G-24 TECHNICAL GROUP MEETING

February 27-28, 2017
Colombo, Sri Lanka

SUMMARY REPORT

The Spring 2018 Technical Group Meeting (TGM) was held in Colombo, Sri Lanka on February 27-28, hosted by the current G-24 Chair, Sri Lanka. The themes covered were debt management and sustainability, the role of trade and investment agreements and managing capital flow volatility. Lastly, there was a special session on the role of Special Drawing Rights in the international monetary system.

In his opening remarks, H.E. Minister Mangala Samaraweera underscored the timeliness of the meetings' themes given tightening financial conditions in the global economy. Faster than expected normalization in advanced economies would have implications for global asset prices and capital flows, leaving economies with high gross debt refinancing needs and un-hedged dollar liabilities particularly vulnerable. Sri Lanka, like some emerging market and developing countries (EMDCs), faces refinancing risks in the coming years, warranting concerted policy responses to mitigate such risks. Referencing the WB-IMF Debt Sustainability Framework for Low Income Countries (LICs), Minister Samaraweera noted that even countries with relatively low levels of absolute debt may face challenges if there are weaknesses in their economic structures and debt management institutions. He emphasized the importance for G-24 countries to further strengthen their macroeconomic policies and institutions, particularly in public debt management. In closing, he hoped that the deliberations in the TGM will inform discussions in the upcoming Spring Meetings in April.

Session 1: Debt Management and Sustainability: Key Challenges
Moderator: Dr. P.N. Weerasinghe, Senior Deputy Governor, Central Bank of Sri Lanka

In his keynote address, **Mr. Marcelo Giugale,** Director of Financial Advisory and Banking Services Department at the World Bank, discussed the World Bank's work in service of clients' debt management needs. Five years ago the Bank created a fully dedicated unit to bring to service of clients the same capabilities it has for itself, important because the Bank is a "super-borrower."

He compared the World Bank's focus in the past to the present and what might be required in the future. In the past, the focus had been on upstream issues such as developing debt sustainability projections, reacting to the debt crises in Latin America and Africa, calculating debt sustainability and putting non-concessional borrowing limits, supporting Paris Club negotiations, arranging debt relief programs and basic institutional development.

Today, clients tend to seek Bank advice on more downstream aspects -- such as on how to borrow and manage the associated risks. For instance, technical implementation (e.g. how to put in place buybacks), contingent liabilities, expanding the investor base, issuing branded bonds (green, sukuk), catastrophe insurance, cash management and infrastructure financing.

In the future, Mr. Giugale forecast that the Bank will be required to deal with “side-stream” issues, as certain developments take prominence such as how to fund pension liabilities, finance the growing needs of mega-cities, climate change, and interact with FinTech, Blockchain and Crypto currencies.

Mr. Yilmaz Akyuz, Chief Economist of South Centre, delivered the second keynote address. He stated that, in spite of the crises in the 1990s and early 2000s, integration of emerging market economies (EMEs) into the global financial system has risen rapidly. One of the factors had been progressively looser monetary policies in advanced economies, especially US and Japan, which had led to a search for yield in high return, riskier assets, pushing capital flows into emerging market economies. Another factor had financial liberalization policy reforms in EMEs.

The external balance sheets of EMEs grew and their composition changed, especially in gross liabilities. On the asset side, Foreign Direct Investment (FDI) was up relative to debt assets, and reserves up relative to debt. On the liability side, there was a lower share of debt compared to equity, a sharp increase in portfolio equity, a shift from bank loans to bonds, a higher relative share of private, compared to public, external debt and an increase in the local currency share of external liabilities.

As a result, new vulnerabilities have built up, to which all EMEs are susceptible to, even those with strong external balances and international investment positions. A large foreign presence in equity markets means susceptibility to entry/exit of foreigners. The large number of local bonds held by non-residents creates exposure to fickle investors. The integration of bond markets makes long-term rates highly susceptible to US bond markets, and growth of corporate debt contracted in dollars increases exposure to foreign exchange risks. The large share of foreign banks magnifies the channel for transmitting shocks from the policies and markets in their home countries.

Given these changes, some standard measures that EMEs had taken to increase resilience are less likely to be adequate. One such measure was the shift to more flexible currency regimes, but currency crises could happen with free capital mobility both under fixed or flexible rate regimes. Another were improvements in banking regulation and supervision to restrict currency and maturity mismatches in bank balance sheets but banks now have become less prominent in intermediation of capital flows. Third was maintaining fiscal discipline and sovereign debt sustainability, which was undermined by excessive private indebtedness. Finally, EMEs have accumulated more reserves to self-insure, but these have come, in most cases, from capital inflows rather than current account surpluses, so external liabilities had increased in tandem. More broadly, to gauge the sufficiency of reserves it is no longer enough to look at the volume of short-term debt in dollars, but foreign holdings of stock, bond and deposit markets, and capital flight by residents represent a greater threat.

Against this background, a number of potential shock scenarios, e.g, faster than expected monetary tightening in the US, are likely. For EMEs, the policy space to respond to such shocks is more limited than in 2008. A global strategy to respond to shocks lacks international mechanisms for effective and equitable resolution of liquidity and debt crises in EMEs.

Participants raised some questions about the cost of issuing branded bonds and how to ensure the developmental use of proceeds from debt. In addition, even liabilities on local currency, if the respective instruments are held by foreign investors can become a disrupting factor for the exchange rate because the investors often seek to convert their gains into foreign currency in order to repatriate them.

Session 2: Debt Management and Sustainability: Strengthening Liability Management,
Moderator: Mr. Fernand Ngoussi Mayangah, Deputy Director, Debt Directorate of the Ministry of Economy, Investment and Planning of Gabon

Mr. Rodrigo Cabral of the Debt Management Unit of the World Bank highlighted lessons learned in using liability management operations (LMO) in external markets. LMO are useful to debt management and are used to change the cost-risk tradeoff, reduce refinancing risk, improve the yield curve and for reinforcing benchmarks. In Brazil, a continuous buyback program improved the yield curve over time, particularly by reducing refinancing risk. Traditional LMO in external markets include buybacks (tender offers) and exchanges. More recent approaches include discrete buybacks in the secondary market, accelerated switch tender offers, and make-whole call and par-call clauses that allow the issuer to buy back bonds when they are close to maturity.

In LMO, financial derivatives may be used to separate funding and risk management decisions, as additional options for managing risks, achieving strategic benchmarks, widening the investor base or as a potential cost advantage for particular markets. However, derivatives come with some challenges including, credit risk and liquidity management, accounting, systems and operational capacity needs, and markets may be limited in some countries. Countries' experiences have brought some lessons to the fore: 1) the need for a robust governance framework in place; 2) derivatives are useful to improve risk management; 3) full capacity and framework have to be developed; 4) markets conditions matter; 5) political and reputational risks are real; and 6) if not properly used, results can be quite bad.

There has been a substantial increase in EUR-denominated EM bonds, which could be associated with the divergence in monetary policies. The two markets -- US and EUR-denominated bonds markets -- have their own particularities in the depth and tenors of issues, and acceptance of lower-rated issues. Countries should avoid having a 'view on the market' and rather use cross-currency swaps to compare costs. The reasons for tapping the EUR market goes beyond costs to include factors such as risk, investor base and branding. Finally, decisions should ultimately be anchored in a debt management strategy.

Mr. Baudouin Richard, ex-Director of Treasury and Capital Markets at the Ministry of Finance of Belgium, presented on strengthening liability management in local currency sovereign bond markets.

The objectives of liability management (LM) and public debt management (PDM) differ. PDM aims to minimize costs and/or risks whereas LM aims to restructure outstanding borrowings to improve the composition of the existing debt portfolio while also minimizing cost and associated risks. Thus, LM provides no additional funding and coves a narrower scope of risks. The main rationale for LMO is to support market development by decreasing refinancing risk, reinforcing the creation of benchmarks and increasing price transparency. In local currency bond markets (LCBM), the LMO instruments most often used are buy backs and bond exchanges. As LCBM develops, LMO increasingly shifts to enhancing market liquidity.

LMOs in LCBM evolve in three stages as their objective widens. In the first stage, LMOs decrease the refinancing risk created by large maturities. In the second stage, they increase the liquidity of the debt portfolio. Lastly, there are other objectives such as to correct market distortions, support the good functioning of the market, restore the issuer's access to the market and create a borrowing need in order to be able to keep issuing.

Despite the advantages of using LMO, there are challenges to using LMOs, particularly at their initial stage of development. First is the challenge of selecting the most appropriate instrument; the second is selecting the procedure for using the selected instrument and lastly, convincing investors and the issuer that they have a common interest in cooperating to put the selected procedure in place.

Multilateral organizations have a role to play in facilitating the exchange of experiences between debt managers confronting similar issues; this having proven to be an efficient way to support countries in implementing appropriate reforms. Peer learning helps in assessing the procedure best adapted to specific markets and in addressing issues of price discovery, minimizing the issuer's funding risk and minimizing the investors' investment risk, particularly for markets in the early stage of development.

Ms. Benu Schneider, former Chief of the Development Finance & External Debt Unit at UNDESA presented emerging issues in sovereign debt and what developing countries can do to address them.

Key policy goals for countries are debt crisis prevention and stabilization in stress periods. Prevention can be achieved through information, standardization and liability management. Stabilization can be achieved through the provision of safety valves in contracts, contractual arrangements for bonds and commercial bank loans (CBL), and improving process. However, information about sovereign debt is fragmented and costly leading to poor risk management and accountability. Improvement in debt data collection and reporting, standardizing essential features of contracts, debt and liability management, and better data on past debt restructurings are required to improve crisis prevention and management.

Litigation in sovereign debt defaults is more common than is generally perceived. Fifty percent of debt crises involved legal disputes affecting 25 countries. The strength of holdout creditors is increasing, as shown in Argentina's case, and creditor returns tend to be high in ligation cases, e.g., 400% for Elliot in Peru.

Reforms in bonds contracts have included: the introduction of Collective Action Clauses (CACs), new aggregated CACs, and standardized *pari passu* provision. Accordingly, approximately 87 percent of new international sovereign bond issuances since 2014 included enhanced CACs, and 81 percent modified *pari passu* provision, with no observable market impact on the inclusion of these clauses. But only 27 percent of the total outstanding stock of bonds have enhanced clauses of which 30 percent will mature in more than 10 years. Bonds governed by New York law may pose the highest risk of holdout behavior.

Commercial bank loans (CBL) comprise a high proportion of sovereign debt but their contracts have hardly changed over the past 3 decades. Innovations in CBL contracts can reduce the likelihood of a holdout and "mitigate the problem of too little too late". Restructuring techniques for loans differ from those of bonds. Syndicated bank loans are amended or refinanced, a majority can accelerate the loan, and on amendment they require unanimous consent on payment terms. Ms. Schneider discussed areas in assignment, amendment, *pari passu*, jurisdiction, sharing and setoff clauses that require a closer look in contractual arrangements.

Ms. Schneider proposed an institutional work agenda that included encouraging the IMF to play a greater role in the provision of information, standardization and a record of restructuring agreement, the BWIs and G20 to set up a global debtor and creditor reporting of debt, and the World Bank/G-24 to provide a template for standardized bond and CBL contracts, among others. Developing countries were encouraged to ensure quality of debt data, manage liability, give attention to legal documentation in contracts, and include aggregation and *pari passu* clauses both in bond and commercial bank loans. Additionally, sovereign bond issuers should consider the recommendations on contracts, trust structures and disclosures, and countries should review existing CBL and bond contracts.

Mr. C.J.P. Siriwardena, Deputy Governor of the Central Bank of Sri Lanka presented his country's experience with debt management and sustainability. Sri Lanka's public debt stock has increased overtime due to persistent fiscal imbalances and the depreciation of the domestic currency. Debt-to-GDP at end of 2017 stood at 79 percent, and total debt stock at US$67.6 billion. Over the past decade key developments in the government securities market included, the introduction of: a participant management Intraday Liquidity Facility; a Bloomberg trading platform, a new primary issuance system of T-bonds; and a Liability Management Bill was presented to parliament.

Sri Lanka currently faces a number of challenges, including: high debt-to-GDP relative to peers, high bunching of (annual, monthly and daily) debt, diminishing availability of external concessional funding, limited funding from domestic non-bank resources, and high fragmentation of the domestic T-bond market. There is also a limited horizon (10 years) of external commercial borrowing, flexibility in government budget, and scope to hedge future liabilities, among others.

Sri Lanka's Vision 2025 highlights key debt management strategies in 3 key areas: revenue-based fiscal consolidation to reduce public debt in the medium term, rationalizing government expenditure and initiating liability management strategies. In addition, a number of measures are expected to be implemented, namely: improving cash flow management of the Central Treasury, strengthening the Primary Dealer System, a new auction system for the domestic market, and lengthening the average time to maturity for both domestic and foreign debt stock.

Ms. Tebogo Mosepele, Director of the National Treasury of South Africa, presented an overview of South Africa's debt management process. Since 1998, South Africa introduced a number of developments in its domestic bond market, including: the appointment of Primary Dealers in government bonds, establishment of STRATE the Central Securities Depository, launch of the Financial Markets Act in 2011, and acquisition of the Bond Exchange of South Africa by the Johannesburg Stock Exchange (JSE). Currently the National Treasury is working on launching Electricity Trading Platform for government bonds.

South Africa's liability management strategy focuses on switches and buybacks. This allows for enhanced liquidity across the yield curve, restructuring of the debt maturity profile, reduction in the cost of servicing debt and for investors to get rid of undesirable bonds. South Africa participates in the Eurobond Market to set benchmarks for state owned enterprises, diversify funding sources, reach a diverse investor base, manage the cost of foreign liabilities and maintain presence in the market.

To finance its gross borrowing requirement, which stands at 5.2 percent of GDP for FY2017/18, South Africa uses domestic short- and long-term loans, foreign loans and changes in cash and other balances. Currently the country is meeting its strategic portfolio risk benchmarks; but it faces risks from its large budget deficit, inflation and exchange rate risks, and any further downgrade in its credit worthiness. Additionally, trading under the primary dealer system takes place primarily on a bilateral basis, results in less liquidity, weak price discoveries and lack of transparency. This issue will be addressed by an Electronic Trading Platform to be launched in FY2018/19.

A number of questions were raised by participants in view of the session's presentations. For instance, how a country issuing EURO-denominated bonds to non-residents can hedge its position through financial derivatives, given that its exports are in USD and Euros, and it is a commodity exporter. A question was also raised on whether repeated buybacks do not amount to rolling over maturities, which may have a negative impact on market sentiment.

Session 3: Role of Trade and Investment Agreements
Moderator: Ms. Marilou Uy, Director of the G-24 Secretariat

Mr. Hector Torres, Former IMF Executive Director for Argentina and ex-Legal Counsellor at the WTO, stated that trade growth slowed down relative to the growth in output after the Global Financial Crisis. And while trade growth is now slowly recovering, nobody expects its growth rates compared to output to go back to the pre-crisis levels. This could be due to some structural reasons. First, the combination of cheap capital and job-saving technologies is making it technically and economically feasible to substitute capital for labor. As a result, differences in the cost of unskilled labor matter less, and some supply chains are bringing production closer to consumption centers.

Second, trade growth figures may be influenced by progress in information and communications technology (ICT), which is dematerializing trade, thus making it more challenging to determine the origin of information flows even when these eventually materialize in goods.

While trade still has aggregate beneficial effects, it compounds the frictions associated to such job market developments. There is a growing anti-globalization backlash, partly due to growing inequality within countries and perception that globalization has led to job losses.

Mr. Torres elaborated on a number of political challenges shaking the foundations of the international trade system. First, the country largely responsible for shaping its existing rules has now taken the position that its national interests come first. This is inviting others to do the same, to the detriment of trade rules. Second, the US is also blocking the appointment of new members at the WTO Appellate Body. Eventually it will be materially impossible to appeal panel rulings and, thus, get to the next step which is adoption of panel reports. Third, growing frustration among developing countries has led some of them to insist that if the Doha Development Round does not come to satisfactory conclusion, they will continue to block discussion of "new issues," therefore limiting the WTO's ability to respond to current economic challenges. He argued that such attitude by developing countries overlooks the fact that the US has lost interest in the multilateral system as it believes that its interests are better served by bilateral agreements. China could be a candidate to fill the leadership vacuum but it is unclear whether it is ready to do so.

An ongoing theme at the last WTO Ministerial, in Buenos Aires, was the debate over whether provisions on Special and Differential Treatment should be reviewed, as conditions of many countries that still benefit from such treatment have changed over time. While there was no support for a Ministerial Declaration, four plurilateral decisions were adopted, with support from countries that represent a majority of world's export share and GDP, on E-commerce, investment facilitation, Micro, Small and Medium Enterprises and domestic regulations on services. The deals on these matters will reflect interest of those sitting at the table and divisions no longer split along North and South lines. The remaining realistic alternatives to consensus multilateral agreements are bilateral or preferential deals and "plurilateral" agreements where participants extend the benefits to "free-riders" on an MFN basis. "Plurilateral" agreements on trade in services regulations do not require the participation of a "critical mass" of countries as signatories could grant the application of agreed regulations to non-participants without harming their economies.

He ended by noting that countries may need domestic reforms to ensure trade benefits are more broadly shared, but some of these reforms could affect competitiveness. Consequently, promoting policy coherence of economic and trade policies is crucial. The WTO cannot provide policy advice, but the IMF does not have such limitation, and it would be in better position to provide this advice if it had active presence in the WTO.

Mr. Aaditya Mattoo, Research Manager at the World Bank, began by addressing the trends in global trade, stating that the fragmentation of global production chains in the 1990s – of which many countries took advantage -- was a major cause of the strong trade growth registered in that period. But this process began to flatten out, especially after the Great Recession. An important factor was that China began to produce more and more sophisticated inputs domestically. According to his research trade protectionist rhetoric has created policy uncertainty, estimating that in 2016, policy uncertainty may have caused a 0.6 percentage point decrease in trade growth.

He noted that there are demand and supply side reasons why one should care about slowdown in trade. On the demand side, it means a reduction of opportunities for individual countries to scale up markets. On the supply side, it means less scope for productivity growth through specialization and technological diffusion.

In regards to the trends in trade agreements, they continue to grow in number and participation, and on average each country now participates in 14 trade agreements. For two thirds of countries, preferential liberalization has reduced trade-weighted average tariffs to less than 5 percent. However, in a number of areas tariffs remain high, including areas of particular importance for developing countries, such as agriculture, textiles, footwear. More remarkably, these trade agreements are becoming deeper, including measures affecting good and services trade, investment, competition, etc. and, in some cases, even rules on the movement of capital. The agreements, therefore, affect the degrees of freedom to conduct domestic policies to promote development in a broader swath of areas. Despite the preferential nature of these agreements, some have also desirable non-discriminatory provisions that will promote trade beyond the parties (e.g., customs reforms).

He further discussed the backlash against globalization, noting that it is not an accident, but relates to changes in global relative dominance. Governments of major countries are now becoming more responsive to internationally immobile labor and consumers. So to sustain openness, there needs to be more emphasis on tax cooperation, efforts to shield immobile labor from the pain of globalization, and regulatory cooperation to shield immobile consumers from international market failures.

Trade is a powerful factor to increase output but while some win from it, others lose. So those who argue for trade liberalization do so on the assumption of government action will tax the winners to compensate the losers. However, the burden of taxation has been falling more on the losers and less on the winners. Unless large trading partners can fix this situation, their commitment to openness is bound to become more fragile. He argued that destination-based tax systems, an emerging phenomenon that eliminates tax competition by removing the incentive to locate in low-tax jurisdictions, are likely to become more common.

Likewise, regulatory actions by one state can create costs on consumers in another state, a concern that conventional negotiations based on reciprocal liberalization typically ignore. This can be addressed by destination-based regulatory commitments, which are commitments by exporters to maintain certain regulatory standards towards consumers of another country, in return for access to that country's market. In the current reality of trade dominated by services and flows of intangibles, these commitments are becoming much more relevant.

Mr. Michael Ewing-Chow, Professor and WTO Chair at the National University of Singapore, referred to three large drivers of developing countries' attitude towards International Investment Agreements (IIAs): the transformation from production in a single country to engagement in Global Value Chains, a growing number of developing countries are becoming capital exporters, and the need to deal with the perception of corruption. As a result, there is a growing premium on enhancing the rule of law, defined as a measure of certainty of the behind-the-border regulations that protect investment. He highlighted as an important element in the rule of law that justice is delivered in a timely manner by competent, ethical, and independent representatives and neutrals, who are of sufficient number, have adequate resources and reflect the makeup of the communities they serve.

Mr. Ewing-Chow then discussed whether IIAs help increase foreign investment and contribute to the rule of law. On the latter point, he said there is a diversity of evidence due to the different aspects of rule of law researchers have focused on. Some respond on the negative, for instance finding that IIAs limit the option of countries to take action for public regulation. Others on the positive, for instance relying on evidence that domestic institutions under IIAs tend to become more transparent and certain. He posited that rule of law needs to be looked at as a whole, that there is a need for governance at all levels: international, national, regional and local, and that investment rules provide incentives to all levels to have better governance and a way for all such levels to negotiate with each other. As a mechanism for dispute settlement, arbitration provides multinational companies (MNCs) greater confidence that 1) disputes can be efficiently settled, 2) awards can be enforced across many jurisdictions and that 3) bargains and agreements can be made to stick.

He argued that countries need to have a strategy towards IIAs that manages policy space by balancing the need to allow for public protection with the need to limit protectionism. In a number of Asian countries this balance was driving new approaches to drafting of clauses on transparency for approval of investments, regulatory measures, indirect expropriation, fair and equitable treatment and the incorporation of general exceptions.

The strategy needs to be owned by the state and ask what the country wants to achieve, what systems are working and whether they need improvement, what obligations are in place and whether there is a need to refine them. Regarding Dispute Settlement, it needs to ask what the problems are and use a cost-benefit analysis to decide on alternatives like ISDS, a Court, an appellate mechanism, etc.

Mr. Ramy Afifi, Assistant Minister, Ministry of Finance and International Cooperation, Egypt, said that trade and investment agreements can be crucial in promoting foreign investment and trade, diversifying export markets and enabling domestic market growth. At a regional level, Egypt is part of a number of trade agreements such as COMESA, and is negotiating a preferential Free Trade Agreement with the MERCOSUR countries. Regarding global trade, Mr. Afifi referred to the Egypt's Suez Canal which is in a unique position to reduce shipping costs between East Africa, the Gulf and Europe, as well as between East Asia and Europe. Connected to this, the Suez Canal Economic Zone is strategically located in a route where more than 8 per cent of global trade passes every year, presenting investment opportunities in vital sectors.

While acknowledging the role of trade and investment agreements, he stressed the importance of domestic economic policies in order to benefit from those agreements and avoid their potential risks. In this regard, he underscored Egypt's economic reform program in the last 4 years, which has focused on three pillars. First is the promotion of investment, trade and industry through a number of new legal and regulatory frameworks. Second are macroeconomic reforms including currency devaluation, tax reform and targeted and more efficient subsidies. The third is having proper infrastructure facilities, including a decision to target 65 % of development assistance inflows to infrastructure and a bold energy sector reform, which features greater private sector involvement in the oil and gas sector.

Mr. Vinod Kumar, Deputy Director of the Ministry of Finance, India, discussed India's Model BIT. Following economic liberalization in 1991, India started signing bilateral investment agreements of which in 2015 it already had 74 in force. In light of developments in the sphere of ISDS throughout that time, it became necessary to set in motion a review process. In December 2015 the Cabinet approved a revised Model BIT as well as the termination and renegotiation of existing treaties and the issuance of Joint Interpretative Statements for agreements whose validity was not expiring. The new Model BIT seeks to create a balance between rights and obligations of states and investors, including a chapter on investor obligations, provides appropriate protection to foreign investors while preserving the State's right to regulate, defines investors in a way that only affords protection to genuine long term investments, provides details so as to minimize interpretative authority in the hands of international tribunals and retains the ISDS system.

The definition of investment in the Model BIT equates investment with an "enterprise" incorporated in the host state, clarifies the types of assets entitled to protection and requires that investors have substantial business activity in their home state. Substantive obligations on standard of treatment, non-discrimination, expropriation and transfer of funds have also been reformed. On the latter, broad exceptions allow the state parties to introduce capital control measures in the event of serious balance of payment problems and financial crises. In regards to ISDS, the Model attempts to balance costs and benefits by retaining it while minimizing host states' undue exposure to liability (e.g. requiring exhaustion of domestic remedies first, increasing transparency, preventing conflicts of interest in arbitrators).

Mr. Kumar concluded that the Model BIT should only be seen as a first macro level step in the overhaul of the system. It is expected to be the basis for India's BIT negotiations in the future, but also to motivate other states to reform their regimes.

In the discussion that followed, participants highlighted issues with some clauses typical in IIAs: fair and equitable treatment, definitions of investment, etc., and commented, more generally, that IIAs tend to offer a scope of protection that goes beyond what is reasonable, grant foreign investors favor that local investors lack, and the pool of available arbitrators is short on public policy experts. One contested the notion of developing countries as capital exporters as not accurate for the vast majority and that any advice would have to be nuanced according to their varying interest in investment protection. A particular concern was that transfer of funds provisions could conflict with measures countries need to have available in their toolkit to manage capital flow volatility. Regarding trade, participants discussed how their engagement in trade agreements should be geared to proactively define sets of rules for areas that technological progress was going to make much more relevant (e.g. data flows) than some of the past trade debates.

Session 4: Dealing with Capital Flow Volatility
Moderator: Mr. Rajmal, Director at the Reserve Bank of India

Mr. Jonathan Ostry, Deputy Director in the Research Department of the IMF opened the session with a presentation on managing capital flows and moving toward a policy *vademecum* to do so.

Mr. Ostry began by highlighting the mixed reviews on cross-border flows. Theoretically, the growth and risk-sharing benefits of capital flows include: complementing limited domestic saving in capital-poor economies; flows such as foreign direct investments (FDI) can generate technology spillovers and facilitate other organizational expertise from abroad; international financial flows can serve as a catalyst for financial market development; and capital flows might impose discipline on macroeconomic policies. However, there is decidedly mixed evidence on the aggregate growth effects of capital flows.

The key problem facing emerging economics (EMEs) and fragile markets is that capital flows respond strongly to global financial conditions. There has been a rise in the frequency and magnitude of surges and reversals in EMEs. These surges are synchronized globally pointing to common push factors such as the US real interest rate, global risk aversion and commodity prices. However, not all EMEs have been affected which points to pull factors such as real GDP growth, external financing need, capital account openness, and institutional quality, as well. Surges lead to macro-financial stability risks, significantly raising the risk of crises. It is critical to manage the surges well through an expanded policy toolkit including: exchange rate management/foreign exchange (FX) intervention, monetary, fiscal, macroprudential and capital controls. Structural policies are also important, and policies may need to be coordinated globally. In practice, EMEs heavily use FX intervention to manage capital flows. In some cases, also the policy rate, macroprudential and capital controls, but little countercyclical fiscal measures. On average, FX intervention absorbs 30 to 40 percent of the flow, although with significant variation across individual countries. The use of FX intervention is reflected by the increasing popularity of managed flows in EMEs. Managed flows achieve low crisis risks by limiting transmission of global shocks.

FX intervention is a useful tool during both inflow and outflow episodes. Given the rising popularity of managed flows, there is a need to understand better the optimal FX intervention strategy for inflows and outflows. During an inflow episode, FX intervention should be used alongside another instrument. The FX intervention should be larger when the shock of inflows is less persistent and when inflows are less sensitive to the return differential. During outflow episodes, the possibility that reserves may run out does not remove the desirability of FX intervention, but does generate a new time consistency problem, which can be limited by the use of intervention rules and forward intervention.

Distributional considerations are salient for cross-border flows. They are associated with insignificant output gains but have led to significant increases in inequality. Effects depend on institutions and the extent of capital flows. Capital flows have also led to a significant decline in the labor share.

Mr. Ilhyock Shim, Principal Economist at the Bank of International Settlements (BIS) presented next. Recent developments in capital flows indicate the continued increase in cross-border lending to EMEs. International bond issuance by EMEs remained strong in 2017, in terms of both the residency and nationality of borrowers. A weak US dollar and persistent search for yield by the large stock of global liquidity continue to generate capital inflows to EMEs.

During the global financial crisis (GFC), international lending fell substantially, driven by supply factors, but domestic currency loans by international banks to local affiliates increased slightly. In an ongoing study by Mr. Shim considering bilateral banking flows from 27 lender countries (mostly AEs) to 67 EMEs over the period 2001-2017, financial stress in lender countries is shown as a major driver of banking outflows from EMEs, with US monetary policy being a key global driver of capital flows. Further work also shows that an expansionary shock to US monetary policy increases cross-border bank capital flows through higher leverage of global banks, and an appreciation of the local currency against the US dollar is associated with an acceleration of bank capital flows to individual countries. On the side of firms, when the local currency appreciates against the USD, firms with large FX debt before appreciation increase leverage more than those with small FX debt, with effects being stronger for the non-tradable sector.

Movements in global EME bond funds show evidence of cross-sectional co-movement in simultaneous investor redemptions across funds, simultaneous sales by fund managers and reliance on a relatively small number of benchmarks which are similar across funds.

There is also evidence of procyclical sale of EME bonds – when investors sell bonds, fund managers do as well. Mr. Shim emphasized the importance of focusing on causes instead of symptoms when addressing capital flows. The global economy is a network of financial claims, which is subject to procyclicality driven by global financial conditions. There is need to introduce prudential measures on leverage and liquidity risks with macropudential intent. Decisions by global banks to lend to EMEs or withdraw and decisions by global bond funds to buy or sell EME bonds are important determinants of capital flows to EMEs. On policy tools available to deal with capital flows, Mr. Shim outlined the following: capital controls and FX-related prudential measures, FX reserves and sterilized FX intervention, monetary policy and domestic macroprudential policy, and global financial safety nets.

Mr. Jose Antonio Ocampo, Board Member of the Central Bank of Colombia, began his presentation by highlighting major issues capital flows pose for EMEs. Capital flows towards EMEs are highly pro-cyclical, in terms of availability and cost, which generates financial stability risks and macroeconomic policy risks. However not all booms end up in crises, instead current account deficits and associated currency appreciation are the critical issues.

Capital flows are characterized by a number of features. First, there is a volatility hierarchy – FDI is less volatile than financial flows (portfolio and debt flows). Low income countries (LICs) have more limited access to private capital flows. Flows towards EMEs are sensitive to monetary policy in AEs, and to the perception of risk. Since EMEs have relatively small markets, a small portfolio in AEs has major effects on EMEs. However, sensitivity has declined due to reserve accumulation, development of domestic bond markets, and strength growth in EMEs. There was a major surge in capital outflows after the 2007-09 North Atlantic financial crisis, but there has not been a 'sudden stop' in financing. There was also major disturbance focused on China in 2015-16. The liberalization process has been uneven in EMDCs, with the MENA region exhibiting the greatest efforts in recent years and Sub-Saharan Africa trailing the group.

Types of capital account regulations (controls) include the following: capital inflow regulations – generally on financial flows, but rarely on FDI; capital outflow regulations; FX related regulations –on lending holding deposits in foreign currency, or limits on open FX positions of financial institutions; and financial sector restrictions consisting of differential treatment of domestic financial transactions for residents versus non-residents and restrictions on residents' accounts abroad. Capital flow regulations can be price-based or administrative/quantity-based.

On managing financial-stability risks, Mr. Ocampo noted that large empirical literature indicates that capital inflow restrictions improve the liability structure of borrowing countries and reduce financial fragilities. Additionally, preventative capital account regulations reduce the risk of financial crises, acting as circuit breakers against contagion effects. Lastly, capital inflow takes can enhance social welfare by diminishing the negative effects of capital account volatility.

Drawing on findings from various research literature on addressing macroeconomic-stability risks, Mr. Ocampo noted that capital regulations on inflows taxes and active reserve management can moderate currency appreciation during booms, create some space for contractionary monetary policies (given higher interest rate spreads), and there is evidence that they reduce capital inflows. Additionally, the imposition of CARs during booms reduces the decline in economic growth during crises and facilitates the recovery. Controls on outflows can help moderate restrictive macroeconomic policies during crises and they may be the only way to solve coordination failures in debt restructuring processes.

The IMF's 2012 Institutional View recommended capital account intervention as a policy of last resort, with preference for capital inflows over outflow measures and price-based over quantity-based measures. The Institutional View still embraces liberalization but warns about the costs of premature capital account and financial liberalization.

In conclusion, Mr. Ocampo emphasized that CARs can play an important role as part of the family of macroprudential policies. To promote financial stability, they must be accompanied by strong domestic prudential regulation and supervision and they must be a complement (not substitute) to counter-cyclical macroeconomic policies.

Bruno Saraiva, Alternate Executive Director for Brazil at the IMF, began by emphasizing a key lesson learned from crises in the 1990s and the GFC in addressing capital flow volatility – that more is needed beyond getting the macro policy stance right. A broader set of policy instruments should be used instead, to manage capital flows. To reap the benefits and mitigate the high costs of capital flow management, a number of prerequisites are necessary: a consistent macroeconomic framework, a well-developed and sound financial sector, and adequate buffers.

The presentation then highlighted some instruments used by Brazil to effectively manage capital flows. Under sterilized interventions, during 'normal times', Brazil built up buffers as an explicit objective since 2004, adding US$160 bn to its buffers before the GFC. For macroprudential policy measures (MPMs), in Brazil monetary and macroprudential policies are considered independent, but can complement each other to achieve price and financial stability. Other policy instruments used for capital flow management include: taxation on foreign investments in bonds, taxation on dollar derivative transactions and reserve requirements on bank short dollar positions. These measures have been effective in changing the composition of capital flows, but not the overall volume.

During the GFC, Brazil used FX interventions extensively, including through reverse swaps, repo operations and short-term commercial credit lines. Brazil's experience suggests that FX intervention is important to influence the exchange rate in the short run, mitigating disruptive volatility, and to improve FX market liquidity under stressed conditions. FX derivatives (NDFs) provided predictability and transparency to market participants; strengthened the resilience of the corporate sector; facilitated the realignment of the exchange rates; and was as effective as spot interventions. Post GFC, Brazil resumed accumulation of international reserves adding US$140 bn in the 3 following years.

Mr. Saraiva concluded by highlighting a number of issues for further discussion, particularly in view of the IMF's stance. First, the issue of distinguishing between MPMs from CFMs (which is important because according to the IV, CFMs cannot be preemptive and have to be temporary). There is also the discussion of CFMs on inflows versus outflows. The current prevalent view at the board is that the IMF Institutional View (IV) on capital flows should not be revised now. It could be complemented by a non-prescriptive *vade mecum* of good practices. Lastly, Mr. Saraiva made the observation that instruments used by EMEs seem to have effectively increased their resilience, given the lack of actual crises during the GFC and/or taper tantrum, though the ongoing monetary policy normalization by the US may still be unsettling for EMEs.

Mr. Moses Tule, Director at the Central Bank of Nigeria, prefaced his presentation by noting that Nigeria's policy approach to managing capital flow volatility leading up to 2017 was largely influenced by the urgent economic conditions within the country after the sharp decline in commodity prices, persistent high inflation rate, a recession and limited room for monetary policy action.

Over the period 2013-2017, Nigeria experienced marked capital flow volatility. For its policy response, FX intervention trailed the ebbs and tides of capital flows, with net capital inflows associated with reserve accumulation. On the monetary policy side, an increase in net capital flows was associated with an increase of 21 percent in the policy rate – indicating a strong desire to attract capital inflow into the economy. Fiscal policy was not deployed in dealing with capital flows. The cash reserve requirement (CRR) was the most prominent macroprudential measure in place.

CMMs employed included the following. On the demand side, in June 2015, the Central Bank excluded importers of some goods and services from accessing the official window of foreign exchange market in order to encourage production of these items. Mr. Tule noted that although the IMF was against this measure, it had to be done given the prevailing economic conditions in the country. Flexibility was reintroduced in the FX market in May 2016 and over-the-counter (OTC) FX futures were also introduced. Also, non-oil exporters were allowed unrestricted access to export proceeds. On the supply side, measures were taken to promote transparency and efficiency in the business environment and the government provided support for local content in public procurement by its ministries, departments and agencies.

In Nigeria, capital inflows are skewed in favor of foreign portfolio investments in equities, accounting for 68.4 percent. Currently, aggregate capital inflows to Nigeria have expanded significantly driven by an improvement in commodity prices and domestic production, improved better macroeconomic environment, and friendlier investment policies. This has led to the reintroduction of a one-year cap on capital inflows, a higher CRR and an asymmetric interest rate corridor with a wider lower band to encourage banks to trade among themselves. Lastly, Nigeria could introduce a Market Support Instrument (MSI) as applied in India, to help smoothen upward and downward swings in capital flows.

Participants raised a number of points in the lively Q&A that followed. CFMs cannot replace fiscal and monetary policies but they should not be regarded as last resort measures in the hierarchy of policies for managing capital flows. Consequently, CFMs could be used to complement fiscal, monetary and macroprudential policies, buying time for them to be effective. According to the IMF IV, there is no presumption of full capital account liberalization as the final goal; and the liberalization of the capital account does not rule out the temporary re-imposition of CFMs. There is scope for long-term maintenance of CFMs provided they are not adopted for BOP purposes and that there are no less distortive measures available that are effective. Along the same lines, given that BITs may not allow for CFMs or only allow their application if the integrity and stability of the financial system is at stake, it was proposed for the G-24 to look into whether there is policy space in BITs to apply CFMs preemptively.

Special Presentation: Special Drawing Rights and the International Monetary System, moderated by Mr. Mahinda Siriwardana, Alternate Executive Director for Sri Lanka at the IMF

Mr. Jose Antonio Ocampo, Board Member at the Central Bank of Colombia, characterized the global reserve system as suffering from three main problems. First, adjustments tend to be asymmetric, with the burden of adjustment falling on deficit countries. Second, the inherent instability brought into the system by use of a national currency as international currency (known as "the Triffin dilemma"). Third, the growing inequities associated with the fact that developing countries need to accumulate foreign exchange reserves for self-insurance purposes and, in the process of doing so, transfer significant resources to reserve-issuing countries.

The Special Drawing Rights (SDRs) were created in 1967 with the expectation that they would become the principal reserve asset in the international monetary system and with the aim of creating global liquidity without the problems associated to the Triffin dilemma. But since the very beginning the division of IMF accounts into “general resources” and “SDR” accounts limited the use of SDR allocations by countries and made it impossible to use them to finance IMF programs.

SDRs are not a currency but a potential claim on freely usable currencies in the SDR department. There have been foure allocations of SDRs (in 1970-72, 1979-81, 1997 –made effective in 2009 – and 2009) but they represent a relatively small share of world reserves – about 3 % of non-gold reserves. For instance, most conservative estimates consider demand for reserves to be at least USD 200 bn annually whereas the whole allocation in 2009 amounted to USD 250 bn. In that regard, Mr. Ocampo considers SDRs the most underutilized mechanism of international economic cooperation.

Criteria for allocations of SDRs are a long-term need, of a global character, and with the purpose of supplementing existing reserve assets. Importantly, as they are allocated to countries according to their IMF quota, developing countries get less than one-third of SDR allocations. Nonetheless, the most important users have been developing countries – even though high income countries have been also active users at different times.

In his conclusions, Mr. Ocampo highlighted several potential reforms that could be of interest from the point of view of developing countries. First, he stressed that any relevant reform requires a change in the IMF’s Articles of Agreement, and the most important reform is to eliminate the division between the “general resources” and the “SDR account.” Second, allocations should be made regularly, and to make them counter-cyclically, they could be placed in escrow accounts during booms. Third is using SDR allocations to finance IMF programs. An even better mechanism would be to treat allocated SDRs as “deposits” in the IMF that the institution can use to lend to countries in need – the way a Central Bank issues money. Fourth, SDRs could be used to finance IMF programs with conditionality, but by no means should SDR allocations be made conditional.

Bernardo Lischinsky, Senior Advisor for Argentina at the IMF, speaking as a discussant, agreed with Mr. Ocampo’s description of the main problems of the system and he emphasized that the issues affecting EMDCs are present even under “normal” circumstances in the functioning of the system. Some components of the Global Financial Safety Net can help deal with such issues. So the question is how SDRs can help EMDCs cope with the issues they face in normal circumstances, those that arise in times of scarcity and, furthermore, address inequities that affect them.

Commenting on the proposal to issue SDR deposits – in the way a Central Bank issues money --, he raised the question of how SDR valuation could be stable and in relation to what could such stability be measured. He wondered whether in a a fully SDR-funded IMF original deposits would be backed purely by the issuance of SDRs and whether they would be in same amount as the quota of the membership.

There was a need to address the question of how to effectively prevent global imbalances, something global macroeconomic cooperation at the moment seems unable to do, and he asked whether Keynes’ proposal to penalize countries with large surpluses or adding excess reserves would have any chance to find consensus today.

Mr. Lischinsky agreed with the proposals to change the distribution criteria, including taking into account reserve needs, and the use of SDRs for development and climate finance purposes. He concluded by cautioning that to advance these proposals, in particular those that required changes to the IMF Articles of Agreement, barring extraordinary circumstances, wide consensus needed in the IMF membership is likely to be hard.

Participants discussed whether the real obstacle to broader use of SDRs is the separation between the accounts or the lack of a market for countries that would like to exchange them for hard currency, with one suggesting that perhaps a reform to explore is how the IMF could play a broader role in providing such convertibility. They also raised the issue of how SDRs would be backed and of the need for regular allocations if proposals for broader use are going to work.

H.E. Mr. Eran Wickramaratne, State Minister of the Ministry of Finance and Mass Media of Sri Lanka, delivered the closing remarks.