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Regulating Global Capital Flows for Development

In the wake of the financial crisis, concern about the volatility of cross-border capital flows has been expressed by the International Monetary Fund, the G-20, and actors across the United Nations system. In 2011, an expert task force was convened to channel such concern toward concrete policy proposals to help nations better govern cross-border financial flows.[1] This policy brief summarizes the core findings and policy recommendations coming out of the first report of that task force.

Recent volatility in cross-border financial flows has largely been due to low interest rates and slow growth in the industrialized countries, as well as higher interest rates and faster growth in the developing world (IMF, 2011a).[2] In the immediate wake of the global financial crisis until late in September 2011, cross-border capital flows had reached their pre-crisis levels in many regions, especially in Latin America and East Asia (IMF, 2011b).[3] When the Eurozone crisis became accentuated later in 2011, there was a sudden reversal of capital flows, and capital flight occurred from developing countries back to the 'safety' of the United States market.

The initial wave of inward capital flows became a great concern across the developing world. Indeed, Brazilian President Dilma Rousseff has come to refer to unstable capital flows as the "liquidity tsunami". Brazil experienced an over 40 percent appreciation of its currency between 2009 and 20011, and was riddled with an asset bubble as well. Exporters and their workers alike began losing jobs and competitiveness. Late in 2011, there was capital flight when the storms gathered over Europe, but the tsunami is gathering pace and bubbling in Brazil once again. Similar experiences occurred across Latin America and Asia.

Brazil reacted aggressively by putting in place what the task force refers to as "capital account regulations" on speculative capital entering the country. On numerous occasions, it has levied taxes on stock and bond trading, and derivatives. Brazil has not been alone in taking such action. Argentina, Costa Rica, Indonesia, South Korea, Peru, Taiwan, and many others have taken similar action (Gallagher, 2011).[4]

The first report of the Task Force confirms that such concerns and the policy response to them have been justified and necessary. However, the task force points out that many developing countries are struggling to effectively regulate cross border finance because of a lack of cooperation by the industrialized countries and a lack of full leeway for regulation and cooperation due to numerous trade and investment treaties.

Nations such as Brazil and South Korea are justified in their determination to regulate cross-border flows of finance. Global financial markets are what economists call "pro-cyclical". There is too much capital when the economy is doing well, and too little during a downturn. Regulating capital flows during waves of hot money inflows helps lower the crests, and limits the troughs during outflows. Thus, regulations serve as 'counter-cyclical' measures to smooth these cycles. New research also shows that such measures can correct for inherent market failures in the world economy, and thus increase world welfare (Korinek, 2011).[5]

Recent work by the IMF has also acknowledged that such measures are justified, but a recent set of guidelines regarding the use of

capital account regulations has asserted that such regulations should be only of last resort, temporary, and not discriminating between residents and non-residents. The task force highlights the fact that such guidelines are inconsistent with the peer reviewed evidence showing that capital account regulations have been effective. The task force provides an alternative set of 'rules of thumb' where they argue that capital account regulations should be part of a wide ranging package of regulations that a country should have on hand to prevent and mitigate financial crises.

The IMF Articles of Agreement grant nations the policy space to not only regulate cross-border capital flows as they see fit, but also enable North-South cooperation on such regulation. Indeed, both John Maynard Keynes and Harry Dexter White—the chief crafters of the Articles of Agreement— agreed that the burden of regulating speculative capital should be at "both ends": not only on the recipients of capital inflows, but also on the source countries of that capital (Helleiner, 1994).[6]

The task force points out that when nations are left to unilaterally regulate capital flows, that such regulation is eventually made porous by investors seeking to evade them. Some nations, such as Brazil and Korea, rightly "fine tune" their regulations to try and keep up with efforts to circumvent regulations, but still often struggle to meet the goals of the regulations over time. This is partly due to a lack of cooperation between North and South on this issue.

After the Articles were put in place in 1944 until around 1970, there was some degree of collaboration on capital account regulations. Indeed, France convinced the United States to maintain its regulations on outflows in the 1970s so France would not suffer currency appreciation due to heavy inflows of capital from the US. During the same period, France convinced Germany to tighten regulations on outflows in order for France not to suffer the consequences of excessive inflows of speculative capital.

Some nations shy away from deploying capital account regulations because such measures could be found to violate recent trade and investment treaties (Gallagher, 2010).[7] On the receiving end of all the capital flows are nations that may have signed on to the financial services commitments under the General Agreement on Trade and Services (GATS). Under the GATS, WTO members must allow cross-border (inward and outward) movements of capital if these are an essential part of a service for which they have made liberalization commitments regarding its cross-border supply or establishment.

Many nations may also be party to a free trade agreement or bilateral investment treaty that require the transfer of all forms of capital—including stocks, bonds and derivatives—into and out of the economies to all parties to an agreement 'freely and without delay'.

There are institutional barriers to cooperating on "both ends" of capital flows as well. Most industrialized countries are not permitted to regulate capital flows due to membership of the Organization for Economic Cooperation and Development (OECD) and the European Union.

The task force urges the IMF and other international institutions to work to preserve and enhance the policy flexibilities to regulate cross border finance found in the IMF Articles of Agreement. Indeed, in November 2011, at its Cannes Summit, the G-20 stated that "there is no 'one-size fits all' approach or rigid definition of conditions for the use of capital flow management measures", and that such measures should not be solely seen as a last resort (G-20, 2011).[8] The IMF and other international bodies should follow suit and research how best to design capital account regulations under different circumstances, establishing general design features and best practices for nations seeking advice about how to cope with excessive capital flows.

The IMF and global community could also take part in a "compatibility review" to examine the extent to which various integration and trade treaties conflict with the Articles of Agreement. The IMF and other institutions could then manage a transparent process whereby 'Articles of Agreement-friendly' exceptions to trade and investment treaties could be framed, and inserted into past and future treaties.

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[1] The Task Force on Regulating Global Capital Flows for Development is co-sponsored by research institutes at Boston University, Columbia University, and Tufts University in the USA. In addition to academics from these universities and beyond, the membership includes economists and analysts from the G-24, UN-DESA, an IMF mission, the Asian Development Bank Institute, the Chinese Academy of Social Sciences, and the former deputy governor of the Reserve Bank of India. To learn more about the Task Force, see: http://www.bu.edu/pardee/2012/03/02/task-force-on-regulating-global-capital-flows/

[2] International Monetary Fund (2011a). The Multi-lateral Aspects of Policies Affecting Capital Flows. *IMF Background Paper*, October 21, 2011.

[3] International Monetary Fund (2011b). World Economic Outlook, 2011. *International Monetary Fund*, Washington, DC.

[4] Gallagher, Kevin P. (2011). Regaining Control: Capital Controls and the Global Financial Crisis. *Political Economy Research Institute Working Paper No. 250*, University of Massachusetts, Amherst.

[5] Korinek, Anton (2011). The New Economics of Prudential Capital Controls. *IMF Economic Review 59(3)*, August, pp. 523-561.

[6] Helleiner, Eric (1994). *States and the Re-emergence of Global Finance*. Ithaca: Cornell University Press.

[7] Gallagher, Kevin P. (2010). Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements. *G-24 Discussion Paper No. 58*, May.

[8] G-20 (2011). G-20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experience. November. http://www.g20-g8.com/g8-g20/root/bank_objects/0000005999-Coherent_Conclusions_on_CFMs_postCannes.pdf).