CAPITAL FLOWS AND CAPITAL ACOCUNT REGULATION

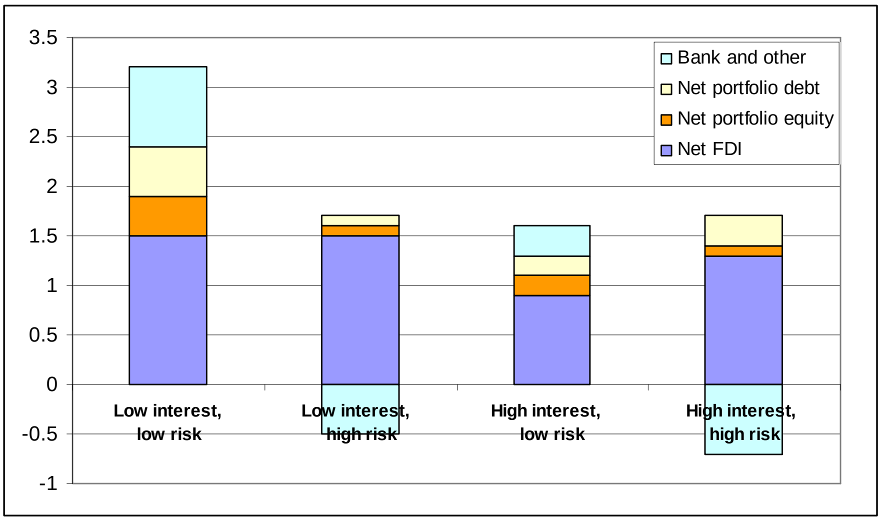
José Antonio Ocampo
Columbia University

CHARACTERISTICS OF CAPITAL FLOWS

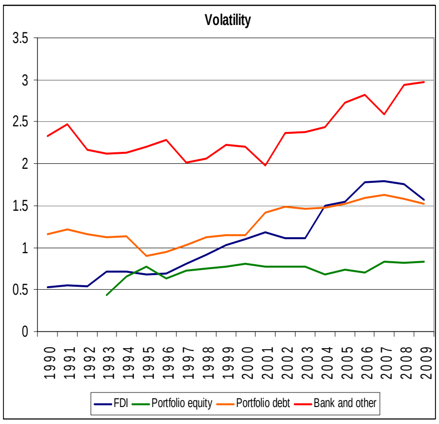
IMF *WEO*: Capital flows are erratic (fickle)

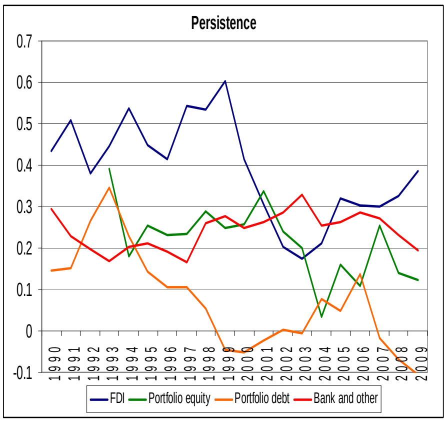
- Volatility has increased over time and is higher for EMEs than for AEs
- Flows towards EMEs are highly sensitive to monetary policy in AEs, and to risk perception
- Different types of flows differ in terms of volatility and persistence, though differences have narrowed down.

Bank and portfolio flows are highly sensitive to interest/risk mix



Volatility has increased, particularly for FDI. Persistence is low and has declined.

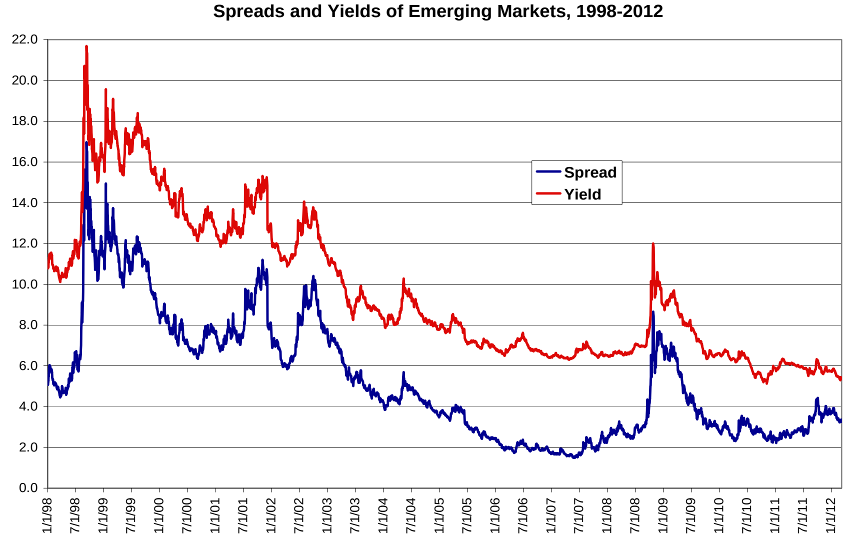




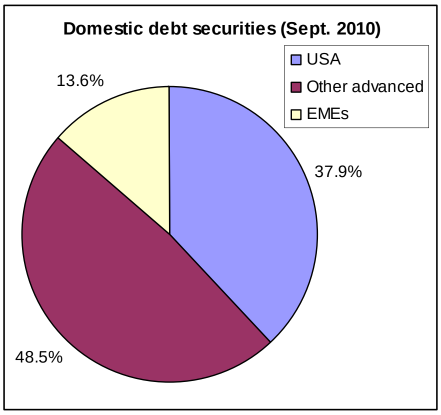
Some additional features

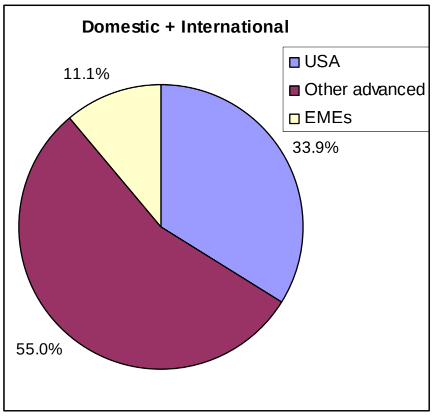
- ❖ Global financial markets are segmented by risk categories. Those “riskier” segments are subject to strongly pro-cyclicality.
- ❖ Segmentation has declined due to reserve accumulation and development of domestic bond markets…
- ❖ … but these achievements have become a double-edge sword in a two speed world.
- ❖ EMEs markets are relatively small ➢ A small portfolio decision in AEs has major effects on EMEs

Riskier markets are pro-cyclical, but segmentation has declined

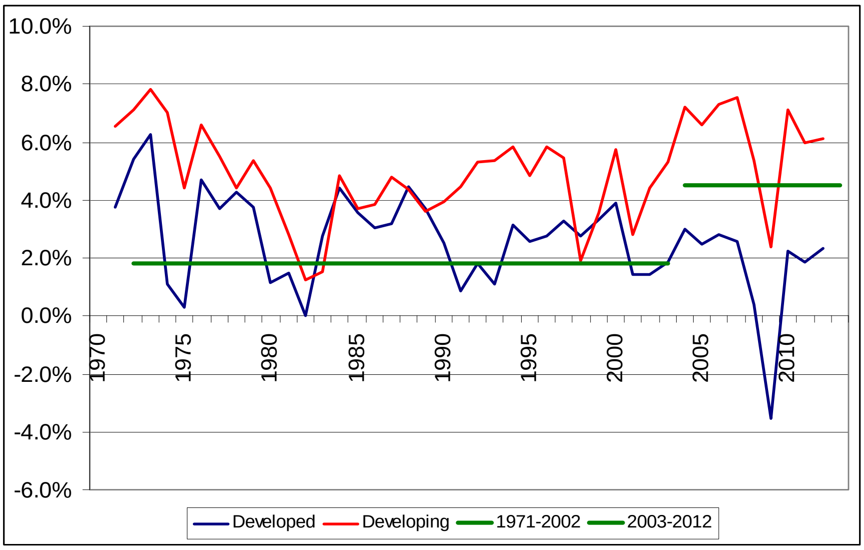


Capital markets in EMEs are small compared to AEs





The two speed world economy, which has its mirror in monetary policies



Major implications

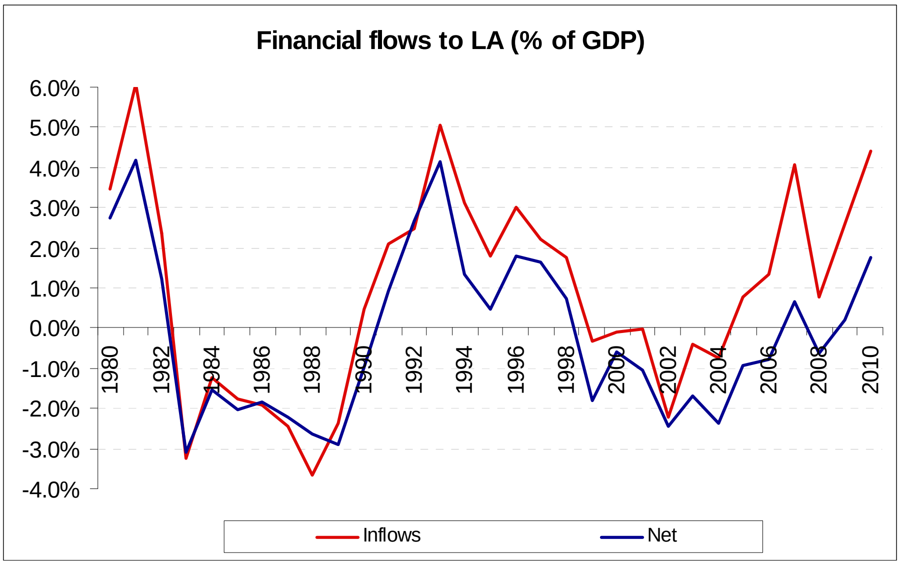
- Stability of EMEs and free capital movements may just be inconsistent objectives.
- With structural imbalances in the world economy, interest rate arbitrage is a source of instability
- So, global (i.e., not only national) capital account regulations may be necessary to manage persistent incentives to interest-rate arbitrage.

THE DOMESTIC POLICY DEBATE

The central policy issues (1)

- ❖ Medium-term cycles, not short-term volatility are the most difficult to manage.
- ❖ The reasons are simple:
  - ✓ Capital flows directly generate pro-cyclical effects
  - ✓ They also reduce the room of maneuver for counter-cyclical macroeconomic policies
- ❖ Fiscal policy can always be counter-cyclical, but:
  - ✓ Pro-cyclical financing reduces the room of maneuver for counter-cyclical fiscal policies.
  - ✓ Austerity during crises generates pressures to spend during the recovery, thus a pro-cyclical dynamics of a political economy character.

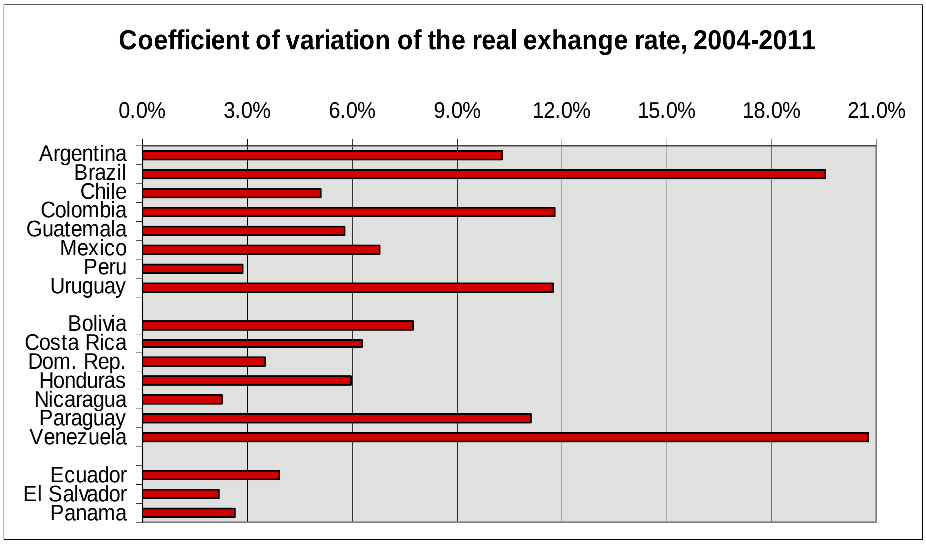
The medium-term cycle



The central policy issues (2)

- Monetary/exchange rate autonomy: with free capital movements, countries may be just choose where they want the instability of capital flows to be reflected in the domestic economy.
- Exchange rate flexibility has real costs:
  - It can easily lead to overvaluation and unsustainable current account deficits.
  - It increases the risk of producing tradables = it is a tax on international specialization (Kindleberger)
- These two issues explain the revealed preference for intermediate exchange rate regimes.
- But the most common instrument, heavy counter-cyclical reserve accumulation, also has costs.

Exchange rate regimes: recent Latin American experience



The central policy issues (3)

- ❖ Under these conditions, counter-cyclical policies require many more instruments, indeed more instruments than objectives (which includes the level and stability of the real exchange rate).
- ❖ Counter-cyclical prudential and capital account regulations are essential ingredients of such policies (macroprudential framework).
- ❖ Thus, they are not measures of “last resort”. They are essential ingredients of the policy package.
- ❖ This is particularly true of capital account regulations, as they target the major direct source of shocks.

CAPITAL ACCOUNT REGULATIONS

Types of macroprudential regulations

- Counter-cyclical prudential regulations (capital, provisions, liquidity, loan/value ratios, etc.)
- Foreign-exchange related prudential measures: limits on deposits/lending in foreign currency, higher reserve requirements, limits on net exposure of financial institutions, etc.)
- Capital-account regulations (capital flow management measures): on financial institutions or broad-based

Although the second discriminates according to currency and the third of residence, there is no clear-cut difference, because domestic and foreign agents manage different assets/liabilities.

Major conclusions of the literature

- ✓ Both regulation of inflows can work, though more orthodox economists are skeptical of the latter.
- ✓ Stronger evidence of effects on debt profiles and interest rate autonomy, less strongly on total flows.
- ✓ Many of them operate as speed bumps rather than permanent restrictions. Circumvention requires dynamic restructuring to avoid loopholes.
- ✓ Administrative capacity is thus essential: regulations that are persistent but managed in a counter-cyclical way work better. Simple quantitative regulations may be easier to administer.
- ✓ They are a complement, not a substitute for counter-cyclical macroeconomic policy.

The recent IMF literature

- ✓ Both capital account regulations and FX-related prudential regulation improve debt structures
- ✓ Both capital account regulations (better economy-wide) and FX-related prudential regulations are associated with reduced FX lending.
- ✓ However, they do necessarily curtail credit booms. In contrast, domestic macroprudential measures moderate lending booms but not necessarily FX borrowing.
- ✓ Greater growth resilience associated with capital account regulations and macroprudential measures.
- ✓ Loopholes (including through FDI) imply that economy-wide regulations may work better, even if the aim is prudential.

CAPITAL FLOWS AND CAPITAL ACOCUNT REGULATION

José Antonio Ocampo
Columbia University