IMF MACRO CONFERENCE

**The Case for Regulating Cross-Border Capital Flows**

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Let me start by thanking the organizers for this opportunity to speak about capital account regulations, a policy instrument on which I have done research for many years and that I also utilized as Finance Minister of my country, Colombia, and fruitfully so.

I will start with two remarks that complement the views just expressed by Rakesh Mohan. The first one is that cross-border capital flows are one of the expressions of finance. It is thus peculiar that in the agenda of the G-20 about re-regulating finance, this issue was entirely excluded, as if cross-border finance was not finance. In fact, the use of words is peculiar, because when we talk about regulating domestic finance we always use the word "regulation." However, when we talk about cross-border finance, we use the word "controls." I actually prefer and have used for a long time the concept of capital account regulations, because that is what they are: regulations. They may be quantitative, such as the prohibitions on certain activities or limits on them, which is also true of some domestic prudential regulations. Some are price-based, such as unremunerated reserve requirements, again like domestic regulations, such as capital or liquidity requirements. They all belong to the same family: what we now call "macroprudential regulations".

My second introductory point is that I come from a tradition of macroeconomic thinking in which the balance of payments is always placed at the center, as the source of both positive and negative shocks, and therefore as the essential source of business cycles. This tradition is the best starting point to analyze developing countries' macroeconomic dynamics, and that of emerging-market economies in particular. Furthermore, a broadly accepted principle is that the best policies are those designed to intervene directly at the source of the shocks. A clear case is a terms of trade shock. The best intervention in this case

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is one that deals directly with the shock, by saving a significant amount of a commodity price boom and using those savings later on when prices fall. This is what Chile has been doing with its copper revenues, and what Colombia did with coffee for a long time. This principle is widely accepted.

The same thing is true of capital accounts. They are the main source of shocks that emerging markets have experienced in recent decades, both positive and negative. Therefore, policies should also focus in this case on the source of the shock. Furthermore, by referring to them as positive and negative, I am also expressing the fact that capital flows have a temporary component, which authorities may want to smooth out. Indeed, such smoothing out is the very essence of what we mean by a counter-cyclical macroeconomic policy.

The starting point here is, of course, the recognition that finance is pro-cyclical. It is particularly pro-cyclical for those agents that are considered to be riskier by markets. This reflects the fact that that there is a significant segmentation in financial markets, and that riskier agents are subject to stronger pro-cyclical shocks than the average market pattern. This is true of small- and medium-size enterprises and consumer credit in all economies. And it is true of developing countries in global markets. Developing countries are considered to be riskier borrowers, so they are subject to the phenomena of flight-to-quality and sudden stops during crises, but they are also subject to risk appetite during booms such as the one that we are experiencing now. That strong pro-cyclicality is the particular issue that policies should address.

On top of that problem, we know that in developing countries financial markets are more incomplete, and that this is reflected in the variable mixes of currency and maturity mismatches in portfolios. These problems are much more important for developing countries and emerging markets than they are for industrial economies. Of course, as countries develop deeper financial systems, markets will partly solve these problems. In any case, they should be the subject of specific attention by regulatory authorities.

I want to underscore that pro-cyclicality is not only a question of short-term volatility. In a sense, short-term volatility is the easiest to administer, through active foreign exchange

reserve management. The most difficult problem is managing the *medium-term cycle* of capital flows. We have experienced three such medium-term cycles in recent decades and may be starting a fourth. There was one that started in the mid-1970s and went through the 1980s. Then we had the 1990-1997 boom (briefly interrupted by the December 1994 Mexican crisis) and the long crisis that started in Asia in mid-1997. The most recent cycle was the boom from 2003 to mid-2008, followed by the sudden stop as a result of the Lehman Brothers collapse. This was a shorter cycle and a fourth one may have started in mid-2009.

The basic problem of these medium-term cycles is that they drive the macroeconomics of emerging and developing economies while simultaneously constraining the capacity to undertake counter-cyclical macroeconomic policies. They drive the exchange rate, spending and domestic demand. They also drive fiscal policy in a pro-cyclical way, as revenues increase and access to capital markets is made easier during booms and then both are cut sharply during crises. And of course, they drive interest rates in a pro-cyclical way, as markets would tend to reduce risk spreads and thus interest rates during booms and increase them during crises, so that any counter-cyclical macroeconomic policy would have to lean against those strong pro-cyclical market trends. So, if authorities want to adopt counter-cyclical macroeconomic policies, they have to ask themselves why they would not want to intervene at all at the major source of the business cycle: the cyclicality of capital flows.

In fact, if authorities do not manage the capital account, they will really be making a choice about the particular way they want the pro-cyclical effects of financial markets to be reflected in their economy. If they control the exchange rate, they will have to give up managing the interest rate, and then the policy would be clearly pro-cyclical. If they decide to control the interest rate, they have to give up managing the ex/change rate, but appreciation during booms and depreciation during crises is also pro-cyclical. The counter-cyclical effects that operate through the current account of the balance of payments are well known. But if we allowed this effect to run fully, exchange rate appreciation during booms will tend to generate overvaluation and current account deficits that increase the risk of a crisis later on. So, it is double-edged sword. Furthermore, there are pro-cyclical effects that operate through balance sheets in countries where the private sector has net external liabilities in foreign currencies, and through income distribution (increases in real wages as a result of

appreciation, and reductions due to depreciation). These pro-cyclical effects tend to predominate in practice.

In both cases, authorities are not in the end controlling pro-cyclicality: they are really choosing which part of market pro-cyclicality they are allowing into the economy. This looks very much more like Robert Mundell's analysis of a fixed exchange rate system: authorities control the *composition* of the quantity of money but they have no control over the quantity of money. In the case we are discussing, authorities are choosing whether they want the pro-cyclicality of global financial markets to be reflected in interest rates or exchange rates, but they are not controlling pro-cyclicality. That is why, if authorities are thinking of doing counter-cyclical management, they should start by looking at the source of pro-cyclicality: the capital account. And they will have to think of combining this with aggressive foreign exchange reserve management. In other words, since the instruments they normally have are insufficient to run a counter-cyclical policy, they have to look for additional ones.

The developing country authorities and emerging market authorities have actually been quite wise in this regard. They have discovered that they can obtain more degrees of freedom to do counter-cyclical macroeconomic policies by adding policy instruments, either intervening massively in the foreign exchange market (buying and selling depending on the phase of the cycle) or regulating capital flows – or both. In this regard, I agree with a point that Rakesh Mohan also raised about the impossible trinity being a somewhat confusing way of understanding the policy choices. In fact, all the interesting things happen inside the impossible trinity.

What does the empirical work on the effectiveness of regulations of the capital account indicate? I must start by underscoring that the most comprehensive analysis I have read on this issue is actually a 2000 IMF study by Akira Ariyoshi and others. The one that was done last year by Jonathan Ostry and collaborators was provocative and an excellent way to stimulate the appetite for the debate, but I think the IMF should probably take a broader look at country experiences and what they reveal about the effectiveness of different types of regulations.

Considering those studies and many others, capital account regulations can be said to have two different effects. They first operate as a liability policy. In this regard, they are designed to improve the term structure of the country's liabilities. In that regard, the evidence is quite strong that regulations are effective, whether they are price- or quantity-based.

The second effect is that regulations are a complement or support to counter-cyclical macroeconomic policies. In that regard, the evidence has been subject to much more debate, in particular in the case of price-based controls, such as the unremunerated reserve requirements used by Chile and Colombia in the 1990s, and Colombia again in the mid-2000s. However, studies have shown either that they do affect the quantity of flows or domestic interest rates, of both, thus allowing authorities to increase rates during booms without attracting additional capital flows. Either way, they *are* effective, and monetary policy will then determine whether the regulations will affect the quantity of flows or the domestic interest rate, or a mix of both. So long as you are able to increase the margin between the domestic interest rate and the foreign interest rate without attracting additional capital flows, or reduce flows at given interest rate differentials, regulations are effective.

However, the evidence also indicates that some of those effects are temporary. In my writings, I have referred to capital account regulations as speed bumps rather than permanent restrictions, essentially because market agents learn how to avoid them. What this implies is that authorities have to be equally dynamic, and strengthen regulations over time, closing loopholes to make them effective. This is true, by the way, for any type of prudential regulation. Authorities always have to see how the market is evolving and adjust regulations to make them more effective.