DEVELOPING COUNTRIES' EXPERIENCE WITH CAPITAL ACCOUNT REGULATIONS

Presentation in the IMF Conference on "Managing Capital Flows: Challenges for Developing Economies", Livingstone, Zambia, May 5, 2017

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Lessons from capital account liberalization (1)

Capital account liberalization makes developing countries vulnerable to the pro-cyclical of capital flows. This generates two types of risks:

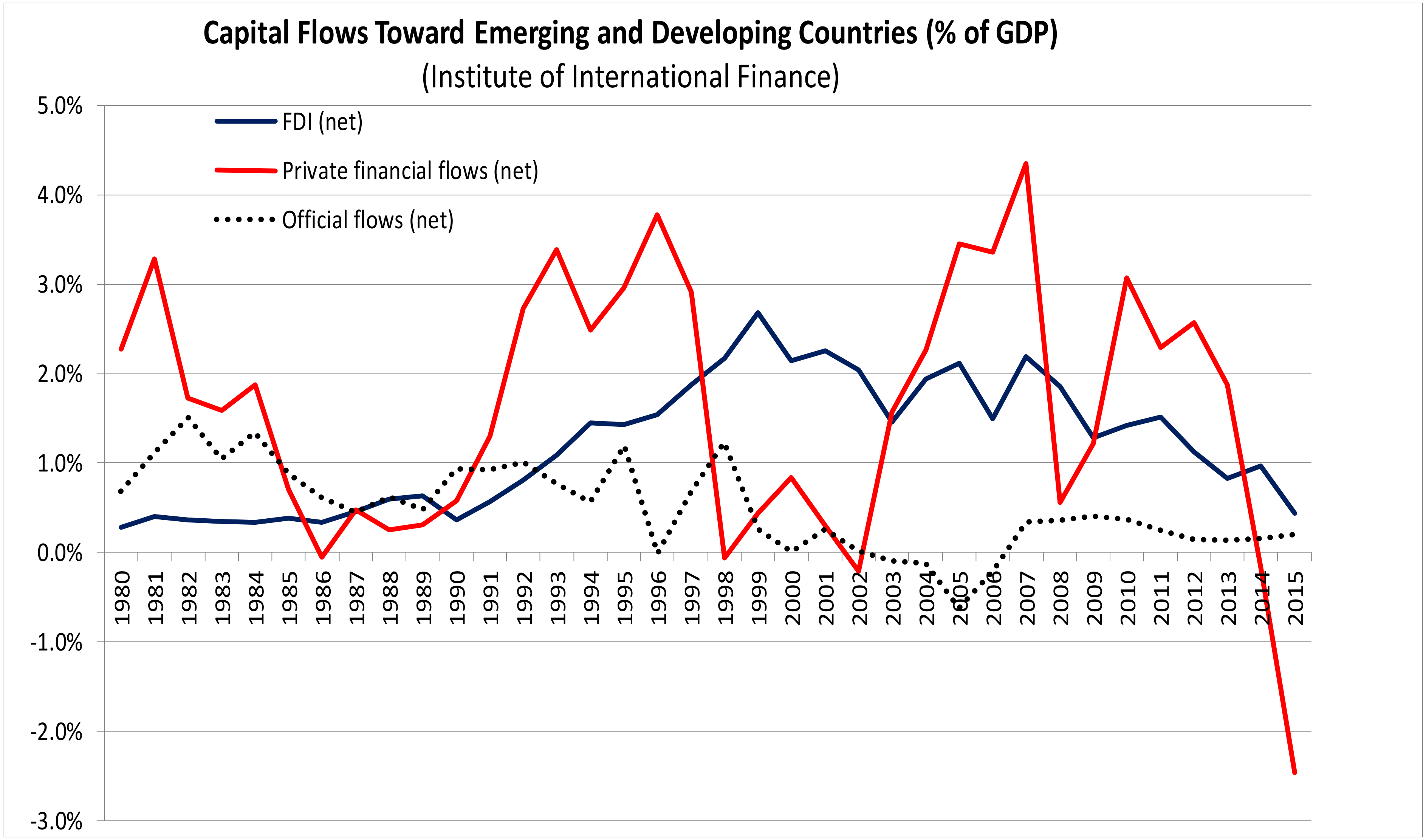
- *Financial-stability risks*: boom-bust cycles in the domestic financial system that may lead to a financial crisis.
- *Macroeconomic-policy risks*: pressure to adopt pro-cyclical macroeconomic management, with large destabilizing effects.

Lessons from capital account liberalization (2)

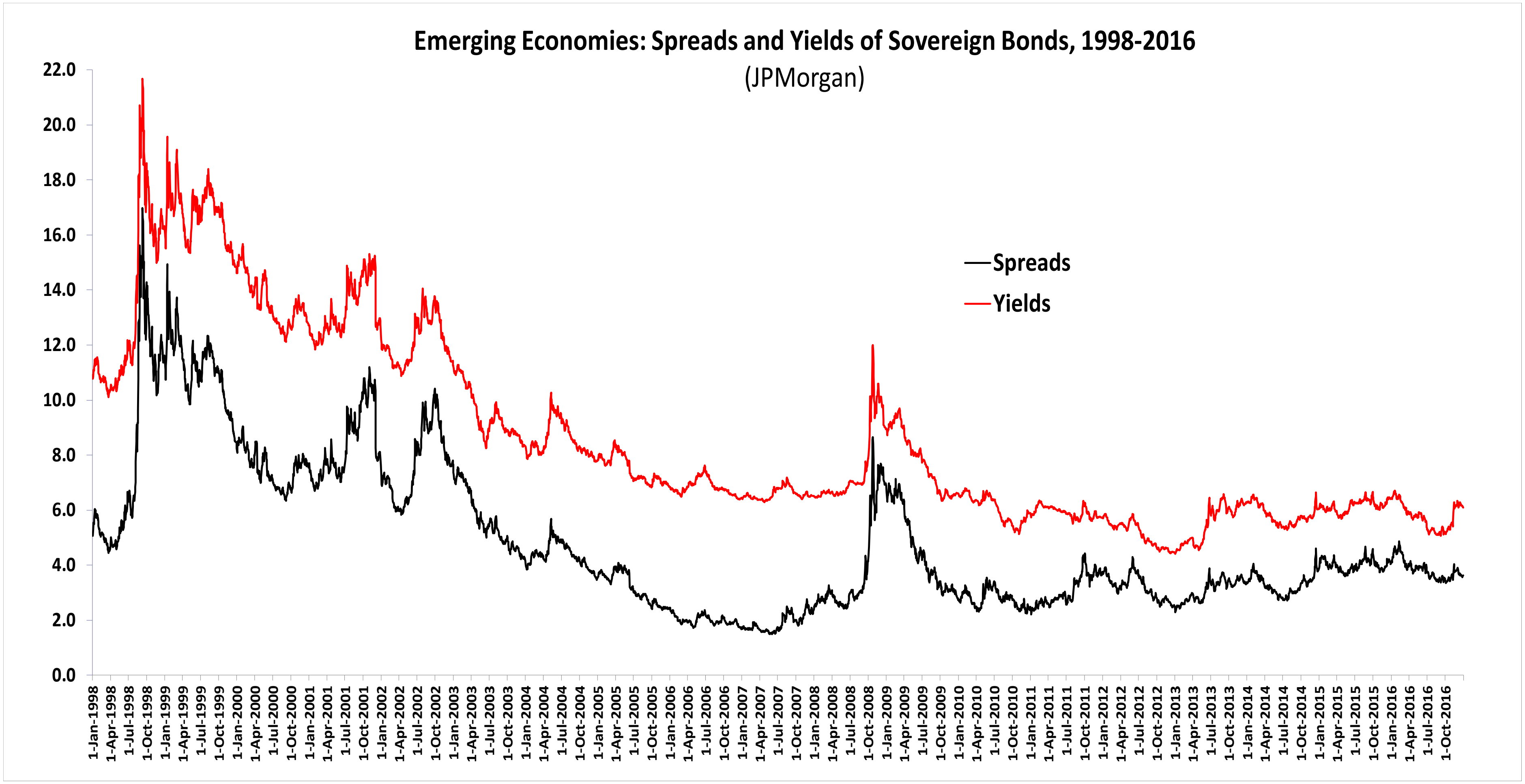
However, not all booms end up in crises: The critical issues are current account deficits and associated currency appreciation.

- Reduction of external debts and accumulation of reserves serve as additional buffers against capital flow volatility.
- The domestic counterpart of the current account deficit is important: the long-term effects are very different if they reflect increases in investment rather than reductions in domestic savings.

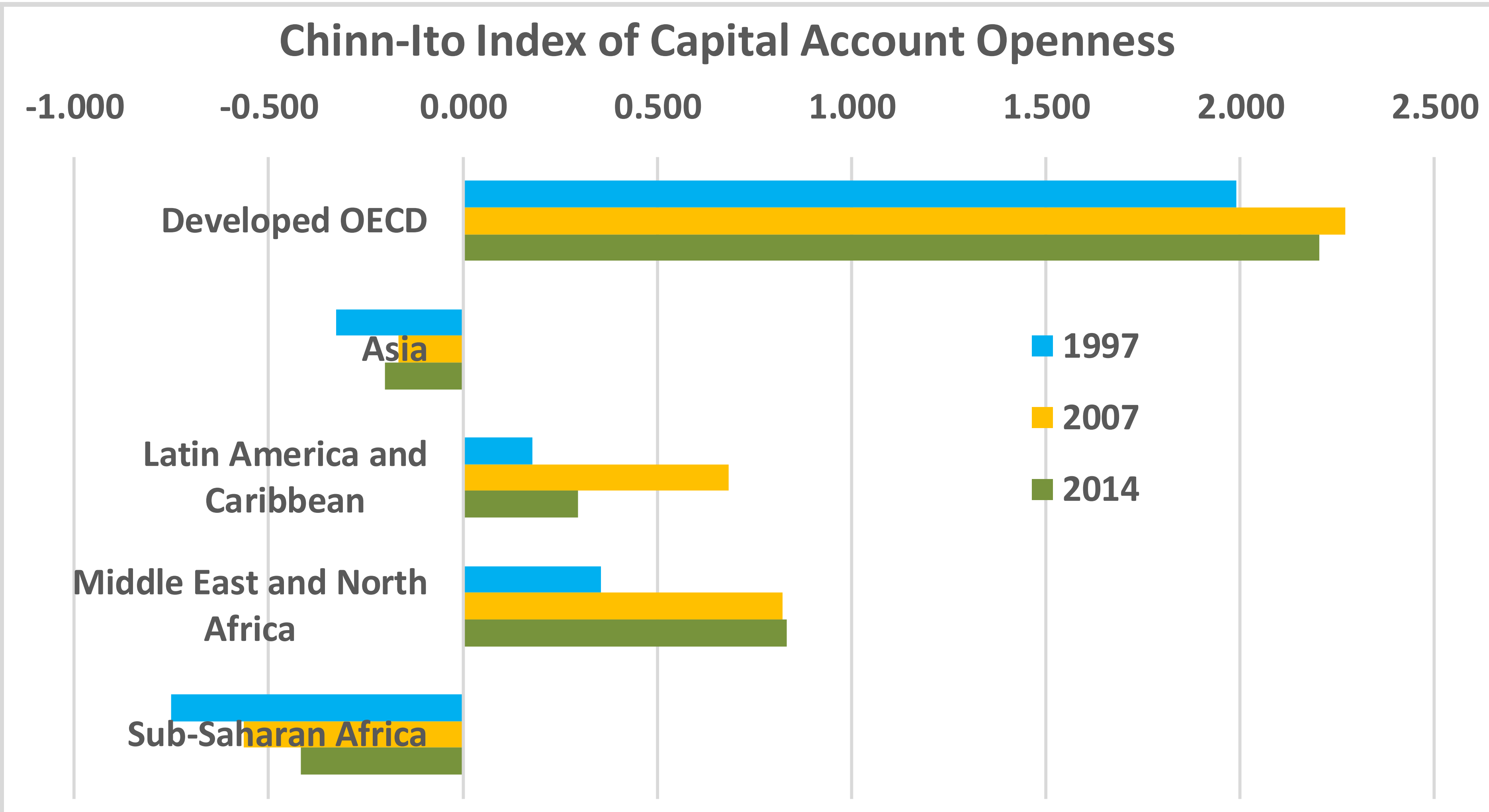
Pro-cyclical pattern of capital flows (1)



Pro-cyclical pattern of capital flows (2)



Sub-Saharan Africa has lagged in the liberalization process

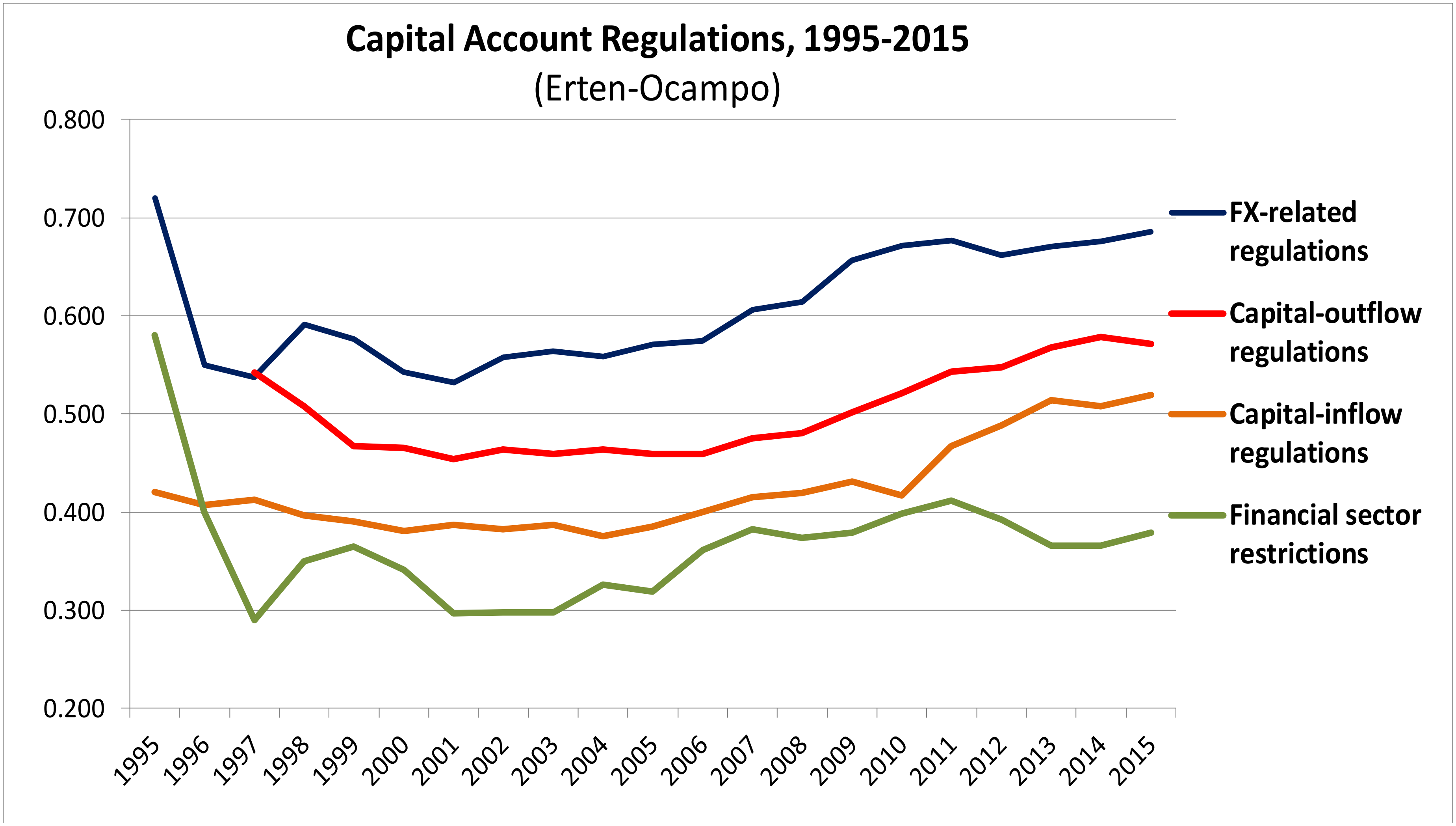


Types of capital account regulations (1)

- Capital inflow regulations (generally on financial flows, rarely on FDI)
- Capital outflow regulations
- Foreign-exchange related regulations: on lending holding deposits in foreign currency, or limits on open foreign-exchange positions of financial institutions.
- Financial sector restrictions: differential treatment of domestic financial transactions for residents vs. non-residents; restrictions on residents' accounts abroad.

Capital inflow and outflow regulations can be price-based (reserve requirements or taxes), but they can also be administrative/quantity-based. Other regulations are administrative-based.

Types of capital account regulations (2)



Types of capital account regulations (3)

Capital Account Regulations in Emerging and Developing Countries by Income Level, 2015 (Erten-Ocampo)				
	Capital-inflow retrictions	**Capital-outflow retrictions**	**Financial sector regulations**	**FX-related regulations**
Upper Middle Income	0.509	0.574	0.278	0.694
Lower Middle Income	0.458	0.521	0.403	0.656
Low Income	0.722	0.778	0.611	0.833

Managing financial-stability risks

- Large empirical literature that indicates that capital inflow restrictions improve the liability structure of borrowing countries and reduce financial fragilities (Ostry et al, several others)
- Preventive capital account regulations reduce the risk of financial crisis, acting as “circuit breakers” against contagion effects (Ocampo/Palma and Stiglitz).
- Capital inflow takes can enhance social welfare by diminishing the negative effects of capital account volatility (Korinek and Jeanne).

Policy options to manage capital-account surges

Macroeconomic policy	Potential costs and limitations
Fiscal tightening	Limited space, politically difficult, time lags.
Reserve accumulation	It has costs, and may be difficult to sterilize.
Strengthening domestic regulation	Can help reduce financial stabilty risks
Exchange rate appreciation	Hurts competitiveness. Enhances probability of crisis
Reducing interest rates	Procyclical. Financial fragility risks.
Capital account regulations (CARs)	Clear advantages, but must be well managed.

Macroeconomic-stability risks (1)

- Capital regulations on inflows taxes and active reserve management can moderate appreciation during booms (Jeanne, Korinek, Farhi/Werning).
- Evidence that they reduce capital inflows and moderate appreciation (Ocampo/Tovar, Edwards/Rigobon)...
- … but there is broader debate on this issue (De Gregorio <u>et al</u>., Magud <u>et al</u>, Klein). In cross-country analyses, it is critical whether or not the sample includes developed countries.
- When exchange rate evolution and reserve accumulation are included in a variable of “foreign exchange pressure”, positive effects of CARs (Erten/Ocampo).

Macroeconomic-stability risks (2)

- Broader evidence that they increase domestic/interest rate spreads, giving some space for contractionary monetary policies during booms (De Gregorio et al., Villar/Rincon).
- Imposition of CARs during booms reduces the growth decline during crises and facilitates the recovery (Ostry et al., Erten/Ocampo).
- Controls on capital outflows can help moderate restrictive macroeconomic policies during crises (Ariyoshi et al., but also several programs in recent years, such as that of Iceland).
- They may be the only way to solve coordination failures in debt restructuring processes.

Conclusion: CARs can play an important role as part of the family of “macroprudential policies”

- Strong evidence that they promote financial stability…
- … and increase the margins for counter-cyclical macroeconomic policies.
- To promote financial stablity, they must be accompanied by strong domestic prudential regulation and supervision.
- They must be used as a complement, not as a substitute for counter-cyclical macroeconomic policies. Their use as a substitute may make crises unavoidable and more severe.

Conclusion (cont.)

- No reason why they should be temporary. They should rather be permanent but managed in a counter-cyclical way.
- Inflow regulations may have advantages over outflow regulations, and price-based regulations over quantity/administrative-based regulations, but the arguments are not compelling.
- Targeting transactions rather than agents may be better, but the effects on domestic vs. foreign agents will always be different.
- Institutional structure and capacity building is essential. It may require maintaining some foreign exchange controls.

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