Making capital flows work: A five-pillar approach

August 2010

Summary and recommendations

The liberalisation of capital accounts and the increasing importance of international capital flows are the common denominator in several important ongoing discussions on global imbalances, financial market regulation, financial safety nets and IFI reform. In order to keep pace with these developments and to integrate the different discussions, a reformed financial architecture to make capital flows and liberal capital accounts work on a national, regional and global scale is of pivotal importance. It can be achieved by means of an integrated five-pillar approach addressing macroeconomic policy, regulation of the financial sector, IMF surveillance, management of excessive capital inflows and volatility, and global and regional financial safety nets.

The first three pillars, the base, pillars, should provide countries with a adequate means to make capital flows work under normal circumstances. There are two additional supporting pillars to provide protection against the downside risks of capital flows in extraordinary situations.

Pillar 1: Macro-economic policy. The effects of macro-economic policies on capital flows (and the feedback thereof on the real economy) should be weighted better by policy makers. This includes the spill-over effects of local policies on other countries through capital flows. In addition, a study could be carried out to assess whether some form of (semi-)automatic stabilisers with respect to available capital could help to reduce volatility in levels of capital.

Pillar 2: Regulation of the financial sector. The new Basel proposals on capital standards address the capability of the sector to absorb the risks. In addition, a global adoption of Basel would limit scope for inefficient regulatory arbitrage that could lead to international capital flows which are not based on fundamentals. Finally, prudential regulation sets the preconditions for efficient use of capital flows and further limits the potential risks to the financial sector.

Pillar 3: IMF surveillance. The incorporation of continued surveillance on the capital account in the IMF's existing surveillance framework can help countries devise their capital account policies.

Pillar 4: Management of excessive capital inflows and volatility. In certain exceptional periods, the three base pillars may not provide adequate protection against downside risks. In this case measures to dampen capital inflows and volatility could be considered. These measures should be: i) market-based (not administrative), ii) clearly communicated in terms of scope, goal and timing, and iii) temporary.

Pillar 5: Global and regional financial safety nets. Stronger integration and coordination of existing initiatives on a country, regional and global level bring together the qualities of safety nets at different levels, greatly benefiting the efficiency, credibility, incentive structures and country ownership, as well as minimising stigma.

Applying all the elements of the five-pillar approach can make an important contribution to enhancing the positive effects and dealing with the downward risks of capital flows.

Introduction

1. Within the G20, discussions have been ongoing on a number of key issues including global imbalances, financial market regulation, financial safety nets and IFI reform. These issues have so far been treated more or less in isolation. However, we believe that they all have a common denominator: international capital flows. The liberalisation of capital accounts represents the most important change to the economy over the last 20 years. Yet economic policy has not kept pace with these developments. Designing the economic and financial system to effectively manage a liberalised system of capital flows is therefore crucial if we are to improve economic and financial stability and development. This paper describes a possible approach to enhancing the efficient allocation of capital while curtailing the downward risks posed by capital flows.

2. The framework for strong, sustainable and balanced growth focuses on current account imbalances. Yet a strong focus on capital accounts is at least as important. After all, the capital account and the current account mirror each other. Imbalances are driven sometimes by the current account and sometimes by the capital account. We should keep in mind that completely balanced capital accounts (and current accounts for that matter) are neither possible nor desirable. Imbalances are a result of both liberal current and capital accounts and the fundamental differences between countries. Therefore deficits and surpluses on capital accounts can be considered "good" if they reflect optimal allocation of capital across time and space. However, imbalances are “bad” if they reflect distortions that cause suboptimal saving or investment behaviour.

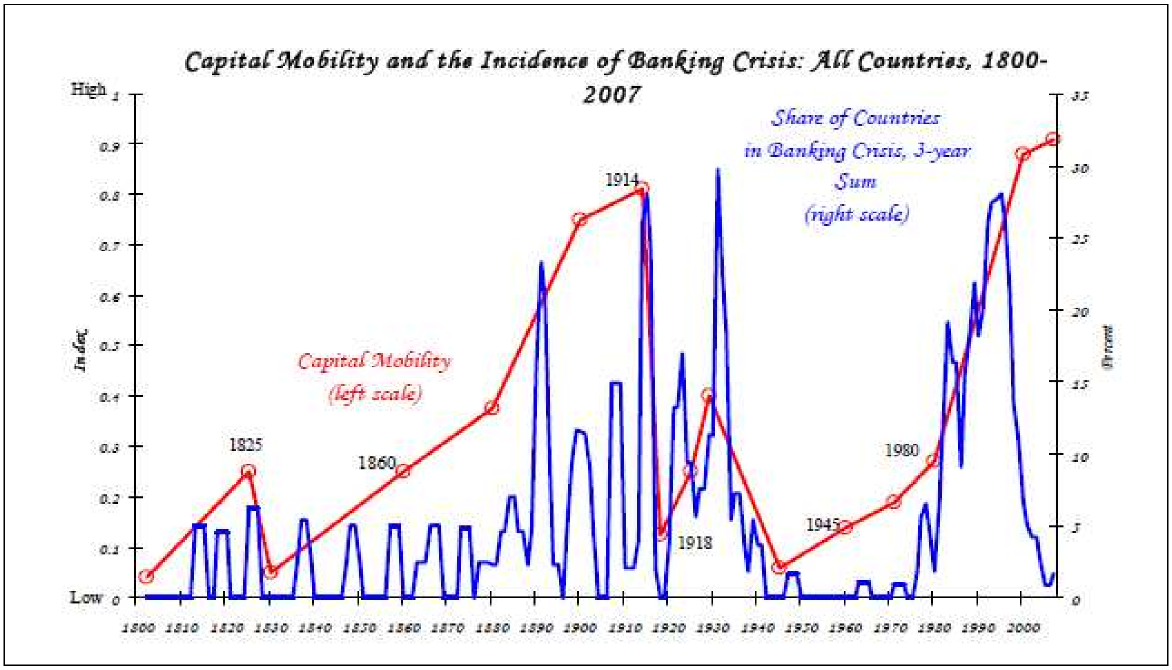
3. Free capital movements facilitate a more efficient global allocation of savings, i.e. help channel resources into their most productive uses and smoothen consumption and investment, thus increasing economic growth and welfare. However, free capital movements entail serious downward risks.

4. Countries experiencing sudden large capital inflows are indeed at a high risk of having a crisis. Moreover, there appears to be a striking correlation between freer capital mobility and the incidence of banking crises (see figure 1). Periods of high international capital mobility are historically associated with balance of payments crises and international banking crises. Furthermore, closer integration of capital and financial markets may increase the risk of contagion across borders and markets.

5. Given the increasing significance of capital flows in our economic system (figure 1), it is of paramount importance to make liberal capital accounts work for all countries by i) enhancing the efficient allocation of capital, and ii) curtailing the downward risks posed by capital flows. We suggest to this end that the global financial architecture should follow a five-pillar approach. The three base pillars are 1) macroeconomic policy; 2) regulation of the financial sector; 3) IMF surveillance. These pillars form a basis of sound economic and financial policies, the most important approach to make capital flows work. A line of defence against downward risks should

consist of two supporting pillars: 4) management of excessive capital inflows and volatility; and 5) global and regional financial safety nets. These pillars will be touched upon in the next sections.

Figure 1: Capital mobility and the incidence of banking crises



Source: Reinhart and Rogoff (2008)

Pillar 1: Macroeconomic Policy

6. It is important that countries consider the implications of their macroeconomic policy on capital flows, since it has considerable impact on both the size of capital flows as well as their effects on the economy. The usual macroeconomic instruments available to a country to respond to a surge in capital inflows are currency appreciation, reserve accumulation, and/or adjustment in fiscal and monetary policy.

7. With respect to macroeconomic policy it should be kept in mind that it is impossible to have, at the same time, 1) a fixed exchange rate, 2) free capital movement, and 3) independent monetary policy. This 'impossible trinity' implies that choices have to be made about the most efficient macroeconomic policy mix.

8. The impossible trinity represents especially a significant challenge in the light of liberal capital accounts because of the possibility of carry trade. Rising inflation requires monetary contraction through higher interest rates. At the same time, however, the higher interest rates attract foreign capital. The case of Thailand leading to Asian crisis has shown the impossibility of a pegged exchange rate with free capital movement and independent monetary policy. In theory, a freely floating exchange rate would bring the economy back in equilibrium. Yet this overlooks the

potential damage of a rapidly changing exchange rate (first as a result of the higher interest rates which induce carry trade, and once again when this carry trade is reversed).

9 A policy blending different elements offers a possible solution to this problem, such as coordinated monetary policy across countries, managed exchange rates between countries and/or managed capital flows. Clearly, there is no 'one-size-fits-all' solution, and the appropriate policy response depends on national circumstances and preferences. At the same time, policy measures in one country or group of countries may also affect policy space and have ramifications elsewhere.

10. Furthermore, research has shown that capital inflows tend to be pro-cyclical, in most advanced countries as well as in emerging and developing countries. At the same time, fiscal policy is also pro-cyclical for most countries. As a result, the capital flow cycle and the macroeconomic cycle reinforce each other.

11. A study could be conducted into whether some form of (semi-)automatic stabiliser of available capital could possibly yield a positive effect for the economy and counter the pro-cyclicality of the capital account. One option would be a mechanism to dampen increase in the total level of available capital in the case of inflows and/or large credit growth and dampen the decrease in the total level of available capital in the case of outflows.

12. Furthermore, the global spill-over effects of domestic macro-economic policies should be considered when designing those policies. The G20 framework for balanced and sustainable growth provides an opportunity for policy coordination on this matter. Capital flows should therefore be a part of the analysis of the Mutual Assessment Process.

12. Prudent macroeconomic policy is a necessary (although not sufficient) condition for the efficient allocation of capital, and especially to curtail the downward risks of capital flows. To this end countries also need adequate and credible fiscal and monetary institutions.

Pillar 2: Regulation of the Financial Sector

13. Appropriate macro- and micro-prudential regulation for the financial sector is an important pillar of the approach to make capital flows work. The financial sector can be exposed to and contribute to significant risks which can be associated with capital flows. In case of, for example, currency mismatches the outflow of capital poses a significant risk. These risks can be addressed by prudential regulation. The new Basel proposals on capital standards (regarding both quantity and quality) are necessary to provide better buffers needed to absorb losses from, for instance, remaining mismatches and pro-cyclical downturns (which can be greatly aggravated by the outflow of capital).

14. In the absence of a global level playing field there are possibilities for inefficient regulatory arbitrage that could lead to international capital flows which are not based on fundamentals.

Capital could flow to less regulated pockets, disrupting the efficient allocation of capital. A more global adoption of the Basel regulatory standards is therefore necessary to ensure a level playing field and a better allocation of capital. Yet a global adoption of the Basel regulatory standards should not be an endpoint. Future innovations in the financial sector, in particular in advanced countries, should be closely monitored.

15. Finally, support to gradual financial market reform in developing countries would not only improve domestic resource mobilisation in these markets, but could also help foster integration of capital markets and further stimulate a global level playing field for financial markets.

Pillar 3: IMF Surveillance

16. In parallel with changes in the global economy, the IMF's role with regard to capital accounts has increased significantly. The IMF has provided important assistance to countries concerning capital account liberalisation. However, the IMF should pay more attention to capital account surveillance.

17. Once capital accounts are liberalised, countries are basically left 'on their own' to make policy decisions regarding their capital account, with no role for IMF surveillance. Enhanced surveillance of the capital account should be incorporated in the advice given to countries in the financial and economic domain, including in the article IV and FSAP consultations. This is in line with the request made to the IMF by G20 leaders at the Pittsburgh summit to strengthen its capacity to help its members cope with financial volatility. Cooperation with other institutions like the systemic risk boards can play a role in these surveillance efforts.

18. An important second part of IMF surveillance would entail surveillance on a more regional and global level. The signalling of potentially dangerous developments that could cause downside risks to materialise, could provide input for i) individual country policies regarding the other four pillars and ii) coordinated policies of the G20 and the other members of the IMF as a part of their multilateral surveillance. A focus on contagion and systemic risk should be at the centre of this surveillance. It is crucial that the recommendations be followed up for the surveillance to be effective. We should use existing structures within the IMF and G20 to ensure this happens.

Pillar 4: Management of Excessive Capital Inflows and Volatility

19. Liberal capital accounts are optimal from both a country and a global perspective. Sometimes however the three base pillars may not provide adequate protection against the downside risks, in particular for countries vulnerable to capital flow volatility. In this case measures to dampen capital inflows (and in particular short term "hot money" capital flows) and volatility could be considered.

20. Several countries have introduced some controls on capital in order to dampen the inflows and volatility. Examples include Chile (1991-1998) and Colombia (1993-1998), and, more recently Brazil (2008, 2009-), Croatia (2006-2007), Thailand (2006-2008), and South Korea (2010).

21. Research shows that, in general, such measures have little impact on the total volume of capital flows. They may, however, alter the composition of inflows and serve a macro-prudential function, such as mitigating financial sector risk. These measures have usually only been effective in the short run.

22. Measures to dampen inflows and volatility when the other pillars prove insufficient should be: i) market-based (not administrative), ii) clearly communicated in terms of scope, goal and timing, and iii) temporary.

23. Measures that could be considered, for example, include unremunerated reserve requirements (URRs) or taxing certain transactions. Both URRs and taxes reduce the rate of return to investors on specific financial transactions and can be applied to cross-border transactions. The cost to investors can be calculated upfront, which makes these measures transparent. The choice depends on the aim of the measure, the nature of the capital inflow and country-specific circumstances.

24. It should be kept in mind that introducing measures to dampen capital inflows could mean moving the flows and their associated downside risks to other counties. There is a risk not only of retaliation but also of prolonging inefficient domestic systems. Utmost reticence when considering these measures is therefore called for and the measures should always be temporary.

Pillar 5: Global and Regional Financial Safety Nets

25. As long as capital is free to flow, there will always be imbalances. This need not to be problematic under normal circumstances. Sound economic and financial policies in the form of the first three pillars will help to ensure this and will protect against the downside risks. Nevertheless, global and regional safety nets are necessary to dampen the effects of the 'mood swings' experienced by market participants, whether rational or not, and to guarantee countries predictability of access to international financial liquidity, even in times of crisis.

26. Previous crises have induced some countries to pool foreign exchange reserves for precautionary purposes. Examples include the Chiang Mai Initiative, the Latin American Reserve Fund and the European Financial Stability Fund. These forms of safety nets have a large degree of ownership by countries, but because of the high degree of correlation in crisis incidence between countries in a region, it is questionable whether these initiatives would suffice to manage a crisis. The debate on global financial safety nets has therefore rightfully been on the agenda for the past year.

27. The IMF and the G20 experts group on financial safety nets are examining ways of creating proper global safety nets in order to provide insurance against downside risks and replace or partly replace suboptimal insurance in the form of excessive accumulation of foreign exchange.

28. Important characteristics for safety nets have been identified: i) certainty about availability; ii) sufficient resources; iii) flexibility to deal with the specific nature of the crisis at hand; iv) the right incentive structure; and v) freedom from stigma.

29. Safety nets should involve cooperation and integration of national and regional self-insurance through reserve pooling within global structures. Combined arrangements and coordination between these levels could lead to efficiency, credibility and ownership by countries and the right incentive structure. The recent cooperation between the EU (euro area) and the IMF in establishing a safety net for the euro zone is a good example, in which sufficient funds, ownership and the right incentive structure are combined.

30. The IMF should play an important role in cooperation and integration of this kind. The fund could be the pivot in bringing self-insurance and regional and global safety nets together, thereby combining all the important elements and mitigating the flaws that exist at each level.