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Coordinating Capital Account Regulation

There is a renewed consensus on the need to re-regulate international capital movements. But there is a collective action problem, which puts developing countries at a particular disadvantage. Countries often have been reluctant to use capital controls, fearing a possible backlash from the markets, as was the case when Brazil implemented capital controls in the fall of 2009. There is also a risk that if one country imposes regulations unilaterally, capital will be diverted to other countries, exacerbating problems elsewhere. Coordinated and concerted regulation of capital account flows is thus an important element of capital account management. It is time for the international community to support countries' efforts, including facilitating regional coordination, in the use of capital controls to stem the devastating impact of volatile private capital.

Capital surges as a emerging country emergency amidst global crisis

After collapsing in 2008, international capital flows to developing and emerging economies have begun to increase again, stemming from the abundant liquidity from developed country central banks, which will likely continue as long as developed countries keep interest rates close to zero. As in many previous episodes, instead of providing long-term productive investment, much of the inflows appear to be financing real estate and consumption, and there is some evidence that they are already leading to new bubbles in domestic markets.

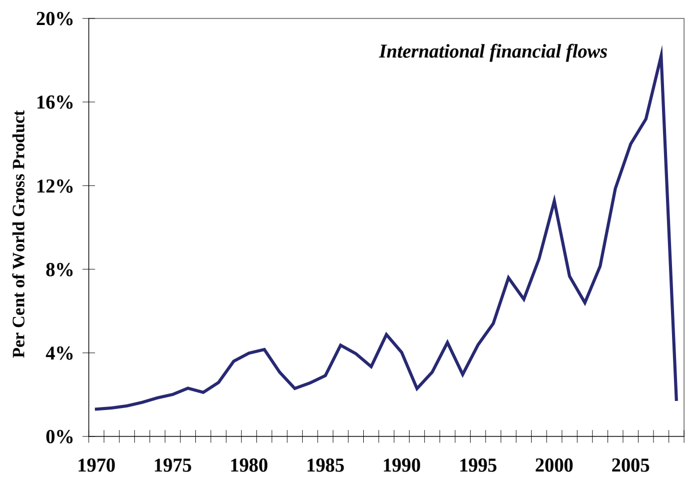
Bubble, bubble, toil and trouble

International capital flows in general and to developing countries in particular have exhibited boom and bust cycles over the past few decades, increasing during expansionary periods and falling during periods of economic slowdowns. (See Figure 1.)

Pro-cyclical capital flows—particularly short-term flows—played a role in most of the crises in the developing world since the 1980s. Contrary to the original expectation that capital market liberalization would increase long-term investment in poor countries, the majority of the inflows inflated finance bubbles, which burst when capital flows reversed following changed market perceptions of investors.

Volatile capital flows have also made traditional macroeconomic policy instruments less effective. In general, governments increase spending and lower interest rates in the face of an economic slowdown. However, open capital markets make these policies more difficult to implement. Central banks may be forced to raise interest rates to stop capital outflows during a crisis or economic slowdown, causing fiscal deficits to widen as the cost of borrowing increases, especially in countries where governments hold large amounts of short-term debt. There is a similar dynamic during booms. With more capital flowing in, interest rates fall, inflating the money supply. If monetary authorities respond by raising interest rates to combat the boom, they run the risk of attracting even more short-term speculative capital, further increasing the money supply and thus failing to take air out of the financial bubble. Moreover, the capital inflows put upward pressure on the exchange rate, making exports less competitive.

Figure 1. **Volatility of International Financial Flows**



Source: United Nations, World Economic and Social Survey 2010, Table O.5, page xxi.

Is accumulating reserves the answer?

Introducing capital controls is one way to stem financial market volatility. In the past, many countries were reluctant to recur to such a measure fearing backlashes from markets. Rather, many developing countries, helped by buoyant world market conditions during much of the 2000s, started accumulating vast amounts of international reserves, motivated in part by the desire to build self insurance against balance-of-payments shocks, as well as that to keep their currencies competitive. However, the strategy of building international reserves has proven costly both to individual countries and to the global economy. For individual countries, there is the opportunity cost of investing overseas instead in domestic development. While this strategy might still make sense from the country's perspective due to the perceived lack of alternatives, in aggregate, the build-up in reserves has exacerbated global imbalances. The potential unwinding of the reserve positions has become an additional source of global financial instability.

Instead, developing countries should be encouraged to use a fuller range of tools available to manage the volatility associated with the international financial system. In the face of failures in financial markets, pro-cyclical capital flows and limited room to manoeuvre for macroeconomic policy, capital market interventions can be less costly ways for policymakers to respond to the volatility associated with international finance.

Managing the capital account

As elaborated in the *World Economic and Social Survey 2010* (WESS 2010), there are different types of capital account regulations. Direct capital controls include quantity and price based regulations, which can be administered on either inflows or outflows. In addition, some countries use indirect regulations, such as prudential regulations on financial institutions or regulations on investments of pension funds, which impact capital flows.

Traditional quantity-based capital restrictions (administrative restrictions and controls) continue to be widely used by developing countries, including key countries such as China and India, despite the gradual liberalization of their capital accounts. Alternatively, governments can impose quantitative limits on the derivatives markets, as the Republic of Korea did in June 2010, when it implemented restrictions on the size of banks' foreign-currency swaps and currency forwards. Other countries, such as Chile and Colombia, implemented price-based interventions (roughly equivalent to a tax on inflows). Such measures aim to discourage inflows during boom periods by raising the associated costs.

The appropriate set of mechanisms for a particular country depends on its regulatory framework, its administrative capability, and the state of development of its domestic markets. The experience of a number of middle-income countries suggests that a variety of instruments can have positive effects, depending on the circumstances under which they are applied. Policymakers in China, India and Malaysia used quantitative capital restrictions to achieve critical macroeconomic objectives, including attracting longer-term forms of foreign investment and insulation from contagion effects of financial crises – leading to greater economic policy autonomy. Policymakers in Chile and Colombia used regulations that taxed capital inflows as 'speed bumps' to slow inflows during boom periods, and there is some evidence that these regulations improved maturity profiles and limited the development of asset bubbles. Colombia reinstated its taxes in 2007-2008, though Chile's ability to use capital account restrictions has been limited to an extent by the conditions of its bilateral trade agreement with the United States.

In addition to direct quantity-based and priced-based regulations, Governments can use a variety of indirect measures to control (or at least influence) capital account inflows and outflows. Prudential regulations on the banking system are one such tool. Numerous countries forbid, or strictly limit, banks from holding currency mismatches on their balance sheets. Regulations can also extend beyond the banking sector, to limit currency mismatches in non-financial firms.

For many countries, direct capital-account regulations, might be simpler to administer than prudential measures. For countries with strong administrative capabilities and a derivatives market, though, a combination of direct and indirect measures can succeed in restricting flows and helping to limit circumvention.

Managing capital flows more effective when coordinated internationally

WESS 2010 suggests that regional and multilateral coordination, with groups of countries implementing controls in a concerted manner, could help shield any one country from having to bear solely the stigma associated with such an undertaking, though it would not reduce the perception in the markets of increased risk. The IMF could also have a significant role to play here. Its 'seal of approval' could make it easier for the market to accept direct controls. ■

Prepared by:
Shari Spiegel, Manuel F. Montes and Rob Vos

For further information please contact:

Rob Vos, *Director,* Development Policy and Analysis Division
Department of Economic and Social Affairs, Rm. DC2-2020
United Nations, New York, NY 10017, U.S.A.
Tel: +1 212 963-4838 • Fax: +1 212 963-1061
e-mail: vos@un.org • website: http://www.un.org/esa/policy

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