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Capital Flows: Shocks or shock absorbers?

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Macro-prudential measures and capital controls: Substitutes or complements?

Financial crises often arise from a sudden stop to capital flows. One way to limit this danger is to restrict capital flows. Another approach would be to structure the financial market in such a way that the damage from a sudden stop is limited. Which approach is more promising? Is there a need to coordinate between the countries receiving capital inflows and those from which the capital originates (or is it intermediated)?

Capital controls (also called capital-flow management measures, or CFMs) and macro-prudential measures (MPMs) are complements rather than substitutes. Both can be employed alongside standard macroeconomic policies, like monetary or exchange rate policies. The optimal mixture depends on the available policy space and the objectives pursued in individual countries and their suitability at a given time in the business/financial cycles. CFMs and MPMs can overlap when large capital flows become a potential source of systemic risk (e.g. capital inflows into the domestic banking sector that can fuel a housing bubble – limits on the credit for real estate transactions).

Emerging economies have tended to use capital controls more often since exchange rate volatility was the root problem, whereas developed economies tended to perceive asset price volatility as the problem, hence a focus on MPMs. In practice the distinction between CFMs

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and MPMs might be less clear than in theory, especially in the emerging economies. In some of the largest emerging economies the long-standing, permanent legal and administrative frameworks that underpin capital controls are often justified as MPMs.

Despite decades of experience with capital controls, the empirical literature on their effectiveness, i.e. in terms of influencing the volume and composition of flows, or avoiding exchange rate misalignments, remains 'surprisingly' inconclusive. Care needs to be taken to avoid capital controls becoming ingrained, as there is never a good time to relax them. In the meantime, they could encourage rent-seeking, hamper the development of financial markets and prevent necessary adjustments. More evidence is emerging on MPMs, with some studies analysing the impact on mitigating excessive credit growth (bank-level data) and the build-up of leverage.

Going forward, it was argued that both capital controls and MPMs should take into account that non-bank financial institutions will continue to gain importance in financial intermediation, and also that digitalisation of financial services may significantly change the configuration of capital flows. Continued vigilance was thus required. The availability of data could be improved in terms of the timeliness, scope and granularity of data on capital flows. A comprehensive database stored at a one-stop at a one-stop information hub for MPMs should be considered.

EMEs and capital flows: What is more stable: bank or bond finance?

The role of global capital markets is in principle to channel the flow of capital from (capital) rich countries to poorer emerging economies (EMSs). But experience has shown that the form of these flows has a huge impact on financial stability. In particular, short term portfolio flows have often been identified as posing the greatest danger to financial stability. Is less better in this case? In the 1990s banks were in trouble because of their exposure to EMEs, and bond finance seemed more stable. This changed again after Argentina. What provides more resilience: bank or bond finance?

The trend in capital flows may no longer be mainly from advanced to emerging economies but from savings-rich to savings-deficit countries within the emerging economies. For example, in Latin America, investment needs are higher than domestic savings, hence the need for foreign capital. At the cyclical frequency, capital flows to emerging markets tend to be quite pro-cyclical and are often linked to turning points in monetary policy in advanced economies (e.g. the so-called 'taper tantrum' episode in 2013). Volatility in capital flows is thus 'a fact of life' in emerging economies. One concern is that 'push' factors will become more important than 'pull' factors in a world of diverging monetary policies.

In response to inflow surges or disruptive outflows, emerging economies can resort to traditional instruments which should, however, be calibrated to the circumstances. Inflows represent an occasion to build up countercyclical buffers, whereas in the case of disruptive outflows, the exchange rate might have to absorb the shock. The form that cross-border flows take is important along three dimensions: the type of instrument (debt or equity, bond or bank finance), the maturity (short or long-term) and the different layers of intermediation (banks and non-banks).

Long-term, non-debt flows are preferable to short-term debt flows. Among debt instruments, bank and bond finance present both risks and benefits. FDI (including in the financial sector) was deemed as the relatively most stable component. Where local capital markets remain underdeveloped (Latin America), foreign capital flows should continue to be channelled via the local banking system, which is perhaps better equipped to evaluate the risk of potential borrowers. Nonetheless, it is desirable to bring foreign finance to the domestic market through local institutional investors.

A key development for the future is that the intermediation of capital flows is changing. Non-banks, in particular asset managers, are now managing larger shares of capital flows. Asset managers are real money investors, but since they must promise immediate redemption, they are also confronted with maturity mismatch and liquidity transformation issues. In addition, large waves of fund redemptions can have systemic implications as emerging markets have an important asset class due to the search for yield by investors. Waves into and out of this investment class by vehicles following market benchmarks could be pro-cyclical and destabilising in the event of a sudden loss of confidence.

External effects of capital controls: Race to the top or the bottom?

The imposition of capital controls might produce external effects. If a country imposes controls in a crisis, financial markets might anticipate a similar move elsewhere, thus leading to capital flight in other countries and possibly even forcing these countries to impose controls as well. Is some coordination required in this area to limit systemic effects? What is the role of the OECD and the IMF's codes of conduct and rules in this area?

Decisions on capital controls are usually taken by the country concerned without much international or global coordination, as their purpose is to support national economic policy. However, there is a case for coordination as there are a number of ways in which external effects can emerge. For example, if there is regional boom, tightening of controls on inflows by any one recipient country can lead to more inflows and currency appreciation in other countries in the region (dubbed 'bubble thy neighbour'). But policies in source countries can also result in destabilising flows in the recipient countries. This has two aspects. Monetary policy in the advanced economies might have side effects on overall flows to emerging economies. Should this be taken into account when setting policy?

Moreover, changes in controls on outflow by source countries could also increase or reduce the funding available for savings-deficient emerging markets. There are thus ample reasons to coordinate capital flow measures. The same also holds true for macro-prudential policies. Emerging economies should benefit if advanced economies would dampen their own cycle. More organised/transparent discussion between source and recipient countries about their choice of policy tools and their preferred composition of flows (trade-off financial stability and growth) is needed. Different fora, the G20, the IMF and the OECD (with its code of conduct) all covered part of the agenda. What could be the objective of global coordination on capital account measures and their liberation? To many, a reduction in the volatility of capital flows appears desirable, but some volatility over the cycles seems unavoidable. Increasing the resilience of the financial system to this volatility needs to be also part of the response.

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