started to liberalize their capital accounts in the early 2000s with different degrees of intensity according to the divergent development levels. Generally, the larger economies took bigger steps in their integration into external financial markets and have received significant amounts of capital. The greater penetration started after the 2008 crisis, when net capital inflows soared from $6 billion in 2010 to $68 billion in 2018. Concerning the composition of the capital flows, FDI grew significantly, primarily destined for extractive industries. Also, other forms became relevant, particularly portfolio investment, which tends to be more speculative and move rapidly. In terms of outcomes, for the smaller economies, openness did not lead to greater capital flows. By contrast, investor reticence prevailed in these cases mainly due to risk perceptions. Larger economies like Nigeria and South Africa managed to attract large capital flows that reflected an increase in vulnerability. The weakness of the strategy was manifested, among other indicators, in a deep decrease in the share of total reserves as a percentage of the total external debt since 2009. The African experience demonstrates the positive correlation between commodity prices and capital flows, which tends to reinforce instability and vulnerability in period of stress. In this context, the case of Nigeria stands out where a countercyclical policy aimed at decoupling this tendency was implemented. In 2004, the Excess Crude Account was created, and it was meant to accumulate oil reserves in boom times to serve as a buffer in crisis periods, such as the GFC, and proved to be helpful in mitigating instability.

The Latin America experience is framed by a period characterized by low GDP growth and increased volatility. As Africa, this region is also heavily influenced by commodity price trends since exports are primarily linked to natural resources, except for Mexico. In general terms, there has been a renewed push for some sort of capital control management after the global crisis. Although countries have entered into bilateral trade agreements with developed countries and international financial institution programs, there is still some scope and capabilities for governments to implement CCMs. There is great variability in the type of policies implemented, and an expansion in the policy tools used was observed. For instance, the intervention in the foreign exchange derivative markets and spot markets to tackle exchange rate pressures has become more frequent. Moreover, some countries, such as Brazil, introduced new measures like a tax on derivatives positions which proved useful to discourage the carry-trade. Notwithstanding that there were different goals and objectives across the different countries, they tended to be successful in changing the composition of inflows, particularly in enhancing the prevalence of longer maturities. Out of the countries analyzed in the survey, Peru was the one that relied most on capital account measures, which is especially remarkable since it managed to reduce the dollarization of the financial system (both in terms of credit and deposits) from 80% of deposits in the early 2000s to 35% in 2019.

After reviewing the three general experiences, some important aspects emerge. First, within regions there are country-specific characteristics that need to be considered and that might explain the different performance of policy measures. Second, even though there are great variations across these three cases, it is possible to find common ground: in all of them, vulnerability increased with capital account openness and international financial integration. A final point, related to the latter, is the importance of the productive structure and international integration that heightens instability and vulnerability. The African and Latin American contexts reveal how the high exposure to changes in commodity prices reinforces capital inflows and outflows, deepening the impacts on the balance of payments.

3- Policy recommendations and expected goals from the project

Since the 1970s there has been a progressive financial deregulation that translated into a massive increase in financial flows worldwide and in the size of the financial sector. In this process, capital controls were set aside, mainly from the conventional point of view, arguing that the modernization and expansion of capital markets in developing countries were conditions for fostering investment and economic growth. Given the capital scarcity that exists in these countries, external flows could provide the source for financialization. Nevertheless, the above survey showed that in all cases countries became more vulnerable to external financial shocks. This has been largely proved with the several crises that countries have faced -the Tequila and Asian crises in the 1990s, the dot-com crisis and the GFC of 2008, among others-.

This scenario led to the acknowledgment of the existence of a global financial cycle. Even though there are different perspectives in the literature about its nature, there is a relative consensus that it is mainly driven by the monetary policy of the core countries, especially by the United States due to the crucial role of the dollar in financial transactions. Within this framework, developing countries are heavily constrained, limiting the degrees of freedom of their monetary policy. Moreover, given that this took place even in countries that have adopted flexible exchange rate regimes, it appears that the traditional trilemma no longer holds. Instead, countries are confronted with a trade-off between free capital mobility and independent monetary policy.

The foregoing arguments were present throughout the seminar. In addition, the workshop provided empirical evidence supporting a positive relationship between the global financial cycle and commodity prices. This trend bolsters the vulnerability of the economies, particularly for the ones that rely more on these kinds of exports. Therefore, given this context, it seems unlikely that capital controls will be completely foregone.

Further, the relevance of using a particular variety of capital control is also linked to their purpose. In this sense, the main goal they should pursue is economic development and structural change. This requires that they should be part of a broader development agenda. The previous experiences reflect that the vulnerability and fragility to which countries are exposed derive from profound crises that not only negatively affect macroeconomic indicators -GDP growth, employment, investment rates-but also in many cases increase the balance of payments constraints creating an extra obstacle in the race towards development instead of encouraging it.

Considering that there are certain similarities and common ground between countries in the different regions, regional integration could play a role in pushing for a broader acceptance of capital controls. To conclude, during the workshop it was stressed that among the outcomes from the project, it would be desirable to provide policy recommendations that would be feasible to implement in Latin America.

Part II: Synthesis of the panels and successive discussions

Panel 1: The Asian experience with macroprudential policies

Presentation by Ms. Jayati Ghosh - Amherst University

Ms. Ghosh began her presentation outlining the purposes of macroprudential policies. They are aimed to address numerous risks such as excessive domestic credit growth, especially directed to non-tradeable sectors, exchange rate volatility, surges of short-term inflows (including carry trades), sudden and sharp capital outflows that tend to lead to sharp changes in asset prices, the fragility of the domestic banking sector, external commercial borrowings, and debt crises. In order to avoid or prevent these risks, there are some features that should be taken into account such as identifying early indicators of weakness to limit their development and generate buffers against pro-cyclical feedback effects of financial instability. Finally, the measures could be intended for both external and domestic financial markets.

The presentation focused on four countries: India, Indonesia, Malaysia and Thailand and on two specific periods of increased external vulnerability: during the GFC from 2008 to 2010 and before and after the Taper Tantrum between 2011 and 2014.

There has been a shift from administrative to market-based interventions. Within this context of capital flow liberalization, there has been room for more "prudential" controls. Because of the shift from administrative policies, macroprudential policies have focused mainly on exchange rate management, domestic asset price inflation and bank resilience. She stressed that macroprudential policies include a wide variety of measures such as domestic asset price, inflation, bank resilience and exchange rate management. For the remainder of the presentation, she expanded on the latter.

The main conclusions of the case studies were:

In general, the four countries showed an enlargement of foreign reserves. However, this came at the expense of net negative returns.

India evidenced a rise in foreign reserves together with a declining rupee. Ms. Ghosh believes that the latter was not on purpose but rather a consequence of capital flows. Open market operations have not been successful during the GFC, nor at the beginning of the Taper Tantrum, mainly due to large capital flows.

Indonesia focused on the offshore market. Regulations on transfers and derivatives transactions -particularly ones that are not substantiated in real transactions- were implemented. There was a challenge in coping with inflows and outflows of primary income. In 2010, incentives to hold longer-maturity assets for foreign capitals, as well as controls on short-term forex debt held by banks and non-banks were introduced. Moreover, in 2011, there was an increase in the forex reserve requirement. However, these policies had a small effect on controlling forex outflows of primary income. Nevertheless, it was noted that after a dramatic decline in the primary income observed at the beginning of 2010, at least these measures could stabilize the flows -i.e. they prevented it from falling further-.

In Malaysia, there was a gradual reduction of capital and prudential controls, including offshore currency and credit markets from 2002. There was a sharp depreciation of the ringgit despite current account surpluses. The volatility in the currency was driven by the volatility in capital flows.

In Thailand, another strategy was followed in which the appreciation of the baht was the aim. However, this was not entirely successful. Both the current account and capital account experienced marked surpluses. In 2010, a 15% tax on capital income was launched, but this had a short-term impact. Besides, the central bank kept absorbing reserves, but the effect on the exchange rate was limited.

Overall, these experiences demonstrate that after removing capital controls, the capacity to manage the exchange rate is extremely limited and quite expensive. It derived from this that volatility, instability and vulnerability are a result of deregulation. Overall, macroprudential measures were not completely effective, so it is important to design them in a way to target medium to long-term macroeconomic goals and address the problems of the real sector.

Comments by Yilmaz Akyüz

Mr. Akyüz started his comments proposing a forward-looking question: in the current context of capital account regimes and policies, how vulnerable are developing countries to a significant and extended worsening of global financial conditions that many experts deem likely to occur? He suggested that the identification of vulnerabilities is a precondition to discussing appropriate policies.

He pointed out the large amount of capital inflows that emerging economies have received during the 2000s, which were only partially affected by the GFC or the Taper Tantrum. The strong monetary response both in the U.S. and in Europe prevented significant capital cutoffs from these emerging countries. Within this context, there have been few efforts to control inflows in 'normal' times, which makes it more difficult to control outflows in tight periods.

Mr. Akyüz agreed with Ms. Ghosh on the fact that the capacity of financial resilience is overestimated in some cases which leads to excessive risk taking. In light of this, a broader understanding of vulnerability was highlighted. Mr. Akyüz emphasized the fact that it is important to consider the structure and leverage of external balance sheets. This involves taking into account several factors such as currency, maturity, liquidity, capital and sectoral mismatches between gross external assets and liabilities.

His presentation also stressed the structural change evidenced in the external balance sheets of emerging countries. This new context brings about different transmission channels in comparison to previous times. As a result, former policies and potential solutions to overcome a crisis may no longer be entirely effective or desirable.

While in previous times the global financial integration of emerging countries mainly consisted of cross-country lending and borrowing, nowadays it has shifted towards an increased penetration of international financial capital in the credit, deposit, bond, equity and property markets. This has dramatically influenced and transformed external balance sheets and entails a new source of vulnerability. There has been a transformation in the profile of external debt caused by different factors. The deeper involvement of foreigners in national bond markets is one of the salient ones. Besides, this implies facing higher speculative risks and losing control capacity. There has also been a rise in the influence of foreign banks, which can more easily convey risks from their subsidiaries to the headquarters countries.

As a result, the strong presence of non-residents in local markets and capital flight by residents constitute major sources of currency instability. Within the context of flexible exchange rate regimes, a sudden exit of foreigners from the domestic market and outflows by residents significantly affects the local currency; however, this movement is not necessarily followed by defaults on external debt. Mr. Akyüz acknowledges that the paper by Ms. Ghosh reflects the fact that countries have adopted some policies to limit the influence of the former; nonetheless, with a small rate of success, except for Taiwan.

Claudia Ramirez Bulos - Central Bank of Mexico

Ms. Ramirez Bulos started her presentation by showing the long-term trends of accumulated flows (including both bond and equity flows) in emerging economies (Latin America and Asia - distinguishing the latter into developed and emerging). In all cases, an upward trend was observed, as well as an increase in volatility since 2003. Although there are transformations in the international financial integration of countries, she referred to the relevance of understanding past experiences and how they were handled from the policy point of view in order to provide inputs for present policymaking.

Ms. Ramirez Bulos stressed the main findings by Ms. Ghosh and highlighted the mixed nature of the policy results in terms of success. Moreover, she emphasized the numerous policy responses that governments adopted in light of the COVID-19 crisis, while also manifesting concern about the implications of these for financial stability risks. In this sense, some of the potential issues that were raised were: possible distortions in asset prices -that would lead to an eventual correction-; the large amount of liquidity in international markets could revert in a disorderly manner; insolvency problems and firm bankruptcies, given the high volume of debt that both the public and private sector experience; inflation problems trigged by expansive fiscal policy underpinning recovery programs; and an increase in U.S. interest rates that always leads to capital outflows from emerging economies.

In this scenario, she highlighted that macroprudential policies can contribute to counterbalance financial vulnerabilities. Nonetheless, there are potential challenges when it comes to the design and implementation of these policies. Therefore, some of the aspects that need to be considered are the interactions between these types and other policies, costs, evaluation -which is always difficult in macroeconomics because of the lack of a counterfactual- and communication. The latter is of particular importance given that the success of these interventions mainly relies on the ability of policymakers to properly convey the objective of their actions.

As final remarks, the role of macroprudential policies to contain systemic risks was underlined, as well as the impetus needed to count on empirical evidence to assess their effectiveness.

Comments by Jomo Kwame Sundaram

Mr. Kwame Sundaram also mentioned the enormous policy responses that are taking place as a consequence of the COVID-19 crisis, and he emphasized the idea of ‘building forward better’ instead of ‘building back better’ -as some policymakers stated-. In line with Ms. Ghosh and Mr. Akyüz, Mr. Kwame Sundaram pointed out the importance of being aware of the structural changes in financial and capital markets as well as the reduced role of the banking sector. The greater influence of other kinds of markets, such as the bond and stock markets- poses challenges for prudential regulations. In the same vein as previous interventions, he acknowledged that while there are still lessons to learn from former experiences, it is extremely important to identify to what extent countries are differently impacted from them.

Mr. Kwame Sundaram put forward the role that political economy plays in the design of these policies. For instance, the example of the resistance from southeast Asian countries to enhance regional integration was triggered by the interest that elites from these countries have in financial asset prices rather than in developing the real economy. There is more constraints on fiscal policy implementation because of reduced tax revenues over the years. Thus, this implies the need to borrow. In his opinion, it is important to dig deeper into the possibility of borrowing domestically. It is important to consider macroprudential policies not only for dealing with international markets but also to explore other opportunities for raising fiscal resources.

In the Q&A session the following points were discussed:

Given the penetration of non-residents in the domestic bond and asset markets, it is important to design policies to address the mobility that they entail. In this sense, some pieces of advice were mentioned such as strengthening countries' domestic financial base first, instead of overly relying on international markets. In addition, other possibilities like restrictions on the type of assets that foreigners can invest in, enforcing minimum stays or borrowing abroad only for certain purposes (e.g. for investment goals) were also suggested. However, the adequate policies to achieve these objectives are still a challenge to uncover and should be further investigated. On a separate but related issue, the need to expand and strengthen the domestic capital market was also emphasized. This could be a challenge, particularly in the Latin American case where the non-financial corporate sector operates with a currency mismatch that has been increasing since 2007.

Another point that was introduced is the 'regulator dilemma'. This is related to the fact that during normal times it is difficult to resist the 'temptation' of cheap borrowing and high yields, which prevents authorities from adopting capital inflow controls, which are needed to regulate future potential outflows. This is also an important aspect to consider for policy design.

Finally, the opportunities that the current scenario brings were discussed. The COVID-19 crisis represents an extraordinary chance to implement a significant tax reform on a global scale. More specifically, wealth taxation could be a source of revenue to increase the scope of fiscal policy. Lastly, it was stressed that the latter needs to have a forward-looking focus and design to tackle both business cycles and long-term goals.

Panel 2: The African experience with macroprudential policies

Presentation by C. P. Chandrasekhar

Mr. Chandrasekhar started his presentation by pointing out sources of external instability on the continent. This implies weaknesses in the current account and excessive debt or non-debt inflows on the capital account. These two factors are somewhat related and pose a challenge because measures should be designed to address current account shocks avoiding short-run capital flows dependence and controlling the exchange rate. The mechanism is derived from the current account deficit that leads to a currency depreciation, which could be further aggravated by speculation. Moreover, the vulnerability to systemic crisis could be even more harmful if it results in sudden capital flight outflows. COVID-19 increases exposure to systemic risk as a result of the contraction in the global economy entailing less foreign currency from exports, a shortfall of tourism as well as a fall in remittances from residents abroad.

Given its productive structure, Africa heavily relies on the prices of commodities, which are extremely volatile. This reflects in shocks to the current account that are later transmitted to the real economy. Therefore, there is a marked exposure to volatility as a result of commodity price dependence. In general, capital inflows became significant after the GFC and the empirical evidence suggests that they move in line with the commodity prices. Regarding the composition of the capital flows, FDI grew significantly, and it was allocated to extractive industries. Nevertheless, other forms also became relevant, particularly portfolio investment which tends to be more speculative and react quickly. The weakness of the strategy was manifested by, among other indicators, the deep decrease in the share of total reserves as a percentage of the total external debt since 2009.

Mr. Chandrasekhar turned to the case studies to analyze the different policy interventions related to exchange rate management. In Ethiopia, despite maintaining a competitive exchange rate to enhance export competitiveness, current account deficits persisted which were financed with external debt. To contain the vulnerability that this entails, the country implemented very strict controls on international capital flows, where the National Bank of Ethiopia had a strong influence in the administration. Furthermore, there were maximum limits on investment by residents in assets issued by non-residents as well as on foreign portfolio investment.

Zambia shows difficulties mainly due to its structural issues. The country experienced a sharped depreciation of its currency as the external demand of their main export product-copper- fell, resulting in a decrease in its price, hitting the current account. Some partial intervention was introduced, such as the enforcement of repatriation of foreign currency from exports, with limited results.

The case of South Africa is slightly different as the focus during the early 1990s was on implementing market-mediated measures instead of using reserves, before switching to a 'market driven' floating exchange rate by 1998. This transition to capital flow management prevented excessive capital inflows and served as an effective macroprudential policy.

Nigeria strongly depends on highly volatile oil prices. This source of instability is also reinforced by the tendency that capital flight moves hand in hand with these price variations. In order to cope with this, Nigeria applied a countercyclical approach with the creation of an Excess Crude

Account in 2004. This consisted in accumulating the surpluses of oil exports in this fund in periods with high prices to use them when prices experienced a downward trend. This policy was very successful, particularly in the 2008 crisis. In 2001, Nigeria launched a set of "Guidelines for Foreign Borrowing for On-Lending by Nigerian Banks", which was rooted in the huge increase in external borrowing provoked by the lower international interest rates in comparison with the domestic ones. However, the liberalized nature of the regulations still provided considerable freedom to national banks for borrowing abroad, thus resulting in weak macroprudential policies. By 2014, there was a need to tighten restrictions in light of the decline in oil prices and the external debt burden that resulted from the depreciation of the national currency. The main measures were aimed at reducing the amount of external borrowing that national banks can take on, limiting it to 75% of their shareholders' funds.

Ms. Annina Kaltenbrunner - Leeds University

Ms. Kaltenbrunner highlighted the salient features of the report and complemented them with her own work on Africa, which shares many of the same observations. She also stressed the volatility and diversity of African exports and the heterogeneous productive structure. Overall, it is possible to acknowledge a strong intervention in foreign exchange markets in Africa along with different levels of development in terms of market openness and sophistication across the different nations.

Ms. Kaltenbrunner raised the point that although capital flows have been increasing, they remain low in African countries, including portfolio flows with a few exceptions. She also argued that some countries are not even integrated into the international market; thus, in light of these great disparities, there should be a clear distinction about which countries we are referring to. South Africa, Nigeria, Uganda and Egypt are considered highly financially integrated countries, whereas Ghana, Kenya, Zambia have an intermediate integration.

In terms of the influence of the different types of investments on the exchange rate, her research suggests that while portfolio and FDI do not have significant impacts, other types of investments tend to affect local currencies.

As discussed in the previous panel, she emphasized that there is evidence of non-residence in the local sovereign bond markets with its correspondent implications for risk. What is particularly notable is the Eurobond issuance by many African countries, which further contributes to increased risk.

Mr. Horacio Aguirre – Central Bank of Argentina

Mr. Aguirre firstly highlighted the strong contribution of the study for a deeper understanding of the emerging market economies and the implementation of capital flow management (CFM) and macroprudential measures (MPMs) from the 1990s onwards. Moreover, several takeaways from the paper were stressed. Many of the findings point to the importance of the development levels of the countries, commodity export dependence and risk perceptions that can affect the flow of foreign capital (except for larger countries). Furthermore, liberalization is not a sufficient condition to incentivize capital inflows as there is investor reticence; as well as a greater vulnerability observed in larger economies. The implementation of macroprudential responses and exchange rate controls originated in problematic times entailing a more reactive stance. Finally, there is path-dependence with a reticence to revert liberalization in countries that had begun to open earlier, whereas there seems to be more caution in countries in which openness started at a later stage.

Next, he stressed the link between macroprudential policies and capital flow management. The target of the former consists of limiting systemic risk, which is considered endogenous and interconnected with the system. It is within this context that CFMs become relevant since they can serve macroprudential purposes.

Mr. Aguirre focused on key issues of the relationships between commodity prices and capital flows. This is relevant for FDI and portfolio flows. He built upon the paper's findings to show that there is a self-reinforcing dynamic between capital flight and commodity prices, evidenced in a positive correlation between the latter and financial conditions. Moreover, this is a common trend across developing countries.

Additional points to explore further in future work were raised. Particularly, the trade-off between financial development and stability. This would entail looking at financial sector development and the credit cycle. On this point, other dilemmas were put forward such as the relationship between higher or lower liberalization and financial sector development and real growth. Moreover, the COVID-19 experience provides important issues to look at such as the relationship with the Debt Service Suspension Initiative (DSSI) and the procyclical financial conditions.

Mr. Tarron Khemraj - New College of Florida

Mr. Khemraj built upon the Caribbean experience, which reflects low manufacturing development and high dependence on commodity exports as in African countries, even though there are great disparities across them as has been said in the previous interventions. He concluded that in the Caribbean region, as well as in Africa, there is still a divorce between macroprudential policies and capital flows control and exchange rate management, and that there should be a better connection between them. Now, how do we bring them together? For this, we need to look at excess liquidity assets in local currencies. It is also important to look at government spending and central bank securities.

In the Q&A session, the following points were discussed:

One of the salient points in the discussion was the necessity to deepen the local currency bond market. For achieving this, it is important to increase the presence of domestic institutional investors. Some Latin American countries have relied on pension funds for this. However, an emphasis was raised concerning the currency in which they are channeled. In this sense, it is important to invest funds in local currency; otherwise, there is a risk of facing the problems that Argentina and Greece had when they defaulted.

Some suggestions for further research were introduced as well. For example, it might be worth digging deeper into the interplay between trade tensions and the recent de-globalization trends. This is of value since they might have impacted banking activities.

Other issues that developing countries have to target were stressed such as the low trust in the domestic currency, which is difficult to address.

Closing Remarks by Mr. Esteban Pérez

Based on what had been discussed in the panels, Mr. Pérez returned to the important fact that identifying vulnerabilities is a precondition for policy design. It is not possible to know which policies are necessary to apply if there is not a clear diagnosis of the source of instability. In these cases, this derives from the external sector. Traditionally, in Latin America this has been linked to current account deficits, where capital constraints were believed to underlie these deficits. However, even before a negative current account balance, there could exist capital account constraints. In this sense, the panels proved useful to expand understanding around capital flows. In this sense, it is possible to highlight the increasing importance of short-term flows. These are not only included in other investments but also in FDI and portfolio investments, and their share is greater than in earlier periods. Therefore, through this channel, they have implications in the cycle. The influence of the bond market and the penetration of foreign banks is also relevant because their size has implications for monetary policy transmission in Latin America. Another important point that was raised was the interlinkages between the financial sector and the real economy, for which the exchange rate is the common ground.

Panel 3: The Latin American experience with macroprudential policies

Presentation by Pablo Bortz – National Council for Scientific and Technical Research (CONICET, in Spanish)

Mr. Bortz provided an overview of capital account management measures, macroprudential policies, and their effects across Latin American countries. Firstly, he presented the motivations underlying their adoption. In this context, there is marked external indebtedness of public, financial, and non-financial corporations (NFCs) in different maturities, mainly in short-term maturities and in various instruments (portfolio, some types of FDI flows, derivatives, among others). They are related to international financial spillovers as they represent sources that can facilitate capital flight. Besides, they are also linked to exchange rate volatility and spillovers. There are also country-specific features that motivate their implementation. In this sense, it is possible to highlight the reduction in dollarization in the Peruvian case or the deep penetration of foreign banks in Mexico. There is also the evolution of new instruments and new actors in the resilience of the financial system, international regulation -e.g. the Basel III-. Finally, they are also linked to the expansion of the credit cycle, housing prices, and domestic indebtedness.

In Latin America, in general terms, there was a decrease in the adoption of capital account management measures in the early 2000s, whereas a renewed upsurged is observed after the global crisis. There is great variability in the type of policies implemented. However, most countries in the analysis targeted foreign reserve accumulation. Further, many intervene in the foreign exchange market - Chile is probably the one that intervened the least- and derivatives markets. Some countries implemented unremunerated reserve requirements with diverse objectives. Other sets of policies involved minimum stay taxes, limits, authorizations and prohibitions, as well restrictions on foreign exchange trading.

Among the positive effects, the following outcomes stand out. Firstly, these measures resulted in a change in the composition of inflows by extending maturities. Secondly, they led to a reduction in external debt and in sovereign risk. Moreover, they were able to reduce foreign exchange exposure of banks and other sectors. Finally, in some cases, they also manage to control mechanisms for evasion.

Mr. Bortz then turned to macroprudential policies. Most countries implemented macroprudential measures after domestic financial crises (1980s, late 1990s and early 2000s), while some introduced them after the 2008 crisis. He pointed out that some capital account management policies are also embedded in MPMs. Some examples of these include taxes, capital requirements for foreign exchange exposure, lending and borrowing, differential reserve requirements, curbs on external exposure and currency mismatches, operations with related firms and liquidity requirements on foreign exchange. Apart from these foreign-based measures, a set of domestic ones were also used such as dynamic loan-loss provision, limits on interbank lending, limits on concentrated lending involving surcharges on capital requirements, countercyclical reserves and capital requirements, liquidity regulations and capital requirements on housing, car, and consumer loans.

Concerning the effects, it is possible to identify a reduction in foreign exchange exposure over debt, and improvement in foreign exchange liquidity. Besides, the countercyclical reserve conditions helped to prevent credit crunches. One particularly notable outcome was the case of Peru, which experienced a 50% decrease in dollarization. Also, a reduction in non-performing loans was evidenced, attenuation of external banking shocks and credit growth. The main challenges are the external indebtedness of non-financial corporations, the role of non-residents in domestic debt markets, and the expansion of commercial lending. Here an interesting feature from the Brazilian case was that public and development banks served as the main lenders after the 2008 crisis, replacing private banks, which resulted in avoiding a large expansion of credit. The impact of climate change on the financial system might become a new source of vulnerability.

Mr. Daniel Osorio - Central Bank of Colombia

Mr. Osorio, building upon the main takeaways from the paper, expanded on the Colombian case. He picked up on a key issue which is the assumption that the nominal exchange rate performs as a shock-absorbing buffer, minimizing the response of output to external turbulence. However, this has prerequisites as it requires a credible exchange rate flexibility, and reduced exposure to currency risk. These aspects call for macroprudential policies. In this sense, the Colombian experience represents a successful story. In 2015, the country experienced the largest nominal depreciation in 50 years without strong impacts on the GDP. This was possible since, on the one hand, in the early 2000s macroprudential policies on the foreign exchange market were implemented, and on the other because despite having a flexible exchange rate regime, there was an important accumulation of reserves -which is important for maintaining confidence in the regime-. The macroprudential policies on the external markets included limits to opening the net foreign exchange position, liquidity coverage ratio considering liquidity needs in different currencies and capital requirements for currency risk. Moreover, the currency risk in the non-financial corporate sector is spread between local and foreign currency which reinforces the credibility of the exchange rate regime entailing a small risk.

Despite being a fruitful story, there are two remaining challenges. First, the internationalization of the Colombian financial system; and secondly the international standards, particularly Basel III, which was designed mainly for the advanced economies' structures and did not address currency risk requirements (since this is not a problem for them). However, developing countries face the trade-off between risk versus competitiveness.

Mr. Matias Matías Ossandon Busch – Center for Latin American Monetary Studies (CEMLA, in Spanish)

Mr. Ossandon Busch focused on the report about macroprudential policies and started by providing feedback and suggestions for future developments.

He first explained what, in his view, macroprudential policies imply. According to this, the main aim is at containing systemic risk by controlling the odds of a financial collapse triggered by firm-level events. In this sense, they intend to connect micro and macro aspects that are interconnected. Moreover, he introduced some evidence from the literature that focuses on micro-level data. Despite concluding that macroprudential policies have a significant effect on containing systemic risk, measured by credit, the actual economic implications turn to be more questionable. Mr. Ossandon Busch provided some of his own calculations, based on the papers that he highlighted, where we found that macroprudential policies, in the end, explain a small portion of the change in credit. In this sense, he outlined that a potential explanation for the limited effect could be related to 'regulatory leaks' that involve essentially unplanned interactions that result from the large number of policies implemented. Latin American and Caribbean countries normally use many macroprudential tools, which reflect structural (non-cyclical) rather than cyclical regulation. These regulations can reproduce the unintended interactions found in the literature.

Ms. Fernanda Bandeira - Central Bank of Brazil

Ms. Bandeira offered her view as a practitioner within the Brazilian context. She started by pointing out that the local structure is mainly national bank-based which allows the central bank to have a leading role in the design, coordination and monitoring of policies and regulations, as well as in information and data gathering. The toolkit has been noticeably increasing. Now the bank is principally focusing on countercyclical capital buffers, capital and reserve requirements, among others. The decision is data-driven and restricted to the assessment of risk. Besides, recently a long-term project has taken place which aims at liberalizing the foreign exchange rules to enter the OECD. Some present measures such as adequate reserves will remain relevant. In light of the pandemic, the policy framework has not changed substantially. However, the Central Bank has strengthened the decision-making process and communication. Finally, she stressed the multifactor feature of macroprudential policies and the importance of counting on several indicators to assess the suitability of the measures.

Mr. Harold Ayatollah Vasquez Ruiz - Central Bank of the Dominican Republic

Mr. Vasquez Ruiz elaborated on the experience of the Dominican Republic. In this country, there have been no capital controls and high dependence on commodities (oil for imports and gold for exports). Trade with North America (particularly the U.S. and Canada) explains two-thirds of the total volume of transactions. The country adopted an inflation targeting regime in 2012 which was successful until the COVID-19 crisis when the inflation rate spiked. Like the other Latin American economies, Dominican Republic has also been accumulating reserves. Therefore, there have been no measures on capital flow controls or macroprudential policies, but there have been regulatory measures on monetary policies. These involved a credit rating freeze to pre-pandemic levels, no credit rating penalty for loan restructuring, the extension of credit lines arrears up to 60 days, increase in deposit guarantees and limitations and restrictions on dividend payments, among others. There had been a good economic performance until the pandemic.

In the Q&A session the following points were discussed:

One of the key messages in this round was the importance of the study of capital account regulations. Some economists would argue that now, since most of the Latin American countries have achieved a credible flexible exchange rate regime with international reserves accumulation, CCMs are not necessary anymore. Nonetheless, the present approach might be a particular phase of the global financial cycle and underlying the positive context there might be hidden vulnerabilities that could become a potential problem for future periods.

Another point raised was that the productive structure, and more specifically, international integration also matters to tackle systemic risk. In line with this, moving from commodities and diversifying the export basket is important. Moreover, the divergent export performance in Asia and Latin America could be one way to look at the instability issue.

Finally, the accumulation of international reserves in flexible exchange rate regimes was recognized as an important strength -even though it is not the only strategy to follow-. This is important because it provides a source of guarantee that the economy will have enough currency to afford liabilities when facing massive capital outflows.

Panel 4: Overall vision and main takeaways

Presentation by Matías Vernengo - Bucknell University

Mr. Vernengo elaborated on a framework for understanding capital flow management and macro-prudential measures. To do this, he first started by revisiting the IMF view about the concepts of capital control measures and macroprudential measures. Next, he proposed an alternative approach and policy proposals to address the issues found in the Latin American case studies.

From the IMF view, the aim of the CFMs policies, including CCMs and MPMs, is to address systemic financial risk and they tend to be seen as complementary rather than substitutes. In essence, CCMs regulate the relation of the domestic economy with the rest of the world; thus, they are intended to limit capital inflows. The MPMs focus on administrating the risks of the financial sector within the country targeting systemic financial risk. At the core of this perspective, it is the idea CCMs should not be frequently used, but only applied in special situations to control the volatility related to large amounts of capital flight movements. Moreover, he claims that the IMF's vision derives from the fact that MPMs play a greater role in setting the ground and providing a stable macroeconomic environment that could ultimately favor capital account liberalization, as this is still seen as positive for economic growth and development. Given this, he argues that the IMF vision regarding CCMs has not changed substantially, notwithstanding the recent debates around this subject.

Alternative framework

Drawing upon Minsky's approach, there is an inherent tendency for the financial system to become progressively weak and prone to crisis. Under this perspective, the global financial system is organized on interconnected, hierarchical balance sheets, increasingly subject to time-critical liquidity. Therefore, it is possible to derive from this that the distinction made by the IMF about the role of CCMs and MPMs does not hold. Economic agents operate in a global economy where balance sheets are interconnected. For countries on the periphery, this implies that the balance sheets of its agents are to some extent integrated into global financial networks. Furthermore, the centrality of the dollar as the main currency in the global economy implies that it generates enormous asymmetries that are not usually accounted for in the traditional literature.

Coming back to the case studies, all of them show that vulnerability stems from capital and financial accounts and behind this feature there is the context of liberalization and the removal of CFMs suggested by the IMF. Lastly, for the Latin American case, it can be observed that there is a tendency to show deficits in the current account. Nonetheless, this does not necessarily mean that the productive structure and the way the economy is inserted into the global economy are irrelevant for stability. Moreover, this could be a key difference between the experiences of Latin America and Africa versus Asia.

Ms. Solange Berstein - Central Bank of Chile

Ms. Berstein claimed that the integrated policy framework by the IMF could be an effective toolkit if it is used and communicated appropriately. One of the most important aspects to consider is country-specific characteristics. This is extremely relevant to assess the suitability of certain policies. In this sense, she provided some examples of possible policy responses under certain scenarios. For instance, in economies with deep foreign exchange markets, she argues that intervention will not have implications on the exchange rate, so it is preferable to avoid implementing foreign exchange interventions. If the nations have shallow markets, then the policy can influence the exchange rate as well as external balance stabilization. The greater effects to stabilize macro-outcomes after a financial shock can be seen for countries with foreign exchange mismatch under financial stress.

Turning to the Chilean case, greater financial integration started in the late 1990s. The underlying assumption was that domestic capital markets had reached a significant level of development enough to expand their integration with foreign markets. After this, a strong modernization has been observed with fixed income and derivative markets and a high presence of non-resident investors, among other features. The process of capital account liberalization has been constant ever since starting and has not reverted even during the global financial crisis. There have been also some macroprudential policies implemented since 2017 and this was coordinated with the Central Bank. When facing domestic and external shocks, such as the social crisis of 2019 or the COVID-19 crisis, the Central Bank acted by providing external liquidity buffers which allow to increase domestic liquidity and reinforce credit without the need to intervene in the foreign exchange market or adopting capital controls. Finally, challenges for the near future were highlighted such as the deepening integration in financial markets and the incorporation of the Chilean peso in the Continuous Linked Settlement (CLS) system.

Mr. Juan Carlos Moreno Brid - UNAM

Mr. Moreno Brid began his presentation by highlighting that history matters to understand the present context. And for that, he drew upon the Mexican case, where there is a misleading appreciation of the financial system. Since in both the 2008 crisis and during COVID-19 there has been no bankruptcy of financial institutions, it could seem at first glance that the country has a solid financial system. However, the counterpart of this performance is a system that does not take risks and does not lend enough. Mr. Moreno Brid also stressed some limitations or constraints that Mexico has to implement capital controls. One of them has to do with the international trade agreements that the country has subscribed to, such as the NAFTA and the USMCA, which forbid capital controls. The second is related to the productive structure. In order to implement capital flight controls, it is important to consider what is the role of the FDI, whether it is complementary or a substitute for productive financialization. It is in this regard, and this is linked to Matías Vernengo's presentation, that these kinds of policies are linked to the development strategy and industrial policy. Mexico is lacking a strategy in this sense. An additional point that becomes relevant in practical terms is the political economy of capital controls since there can be resistance from local entrepreneurs, mainly based on past experiences with these measures.

Ms. Stephanie Blankenburg - UNCTAD

Ms. Blankenburg touched upon some issues that should be seriously contemplated. In this vein, she highlighted the contributions that the workshop provides and emphasized one of the salient outcomes that stand out of the different presentations is the fact that empirical evidence does not support capital account liberalization as a means to achieve development. In addition, she emphasized the role that financialization of the global economy has and contributes to shaping cross-border financial transactions. As an example, she mentioned the issue of residents' versus non-residents' investments in the domestic economy. This requires paying special attention to balance sheet vulnerabilities, which was remarked upon in several comments throughout the seminar.

Further, she reflected on the necessity and purpose of CCMs, stressing that they should be a tool to prioritize internal over external balances. These policies should be understood as a proactive tool for pursuing productive structure transformation. Thus, they should be seen as a long-term framework and not as a temporary instrument to manage financial fluctuations. Another aspect to focus on is on improving regional macroeconomic integration. Now, there are several caveats that emerging economies face concerning the complexity of such measures, the degree of exposure to international markets, and the underlying domestic structure of the countries. As a closing remark, she suggested that the challenge of the project relies on picking or selecting concrete measures under the broad umbrella of CCMs that should be recommended and that could provide common ground for developing countries to build upon.

In the Q&A session the following points were discussed:

During this session, the size of non-bank corporate sector indebtedness in many developing countries was highlighted, particularly in the Chilean case. In this sense, it is important to focus on how the companies use these debts and if they are transferred to investment in the real economy.

In response to the dollar prevalence and its centrality, a point has been claimed regarding that there might be room for transactions in other currencies, given that there have been changes and new developments in the global economy. Besides, new arrangements are emerging, and they might imply that developing countries may not necessarily have to fall under IMF and/or U.S. rules.

Finally, there was general agreement on the importance of capital account measures to spur economic development goals. On this issue, the potential constraints that governments may face when they design and implement policies were also stressed, particularly from an institutional point of view (such as the Mexican experience as discussed above).