Summary of the conference "Managing the Capital Account and Regulating the Financial Sector: A developing country perspective", organized by IPD in partnership with UNDESA, and with financial and other support from Ford Foundation, FEPS and IPEA. The seminar was held in the BNDES offices August 23-24, 2011
Rio de Janeiro, Brazil

Background and objectives of the Conference

Financial instability and volatile capital flows have increased policy challenges to financial regulators and policy makers in developing countries. Policymakers are faced with the challenge of ensuring stability of the domestic financial systems in the face of volatile short-term international capital flows, while promoting access to credit to support domestic growth. The objectives of financial market stability, capital account regulation, and access to credit are all interlinked. This is why, this meeting organized by UN DESA, IPD, Ford Foundation, IPEA and FEPS brought together representatives from international organizations, policy makers from developing countries, and academics to exchange their views, experiences, and research on how to better manage volatile, pro-cyclical flows, while promoting stability and improving the resilience of their financial systems.

After the financial crisis, capital account management has gained greater acceptance as a prudent policy measure in the international community. The IMF has acknowledged that, under certain conditions, capital account regulations can help reduce the volatility associated with international capital flows. However, questions of the circumstances and ways to intervene in the capital account, and how the interventions fit into the broader policy and regulatory toolkit, remains widely debated.

Summary of main points:

- Cross border flows should not be viewed any less of an area for regulation than domestic regulations
- Capital account management should be part of a broader counter-cyclical macro-prudential risk management of the domestic financial regulator
- Capital account regulations should not be a last resort, but should be an intricate part of policymakers toolkits
- Better monitoring of cross border flows is an important element for improved risk management of the domestic financial system.
- Policymakers need to focus on medium term cycles as well as short term cycles
- The types of capital account management and prudential regulations will depend on the country's situation
- Basel III should not necessarily apply to emerging market and developing countries… but elements can be useful
- There is a need to look at importance of growth and development as well as stability in designing prudential and macro-prudential regulations.

In order to overcome biases and better communicate the functions of capital controls, which go beyond stemming foreign capital flows towards managing and channelling them, it was proposed to re-name the measures. Several participants had used the terms capital account regulation and capital account management techniques in earlier writings while the IMF recently introduced the term capital flow management. One suggestion was to use the term capital account management for the broad management of capital inflows, and capital account regulations for specific government interventions.

Debates on the capital account regulations

Many discussants welcomed the recent shift on capital controls in the work of the research department of the IMF, however, there were several issues of the IMF-position on capital account management that were debated. In particular, the IMF position implies that

> 1) Capital account regulations should be employed only as "measures of last resort", once all other tools are exhausted.
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> 2) Countries should let their currencies appreciate to fair valuation, before capital controls are enforced, in order to avoid beggar-thy-neighbour policies.

Participants identified several problems with the notion of capital account regulation being an option of last resort. First, it was unclear whether the term "last resort" implies sequencing in a chronological or in a logical sense. In the case of the latter, policy makers could enact capital account regulations immediately, if all other measures were seen as incapable of achieving the desired effect. The idea of sequencing policy measures was questioned generally, as the use of several measures at the same time was seen as more advantageous in many circumstances. It was argued that adopting capital control at an early stage could be important to limit capital inflows before asset bubbles and other risks to the economy materialize.

The textbook answers of dealing with capital inflows only by letting foreign exchange rates appreciate and slashing fiscal spending were criticized as inadequate or dangerous policy tools. Letting the exchange rate strengthen can penalize export oriented sectors, thus impacting growth and development, while fiscal cuts can be costly, and the speed of decision making of fiscal spending make it an ineffective policy tool for dealing with short-term volatile capital inflows. Instead, it was argued, policy measures should target the source of shocks from the onset, and therefore aim at reducing the volatility of capital flows. Capital account regulation that could be quickly implemented to act as "speed bumps" for capital flows were seen as an important policy tool.

The IMF also suggests that capital controls should be mostly temporary. However, as capital flows can change rapidly, policy makers need to be able to react swiftly, which is easier in a permanent capital account regime. Such a permanent regime should be adjusted to the country's circumstances. Some maintained that capital control measures could be discontinued if capital surges are abating, though others emphasized the importance of keeping the regulatory framework and infrastructure in place. In this way, policies could be re-enacted quickly in a counter-cyclical fashion, and market actors would not be caught off-guard if capital account regulations have to be reintroduced.

There were also questions raised on using the exchange rate as a rule for allowing capital account interventions. Policymakers were wary of this rule as it would impede domestic policy space. This is particularly the case since it is extremely difficult to gage when a currency is fairly valued. After all, one of the reasons that capital account regulations are necessary is because the market is not fairly valuing currencies. In addition, to the extent that inflows are short-term, the volatility and risks these surges and troughs in flows inflict on the economy exist whether or not a currency is considered over or undervalued from a theoretical perspective.

The debate then turned to identifying the appropriate tools for different policy goals. It was agreed that there is no one-size fits all argument for the effectiveness of specific tools, but that a thorough analysis of the unique situation of each country needs to guide decision making. Countries that have a high degree of de facto dollarization of the financial sector, such as Peru, have different needs than countries with larger domestic local currency markets.

A distinction emerged between capital account management as part of prudential risk management vs. the management of the capital account to achieve macroeconomic policy goals. Some participants linked this to quantity vs. price based regulations. Quantity based measures were seen as particularly useful in regulating domestic credit growth in both foreign and domestic currencies, as well as reducing currency mismatches of assets and liabilities of banks. Another successful quantity-based measure, used to reduce foreign exchange volatility is the limitation of the maximum amount of foreign exchange transactions permitted to large domestic financial players (pension funds) in specified periods. It was contended that many of these quantity based measures should be seen as prudential risk regulation to deal with systemic risk and balance sheet problems.

Some participants suggested that price-based measures are particularly useful for mitigating macroeconomic problems, such as an appreciating exchange rate, in countries with a more open capital account and a more sophisticated financial system. In their view, the sophistication of these markets might undermine quantitative measures, and price based regulation was seen as more flexible, impinging on the profitability of certain speculative measures, not on the actual quota of these deals. Tax-based regulations have the added benefit of generating information about foreign exchange capital flows, ensured by penalties for misreporting to tax authorities. This allows financial authorities to get a more distinct grasp on the current situation and the development in financial markets. In addition they generate tax revenues. Horizontal taxes might be better suited than targeted taxes, as the latter increase incentives for circumvention.

Price-based measures were seen as particularly apt for regulating derivatives markets in foreign exchange, which are important since the future exchange rate often determines the spot rate. The set-up of the new Brazilian measures in this area were discussed, which seek to limit speculative positions in the foreign exchange market and thereby volatility via a tax on un-hedged bets. For this regulation to work, Brazil needed reliable information, which they ensured by making the legal enforceability of derivatives contracts depend on their registration in clearing houses. Brazil introduced this tax at a low level in order to be able to observe unintended side effects. At the same time, the possibility for further raises was seen as a threat to keep speculation in check. It was imposed only on new contracts, in order not to violate old contracts, while the high turn-over in the derivatives markets guarantees almost complete coverage after a year.

On the other hand, quantity-based restrictions can be useful for countries without well-developed administrative capabilities to be able to administer priced based regulations. In addition, quantity based restrictions can sometimes be more effective than price based regulations. For example, Malaysian, Chinese, and Indian quantity based regulations have been particularly effective. In addition, when interest rate differentials are large and/or the market expects strong currency appreciation, price based mechanisms might have to be so large to be effective that they are politically infeasible, or impractical.

In addition to discussing short-term flows, the "financialization" of FDI was also discussed as a risk. Applying regulation to different kinds of foreign capital inflows which have different impacts on growth (financial vs. non-financial FDI, portfolio debt or portfolio equity inflows) might be an option for policy makers, but requires administrative and institutional infrastructure to differentiate desired from undesired flows and to enforce the controls. This is easier in rather simple financial markets, as deviant actors might re-label investments in order to circumvent capital controls or use the derivatives markets to do so. If financial markets are complex and/or administrative infrastructure weak, employing horizontal taxes on all short maturity inflows, which can be refunded if assets stay in the country for longer periods of time, might be a second-best policy option.

The question of whether capital account regulations should aim at capital inflows or capital outflows was also discussed. Some participants criticized the mainstream view to only fight inflows and to not use exit regulation, as no tools are left when the tide turns. As domestic capital flight poses the gravest problems in exchange rate crises, stringent exit-controls, especially for residents, were seen as potentially useful tools in some extreme circumstances. Others suggested foreign exchange reserves as the second best policy option, given the difficulties in implementing exit controls. Foreign exchange reserves act in a stabilizing manner in moments of rapid capital exit, as reserves appreciate when the currency depreciates, thereby improving the fiscal position of the state and improving investor confidence. However, most participants agreed that countries will need to choose a mixture of these two according to the size of their foreign exchange reserves and the efficiency of controls.

Finally, there was an energetic and important discussion on whether global, or at least regional, coordination is necessary for the effective use of capital account regulations. Some participants argued that unilateral capital controls might impose significant externalities on surrounding countries, by diverting more speculative flows into these countries. Others questioned the empirical evidence for the negative spill-over effects, seeing the argument as a rhetorical device for industrialized countries to control the policies of developing countries, thereby reducing their policy space. For example, the promotion of this argument by the IMF, was seen as possibly an attempt of the IMF to extend its jurisdictions to include capital account management.

One point made was that if any global coordination were to happen, it should include the policy actions of developed countries, which was seen as highly unlikely, but desirable. Recent monetary policy decisions such as quantitative easing in developed countries were seen as negatively impacting developing countries, increasing the need for global capital account regulation. Developing countries should push in the debate for complementary measures that developed states can take to make the regulations of developing countries more effective. A currency transaction tax was seen as one such possible measure, though more specific measures could be desirable.

Given the difficulties involved in global coordination, many voiced scepticism that global solutions were forthcoming quickly, if at all. The lack of consensus in the debate might lead to policy stalemate; therefore enacting decisions unilaterally might remain as a second best policy option. Acknowledging these difficulties, a third position suggested bilateral and regional coordination, as foreign exchange regulations never involve only one country and states could help each other by implementing more effective measures in home or host countries, or in regions.

All participants agreed that capital account regulations should be coupled with prudential measures in the financial system. How these two measures interact and how to improve their efficiency are currently investigated by the IMF and are an area of additional research and policy discussion.

Debates on financial regulation

Discussants agreed that important first steps towards greater financial stability have been taken by the international community, but that the implementation horizon is too long and uncertainties over exact implementation remain. A consensus emerged that developing countries should resist international pressure to adopt recent initiatives such as the Basel III agreement in their entirety, but instead carefully tailor it to their needs. The negotiators creating Basel III were focusing on sophisticated financial markets with international banks, but banking systems in developing countries deviate from those. While pursuing greater financial stability, reforms to banking regulation need also to take impacts on growth and access to credit into account. In the past, the introduction of certain aspects of Basel II has caused harm to developing countries, e.g. by possibly reducing the access to credit for small and medium-sized enterprises, which should not be repeated.

Alternative measures such as public development banks and directed credit should possibly be employed to improve access to credit. Some discussants suggested that developing countries could use the lower complexity of their financial system to leapfrog and design a financial system that fulfils the needs of the real economy without generating excessive profits for the financial sector. This would involve slowing the pace of financial innovation and closely monitoring its impacts on the financial system as a whole. Discussants agreed that the policy space for governments to make their own choices needed to be maintained. Some suggested that in order to gain further domestic policy space for financial regulation, developing countries should push for a renegotiation of GATS and bilateral trade agreements, in case these restrict policy actions. Efforts should be invested to convince developed countries that these changes were in their interest too.

While the specificity of financial systems in developing countries was emphasized, many maintained that certain measures taken in international regulation should be adopted. Increasing the quality and quantity of core capital- already high in many developing countries- was seen as recommendable. The counter-cyclical element of new international regulation was seen as especially laudable. By regulating through the cycle and focusing on the medium term, financial regulators should seek to make banks account properly for the likely losses on their portfolio of credits, losses which can be estimated via historical averages. The 11 years' experience of statistical loan-loss provisioning in Spain was seen as a good example, which could be emulated. Discussants noted the lack of good empirical analyses of successful countercyclical action in developing countries, such as India's countercyclical policy in the housing market and suggested to pursue these in future studies.

The idea of macro-prudential regulation, which not only focuses on banks, but also on other parts of the financial sector was seen as a further progressive step. It was suggested that macro-prudential regulation should seek to increase the diversity of actors in the system in order to avoid sudden liquidity crisis stemming from unison behaviour. This means that not all actors in the financial system should be regulated in the same way and with the help of the same measures. If one regulates maturity mismatches in the banking system, there will be less long term lending, so it is crucial to figure out which actors can fill the gap. In this respect, the possible role of financial institutions other than banks should be investigated, given that they hold large parts of longer term assets.

Related to the question of longer term financing, the possible future role for securitization in developing countries was discussed. Many saw a large potential in securitization for generating safe longer term assets and thus increasing the capacity of financial systems in developing countries to finance long term investments. At the same time, others asked how the flaws of the "originate to distribute" model related to securitization,that contributed so much to the US crisis, could be rectified and pointed to problems in the off-balance sheet status of many securitization vehicles. Regulators should consider either forcing everything on the balance sheet of banks or applying similar capital requirements for off- and on-balance sheet items. Different case studies of how securitization works in different countries were seen as important in order to establish bench-marks for how to maintain high-quality standards in securitization.

Some discussants, while acknowledging the progress in new macro-prudential regulation, warned that the recent financial crisis has also been caused by severe faults in oversight and supervision as well as micro-prudential rule-making. There were too many regulatory agencies which were being played against each other, and regulatory arbitrage was one of the main drivers of contagion. This issue requires re-centralizing regulation and supervision. Furthermore, regulation needs to be made by function in an equivalent way, in order to minimize incentives for circumvention.

Directions for future discussions

Questions raised for future discussion include:

- The role, if any, of global or regional coordination in capital account management and the role for industrialized countries.
- More detailed analysis on different capital account regulatory regimes, including greater comparisons between regulations used in other regions, such as Asia; the effectiveness of different measures given the recent volatility in flows and how policymakers can react to these.

- Specific elements of Basel III that should be implemented by developing countries in different contexts, and specific elements that could be particularly problematic in different contexts.
- The role securitization can play in generating a stable supply of long term financing.
- The potential role of public banks to increase access to credit and the ways they can act counter-cyclically in moments of financial crisis.
- Examples and experiences with countercyclical policy tools and macro-prudential regulations to promote growth and access to credit while maintaining financial market stability.
- An internet platform is to be established to exchange views and experiences with capital control and newly introduced prudential measures between developing countries' policy makers