

Time for a new consensus



Regulating financial flows
for stability and development



Publisher: Bretton Woods Project

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Printed by RAP Spiderweb.

December 2011

Thank you to the following, in no particular order, who have provided useful commentary on this report: Stephen Spratt, Alex Cobham, Jesse Griffiths, Nuria Molina, Peter Wahl, Ondrej Kopečný, Antonio Tricarico, and Sarah Anderson. Remaining errors and omissions are solely the responsibility of the author.



Funding for the production of this report has been provided by the European Union, CS Mott Foundation, Rockefeller Bros Fund, and a coalition of UK NGOs. The report should in no way be construed as reflecting the views of the funders.

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The Bretton Woods Project is an ActionAid-hosted project
(Registered charity no. 274467).

Time for a new consensus

Regulating financial flows for stability and development

Executive Summary

In recent centuries the world has see-sawed between globalisation and de-globalisation of finance, with wildly different outcomes.

A long-term historical view shows that the current system of relative ease and freedom for money to flow across borders without regulation is more historical anomaly than the normal state of affairs. The liberalisation of international financial flows should be viewed as an unusual and significant intervention, as finance has normally been largely domestic and regulated.

In the wake of the financial collapse of 2008, the role of cross-border capital flows, which can have both good and potentially devastating consequences, is again being questioned. The countries that fared the worst in the crisis were those with the most deregulated and liberalised policies towards capital inflows. This report explains the drawbacks, especially for development, of policies to deregulate the movement of money across borders, and makes suggestions for a new pragmatic approach to regulation of financial flows to ensure stability and development.

Since 2009, many developing and emerging economies have increased regulation of and control over financial inflows to manage surges from overseas. They have done this in an environment of increasing and more volatile flows to developing countries, with 2010 flows reaching \$1.095 trillion, the second highest ever after a peak of \$1.65 trillion hit in 2007.

However, the empirical evidence shows that movement of money on this scale and speed is becoming increasingly problematic. Capital flows impose a number of risks, such as currency risk, flight risk, fragility risk, contagion risk, and sovereignty risk. There is considerable consensus in the economic literature that capital flow surges and stops contribute to financial and banking crises. And these crises are more than just headline grabbing events, but have wide-ranging negative social impacts. The way in which financial flows are managed impacts on wealth distribution, poverty, children's well being, women's economic advancement and unem-

ployment. These impacts are not generated only by a crisis, as boom periods can also bring problems of inequality and de-industrialisation. Having a fully liberalised capital account also facilitates tax avoidance and tax evasion.

On the opposite side, economic history shows that countries that have successfully developed have used foreign capital to do so, but that this foreign capital did not arrive through fully open capital accounts. In general, investment that is of a longer duration and provides additional benefits or spill-overs is more desirable. Better and more pragmatic management of the capital account could also contribute to reducing global macroeconomic imbalances through reducing the demand for precautionary foreign exchange reserves, improving the ability of countries to run independent monetary and fiscal policies, and potentially managing large outflows and inflows.

Developing countries are already attempting to exert more influence over surges of capital inflows, and there has been significant debate over the effectiveness of the tools being used. It should be clear that no macroeconomic tool will ever be perfect. Capital account regulations can be effective in lengthening the expected investment horizon and changing the composition of incoming financial flows, while there is mixed evidence over their impact on flow volumes and exchange rate appreciation. Some of the most effective country policy stances are in India and China, which maintain extensive controls over the capital account and remain some of the fastest growing economies. Across the world a range of measures have been used successfully by different countries, including: limits on foreign direct investment, foreign exchange restrictions, quantitative controls on inflows, outflow controls, taxes on inflows, banking regulation, and limits on the issuance of derivatives.

Despite the grave social risks involved in not regulating financial flows, international provisions for dealing with capital account management are scattered and a comprehensive overarching global framework does not exist. The extensive liberalisation of capital accounts, witnessed over the past three decades, has been furthered by a broad range of international pressures, including from the International Monetary Fund, under the

World Trade Organisation, from bilateral trade and investment agreements and through the Organisation for Economic Cooperation and Development and the European Union. These institutions present significant hurdles to more effective use of pragmatic capital account regulations, and politically powerful interest groups, particularly in rich countries, have a stake in trying to prevent regulation.

While most capital account regulations are available for unilateral implementation, there are constraints on the effectiveness of these tools for some countries, particularly small developing countries. Potential unwanted domestic side effects can be managed with public policy and public investment focussed on ensuring domestic financial intermediation and financial institutions meet the needs of the poor and work towards sustainable development. Impacts on third countries from implementing regulations appear moderate and could be managed with better regional coordination of regulation.

Even more effective would be policies in rich countries to tackle the risks from capital flows at their source. This includes better overall financial regulation, but consideration should be given to specific capital flows policy in source country. More regional and international coordination on capital account regulation, particularly enforcement of rules, would help developing countries deal with financial flows more effectively. Ultimately, a more ambitious global framework agreement could reinforce mutually consistent management techniques across source and destination countries.

Developing and developed countries would benefit and stability would be enhanced by a more hard-headed approach to macroeconomic policy and cross-border financial flows. It is time for a new consensus, one in favour of pragmatic policies that will seek to channel financial flows for the benefit of people, especially those in developing countries. Given the occurrences of the last few years, it is clear that while the hurdles may be high, achieving finance that works for development is not beyond our reach. Civil society organisations and social movements are vital pressure points to see political change, but their action should be complemented by new thinking among responsible financial actors and policy makers.

In the short term:

- 1. Civil society groups need to recognise that reforms to the management of international financial flows and the underlying structure of the international financial system are important to the achievement of development goals and demand change.**
- 2. Policy makers in developing countries should not fear regulation of the capital account and need to think more proactively about the costs as well as the benefits of different kinds of capital flows.**
- 3. The IMF needs to accept that capital account regulations can be desirable at any time. Once it has accepted this and demonstrated a more pragmatic approach, it can work with countries to help them design the best techniques to fit their desired policy goals.**
- 4. Policy makers and relevant international institutions need to create a system of international data sharing and analysis to help police existing and new measures to regulate financial flows.**

In the medium-term:

- 5. Rich and developing countries need to coordinate to remove the policy hurdles resulting from investment treaties and free trade agreements.**
- 6. Developing country policy makers need to be encouraged, especially by their own citizens, to begin working in regional configurations to coordinate capital account management.**
- 7. Rich countries need to commence serious discussions with developing countries, at the IMF or elsewhere, on how source countries can effectively contribute to the stability of financial flows that enhance development prospects.**
- 8. Existing treaties, such as the Lisbon Treaty in the EU, which already looks like it needs to be renegotiated, should be amended to remove requirements for capital account liberalisation.**

List of Acronyms

AML/CFT	anti-money laundering and countering the financing of terrorism
BIT	bilateral investment treaty
CFIUS	Committee on Foreign Investment in the United States
ECLAC	Economic Commission for Latin American and the Caribbean
EPA	Economic Partnership Agreement
EU	European Union
FDI	foreign direct investment
FIRB	Foreign Investment Review Board (Australia)
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GDP	gross domestic product
IEO	Independent Evaluation Office
IIA	international investment agreement
IMF	International Monetary Fund
IOF	Imposto sobre Operações Financeiras (Brazil)
KIKO	knock-in, knock-out (currency derivative contract)
MDGs	Millennium Development Goals
OECD	Organisation for Economic Cooperation and Development
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
URR	unremunerated reserve requirement
US	United States
WTO	World Trade Organisation

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1. Introduction

The movement of money around the globe is not a new phenomenon. Ancient Roman coins ended up as far away as India.

However, money and markets do not exist in some natural and pure condition in the absence of socially-constructed rules and regulations that define the boundaries of their activity. In the modern era, the nation state has taken the authority and responsibility to set the limits and define the parameters under which finance operates.

In recent centuries the world has see-sawed between globalisation and de-globalisation of finance, with wildly different outcomes. A long-term historical view shows that the current system of relative ease and freedom for money to flow across borders without regulation is more historical anomaly than the normal state of affairs.

The liberalisation of international financial flows should be viewed as an unusual and significant intervention, as finance has normally been largely domestic and regulated. The liberalisation project of the past half century, involving a certain strand of theoretical economics and based on the belief in the infallible role of markets, redefined free flows as normal despite centuries of regulated finance¹. The financial crisis of 2008 threw the theories that have defined our economic policy environments into disrepute, with the head of the UK Financial Services Authority, Lord Adair Turner, calling it “a fairly complete train wreck of a predominant theory of economics and finance.”²

While good theories can and should guide thinking and policy making, they should be based on



achieving practical outcomes with pragmatic and positive purposes. In this context, we must consider what the goal of finance is. Finance must serve the ends of society, not society the ends of finance.

One of the key areas of contention in the wake of the financial collapse of 2008 was the role of international finance, known as cross-border capital flows. These financial flows can have good outcomes but also potentially devastating consequences. This is something that rich countries should realise from a look at their own history, as they employed regulations on their capital account throughout most of their history. Part of the reason the International Monetary Fund (IMF) was set up was to help manage the movement of capital after the Second World War.

Box 1. What are capital account management tools?

The capital account, which makes up one part of the balance of payments, measures the net change in national assets. It is a financial account that records when money is flowing into and out of the country for the purposes of buying assets rather than goods.

There are many different types of capital account management tools, and the term 'capital controls' can stretch to cover an enormous range of different activities. This can make discussion of the topic both confusing and very abstract. Here are illustrative examples of some of the regulations to try to help readers understand just what these tools are:

Controls on foreign ownership of companies/equities – Perhaps most straightforward and obvious are direct limits on foreign investment – literally government control over which capital or financial flows can be invested in an economy. These have been used throughout history and have applied to all the different kinds of flows: portfolio flows, loans, and foreign direct investment. For example, when China first started to liberalise its approach to capital inflows, it maintained a requirement that foreign investment be channelled into a joint venture with a domestic company. The restriction on wholly foreign-owned enterprises stayed in place until 1986³.

Governmental clearances required for foreign investment in certain sectors – Rather than a blanket limit as above, some countries operate a system of controls on foreign ownership only in certain sectors. The United States, under a 1988 law⁴, maintains a review system for any foreign investment that "threatens to impair the national security", and can require undertakings to mitigate threats to national security. The mere threat of a failed review sometimes results in foreign investors withdrawing their acquisition proposals. For example in 2008 the US government approved the acquisition of a ports management company by state-owned enterprise Dubai Ports World, but the vocal opposition by many lawmakers resulted in the company divesting itself of the American operations shortly thereafter⁵.

Limits on outflows of capital – While the above examples involved limits on capital inflows and inward investment, sometimes countries try to stop outgoing flows as well. This is usually done through controls on foreign exchange transactions and currency export controls when the government is short of foreign reserves. A recent example of this policy was conducted in Iceland in 2008 when the financial and banking crisis devalued the krona, the Icelandic currency. As

part of the measures to deal with the crisis, comprehensive exchange controls were put in place, with the blessing of the IMF⁶.

Unremunerated reserve requirement (holding deposit at the central bank for capital inflows)

– One of the most famous tools, an unremunerated reserve requirement (URR), means foreign investors must make a deposit at the central bank equivalent to a certain percentage of their investment. This deposit does not earn interest and is returned after a specified period of time. It adds costs to investments because of the lost interest and the deposit being locked-up at the central bank, and is intended to discourage short-term investors. Between 1991 and 1998, Chile implemented a URR that required a deposit of 30% of the value of the investment for 1 year.

Tax on capital inflows into short-term instruments

– whereas a URR does not provide income for the state, a direct tax on capital inflows can have the same effect by raising the cost of investment, while also raising revenue. This is usually accomplished by a small tax on foreign short-term debt such as foreign purchases of corporate bonds or loans. A recent example (see Box 4 for full explanation) has been the Brazilian tax on short-term foreign investment, which required foreign short-term inflows to pay a tax of 2% on the value of the investment. That tax went up to 6% in late 2010 before being revised down to 2% again in early 2011.

Limits on foreign currency derivatives written by domestic banks

– Given the growing complexity of the global financial system, and the ceaseless process of financial innovation, regulation designed to prevent crises have also had to become more complex. To mitigate the risks from volatility in exchange rates countries not only have to think about actual currency trades but also have to consider currency derivatives, which are purely financial bets on changes in currency prices. Currency derivatives can be used as a form of insurance against exchange rate changes, but can also be used to speculate on changes in exchange rates and interest rates, and can introduce high risks for the banks that are issuing the derivative. To limit this, regulation can set a limit on the total volume of foreign currency derivative contracts to be issued by domestic banks. The world's 13th largest economy South Korea put such a policy into place in June 2010, by limiting the volume of foreign currency derivative contracts to 50% of the bank's capital. Korea hoped to limit short-term debt denominated in foreign currencies⁷.

Movement of capital has played a role in the transformation of economies in East Asia and particularly China. But it also played a debilitating role in the Asian financial crisis of the late 1990s, and numerous crises before and since. The countries that have fared the worst in the recent financial crisis have been those with the most deregulated and liberalised regimes. Good outcomes have been associated with long-term investment, while crises have been associated with 'hot money', which involves financial speculation rather than investment.

This report explains the drawbacks, especially for development, of policies to deregulate the movement of money across borders. It also looks at the potential advantages of regulating flows,

despite the assumption of international institutions such as the IMF and World Trade Organisation (WTO), as well as in the European Union and rich country governments, that this will be harmful. A new consensus around prudential and pragmatic capital account policies and their enforcement can facilitate financial stability, sustainable growth, and social development. First the report will look at the conceptual issues before considering why there are concerns around the free movement of capital. It will then consider the effectiveness of measures to manage the capital account and the policy hurdles to adopting such measures. Finally it will consider the multilateral implications and need for coordinated international solutions, before concluding with a set of recommendations.

Skyline of the financial district of Shanghai (China) - istockphoto



2. Background

Since the second half of 2009, many more developing and emerging economies have expanded regulations and controls of financial inflows to manage surges from overseas.

While such widespread use of capital management measures would have been unthinkable a decade ago, in the wake of the 2008 financial crisis the debate about capital account management has been revitalised. Why are countries having such renewed interest in these measures and what are the conceptual and practical issues that are involved?

Simplified macroeconomics of capital account issues

The capital account is one of the two primary components of a country's balance of payments, the other being the current account. The current account reflects a nation's net income generally derived from trade in goods or interest on loans, while the capital account reflects net change in national ownership of assets. If a foreigner buys an asset, either real like a factory or financial like a share of stock, that is recorded as a capital inflow. Likewise, when a national purchases an asset in a foreign country, that is an outflow of capital. Box 2 explains the basic types of flows that are recorded on the capital account.

The degree of openness of the capital account has important interactions with a country's exchange rate and interest rates. For example, if the capital account is fully open then foreigners can easily invest in government bonds, potentially using money they have borrowed in other currencies. By borrowing in a currency with a low interest rate and investing in a currency with a high interest rate, called the carry trade, investors can realise easy profits, but this flow of funds will im-

Box 2. Categories of capital flows

Foreign capital flows can be divided into public and private flows. Capital account regimes are relevant in relation to private capital flows which will constitute the focus of this paper. In general, private foreign capital flows can be categorised in relation to the method and purpose of the flow. The IMF generally discerns between foreign direct investments, portfolio investments, derivative flows and other private flows, including bank loans⁸.

Foreign direct investment (FDI) is a measure of foreign ownership of productive assets, such as factories or land. It refers to the purchase of a 'controlling interest' in a business in a country where the investor does not reside. FDI is often associated with long-term foreign capital participation in an economy, involving transfer of technology and expertise.

Portfolio investment refers to the purchase of stocks, bonds, currencies and other financial instruments issued by the private or public sector in a country other than one in which the purchaser resides. Sometimes this is broken down into debt-based and equity-based investment, as the two types have different risk profiles. Often, but not always, this type of investment has a shorter timescale and can be associated with higher risks for the receiving economy.

Financial derivatives refer to financial contracts used to trade risks in financial markets. The derivative instruments have prices or values linked to another specific financial instrument or indicator or commodity. A capital flow arises when a foreign investor enters into or purchases a derivative contract issued or held by a resident, such as a local financial institution. As derivative contracts are bought and sold in financial markets, the risks they generate are similar to portfolio investments. Additionally financial derivatives are often used to avoid capital account regulations related to portfolio investment.

Other flows refer to all other types of cross-border flows. The biggest component of other private financial flows is usually loans extended by foreign commercial banks to domestic public or private sector borrowers. In creating private foreign debt they inherently constitute a risk for the receiving economy. Additional types of flows included here are deposits in banks, some remittances, and trade credit.

Source: IMF, 2009.

pact the demand for the currency of the receiving country. This will push up the value of the currency while inflows are surging. If a high interest rate country wanted to keep the exchange rate stable, for example to encourage long-term investment in industrial production for export, it would have to adjust the interest rate downward to attract fewer inflows.

This shows the inability of countries to do all three things at once: keep an open capital account, target an exchange rate and independently manage interest rates based on the needs of the domestic economy. Economists Robert Mundell and Marcus Flemming won the Nobel Prize for modelling this “trilemma” in the early 1960s. For example, if a central bank decides to raise the domestic interest rate for a domestic goal like curbing inflation, this may incentivise short-term inward financial investments from abroad, as they would be attracted by the higher interest rates. These inflows can appreciate the value of the currency, interfering in the goal of targeting a stable exchange rate. In this scenario, if the country wants to maintain an open capital account, the government would have to choose between targeting a stable exchange rate and the initial goal of stopping inflation by increasing interest rates. Fully liberalised capital accounts thus complicate the use of other macroeconomic tools which may be needed for controlling inflation or promoting investment and exports.

Some analysts argue that capital account liberalisation leads to efficient investment of capital across different markets⁹; however, this theory is based on many false assumptions¹⁰. Like the efficient market hypothesis¹¹, one assumption is that all actors have perfect information about the investment opportunities and risks across the world. Of course, few investors have full information and many actors in investment markets trade on false information, hunches, or the momentum of prices. Investors, both individual and institutional, also tend to be subject to herd-

ing, meaning that they follow the trend of other investors both into and out of different kinds of investments, rather than acting on information about the underlying value of the investment. There are also concerns about contagion, where investors do not act purely rationally, but for example withdraw their investment in one country because another country in the region is experiencing some financial problems. The most recent financial crisis demonstrates, as past financial crises have done, that markets do not work as neoclassical economic theory suggests and that any supposed benefits from open capital accounts vanish in the context of financial crisis.

Empirical data accumulated over the decades has shown no consistent evidence that financial and capital account liberalisation are even correlated with higher levels of growth

Empirical data accumulated over the decades has shown no consistent evidence that financial and capital account liberalisation are even correlated with higher levels of growth, let alone get near to showing that it can cause higher growth¹². In 2003, then IMF chief Ken Rogoff argued that, because there is no clear empirical evidence for growth benefits from

financial liberalisation, countries should not be pressured to fully open their capital accounts too quickly¹³. In fact, the Growth Commission, a study of high growth countries, found that managed financial flows and financial sectors were a common factor among all the fast growing countries¹⁴. Chapter 3 will explain in more detail some of the risks and problems associated with unrestrained financial flows.

Recent history of capital account management

Economic theories and their practical application on capital mobility have changed significantly over time, though the public policy debate on capital mobility has been concentrated in the second half of the 20th century. Because of technological limits, including slow transportation and illiquid currency exchanges, much of history was characterised by capital immobility, particularly on the investment side. Only in the 18th century was there any significant cross-border flow of capital, in this case in the form of loans taken out

by sovereigns from Dutch trading houses and banks headquartered in Amsterdam¹⁵.

A first wave of financial globalisation did not really commence until the second half of the 19th century when the expansion of the British Empire enabled London-based banks and investors to begin moving finance around the globe. In the late 1800s and early 1900s, capital mobility was quite high, with a particular role played by the adoption of the gold standard facilitating the movement of assets¹⁶. Although this wave of globalisation focussed on trade in goods and the ability of workers to migrate from one country to another, capital did flow across borders. A great change occurred with the break out of the First World War in 1914 and again at the time of the Great Depression, which dramatically slowed international financial flows and constrained capital mobility¹⁷.

Keynesian ideas held sway after the Depression and the founding of the Bretton Woods system in 1944. British economist John Maynard Keynes and his counterpart in the US together drove much of the analytical work leading up to the Bretton Woods agreement, which focussed on controlling capital movements to provide stability and enable independent monetary policy¹⁸. In the run up to the conference where the system was agreed, Keynes wrote: “In my view the whole management of the domestic economy depends upon being free to have the appropriate interest rate without reference to the rates prevailing in the rest of the world. Capital controls is a corollary to this¹⁹.”

The Bretton Woods agreement, though rejecting Keynes’ proposal for an International Clearing Union to completely eliminate cross-border financial flows, did establish a managed exchange rate system based on the US dollar with the IMF overseeing it, and regulations on capital movements. This system proved extraordinarily stable, with few financial or currency crises²⁰ and stable exchange rates facilitating increases in production and trade. The biggest stress on

The Bretton Woods system proved extraordinarily stable, with few financial or currency crises and stable exchange rates facilitating increases in production and trade.



it was the need for the US to continue to supply dollars to the world through persistent balance of payments deficits. This gave rise to the Triffin dilemma, named after Belgian economist Robert

Triffin, in which the desire of other countries to hold US dollars as reserves would eventually suddenly reverse because of a crisis of confidence from the persistent deficits of the US²¹. The system lasted until the early 1970s when the US broke the peg of the dollar to gold and began moves to liberalise the capital account. In 1973 the US abolished its capital controls and this was repeated throughout the 70s in other industrialised countries²².

The end of the Bretton Woods system and the synchronous opening up to capital movements were driven by several factors. The US needed to import more capital to help finance deficit spending on wars in South-East Asia and new domestic social programmes²³. Financial innovation and regulatory avoidance also played a role. In Europe banks were increasingly taking deposits, lending and helping to issue bonds in US dollars and other foreign currencies, partly to avoid regulations in the US. Competition to capture a greater market share of global financial services created an incentive for governments and their private sector allies to push for further liberalisation²⁴. However, there was also a strong ideological tinge to the abolition of controls, as the US

Treasury officials making policy choices were both groomed in neoclassical economic theory and advised by leading proponents of these unproven theories, who nonetheless advocated for them being used as the basis for policy²⁵. While real world experience with increasing financial crises and the irrationality of markets has proven neoclassical economic theories inadequate to describe the real world, they still prove stubbornly enduring in policy making circles²⁶.

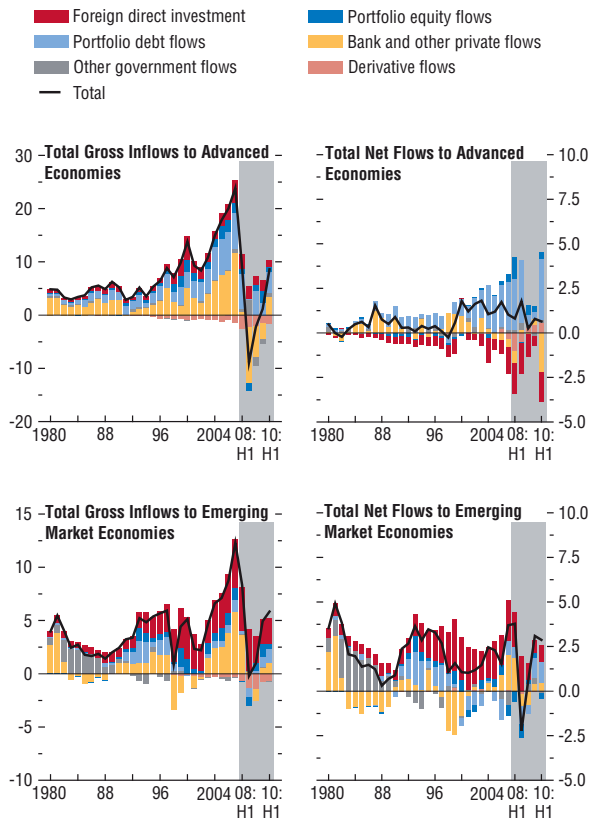
By the 1980s, capital account liberalisation was being pushed in emerging markets as well. Some of the developing countries liberalised financial flows as part of their desire to attract foreign direct investment. Also contributing were the IMF, World Bank and bilateral trade agreements, which worked together to dismantle capital controls in developing countries throughout the 1980s and 1990s. This effort culminated in a failed 1997 bid to get the IMF to change its articles of agreement to require its members to move towards full capital account liberalisation (see Chapter 5 for full details). However, aside from some very large stand outs such as India and China, most developing countries had liberalised many types of financial flows and foreign investment by the end of the 1990s²⁷.

Trends in capital flows

In historical terms the size of capital flows have become large in the last five years, with most countries and regions experiencing peaks in 2007 just before the financial crisis. The crisis brought a sharp fall in flows in both rich and developing countries, as seen in Table 1. Calculations of non-FDI flows made by the UN Conference on Trade and Development (UNCTAD) show that in nominal terms the flows peaked just before global financial crisis (see Graph 2). The subsequent reversal of flows in late 2008 was on aggregate the biggest such reversal in the last 20 years, larger than during the numerous financial crises that were experienced in Asia and Latin America around the turn of the millennium. Even more concerning for developing country is that the IMF finds that over the last two decades, the volatility of flows has been on the increase²⁸. In nominal terms flows have started to recover,

Graph 1.
The Collapse and recovery of cross-border capital flows

(percent of aggregate GDP)



Source: IMF (2011). World Economic Outlook: Tensions from the two-speed recovery: Unemployment, commodities and capital flows, April 2011.

but in a very unbalanced way. In aggregate they have not yet returned to 2007 peaks, but some countries such as Brazil and Turkey have experienced very strong surges in flows, and then again in September 2011 strong retreats. Total flows to developing countries surpassed \$1.095 trillion in 2010 according to UNCTAD, a total surpassed only in the peak year of 2007, when flows were \$1.65 trillion. As seen in Table 1, portfolio investment saw enormous volatility and has not yet returned to pre-crisis levels, while FDI flows have remained more stable. Graph 3 shows that this is true across all regions, with FDI remaining much more stable while portfolio and other flows exhibit significant volatility. All regions saw drops in flows in 2008 with subsequent recovery. Flows in 2011 are predicted to again increase everywhere except the Middle East and North Africa, where political upheaval in a number of

Table 1. Capital flows to developing countries

(billions of dollars)

	2005	2006	2007	2008	2009	2010
Total	579	930	1,650	447	656	1,095
FDI	332	435	571	652	507	561
Portfolio investment	154	268	394	-244	93	186
Other Investment ¹	94	228	686	39	56	348
% of total						
FDI	57%	47%	35%	146%	77%	51%
Portfolio investment	27%	29%	24%	-55%	14%	17%
Other Investment	16%	25%	42%	9%	9%	32%

¹ Other investments include loans from commercial banks, official loans and trade credits.

Source: UNCTAD (2011). World Investment Report: Non-equity modes of international production and development, 26 July, <http://www.unctad.org/Templates/webflyer.asp?docid=15189&intItemID=6018&lang=1&mode=downloads>.

Graph 2. Net private financial flows to emerging market and developing economies (excluding FDI)

(billions of dollars)



Source: UNCTAD 2011, Trade and Development Report based on IMF data

countries has resulted in declines of FDI and new outflows of portfolio and other flows. Of particular note is the size of flows to Central and Eastern Europe, as seen in Graph 3. For this region, flows are much higher as a percentage of GDP than for other regions, partly as a result of increasing cross border integration with the EU. Many banks are now owned by Western European parent banking groups, who provide their subsidiaries with capital for lending to

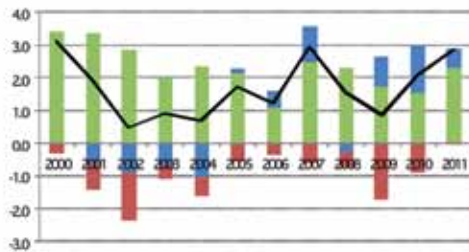
households and businesses in the region, often in foreign currencies. The reversal of these flows in 2009, contained in the ‘other private financial flows’ category, partly explains why many countries in the region experienced problems in the banking sector and have seen rising stresses on households and business that have both lost access to credit and seen the real value of debt increase with currency depreciations.

Graph 3. Regional net financial flows

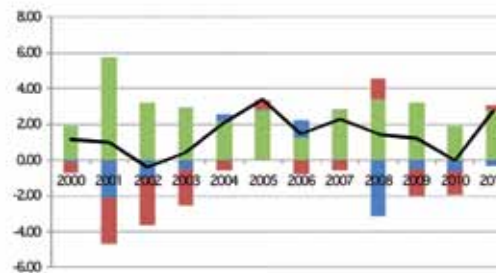
(Percentage of aggregate GDP)

- Direct investment, net
- Other private financial flows, net
- Private portfolio flows, net
- Total

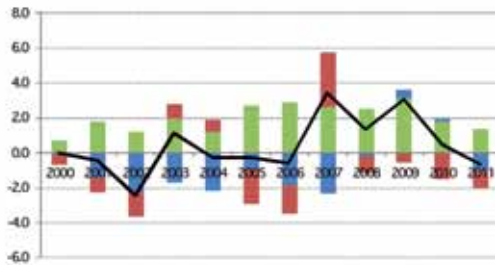
Latin America



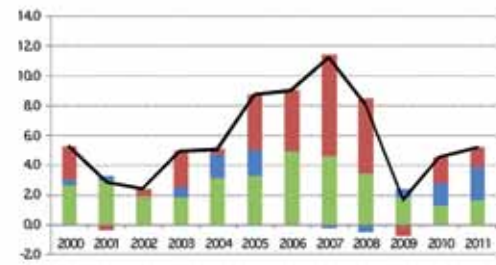
Sub-Saharan Africa



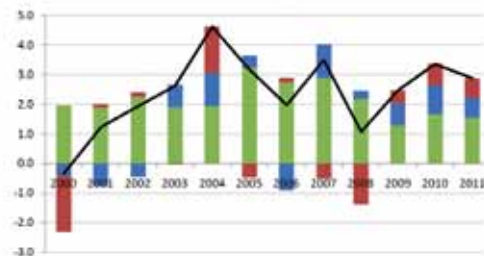
Middle East and North Africa



Central and Eastern Europe



Developing Asia



Source: IMF 2011, International Financial Statistics Database.

3. Large risk, little reward

Of course there are many economic policy debates, but why should we prioritise the handling of the capital account above other areas?

As shown in Chapter 2, policy makers have been oscillating back and forth over whether flows are a good idea. Meanwhile flows have grown ever larger, meaning that risks are being amplified. Given the size of the financial sector and the magnitude of flows compared to real economic activity, the movement of money is becoming increasingly problematic.

This section surveys the problems, particularly for developing countries and their citizens. The potential downsides from the financial crises that often result from speculation and ineffective capital account management are found to be truly debilitating, destroying wealth, human development, livelihoods, and social cohesion. Meanwhile, the possible upsides from well-regulated financial flows could be important.

Academics, civil society groups and policy makers have long criticised advocates of capital account liberalisation for not addressing the risks of liberalisation and ignoring the correlation between open capital accounts and increasing socially destructive financial crises. In a 2010 study, Nobel-laureate Joseph Stiglitz finds welfare-decreasing effects of full capital account liberalisation: “If we can impose restrictions on capital flows ... then it will, in general, be desirable to do so. Without circuit breakers, no liberalisation may be preferable to liberalisation.”²⁹

In Table 2 we outline some of the potential risks and rewards related to foreign financial flows. The list is not comprehensive, but illustrates some of the worries that make this issue important to address.

Economics professor Ilene Grabel of Denver University identifies five different but overlapping categories of crisis risks associated with unregulated global capital flows³⁰:

- **Currency risk** under open capital accounts has two dimensions. On the one hand, it refers to a country’s exposure to currency speculation and the risk of currency collapse following investors’ decisions to sell their holdings.
- **Flight risk** refers to sudden capital outflows from an economy because of panic and investor herding, causing sudden drops in asset values. Episodes of capital flight can become self-fulfilling prophecies in the case of sudden drops in confidence.
- **Fragility risk** refers to borrowers’ and an economy’s vulnerability to external debt obligations. Often fragility risk is heightened by short-term foreign borrowing being used to finance long term investment. Changes in conditions may make it difficult for the borrowers to continue repayment or for an economy to roll-over debt obligations coming due.
- **Contagion risk** refers to being effected by financial crises that have their origins in other countries through financial integration. Often this may be cross-border versions of investor herding or panic, as was seen in the Asian financial crisis.
- **Sovereignty risk** describes the risks that a government will be constrained in its ability to pursue independent social and economic policies as a consequence of capital account liberalisation. This is related to the macroeconomic trilemma discussed in Chapter 2.

These crisis risks are daunting, but they are not simply remote possibilities. Financial crises related to liberalisation happen disturbingly frequently. And they have devastating consequences. On top of that, liberalisation of financial flows creates additional problems not related to

Table 2. Outline of the potential risks and rewards of different types of flows

(types of flows most associated with the risk or reward)

	Short-term flows	Long-term flows
Some potential risks	Sudden stops and reversals in flows (portfolio, loan) Asset bubbles (FDI, portfolio, derivative) Over-borrowing (portfolio, loan, derivative) Maturity mismatches (portfolio, loan) Currency appreciation and de-industrialisation (all) Loss of monetary policy independence (portfolio, derivative)	Crowd out domestic industry (FDI) Over-borrowing (loan, FDI) Loss of control over domestic resources (FDI) Loss of tax revenue due to evasion/investment incentives (FDI) Capital flight through profit repatriation (FDI)
Some potential rewards	Enhanced credit availability (portfolio, loan) Hedging/insurance for volatility (derivatives) More liquid financial markets (portfolio)	Real resource transfer (FDI) Technology transfer (FDI) Employment (FDI) Local supply chains (FDI) Demonstration effect (FDI) Enhanced credit availability (portfolio, loan)

the crises that may result. Even boom periods have problems associated with them.

Given all these risks there may seem to be little rationale for letting in foreign capital. As discussed in Chapter 2, the drive for liberalisation has been based on a number of false assumptions. We will return in Chapter 5 to look at some of the political drivers that have kept the pressure for liberalisation up. But there are potential upsides to some kinds of capital flows, particularly foreign direct investment. FDI is not a development panacea, and is associated with many problems, but should a country wish to use FDI, it is important to consider what impact that might have on schemes for managing the capital account.

Liberalisation heightens risks of financial crises

Professor Carmen Reinhart and former IMF chief economist Kenneth Rogoff studied over 800 years of financial and banking crises in their 2009 book *This Time is Different*. They note that “one common feature of the run-up to banking crises is a sustained surge in capital inflows”, for which they use the term “capital flow bonanza”. Summarising the research on the probability of crises being related to a bonanza, they conclude, “The majority of countries (61 percent) register a higher propensity to experience a banking crisis around bonanza periods; this percentage would be even higher if one were to include post-2007

data in the table.”³¹ The core take away message they give is: “Periods of high international capital mobility have repeatedly produced international banking crises, not only famously, as they did in the 1990s, but historically as well.”³² Of course capital account crises do not develop independently of other macroeconomic factors. In a wide ranging analysis of the crises that hit developing countries in the 1990s, Cambridge Professor Lord Eatwell and New School University Professor Lance Taylor find that the exchange rate regime had important implications for the sagacity of opening the capital account in emerging markets. “The privatisation of risk implicit in floating exchange rates demands a liberalised capital market. This combination transforms the exchange rate into both an object of enormous potential profit (an incentive to speculation) and an object of fear (a risk that must be hedged).”³³ They go on to explain that the extraordinary stability of the Bretton Woods era from 1945 until 1971 would not have been possible without a regime of capital controls in place.

There are a number of ways by which uncontrolled capital flows can contribute to crises. These mechanisms are widely explained in studies on financial crises and how they have developed over history. Building on the different categories of risk discussed earlier, the mechanisms include:

- Financial inflows suddenly stopping when countries are running current account deficits;

- Capital suddenly flowing out because of balance of payments concerns, precipitating a crisis;
- Asset bubbles building up and then bursting, leading to a banking crisis;
- The private sector over-borrowing leading to a banking crisis;
- Investors acting irrationally, generating inherent market instability and self-fulfilling prophecies; or
- Investors taking fright despite solid economic fundamentals in the country concerned because of economic events in another country, this is called a herding or contagion effect.

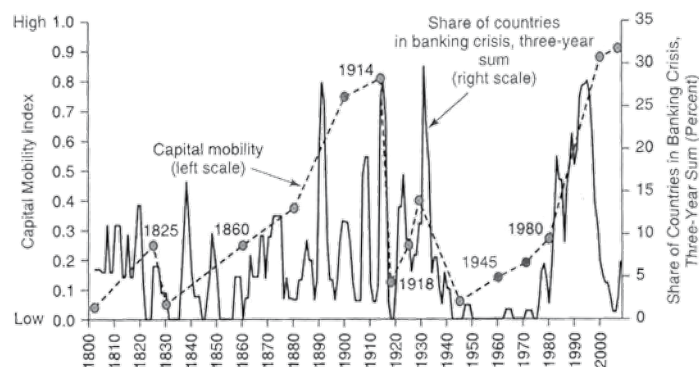
Post-crisis IMF research has now found increasing evidence for the relation between volatile financial flows and financial and economic crises. One IMF study argues that “capital inflows – especially certain types of liabilities – can make the country more vulnerable to financial crisis. An obvious example is debt versus equity flows, where the latter allows for greater risk sharing between creditor and borrower.”³⁴ It points at the potential usefulness of capital controls in addressing both macroeconomic and financial stability.

Social and economic effects of financial crisis

These risks indicate that capital account management is much more than a technical economic issue. Due to its effects on financial stability it has wide ranging social implications. The way in which financial flows are managed impacts on wealth distribution, poverty, and unemployment, especially when crises materialise due to unregulated financial flows.

Reinhart and Rogoff have also examined the aftermath of severe post-war financial crises and evaluated data for 15 to 23 country cases on different outcomes. They found a “deep and lasting effect” on asset prices, real GDP per capita, and employment. While asset prices and GDP

Graph 4.
Proportion of countries with banking crises



Source: Reinhart and Rogoff, 2011

declined for many years after the outbreak of crises, unemployment levels substantially increased. Moreover, real public debt soared by 86 per cent on average three years following a crisis³⁵.

A December 2010 UNICEF report analysing the social effects of Mexico’s 1995 and Argentina’s 2001 crisis finds disastrous welfare outcomes in both countries. In Mexico, prices rose by 35 per cent and output fell by more than 6 per cent in 1995 alone. Real wages declined by 25-35 per cent, and unemployment almost doubled. As a consequence, extreme poverty soared from 21 to 37 per cent of the population between 1994 and 1996 and it was not until 2001-2002 that it fell back to pre-crisis levels. Moderate poverty during the same period increased from 43 to 62 per cent.³⁶ In Argentina, as a result of the crisis, 58 per cent of the population fell under the national poverty line by 2002. “Analysis has shown that children and youth were particularly impacted”, with 75 per cent living in poverty. Unemployment soared from 13 per cent in 1998 to 22 per cent in May 2002, with another 22 per cent of the Argentinean population being underemployed³⁷.

Impacts on wealth distribution

As noted about Argentina, financial crises increase poverty, but at the same time they may not have uniform impacts on a population. The UNICEF report shows that income distribution in Argentina became more unequal in the wake of the crisis, with the Gini-coefficient rising from

0.50 to 0.53. Despite a decrease across incomes, poorer groups' incomes fell more sharply than richer groups. However, in some countries the decrease has not been universal and some segments of the population have gained out of a crisis. Overall, it is the poor and vulnerable that lose out the most.

A study of Latin American financial crises in the 1990s by economics Professor Nora Lustig, then at the Inter-American Development Bank, has stark findings: "Crises in Latin America and the Caribbean tend to be accompanied by increases in inequality, the impact of economic contraction tends to disproportionately reverse previous gains in poverty reduction. ... Also, crises ratchet up inequality: since subsequent growth does not tend to eliminate the higher level of inequality generated during a severe economic downturn."³⁸ Citing empirical evidence from the region, she continues "The poorest quintile of the population was not always hurt disproportionately. In general it was the share of the middle ranges which fell the most. In contrast, in the majority of countries the income share of the top 10 percent increased, sometimes substantially."³⁹

This effect is not unique to Latin America. Studies on Indonesia and the impact of its 1997 financial crisis have shown that the districts with the most income equality experienced the greatest increases in inequality⁴⁰ and that the urban poor suffered the most.⁴¹ And the effect is not confined to developing countries, with a preliminary study on the US and UK by the International Labour Organisation, finding that "results support the view that the crisis has also led to an increase in income inequality, both because low wage earners have been more likely to lose their jobs and because social transfers are in general lower than the earnings received earlier."⁴²

The global literature finds the same results. A World Bank paper studying 30 years of recessions across 72 countries finds "volatility and,

particularly, adverse extreme output events (e.g. macroeconomic crises) have negative and persistent effects on equity and poverty, as well as a discouraging effect on school enrolment."⁴³ A preliminary cross-country exercise covering 100 years of crises for 25 countries (including both rich countries and developing countries) by researchers at the UN Development Programme finds that "the empirical evidence suggests that cases in which inequality tend to increase following the crisis are in majority."⁴⁴

Specific impacts on children

The global financial crisis of 2008 also had very significant effects on the well-being of children, and not just in countries that were at the centre of the financial storm. Caroline Harper and Nicola Jones of the think tank Overseas Development Institute highlight that research shows that crises affect children through "declining expenditure on social services, rising unemployment and underemployment and declining working conditions, declining social capital, and reduced access to credit. Impacts are also channelled through households themselves, which make decisions about time and expenditure allocations and consumption – especially of food, among other changes – and also about the removal of children from school or taking on additional work, thereby reducing time for child care and increasing child labour."⁴⁵

A study on the effects of the 2008 financial crisis on children in El Salvador provides interesting evidence about how even countries far from the epicentre of a crisis can be effected through these transmission channels. Even by the end of 2008 "the probability of school attendance among children between the ages of 10 and 16 fell by 2.1 percentage points. For youth continuing to attend school the crisis was associated with a shift in the type of school attended, with an increase of 5 percentage points in the probability of attending public school."⁴⁶

More worrying evidence comes from examination of previous financial crises in developing

“Crises in Latin America and the Caribbean tend to be accompanied by increases in inequality, the impact of economic contraction tends to disproportionately reverse previous gains in poverty reduction”

countries. Summarising some of the academic research on these links, a team of Overseas Development Institute and University of Sussex researchers found a rise in infant mortality from 5% to 7% in just one year in Mexico after its 1995 financial crisis. Similar rising child mortality was found in Thailand, Indonesia, and the northern provinces of Argentina after their financial crises. And further effects were found in nutrition, health care, educational outcomes, and youth unemployment.⁴⁷

Gender-specific impacts

While it is very hard to demonstrate a direct gender differentiated impact of capital account policy on women, there has been work done on the gendered impact of financial crises. Because capital account policies affect growth as well as the frequency of financial crisis, they will also affect employment, incomes and other factors, all of which have a gender dimension⁴⁸.

Empirically there is strong evidence that economic and financial crises have differential impacts on women. A review of the evidence by World Bank economists has particularly noted that there are significant impacts in the areas of health and infant mortality: “While boys and girls benefit from positive shocks to per capita GDP in a similar way, negative shocks are much more harmful to girls than to boys.”⁴⁹ Many of the impacts are not related to simple economic indicators like the percentage of female work force participation, but to the multiple stresses placed on women in a financial crisis, including having to seek extra earnings, often in the informal sector, while still performing household duties. Intra household relationships may be strained and women may suffer greater deprivation as household incomes decline in order to shield children from the impacts of the crisis⁵⁰. A series of case studies on the Asian financial crisis, for which volatile capital flows have been implicated as one of the key drivers, corroborates these findings. “Women (and female-headed households) have generally been harder hit by the employment and income-impact of the crisis in Korea, Malaysia, Philippines, and Thailand.” The study finds greater burdens of income-earning activity, increased sexual harassment



Bangladesh
Photo ©Elena Cavassa

and abuse in the workplace, greater domestic violence against women, and in some cases a decline of girls’ school enrolment⁵¹.

Booms have consequences as well

It should be clear that boom-bust cycles of financial movements and economies create poverty, unemployment and suffering. The rapid swings result in high unemployment, worsening social indicators and retreats in poverty eradication and human development, meaning that the economic and social rights of people, especially vulnerable people, go unfulfilled. However it is not just the bust that causes problems, the boom periods, associated with rapid influxes of capital, have problems of their own as they bid up assets prices such as stock and property markets as well as push currency appreciation. These problems are independent of the potential crash that the boom period may set up.

Inequality

Booms have costs in terms of driving inequality upwards and weakening social cohesion. And these booms create interest groups that can distort the public purpose of the state and shift it towards serving the interests of a small minority. In particular financial interests gain power, enabling them to lobby governments more strongly and capture the regulatory system.

Research has shown that empirically the stock market booms associated with financial market and capital account liberalisation are only benefiting those already at the top of the income distribution. A study by economists at Columbia University on the effects of capital account liberalisation in 11 countries with good data on income distribution showed that “the middle class ‘suffers’ in the wake of a liberalising reform while the upper [20% of the population] gains”⁵². The process of financial liberalisation that began in India in the early 1990s has been shown to have contributed to increased inequality rather than helping reduce it⁵³.

The power of the financial sector is gained vis-à-vis manufacturing industries or producers of other services, and especially in comparison to ordinary citizens. In a cross-country empirical study on the degree of capital account liberalisation, the aggregate amount of national income going to labour goes down as liberalisation in-



Sri Lanka 2001 Photo Carlo Dojmi

creases, especially in high-income countries. The author argues that “capital mobility can have significant negative effects for the bargaining power of labour as a whole” because it gives employers a stronger bargaining position in that they can more easily threaten to relocate⁵⁴.

De-industrialisation

Booms associated with unsustainable financial flows can lead to currency appreciation, as demand for the local currency goes up while flows are in the boom stage. This is reminiscent of “Dutch disease”, which was the situation the Netherlands experienced in the 1960s and 1970s after the discovery of gas deposits. The discovery led to an increase in exports and a higher currency, as large amounts of money flowed into the country because of these exports. Despite this export boom, the Netherlands experienced lower levels of manufacturing and thus levels of employment.⁵⁵ As the currency appreciated, Dutch manufacturing became uncompetitive compared to other countries, initiating a process of de-industrialisation. While the Dutch case was because of exports of commodities bringing in dollars, the same situation occurs when dollars or other foreign currencies flood in during a capital flow bonanza.

Currency appreciation driven by short-term capital inflows can fairly quickly decimate the manufacturing base of an economy given the globalisation of trade. However, de-industrialisation of this type is not accompanied by significant job growth in other sectors, especially not in the short to medium term. This induces a reduction in both sustainable employment and in productive capacity. A country’s manufacturing base can not easily or quickly be rebuilt once capital inflows subside and a currency returns to normal levels. Eventually, as the currency overvaluation driven by the unsustainable capital inflows reverses, with or without a full-blown financial crisis, the manufacturing base has dissipated leaving lower employment, exports and overall economic activity.⁵⁶ This worry about de-industrialisation is one of the least considered aspects of capital flow problems, as it may not manifest itself immediately, but can create a generation of economic problems.⁵⁷

Tax evasion and secrecy problems

Uncontrolled and underreported financial flows are also a key problem associated with the inability of countries to raise sufficient tax revenue. Those seeking to both avoid and evade taxation can make use of the liberalisation of financial flows to more easily accomplish their aims. The volume of lost tax revenue is immense, with a January 2011 report from research organisation Global Financial Integrity estimating that developing countries are losing an increasingly large sum of money. While estimates of the loss in 2006 ranged from \$856 billion to \$1.06 trillion, by 2008 the loss was \$1.26 trillion to \$1.44 trillion.⁵⁸ Rich countries lose out as well, but global estimates are very hard to produce. In a 2004 book, former international businessman Raymond Baker published his conclusions from 8 years of research into tax evasion, capital flight, money laundering and corruption, estimating that global cross-border flows ranged from \$1.1 trillion to \$1.6 trillion annually.⁵⁹ Country-by-country estimates are hard to come by, but UK trade union research estimated that the UK alone loses nearly £25 billion (\$40 billion) a year to tax avoidance and tax planning. Much of this is facilitated by the free flow of capital to and from off-shore accounts and tax havens⁶⁰. While a full international treaty for automatic exchange of tax information and mandatory withholding of taxes on foreign-held assets would be the best solution, that does not seem imminent. As far back as 1999 World Bank economist John Williamson admitted that capital account liberalisation may facilitate tax havens. He noted that “It is much easier to avoid paying taxes on income earned on one’s assets if those assets are in some domicile other than that in which one resides, especially one that is known as a tax haven,” and that this linkage between capital flows and tax evasion “becomes ever more critical the more liberal are capital flows.”⁶¹ This leads to worries that the liberalisation of capital accounts and financial flows is contributing to tax evasion.

Researchers looking into how to stamp out tax avoidance and evasion argue that the liberalisation of financial flows has constrained one of the most important things for accomplishing a crack

down on tax evasion: simple information about financial flows. Without any data on source, destination, ownership, or purpose of a financial flow across borders, it is near impossible to figure out if it involves tax evasion⁶².

Potential rewards of inflows

Capital flows, like all investments, carry risk. However the cross-border nature of some flows brings additional risks beyond those of normal investment projects. So it is important to balance the risks with potential rewards.

Economic history shows that countries that have successfully developed have been assisted by foreign capital, though this is not the only or even the main factor in their success. As explained in Chapter 2, the Growth Commission found that this foreign capital did not arrive through fully open capital accounts. Clearly there are some capital movements which can contribute to positive outcomes. In general, investment that is of a longer duration and provides additional benefits or spillovers would be more desirable.

In the categories of capital flows described in Box 2, FDI is more likely to be of longer duration and to provide additional benefits.

An enormous volume of material has been written on FDI, and reviewing it is beyond the scope of this paper. Much of the literature touts the benefits of FDI to developing countries.⁶³ ‘Investment climate’ reforms that seek to make it easier for companies to do business, especially across borders, have been a focal point of the Doing Business report, the flagship publication of the World Bank’s International Finance Corporation (IFC). FDI might, under the right conditions and with the right policies in place, have beneficial effects like informational spillovers, demonstration effects, technology transfer, the development of local supply chains, and learning by doing.⁶⁴ However, Dani Rodrik of Harvard University argues that the empirical evidence may not even show that these are significant.⁶⁵ It should be clear that FDI can have significant costs, and even long-term stable FDI may have ramifications for industrialisation, the balance of payments, taxation, employment and other macro-economic factors.⁶⁶

To balance these factors it is important to focus on the quality rather than the quantity of FDI.⁶⁷ Achieving any potential benefit of FDI does not require opening up to every possible kind of investment, nor even to every type of FDI. Especially given that categorisation of flows is not perfect, which means that the distinction between FDI and a portfolio flow can be somewhat arbitrary, selectivity can be important. Selectivity in accepting FDI can help ensure that it meets with national development strategies, much as was done in the process of industrialisation in East Asia.⁶⁸ A fully liberalised capital account makes selectivity in FDI impossible. On the other hand regulations on inward investment may promote the kinds of investments desired while discouraging those too risky or undesirable for other reasons.

Controlling global trade imbalances

The financial flows and the financial imbalances discussed above do not occur in isolation from the real economy. Along with increasing volumes of capital flows the world has experienced increasing trade and trade imbalances. These current account imbalances reflect that consumption of imports in some countries, such as the US and UK, has persistently been higher than their exports. These are the countries with persistent current account deficits. The opposite situation has prevailed in the current account surplus countries such as Germany, Japan and China. The financing of these gaps is achieved through changes in levels of reserves and financial flows on the capital account. Thus, capital flows are closely intertwined with trade imbalances. The ability of certain countries, particularly the US, to run huge and persistent current account deficits – and the corresponding capital account surpluses that sucked finance into their countries – effectively allowed them to live beyond their means, supporting growth on the back of credit rather than savings and investment. On the opposite side developing and emerging countries have kept some of the dollars they earn by selling goods to the US as precautionary reserves. Global imbalances were a major contributing cause of the financial and economic crisis and are still a major problem.

There are several reasons why developing countries have accumulated these reserves, including the lack of exchange rate coordination mechanisms; the dollar's position as international reserve currency; IMF failures; and the desire for self-insurance against financial crises. In particular, after seeing the IMF's role in the Asian financial crisis, the perception by developing country leaders of the negative political and economic consequences of turning to the IMF have driven some of the reserve accumulation.⁶⁹ The accumulation of these precautionary reserves is a significant component of the build up of global imbalances. If the risks associated with capital flows and sudden stops or reversals of investment were moderated, countries would have less need for these extra large levels of reserves. Additionally, global imbalances are driven by excessive savings in surplus countries and insufficient savings in deficit countries. Some argue that surplus countries, particularly China, are manipulating their exchange rates in order to maintain surpluses, but this argument is never applied to large surplus countries like Germany. Rather than branding countries currency manipulators, tools and policies to help manage flows can slow accumulations in both surplus and deficit countries. It will also allow the better operation of independent monetary and fiscal policies targeted at domestic priorities. This is a crucial element to tackling the imbalances problem as surplus savings countries need to use the full range of macroeconomic policies along with social policies to encourage better use of their surplus savings, rather than using them to finance US deficits.

Additionally, coordinated implementation of capital account management techniques could help control capital inflows and outflows from countries like the US. While the US has large private outflows, it simultaneously has even larger inflows, particularly into holdings of US government debt. We will return to these ideas in Chapter 6, but there are possibilities for putting in place incentives and policies that reduce imbalances.

4. Effectiveness of capital account management

Given what we have seen in the previous section, that unrestrained capital movement presents both economic and social risks while there are potential benefits to be had from regulating the capital account, citizens and policy makers should be asking themselves what they can do about it.

Because management of the capital account is important for safeguarding and augmenting the well-being of people, careful consideration should be given to measures that can be taken. This section surveys the effectiveness of different kinds of capital account regulations in achieving both intermediate and long-term goals.

Developing countries are already attempting to exert more influence over the composition and volume of surges of capital inflows, but there has been significant debate over the effectiveness of the tools being used. This is also true of tools to prevent capital flight. It should be clear that no macro-economic tool will ever be perfect whether it relates to liberalisation or regulation. However this is not an argument for avoiding the subject or abdicating responsibility. Clear-thinking and pragmatic decision making can help arrive at the best possible mix of tools that suits the contours of the economy and the macroeconomic situation.

Overview

An IMF paper, published in 2010, examined the experience of governments that regulated capital flows, and notes “that the use of capital controls



was associated with avoiding some of the worst growth outcomes associated with financial fragility.” Specifically, the authors find that GDP fell less sharply during the financial crisis in countries that already had such policies in place. The report cites Brazil’s taxes on short-term debt, and policies pursued by Chile, Colombia and Thailand which require inflows of short-term debt to be accompanied by a deposit with the central bank.⁷⁰

A 2011 paper⁷¹ from a different department at the IMF confirmed that capital account management can be effective in shifting the maturity and composition of incoming financial flows. It finds mixed evidence in terms of reducing the overall volume of inflows or stemming exchange rate appreciation. Evidence across the board is mixed on the effectiveness of capital account management to reduce exchange rate appreciation. One of the key problems has been that the literature does not generally seek to assess different kinds of capital account management techniques in terms of their effectiveness in achieving these goals.

Even more importantly, there is little discussion in the empirical literature of what kinds of changes in the international policy environment might enable management techniques to achieve these goals. For example coordinated enforcement policies, as discussed in the next section, should enable more effective progress in controlling unwarranted appreciation of currencies and exchange rate overshooting.

Limits on foreign company ownership/participation

One type of capital account management technique which has been particularly effective is specific limits on foreign ownership of domestic assets. These can cover both publicly listed companies as well as private companies. These sort of practices, which are a control on what financial flows can enter a country, have multiple possible rationales. They can be done on grounds of national security, for macroeconomic reasons, or as a part of industrial policy to promote certain strategic industries.

The United States today constantly uses this kind of capital account management technique to prevent transfer of ownership of specific assets into the control of certain foreign companies. It uses a legal provision around national security to accomplish this, which means it can avoid application of its investment treaties (as discussed in the next section). Under the Exon-Florio Amendment to the Omnibus Trade and Competitiveness Act of 1988⁷² the US parliament required the US President to maintain a review system for any foreign investment that “threatens to impair the national security”. Under this law the Committee on Foreign Investment in the United States, comprised of representatives from 14 government departments in the US, has the power to review every foreign investment in the US and can require undertakings to mitigate threats to national security.⁷³ The mere threat of a failed review sometimes results in foreign investors withdrawing their acquisition proposals, for example the 2008 case of Dubai Ports World. Another case was the 2007 attempted acquisition of a relatively small US oil company, Unocal, by the third largest oil company in China, China National Offshore Oil Corporation. The bid, which was ultimately withdrawn in the face of opposition from the media and the US legislature, demonstrates that there are both legal and public relations limits on foreign investment in the US.⁷⁴

Australia maintains a Foreign Investment Review Board (FIRB) under its 1975 Foreign Acquisitions and Takeovers Act which enables the government to prohibit foreign investments where they

are considered “contrary to the national interest”.⁷⁵ This type of review has been used recently to block foreign investment by Chinese mining companies in Australian mining companies. In 2009, China Non-Ferrous Metal Mining, a state-owned mining company, was blocked by Australia from buying a controlling stake in Lynas Corporation, a miner of rare-earths. The FIRB limited the Chinese company to a 50% stake.⁷⁶

Many East Asian economies, including South Korea⁷⁷ and Taiwan⁷⁸, used these kinds of measures as part of industrial policy to ensure that their economies advance up the industrialisation scale. However, these strategies were in actuality copied from now developed economies that used them during their period of industrialisation. Cambridge University economics Professor Ha-Joon Chang has studied the industrialisation path of many now rich countries and has found that “during their early stages of development, now-developed countries systematically discriminated against foreign investors. They have used a range of instruments to build up national industry, including: limits on ownership; performance requirements on exports, technology transfer or local procurement; insistence on joint ventures with local firms; and barriers to ‘brownfield investments’ through mergers and acquisitions.”⁷⁹ He concludes that, “only when domestic industry has reached a certain level of sophistication, complexity, and competitiveness do the benefits of non-discrimination and liberalisation of foreign investment appear to outweigh the costs.”

Traditional capital inflow controls

As explained in Chapter 2, capital flows were subject to regulations in the post World War II period. This did not mean that investors in one country were unable to invest in other countries, merely that there was regulation. This regulation was there to deal with the risks associated with the investment and with the need to prudently manage the overall macroeconomic position of the country.

In the post-war period there were a number of tools used, prominent among them being foreign exchange restrictions. These required foreign exchange dealers to be registered and provide

data to the authorities on the volume of transactions, as well as requiring purchases of foreign exchange above a certain size to be specifically authorised. For example, exporters and importers were required to show invoices against large transactions involving foreign currencies. In some cases two-tiered exchange rate systems were set up with different exchange rates for different types of transactions. Additionally, there were often quantitative limits on inflows, limiting the overall size of such financial movements in the economy. This could prevent unsustainable deficits or surpluses of the current and capital account from building up without the authorities being able to take action. There were also approval systems in place, which could limit the types of inflows and require them to seek permits for the investment. As countries deepened their financial systems and developed domestic equity and bond markets, they also regulated the participation of foreign investors in these domestic markets. This was particularly true for portfolio investors, often large institutional investors from rich countries.⁸⁰

The main complaints against these types of controls are that they introduce distortions in the allocation of resources and that they are ineffective, particularly in preventing balance of payment crises or controlling exchange rate volatility.⁸¹ Most commentators think particularly of the exchange controls and the dual exchange rate systems, either officially sanctioned or black market, as the most problematic type of controls. Indeed, research shows that these have been subject to abuse and misuse, while imposing high costs in some developing countries.⁸² However, not all cases exhibit the same problems, and the evidence shows that other countries, especially those with high administrative and enforcement capacity in financial sector regulation, can effectively use broad-based capital controls. This is confirmed by a recent IMF staff review of the effectiveness of capital controls, which found: “In China and India, which maintain more extensive controls, interest rate spreads remain significant and persistent over time. This conclusion is consistent with the view that controls are more effective in countries that more heavily control capital flows.”⁸³

China, while the fastest growing economy in the world and soon to be the largest economy by some measures, still maintains one of the most extensive systems of controls on inflows. Though it no longer requires all FDI to be conducted in joint ventures, portfolio and other inflows are subjected to strict controls and foreign exchange dealings are still heavily regulated. Non-residents are not allowed to participate in domestic money market funds, or derivative markets, and can only invest in limited kinds of instruments on equity and bond markets.⁸⁴ A study by economists at the Bank of International Settlements shows that while China has experienced a marked increase in cross-border financial flows, this has not meant that Chinese controls have become ineffective. To the contrary, “although the Chinese capital controls have not been watertight,” they find that “China’s capital controls remain substantially binding. This has allowed the Chinese authorities to retain some degree of short-term monetary autonomy, despite the fixed exchange rate.”⁸⁵

India, also one of the fastest growing major economies in the world, still maintains controls on financial inflows for investment in many sectors and for portfolio inflows. The banking and retail sectors are still largely closed to foreign investment, though retail opening is being proposed. Foreigners cannot buy government debt and can only invest in equities through registered foreign institutional investors.⁸⁶ While India seems to have leakier capital account measures than China, with reducing independence of its monetary policy found in some research⁸⁷, other recent studies have shown that the country does maintain considerable independence.⁸⁸ India’s former central bank governor YV Reddy credits his bank’s cautious and pragmatic approach to capital account liberalisation as a key reason why India fared well in both the Asian financial crisis of the 1990s and in the 2008 financial crisis. Without generalising about the direction of management of the capital account, Dr. Reddy argues that “appropriate management of the capital account is critical for both growth and stability.”⁸⁹

Box 3. De facto versus de jure measures

It can sometimes be difficult for researchers to determine what exactly should count as a capital account regulation, complicating efforts to empirically assess the effectiveness of the measures. While the traditional measures of quantitative restrictions are easy to identify, a number of other measures used historically were not in fact formally specified as capital controls. Even the existence of such a quantitative restriction may not tell you how important the measures are. The level of the restriction would have to be compared to the size of the economy and the past volumes and trends of such flows to know whether it was severe or not.

Additionally, while some countries had controls in place, investors and financial institutions often sought to avoid them, making the measures less effective. Traditionally researchers looked at whether a country had exchange restrictions in place, however these type of binary assessment also failed to distinguish between light-touch regulations and more heavy-handed measures. A number of researchers have tried to construct indexes that assess the depth of measure, capturing the de facto results rather than just the de jure rules.⁹⁰

Capital outflow regulations

As described above, China and India maintain significant schemes for managing the capital account. Those schemes operate on both inflows and outflows. However, many other countries tend to have one or a few instruments in use and usually focus on the problem at hand. Countries facing surges in inflows will logically use inflow controls, while countries facing sudden capital flight, particularly by residents, may attempt to use capital outflow measures. These types of controls are most frequently used during a financial crisis to try to stem the flight of bank deposits to banks in other jurisdictions. As explained by economists Ethan Kaplan of University of California Berkeley and Dani Rodrik of Harvard University: “a country can be faced with creditor panic and a run on reserves even when it has strong fundamentals. In these situations, a temporary suspension of capital account convertibility can halt the rush to the exits and provide time for policy makers to take corrective action.”⁹¹

Malaysia’s late 1998 response to the Asian financial crisis is the most famous example of these

types of controls. The government enforced the repatriation of all the local currency – the Malaysian ringgit, strictly regulated offshore and international transactions in ringgit, required approval for foreign investment by Malaysians, and required foreign investors in the local equity market to hold the proceeds of any equity sales in the country for 12 months before repatriating the profits to their home country.⁹² Kaplan and Rodrik, assessing a multitude of evidence, suggest that the Malaysian controls were effective in isolating the ringgit from speculation to provide breathing room for monetary and fiscal policies, and allowed the economy to recover faster than if the government had gone to the IMF for a loan.⁹³

At the time the IMF looked askance at the Malaysian moves, saying it would hamper investor confidence. The IMF’s Independent Evaluation Office (IEO) 2005 review of the Fund’s approach to capital account liberalisation looked at four instances of capital outflow controls and found that the IMF was not supportive of them in any instance, though they were not oppositional in the cases of Thailand and Russia.⁹⁴ By the time Iceland experienced a deep banking crisis in 2008, the IMF was starting to see things differently in some cases. As part of the loan package to Iceland, capital outflows were essentially forbidden with foreign exchange controls that allowed currency transactions only for exports and priority imports such as food and medicine. The central bank required daily reporting to ensure that banks “avoid using foreign currency that is received in the banks for financial-related currency transactions of any sort.”⁹⁵ At the time the IMF supported these rules⁹⁶, and in a conference in 2011 to assess the impact of the crisis resolution measures, IMF staff and management concluded that “Capital controls were necessary and are now seen as useful addition to [the] policy toolkit.”⁹⁷

In the Malaysian and Icelandic cases, the outflow regulations were initiated in the context of large currency speculation and large outflows. The controls were more effective, and experienced little evasion. This is not always the case, as Argentina’s measures put in place after their 2001



Protesters at Austurvöllur - Iceland

The Kitchenware-Revolution in Iceland was organised by Hörður Torfason's social movement called "Raddir Fólksins". It started in the wake of the collapse of the banking system followed by the decimation of Icelandic economy in the beginning of October 2008.

Protest meetings were held every Saturday from mid October 2008 until the end of January 2009 at the Austurvöllur square in front of Alþingishús - the Icelandic parliament house. It resulted in the resignation of Icelandic prime minister Geir Haarde and his cabinet on 26 January, 2009. (Source: Wikipedia)

Photo: Oddur Benediktsson (Flickr, CC Share Alike - attribution)

financial crisis attest. A range of controls were placed on residents outward financial transaction initially in 2002, which proved effective as part of a new macroeconomic framework. Stricter regulations were implemented in 2007, and these have had some effect in deterring domestic institutional investors from sending money overseas, but capital flight remains a problem for the Argentine authorities. The Argentine authorities place particular blame for the problem on tax evasion and the use of tax havens and secrecy jurisdictions by residents.⁹⁸

A clear issue with the effectiveness of outflow measures is enforcement of the regulations. The greater the ability of the authorities to regulate and oversee financial institutions, the better results will be achieved. Additionally, outflows also must have a destination, and evasion of outflow regulations implies some connivance on the part of the receiving jurisdiction. That may be more nefarious or it may simply be the authorities and financial institutions in the receiving jurisdiction turning a blind eye to the source and possible illegality of the financial flows. Mutual enforcement would help curb some of the evasion of outflow regulations if the international community committed to working together, much as has been done in anti-money laundering and countering the financing of terrorism (AML/CFT). Overall, outflow measures can be effective in stemming capital flight in an emergency, but there is a role for better design, application, and enforcement. Better still would be preventative measures that lessen the need for using outflow regulations in a crisis.

Taxes/cost-based measures

Some of the most well recognised and regarded measures for capital account management are cost-based measures or taxes on financial inflows. The best example of these is the Chilean unremunerated reserve requirement that was implemented in the 1990s. An unremunerated reserve requirement is when a foreign investor must deposit a percentage of the value of their inward investment with the central bank. The central bank does not pay interest on this deposit and holds it for a specified period of time. In Chile's case it was 30% of the inflow amount held by the central bank for 1 year.

More than a dozen detailed economic studies of the Chilean case have been undertaken since the controls, called the encaje, were implemented in 1991 and finally phased out in 1998. Though there have been some small variations in findings, overall the literature shows that the Chilean controls were effective in curtailing short-term inflows in favour of incoming investments that had a longer duration.⁹⁹ A paper published by former Chilean Central Bank staff and IMF officials by the Economic Commission for Latin American (ECLAC) argues that the controls had a positive, but limited effect. It says that controls "helped to offset the push factors by widening the spread and restraining net capital inflows,

Box 4. Evidence from Brazil

Between 2008 and 2011 short-term investments, known as carry-trade flows, flooded Brazil and artificially inflated the value of the real, the Brazilian currency.

This posed a threat to the competitiveness of Brazilian industrial exports. The tax on foreign purchases on the stock and bond market adopted since 2009 is intended to reduce the risks associated with these inflows, notably currency risk, and increase monetary policy space. Evidence suggests that these controls have shown some effectiveness in slowing capital inflows and reducing currency appreciation. The sudden reversal in flows in mid-September provides lessons both on why preventive action was prudent, and on the ability of macroeconomic policy to control or influence.

Liberalisation, 1998 crisis, aftermath

In the early 1990s Brazil began liberalisation of trade and finance to simultaneously stabilise prices and create a market-based economy. Although the reforms were successful in reducing inflation and attracting investment, they were also responsible for the expansion of the current account deficit and increase of financial volatility that pushed the country to the 1998-99 crisis.¹⁰⁴

The opening of the capital account together with high interest rates attracted speculative capital which suddenly fled the country in 1998, due to the uncertainty and contagion generated by the Russian default and the Asian financial crisis that year. This sudden capital outflow precipitated a financial crisis and forced the government to float the currency, the real, in order

* This box is based on Breaking the Mould: How Latin America is coping with volatile capital flows. Please see <http://www.brettonwoodsproject.org/breakingthemould/> for the full details of the Brazilian case study.

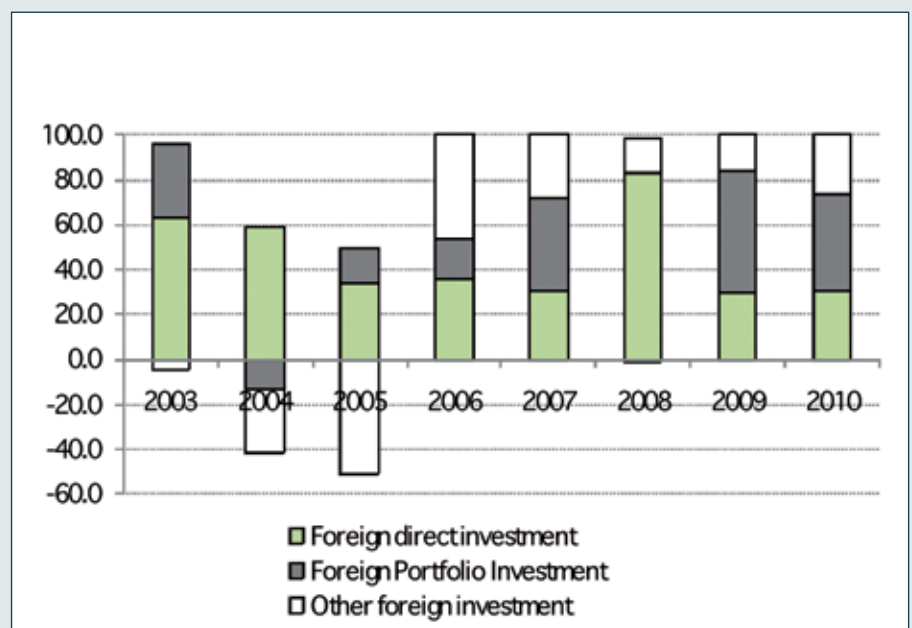
to avoid a complete depletion of its foreign reserves. In 1999 Brazil abandoned its crawling peg exchange rate system and implemented an inflation targeting monetary policy.

The Brazilian strategy contributed to stabilising the general price level with steady growth, though at lower rates than in neighbouring countries.¹⁰⁵ This strategy also contributed to attracting an important amount of foreign capital, consisting of both long- and short-term investment, which increased the country's exposure to external shocks, especially to the risks associated to volatile capital flows. Between 2008 and 2011 short-term investments, known as carry-trade flows, flooded the country, taking advantage of high interest rates. The flows artificially inflated the value of the real, which appreciated by 46% in relation to the dollar between late 2008 and August 2011 (see Graph 5), posing a threat to the competitiveness of Brazilian industrial exports.¹⁰⁶

Capital account regulations and their effectiveness

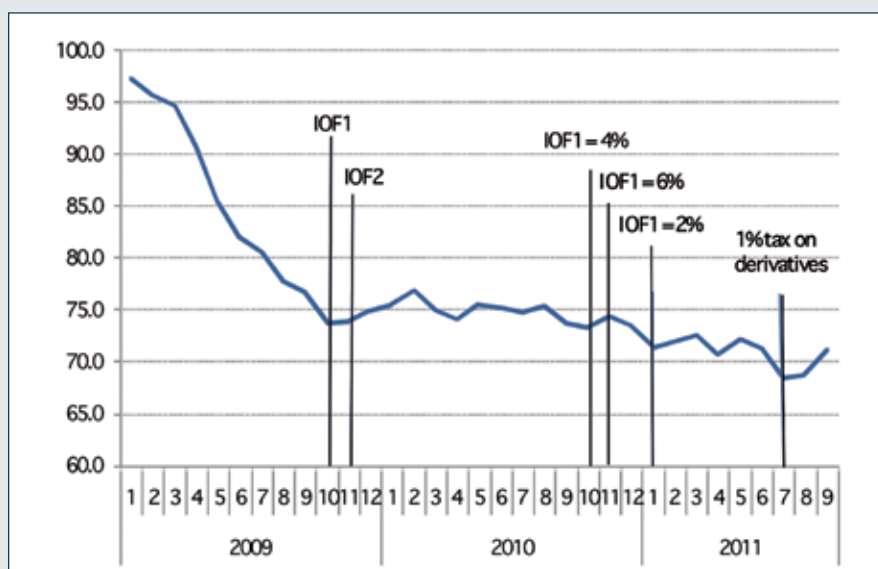
In October 2009 during a surge of inflows, the government established a 2% tax on foreign purchases of stocks and bonds, later named IOF1 (Imposto sobre Operações Financeiras), in order to stop unwarranted exchange rate appreciation. Finance Minister Guido Mantega explained that taxation of foreign capital inflows has a regulatory role, not a revenue-raising one, aiming to balance the inflow of foreign capital in the Brazilian economy and stop the rising value of the real against other currencies. Pressures on the exchange rate were softened after the IOF1 was announced and implemented.¹⁰⁷ However, it was also observed that there was space for evasion. Because of this, in November 2009, the government introduced a 1.5% tax on the sale of foreign deposits in the country, called IOF2 to differentiate it. In October 2010 the government increased the IOF1 tax to 4%. Secretary of the Treasury Arno Augustin said the IOF sought to dissuade short-term investors from speculating on possible exchange rate vola-

Graph 5. Composition of foreign capital inflows (%)



Source: Banco Central do Brasil

Graph 6. Brazil - Effective Real Exchange Rate (index, 2000 = 100)



Source: Instituto de Pesquisa Econômica (IPEA)

tility, as well as to attract long-term investments. However, after three weeks the government declared that these measures did not sufficiently curtail exchange rate appreciation. They announced subsequent increases in the IOF1 tax levels to 6%. Finally, in December 2010, the government decided that tax rates would be reduced, starting in January 2011, to a 2% rate.

In a statistical analysis Kevin Gallagher, professor at Boston University, finds evidence that the taxes implemented in Brazil in 2009 and 2010

“are associated with a lower level of appreciation and an eventual slowing of the rate of appreciation.” He also found that the controls were effective in increasing monetary policy space.¹⁰⁸ Interestingly, Gallagher finds that the effectiveness was stronger when the IOF rate was increased to 6%. These findings, he says, coincide with statements from fund managers complaining that “the appeal of the carry trade had diminished considerably” after the 6% tax, “especially for investors trading on timescales of less than a year.”

Other initial assessments also prove some effectiveness of the controls. In July 2010, after concluding its Article IV consultation, the IMF declared that the tax implemented in 2009 appeared to have an impact in

slowing capital inflows.¹⁰⁹ Similarly, Eduardo Levy Yeyati and Andrea Kiguel, researchers at Torcuato Di Tella University, analysed the impact of the IOF1 and found that the Brazilian real “depreciated about 1.1% with the introduction of the tax and another 0.9% percent the following day as the market digested the measure, but the effect was partially undone later on. All in all, their exercise indicated that the IOF depreciated the currency by roughly 1.2%.”¹¹⁰

A relevant question to ask about the capital inflow taxes is if the tax rate is high enough, or if higher tax rates would be more appropriate.

In the current context of large capital inflows and high profits in the financial sector, it does not seem likely that further regulations or taxes will create balance of payments problems or a shortage of capital. Furthermore, the incentives and benefits received by short-term investors remain too large to be discouraged by a 2% tax. High interest rates are complemented by tax exemptions on the earnings of foreign investors that purchase public debt.¹¹¹ Implemented in 2006, these benefits encourage short-term investors. A comprehensive macroprudential framework would help to address these incentives.

Evidence of the continued volatility of Brazilian financial inflows was in abundance in September 2011. At the end of August 2011, in order to stop currency appreciation the central bank reduced its benchmark interest rate by 0.5%. This move, in combination with increasing global economic uncertainty due to the euro-zone crisis, generated a sudden reversal of capital flows. In the subsequent month, the real depreciated 14% against the dollar and forced the Central Bank to intervene for first time in two years in order to support the value of the currency rather than hold it down.¹¹²

The case of Brazil shows clearly how speculative, short-term investments can destabilise an economy and how pragmatic policies can help insulate a country from crises. The IOF is part of a pragmatic approach to reducing currency speculation and protecting the economy from external shocks, and also addressing the restrictions on monetary policy space in the context of open capital accounts. These taxes appear to have had some effectiveness in discouraging unwanted short-term flows, helping moderate further appreciation of the exchange rate as well as increase monetary policy space. Furthermore, the destabilising impact of the sudden reversal of flows experienced in September 2011 would have been clearly stronger in the absence of regulations. The main concern of policymakers and researchers is related to the impact this speculation and currency appreciation might already be having on industrial capacity and employment. Although recent work by the IMF on capital controls recognises their role in supporting the stability of the financial system, it leaves stability of the real exchange rate out of its analysis. The risks of not taking into account the latter are many, especially since the negative effects of exchange rate appreciation on production and jobs manifest gradually, and when they appear they may be hard to revert.

particularly short-term, thus gaining additional room for monetary-policy manoeuvre. An early elimination of the encaje during the capital inflow surge would have boosted the inflows still further, thus aggravating macroeconomic imbalances. An intensification of the encaje, however, would have had limited marginal effectiveness due to circumvention and the bound imposed by short-term inflows, already close to zero.”¹⁰⁰

Similar results are found for experiences with these types of taxes in Brazil, Colombia, Croatia, Malaysia, and Thailand, regardless of methodology used to study their effectiveness.¹⁰¹ Sometimes called speed bumps, these measures can help screen out capital flows from sources which are prone to flight, and this improves the stability and quality of capital inflows. This can actually help increase the inflows of stable, long-term investment as exchange rate and other risks will be deemed to be lower in a country with prudential capital account management measures in place.¹⁰² A recent attempt to look at cross-country effectiveness of capital controls on inflows along the lines of the Chilean experience argues that “Capital controls on inflows seem to make monetary policy more independent, alter the composition of capital flows, and reduce real exchange rate pressures (although the evidence there is more controversial). Capital controls on inflows seem not to reduce the volume of net flows (and hence the current account balance).”¹⁰³

Regulatory measures

More recent in the evolution of different kinds of capital account restrictions are targeted regulatory measures on certain elements of risks in the financial system. As we saw in Chapter 3, when financial sectors were deregulated in both rich and developing countries, a series of financial crises erupted through a number of different mechanisms. In some cases these were assets bubbles, such as overvalued property markets which went bust. In other cases, they have been the result of self-fulfilling confidence

“macro-prudential” regulations are both prudential rules to try to control risk but also macroeconomic in scope and not necessarily targeted at the stability of an individual financial institution



Occupy Wall Street Zuccotti Park, 1 Liberty Plaza, New York
Photo Steve Minor (Flickr, CC Share Alike attribution)

crises despite underlying economic strengths. Financial sector deregulation coupled with unregulated capital movement have combined to produce crises.

After direct experience with these types of crises, many countries are now innovating new regulatory measures that tackle the risks involved. These are now often being called “macro-prudential” regulations to emphasise that they are both prudential rules to try to control risk but also macroeconomic in scope and not necessarily targeted at the stability of the individual bank or institution on which they are applied. Given that much of the innovation in regulation in this area has only occurred since 2009, there are few comprehensive studies looking at the application of these tools. And long-term impacts cannot yet be assessed. However the evidence so far shows that these measures can be effective in controlling specific risks.

It is important to note that these types of measures are much narrower in scope than those discussed earlier. As such they end up having less power to alter macroeconomic outcomes such as exchange rates or investment maturities. They are more specific to addressing financial stabil-

Box 5. KIKOs

KIKOs stands for knock-in, knock-out and is a bespoke kind of foreign currency derivative contract. A derivative is a financial contract with a value derived from the value of something else such as an asset or price. It can be used as a means of speculation or a means of insurance. A foreign currency derivative can allow the purchaser to secure a fixed exchange rate; this can help exporters plan ahead and reduce the risk from incurring expenses now in local currency before earning foreign currency in the future.

However, the KIKO, widely sold to small and medium enterprises by banks in South Korea in the run up to the 2008 financial crisis, only ensured against a currency appreciation and depreciation within a set of agreed boundaries. The contracts are nullified in case of a strong appreciation, but in the case of a strong depreciation, the banks can require the contracting business to sell them more than the contracted amount of dollars. This presented a huge downside risk to the exporter in the case of currency depreciation.¹¹⁵

While expectations were for consistent appreciation of the Korean won before the crisis, in just four months in late 2008 the won depreciated by over 50%,¹¹⁶ exposing the businesses that had bought KIKOs to huge losses when the contracts expired. However the losses were not only for the businesses, with the contracts sometimes purchased without firm export orders to support them. As some of the businesses went bankrupt, the banks were left holding the other side of the contract, which had often been insured on international markets for the US dollar. The private banks were thus exposed to very high and unexpected currency risks due to the financial inflows associated with their sale of contract.

ity risks that emerge as capital inflows surge. An IMF staff paper on the topic notes that “in general there will be a multiplicity of risks, and that no individual instrument will have traction against all concerns in most real-world situations,” and thus advises “multiple instruments will generally be required, though the mix will vary by country.”¹¹³

One of the widest used types of these measures is regulation on foreign currency exposure. These may impact on foreign-currency borrowing or on the volume of foreign-currency denominated assets. While individual banks and firms may have incentives to borrow in foreign currencies because of reduced funding costs, the combined

weight of foreign currency borrowing from all domestic companies might overwhelm the ability of the state to provide guarantees or reassure investors that sufficient foreign reserves are available to cover outstanding loans. Thus governments are well advised to control these risks through various types of limits on foreign currency borrowing.¹¹⁴

These kinds of limits can be accomplished via several types of prudential standards applied on each financial institution, such as banks, in the country. They can include regulations on borrowing and/or lending in foreign currencies, sales of locally-issued foreign-currency denominated securities (including derivatives), foreign-currency denominated bank accounts and overall foreign currency exposure. A spring 2011 study by IMF staff members of the effectiveness of these measures across 41 emerging market economies found that the implementation of such measures helped limit the economies’ overall level of foreign currency borrowing and thus risks presented by such borrowing.

Of course regulation is only effective if it can be enforced, meaning that countries must have adequate regulatory institutions in place. Banks and other financial institutions may also try to avoid regulations, particularly by creating and trading in more exotic financial instruments. In 2010/11 South Korea imposed specific limits on foreign currency derivatives because of their heavy use by domestic and foreign-owned banks. This was driven partly by a large trade in ‘KIKO’ foreign currency derivatives, which at the onset of the financial crisis ended up bankrupting many small and medium-sized businesses (see Box 5).¹¹⁷

The Korean Central Bank took action in June 2010, by limiting the volume of foreign currency derivative contracts to 50% of a domestically-owned bank’s capital base. Restrictions were also put in place on foreign-owned banks use of derivatives, but at a much higher level of 250% of the capital base, given that their parent companies could cover the foreign exchange risk. Korea hoped to limit short-term debt denominated in foreign currencies.¹¹⁸ Initial evidence suggests that they were successful.¹¹⁹

5. Hurdles to effective capital account management

Despite the grave social risks involved (discussed in Chapter 3), international provisions for dealing with capital account management are scattered and a comprehensive overarching global framework does not exist.

The extensive liberalisation of capital accounts, witnessed over the past three decades, has been assumed under a broad range of international legal obligations, including the OECD Code of Liberalisation of Capital Movements, the Treaty on the Functioning of the European Union, the WTO's General Agreement on Trade and Services, and several thousand bilateral or regional investment treaties or free trade agreements with investment chapters. In this section, we will examine some of the policy hurdles faced by countries seeking to apply the tools discussed in Chapter 4. Only with these hurdles in mind will we be able to consider how the international financial architecture can change to enable development.

IMF surveillance, conditionality, and advice

The IMF has been one of the key proponents of liberalised capital account regimes. While enjoying a comprehensive mandate to deal with payments related to the current account, largely meaning the trade in goods, the Fund's role in relation to capital accounts is far less specified. Yet it has not only demanded liberalisation as a condition of loan programmes, it has also provided intellectual leadership for the liberalisation pressures of the 1980s and 1990s. The IMF at its founding was filled with economists who subscribed to the Bretton Woods system and believed that controlling capital flows would help bring stability to the international financial

system. However, over time the character of the Fund changed, as a vanguard of staff members brought in their faith in the theoretical arguments described in Chapter 2. The belief that full capital account liberalisation was the best possible system became entrenched in IMF staff thinking.¹²⁰

In the late 1990s, IMF management and several major shareholders tried to amend the Fund's statutes to explicitly require unrestricted financial movements. This approach, part of the then-ascendant belief in the infallibility of unfettered markets, was supported both by Fund staff and major shareholders such as the US, UK and France.¹²¹ It was only stopped because of the awful consequences of the Asian financial crisis in 1997-8 and subsequent contagion to other emerging markets. This emboldened developing countries to oppose the move.

Despite never reaching agreement on the issue, the Fund has promoted capital account liberalisation in its surveillance and lending operations.¹²² This runs counter to the spirit of the IMF Articles of Agreement which actually allow the IMF to force countries to manage capital accounts rather than liberalise them. The IMF Articles of Agreement guarantee the rights of members to use capital control techniques. While the IMF members are generally required to avoid restrictions on current payments, that is payments generally related to ordinary trade, they must also "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."¹²³

There is, in fact, an entire Article (VI) devoted to capital transfers, which clearly shows that the IMF's mandate includes advising, and even sometimes requiring, countries to use capital controls to prevent "large or sustained outflow of capital", namely financial crises of the type seen in many emerging markets. The Article even forbids the use of Fund resources for financing such outflows and states that if "a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund."¹²⁴



(November 16th, 2009) **Hundreds of taxpayers rallied outside the Goldman Sachs DC office** to deliver a letter for their CEO, Lloyd Blankfein, demanding he forgo paying out its multi-billion dollar bonus pool and instead use that money to help the millions of families facing foreclosure. Washington, DC Photo 2009 Kate Thomas / SEIU (Flickr - CC Share Alike attribution)

The IMF has promoted liberalisation of the capital account or argued, both publicly and in private, against specific instances of capital account regulations. The 2005 IEO evaluation of the IMF's role found that "The IMF's analysis prior to the mid-1990s tended to emphasize the benefits to developing countries of greater access to international capital flows and to pay comparatively less attention to the potential risks of capital flow volatility." From the mid-1990s, staff analyses began clearly to advocate capital account liberalisation. Concurrent with the initiatives to amend the Articles to give the IMF an explicit mandate for capital account liberalisation and jurisdiction on members' capital account policies, management and staff expanded the scope of the IMF's operational work on capital account issues in Article IV consultations and technical assistance in an effort to promote capital account liberalisation more actively.¹²⁵

As part of the discussions on how to enhance global financial stability after the 2008 global crisis, the IMF has reconsidered its role in relation to capital account management. Despite several Fund papers that were accepting of the useful-

ness of capital account regulations, the policy framework put forward by the Fund in February 2011 was overly cautious on the appropriateness and timing of using capital account management measures. The Fund only recommended such measures as a last resort option once all other macroeconomic policy tools had been exhausted.¹²⁶ However, developing countries have domestic needs that should take priority above accommodating the spillovers from financial policies in rich countries.

Professors Stephany Griffith-Jones and José Antonio Ocampo, both of Columbia University and Kevin Gallagher of Boston University, released an issues paper calling for an alternative approach. It summarises the discussions of an independent task force on capital flows management that also included former Reserve Bank of India deputy governor Rakesh Mohan. They argue that IMF "prescriptions fall short of being sound advice for many developing countries" and instead capital account regulations "should be seen as an essential part of the macroeconomic policy toolkit and not as mere measures of last resort." They propose a set of guidelines for the use of



such regulations, and call for the IMF and other global bodies to “make a stronger effort to reduce the stigma attached to capital account regulations and protect the ability of nations to deploy capital account regulations to prevent and mitigate crises.”¹²⁷

World Trade Organisation

Negotiations at the World Trade Organisation (WTO) also have a significant impact on capital account management options because of existing agreements and future negotiations. The WTO has a General Agreement on Trade in Services (GATS), which entered into force in 1995, and covers trade in all manner of intangibles. Already under Article XI of GATS, no restrictions are to be applied by a member country on international transfers and payments for current transactions relating to its specific commitments. Additionally, under GATS there was a schedule for financial services liberalisation to free up trade in financial services across borders.

WTO member countries were asked to pledge commitments for liberalisation. These commitments would by default require greater capital account liberalisation because the country would need to allow inward investments for the purposes of ‘establishment’. Establishment would in this case be the setting up of a financial institution like a bank.¹²⁸

Because of the treaty-based nature of the commitments under GATS, they become hard to change when the need arises. According to Chakravarthi Raghavan, expert in trade negotiations at SUNS – South-North Development Monitor, “At best, then, the GATS route is one for progressively moving towards capital account convertibility, but with every step in that process becoming an irreversible one.”¹²⁹ While not

all countries have liberalised trade in financial services, some did so with insufficient protections or exemptions in place, for example on the health insurance sector¹³⁰, and rich countries are pressing for further liberalisation.¹³¹ There is also a worry that there is much ambiguity over a provision in the GATS annex on financial services allowing for “prudential measures”, as the agreement also specifies “Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement.”¹³²

In the discussions on the current round of trade negotiations, rich countries tabled the so-called Singapore issues, or new issues that they wanted included in the next round. One of these was trade and investment, and was pushed by rich countries, particularly in Europe. The negotiations would have been on how and when to liberalise foreign investment, which again would have required commitments from all WTO members on how to reduce barriers to investment, including capital account restrictions. The disagreements on these issues, as developing countries opposed their inclusion in the trade negotiations, were one of the reasons why there was a failure to progress trade negotiations in Cancun in 2003.¹³³ While efforts to include these issues were resisted by the developing countries, there is a risk that

they will return to the agenda in future rounds of negotiations. Instead, campaigners have argued that countries should be allowed to roll back existing commitments under GATS.¹³⁴

Bilateral agreements

While the policy hurdles contained in the GATS and IMF policy advice are significant, they are arguably less stringent than the ones contained in bilateral agreements covering investment. Bilateral investment treaties (BITs) have been negotiated for over 50 years and there are now more than 2,800 of them.¹³⁵ They complement a number of other types of international investment agreements (IIAs) which include free-trade agreements (FTAs) with investment chapters.

The total number of IIAs has grown to over 6,000.¹³⁶ These types of agreements bind two countries into a legal and enforceable agreement on rules governing investment. However, because they usually include most-favoured nation clauses, the provisions granted under a BIT or other IIA to any one country will apply to all countries with which there is an agreement in place.

These agreements usually contain provisions for freedom of payments on both the current account and the capital account in order to facilitate investment and reassure investors. The treaties cover both inflows and outflows, as protection is given to the inward investment and outward profit repatriation. They also include enforcement mechanisms allowing investors to take governments to binding arbitration to enforce the treaty obligations, and are difficult to break, as withdrawal from a treaty usually takes 10 years to come into effect. The US BITs are some of the most extensive and stringent and contain strong provisions against the use of capital account regulations.¹³⁷

In late January 2011, more than 250 economists sent a letter to the US government expressing concern “regarding the extent to which capital controls are restricted in US trade and investment treaties”. The letter states that “given the severity of the global financial crisis and its aftermath, nations will need all the possible tools at their disposal to prevent and mitigate financial crises. ... New research points to an emerging consensus that capital management techniques should be included among the ‘carefully designed macro-prudential measures’ supported by G-20 leaders at the Seoul Summit.”¹³⁸

BITs/FTAs are particularly problematic because of the large number of them have been signed and the inability for countries to modify their provisions.¹³⁹

In the EU, the recent Lisbon Treaty moved authority over investment agreements to the Eu-

ropean regional institutions. This means that, as of December 2009, EU member states should no longer be negotiating individual BITs with other countries, as the agreements should be conducted by the EU as a whole¹⁴⁰. For now there is still disagreement in the EU over how this will be implemented, with questions over the status of existing BITs.¹⁴¹ For the EU, increasingly invest-

ment is being included in FTAs – called economic partnership agreements (EPAs) for those being negotiated with countries in Africa, Caribbean and the Pacific – that are being negotiated with developing countries. Warnings have been made that that these contain specific commitments forbidding capital account management by the

countries signing them with the EU.¹⁴²

An analysis of the EU EPA with the CARIFORUM group of Caribbean countries finds that “the parties undertake to impose no restrictions on the free movement of capital relating to direct investments and the liquidation and repatriation of these capitals and any profits stemming therefrom. Thus, the EPA, like most other North-South FTAs, facilitates the maximum opening, deregulation and liberalisation of financial flows.”¹⁴³

Looking at this example of EU trade policy, researcher Myriam Vander Stichele concludes, “Such rules prohibit countries to have the necessary flexibility to prevent a financial crisis or to act during times of financial crisis.”¹⁴⁴

Other multilateral agreements – Lisbon Treaty and OECD Code

There are also multilateral arrangements that seek to force the liberalisation of capital movements and these can potentially harm developing and developed countries alike. The most widespread and enforceable of such multilateral arrangement is the Lisbon Treaty of the European Union. Its Article 63 enforces open capital accounts across the European Union and requires that EU members not restrict capital account transactions with other countries as well.¹⁴⁵ Of course, the banking crisis that started

Bilateral investment treaties (BITs) usually contain provisions for freedom of payments on both the current account and the capital account in order to facilitate investment and reassure investors.

in 2008 and in 2011 has turned into a full-blown financial crisis has been impacted by this provision. Greece had steady massive capital outflows from its banks during the crisis in 2011.¹⁴⁶ Those countries like Greece within the eurozone are not able to take measures to reduce capital flight from debt markets or banks in their territories. Along with many other problems being experienced in the eurozone, the Lisbon Treaty provision complicates potential measures to deal with the crisis.

The OECD was created in 1961 and in the process its members agreed to a Code of Liberalisation of Capital Movements.¹⁴⁷ The code is not a treaty and does not create the same kind of obligations as the Lisbon Treaty, but it does create an expectation that OECD members will fully liberalise the capital account. The code did not require immediate liberalisation, but set that as the end destination and described a pathway for member countries to follow. The OECD says it enforces the code with “peer pressure”.¹⁴⁸ However some short-term flows were excluded from the code until 1989. Then the French government dropped its opposition to the sweeping liberalisation that would now be included in the code, and virtually all financial flows between OECD members would now move freely.¹⁴⁹

Both the OECD Code and the Lisbon Treaty would be hard for their members to break from. The Lisbon Treaty especially makes it very difficult for the EU to consider new, pragmatic financial stability rules or capital account regulations that could benefit both Europe and developing countries being impacted by large scale capital movements.

Political interest groups

What is it that has caused the above institutions to adopt the policies they have? Several scholars have studied these policies in the international sphere, finding that there is a trend of policy diffusion which is influenced by the evolving composition, beliefs, and strategic agency of the staffs of the relevant institutions.¹⁵⁰ Additionally, the

impact of balance of payments crises opens opportunities for great changes in policies that may not have occurred without a crisis. These crises present opportunities for the potential winners from opening the capital account to join forces with political leaders looking for quick solutions, such as an influx of investment to help relieve a balance of payments deficit.¹⁵¹

However, once countries have moved down the path of deregulation, it is very difficult to re-regulate again. The policy hurdles described above are in place to prevent countries from returning to the use of the previous policies. These policy hurdles have similar origins in the political economy of the most powerful countries. Removing pragmatic tools of regulation from the hands of policy makers can actually benefit a number of small and unrepresentative interest groups in rich countries, as well as some interest groups in developing countries.¹⁵²

Once countries have moved down the path of deregulation, it is very difficult to re-regulate again.

It is not surprising that the US and UK were the leaders of the global movement to prevent policy makers from using these pragmatic and effective tools. They have the strongest financial sectors with significant influence in the political sphere. Both

Wall Street and the City of London have greatly benefited from the speculation and volatility that has been generated by this movement towards volatile and uncontrolled financial flows. However many countries benefit from the convoluted mechanisms by which cross-border flows are allowed. The beneficial tax arrangements of certain jurisdictions, such as parts of the US and countries like Luxembourg and the Netherlands, thrive on the removal of regulations on international financial flows.

In the wake of the 2009 financial crisis many questions were asked about both the financial regulations adopted in the US and UK and their use by the regulators. Financial sector regulation was subject to a great degree of regulatory capture, with the regulators blindly accepting the assumptions, models and preferences of those they are regulating.¹⁵³ Likewise, the international institutions responsible for watching over imple-

mentation of financial regulation have failed in their task. The IMF's own evaluation office said the institutions work in the run up to the crisis was "hindered by a high degree of groupthink, intellectual capture, a general mindset that a major financial crisis in large advanced economies was unlikely, and inadequate analytical approaches."¹⁵⁴

Indian economist Jayati Ghosh argues that similar regulatory capture was in play when it came to cross-border financial flows. She describes how powerful financial institutions in the US and the UK were constantly looking for new profit opportunities and as developed country financial markets experienced growing liquidity and reduced returns on capital, they sought to expand into emerging markets.¹⁵⁵ This preference extended across rich countries over the course of the 1970s, 1980s and 1990s. By the time of the Asian financial crisis erupting in 1997, the countries that would make up the G20 had, by and large, moved towards freeing up their capital accounts and financial sectors. Only India and China, the two biggest nations by population, had any significant regulations still in place. Even India was in the middle of a programme of liberalisation that seemed on track to take it the direction of the other countries that would make up the G20.

Now the balance may be shifting in terms of the approach of governments. Argentina made a complete U-turn as a result of its financial crisis in 2001, abandoning the orthodox theoretical approach in favour of a more pragmatic approach that allowed it to return to growth and a course of poverty reduction.¹⁵⁶ South Korea and Brazil experienced their own capital account crises around the turn of the millennium. In the wake of the most recent financial crisis, when in 2008 they again experienced sudden stops and reversals of capital inflows, they have now firmly moved to more pragmatic approaches, expressing scepticism towards the dogma of leaving

financial flows unregulated. Similar scepticism has been expressed by other large emerging markets and many smaller developing countries. When developing country policy makers prioritise their own stability and domestic development over the desire of footloose international investors, they can start work together to return sensible regulation to use. Because the intellectual and empirical evidence is so strong in favour of the pragmatic and cautious approach, the consensus for liberalisation is weaker than might be expected.

Regulatory capture was in play when it came to cross-border financial flows. Powerful financial institutions in the US and the UK were constantly looking for new profit opportunities and they sought to expand into emerging markets.

Of course the politics of placing more regulation on financial flows will run up against strong opposition from financial sector interests. Other opponents will also come forward, for example wealthy people in developing countries who have used the trend towards fully unregulated capital accounts to shift their assets into tax havens or secrecy jurisdictions. Financial sector and other interest groups, who demand deregulation out of self-interest and who generally do not pay the costs of financial crises thanks to 'bail-outs' by allies in government, will have to be countered. As citizens in rich countries begin to demand that their own governments stop prioritising financial interests above social interests, they can counter this political pressure. Their demands for greater regulation will be favourable both to their own domestic economic situation but also to developing countries. While there are political hurdles to the adoption of pragmatic regulations, developing countries need not wait for global coordinated action.

6. Multilateral or bilateral approach

One of the clearest problems is that financial flows are now so international and so ubiquitous (as seen in Chapter 2) it is difficult to imagine the transition to a system by which they can be more regulated.

Mindful of the large risks associated with opening of the capital account, and the potential benefits of regulation (Chapter 3), most of the measures presented in Chapter 4 are available for unilateral implementation. There are, of course, constraints on the effectiveness of these tools for some countries. There are also consequences both for the country concerned and for other countries integrated into the international financial system. This section argues that more international coordination and removal of the hurdles discussed in Chapter 5 would help developing countries deal with financial flows more effectively.

Unilateral action and consequences

Unilateral action has been limited for decades because of the dogmatic pursuit of liberalisation. However the financial crisis has brought these pragmatic tools back in use. However their use does have consequences. There is a potential for both unwanted domestic impacts, such as reduction in credit availability, and for speculators and investors to simply shift their investments towards other countries, territories or sectors. First, it is important to recognise that the playing field is not level when it comes to international capital flows. While many middle-income countries have experienced capital flow bonanzas for decades, for low-income countries increases in private capital flows only gained strength more recently. However these flows have been just as volatile relative to the size of the economies involved and have generated crises without much

attention being paid to them.¹⁵⁷ However, low-income countries and smaller economies just do not have the same capacity to implement capital account regulations. This may be a matter of administrative capacity, or it may be because of the structure of the domestic financial system. For example, countries with a banking sector that is predominantly foreign owned will have a much more difficult time making and enforce prudential regulations to manage the risks of financial flows. Importantly, the small size of many developing countries means that some of the more nuanced and calibrated measures discussed in Chapter 4 could easily be swamped by nominally small volumes of flows from rich countries. The financial fire power of rich world investors is orders of magnitude greater than the counter measures that many countries could use.

Additionally, there may be unwanted domestic side effects from implementing new capital account regulations. While there is evidence on reduced credit availability to smaller firms in developing countries that have used capital inflow controls¹⁵⁸, these small side effects are possible to remedy with other tools at the disposal of governments. Publicly owned or backed financial institutions are able to use their balance sheets to bolster credit to targeted firms, including those in particular sectors or of certain sizes. Many developed countries already operate many policies to target credit availability to smaller enterprises, for example the UK government's Project Merlin agreement¹⁵⁹ with private sector banks to support small businesses. Similarly private sector development finance institutions such as the World Bank's International Finance Corporation (IFC) or the European Investment Bank, offer loans to banks in developing countries that could be used to provide credit to small businesses.

There is no evidence that the side effect of unilateral management techniques is to shift 100% of the financial flows into other countries. In the case of price-based controls, such as the taxes Brazil implemented, some will continue regardless. Some flows will be changed into longer maturity flows or into FDI rather than portfolio flows, or into other tools to circumvent management techniques. An additional portion would

stay in the origination country and be redirected into other investment vehicles. Finally, a proportion is likely to be redirected into a third country. Some economists might call these spillovers from the capital account management tools put in place. This would be an unfair characterisation, as the management tools are usually a response to spillovers from policy in the origination country. Often, the policies in the source country of the international financial flow have somehow stimulated the flow. This could be through a low interest rate policy or quantitative easing (essentially printing money) adopted in the context of an economic slow down. Or it could be due to deregulatory efforts, or other changes in financial sector policies. Those actions are also taken unilaterally, and usually without consideration for the potential international consequences.

The most recent empirical evidence by the IMF on the potential spillovers to third countries from the capital flow management shows them to be limited. In some cases the flows increased to neighbouring countries, however in other cases they decreased.¹⁶⁰

The IMF's first Consolidated spillover report examining the effects in other countries of the policies of five globally important economies – the US, China, the UK, the eurozone and Japan – was released in September 2011. It acknowledges that a tightening of US monetary policy (by for example raising interest rates) “will reverse the rise in emerging market capital inflows and currencies”, or, said the other way around, the loose monetary policy in the US contributed to generating those capital flows in the first place.¹⁶¹ Further empirical research from the IMF finds that “the influence of monetary policy in major advanced economies on world interest rates suggests that they may have significant effects on capital flows to [emerging market economies].”¹⁶²

Given the above discussion, there are two distinct possibilities on how the world can more effectively deal with the volatility and riskiness of capital flows. Unilateral measures of course have their place, but will also face limits. The first option would be to address the volatility and risks of capital flows at their source. A second option

would be to implement coordinated solutions in the recipient countries to strengthen their effectiveness. Ultimately a combination of the two, particularly combining them through agreement by all parties, would be the most effective.

Source country policy

Given that the flows often originate in a few jurisdictions, with the US, eurozone, and the UK accounting for nearly 70% of total outflows in 2010¹⁶³, policies in these countries should be carefully considered. Leading developing country policy makers, including the finance ministers of South Africa, India and Brazil, have demanded greater discussion of policies taken in source countries.¹⁶⁴ Finally, the IMF executive board discussed the topic in mid November 2011, but on the table were only limited efforts at finding a solution.

The IMF found that macroeconomic, particularly monetary, policies and financial sector regulation in rich countries had important implications for capital flows to developing countries. The IMF stressed that it was not only the size of flows that were effected, but also their riskiness. Yet, after looking at the evidence, the IMF, by and large, did not propose significant measures for rich countries to take. It backed a rhetorical commitment that “National prudential authorities should be mindful of the risks associated with the cross border activities of the markets and institutions in their jurisdictions and be prepared to take measures to address them.”¹⁶⁵ However, the IMF executive board did not take the step of asking rich countries to actively consider the impact on developing countries of their monetary policy choices. And while the IMF board did agree that better financial regulation in rich countries would help, the IMF has yet to propose specific policies that would mitigate the risks.¹⁶⁶

As described in Chapter 4, capital account management tools can apply on both capital inflows and/or to capital outflows. Developed countries that are the source of flows could apply some of the measures discussed on outflows from their jurisdictions. In fact, Professors Stephany Griffiths-Jones and Kevin Gallagher argued this

year that this would actually benefit the US economy.¹⁶⁷ This is not without precedent, though in a very different international financial environment, as the US applied an interest equalisation tax in the 1960s to try to deter capital flight. The measure, established in 1963, ran for 11 years and taxed the purchase of both debt and equity in foreign jurisdictions.¹⁶⁸ This is analogous to the taxes on capital inflows that have been implemented in a number of developing countries. A tax on outflows is not the only sort of measure that could be applied to outflows. Rich countries could also implement something like a URR which would be an indirect tax.

There are many other possibilities when looking at financial regulatory policy. It would be possible to put controls on the foreign currency exposure of financial institutions, much as the prudential regulations adopted in South Korea sought to do. As US-based but globally operating financial institutions play some part in a significant portion of capital flows, such a measure in the US could be very beneficial to developing countries. Financial regulations being proposed in rich countries, like leverage ratios or liquidity ratios, could also be modified to try to disincentivise short-term outflows while rewarding long-term, productive investment that is conducive to sustainable development. The measures could be designed to target short-term, speculative flows, while encouraging long-term investment in developing countries that are short of capital. As outflow measures have not recently been applied in countries with such deep and sophisticated financial centres as the US and UK, careful study would need to be made of the design and fine-tuning of the measures to avoid regulatory evasion. However, concerns will be raised about disadvantaging the competitiveness of what in some countries, especially the UK, has become an important sector of the economy in terms of export revenue. These arguments by special interest groups will have to be overcome by publicly motivated actors in those countries.

Any such measures would need to be designed in conjunction with developing countries, to ensure that they would not create problems by curtailing needed investment. Such joint design should take place in a forum that is trusted by both parties and with governance that is considered fair,

democratic, transparent and accountable. However, declines of private sector flows that might result from source country regulations could be offset by more and better delivered public finance. Aside from meeting aid commitments, rich countries could support the expansion of publicly owned national and regional development banks. Like aid delivery frameworks, many of these banks also need root and branch reform of their governance and policy frameworks to make sure that their investments truly serve the needs of poor and vulnerable people as well as respect environmental sustainability. However, given the market failures observed in Chapter 3, there is a strong argument for using public finance to fill the gaps that might be created by attempting to better manage fickle private finance.

Desire for coordinated solutions

With both source and destination country policies, there are potential unintended consequences. These may be domestic in nature, or they may be international giving rise to the need for more global and regional coordination over policies of financial flows and capital account management. Evidence from past financial crises is that contagion is often a regional phenomenon. Likewise, institutional investors or speculators may have a regional framework built into their investment mandate. This makes regional coordination of policy a wise place to start.

Regional arrangements can be put in place that coordinate similar kinds of management tools to be used across a region. This is likely to enhance the effectiveness of the tools put in place as well. The additional advantage of a regional framework is that there are often already institutions in place that can serve as venues for negotiations to coordinate such policies. A prime example of this sort of initiative is in East Asia, where the Association of South East Asian Nations (ASEAN) plus Japan, Korea and China, in a formation called ASEAN+3, has taken steps to enhance regional financial cooperation. Their work on a regional reserve pool to help insulate member countries from crisis and a regional bond market initiative have been preliminary steps to pragmatic regional financial cooperation.¹⁶⁹ The ASEAN+3 space could likewise be used to coordinate joint regulations.

Such collective action in international financial policy is difficult to achieve, as evidenced by the trend for deregulation in order to attract foreign investment.¹⁷⁰ Building on the trust built up in such forums as ASEAN+3 could radically change the scope for developing countries to implement pragmatic tools. In Latin America, on top of the trade body Mercosur, a number of regional bodies are being developed, including a regional reserve pooling arrangement and a new regional development bank. Regional cooperation through these kinds of institutions could start with learning and sharing of experience. However a more ambitious approach would seek to prevent unwanted spillovers and enable smaller countries, which might not have sufficient ability to act alone, to also benefit from capital account management policies. In this configuration a regional body could negotiate and agree measures to be implemented jointly, much like a customs union jointly sets tariffs. In the case of taxes on inflows, revenue from the taxes could be shared using the same sorts of formulas that customs unions use.

International and cross-regional coordination should also be considered. The IMF is the logical venue for this to take place, but the institution is not trusted by many developing countries after their negative experiences of the preceding decades. IMF governance reform, including of the system for selecting top management, would bolster trust and the ability to use it as a venue for coordinating capital account management tools. The experiences of the last five years have shown unwillingness by rich countries to cede control of the IMF's governance, but the continuing evolution of global geopolitics and the financial crises engulfing Europe bring the possibility for faster reform.¹⁷¹

Consideration of a global framework

Consideration needs to be given to a coordinated global agreement on capital account management techniques, including on enforcement regimes. This is not beyond the realm of possibility, as such a framework was agreed at Bretton Woods in 1944.

Most importantly there needs to be agreement on helping to enforce management techniques

effectively through information sharing and joint action on violators. There exists a strong will to crack down on money laundering and countering the financing of terrorism as evidenced by the AML/CFT programmes set up in the early part of the century. Similar efforts need to be made on financial flows that seek to evade legal restrictions in place in source or destination countries.

These are financial crimes with real social impacts and should be treated as such. A first step in such a battle against evasion would be much better data on financial flows. Currently there is very little comparable data on financial flows, and poor standards for collection and sharing of this information. Rich countries are already experimenting with information gathering and exchange on the tracking of asset ownership of their residents for the purposes of cracking down on tax evasion. The EU Savings Tax Directive is the most comprehensive multilateral effort to share information on financial flows, in this case bank deposits.¹⁷² Having real-time data on cross-border financial flows to help reduce the risks from volatility should be seen as best practice that all countries should follow.

A more ambitious global framework agreement could reinforce mutually consistent management techniques across source and destination countries.¹⁷³ It would require significant negotiation and international agreement, but should be approached sooner rather than later. The interest groups in rich countries that have benefited from liberalisation will be strong opponents of any such new agreement, so public oriented actors such as civil society and NGOs will need to mobilise in favour of such a new global agreement. It can form part of a wider new global economic order that tackles the problems of poor global economic governance¹⁷⁴, global imbalances, the asymmetric international monetary system, and persistent tax avoidance and tax evasion¹⁷⁵. The arguments in favour of such a new system are broad, and include the benefits to be derived for citizens in the EU and other rich countries, however the development angle should be stressed. Financial policies pursued in rich countries need to be coherent with development goals and solidarity with the poorest and most vulnerable should be demonstrated.

7. Recommendations and conclusions

Developing and developed countries would benefit, and stability would be enhanced, by the adoption of pragmatic approaches to macroeconomic policy and cross-border financial flows.

This report has shown how the size of flows and their volatility have grown. It has also explained the massive risks they pose to countries in the form of financial crisis, and how those crises have severe economic and social impacts. There are tried and tested tools available for capital account management. Countries need the space to implement these regulations, including assistance in preventing evasion and fine-tuning them to meet their needs and promote national development goals. However, there are hurdles and political obstacles that need to be overcome. These will not be overcome on their own, given the vested interests at stake. Citizens must demand that their governments take action. Civil society organisations and social movements are vital pressure points to see political change. Responsible actors in the financial sector also need to organise themselves to support this agenda. Politicians should recognise that their political future is dependent on preventing crises and taking action.

In the short term:

1. **Civil society groups need to recognise that reforms to the management of international financial flows and the underlying structure of the international financial system are important to the achievement of development goals and demand change.** Policy change is not a technocratic exercise but a political one. Special interests that benefit from the current system, despite the system's great flaws, are well placed to lobby against change. Only with pressure from the public will reform be possible.



Occupy London 2011
Photo Luca Manes

2. **Policy makers in developing countries should not fear regulation of the capital account and need to think more proactively about the costs as well as the benefits of different kinds of capital flows.** The old paradigm – to do whatever is necessary to attract footloose foreign capital – should be abandoned in favour of a more balanced and pragmatic approach. Each country should design macroeconomic policy related to the capital account to best suit its own domestic needs while keeping in mind the potential international ramifications.

3. **The IMF needs to accept that capital account regulations can be desirable at any time. Once it has accepted this and demonstrated a more pragmatic approach, it can work with countries to help them design the best techniques to fit their desired policy goals.** The Fund should not demand that capital account management techniques are a last resort after cutting spending or changing monetary policy. Developing countries have domestic needs that should take priority above accommodating the spillovers from monetary and financial policies in rich countries. A truly reformed IMF could be well placed to work with both source and recipient countries
4. **Policy makers and relevant international institutions need to create of a system of international data sharing and analysis to help police existing and new measures to regulate financial flows.** This can be modelled on the AML/CFT effort and would need to be done in an automatic and transparent way. To make the data useful, greater information about the true source, purpose and beneficiary of flows would need to be gathered. This would also complement efforts to crack down on tax evasion and avoidance.
5. **Developing country policy makers need to be encouraged, especially by their own citizens, to begin working in regional configurations to coordinate capital account management.** Moves have already begun on regional reserve pools in both Latin America and Asia, and this should be seen as a natural complement to such policies.
6. **Rich countries need to commence serious discussions with developing countries, at the IMF or elsewhere, on how source countries can effectively contribute to the stability of financial flows that enhance development prospects.** Source countries need to implement agreed measures expeditiously.
7. **Existing treaties, such as the Lisbon Treaty in the EU, which already looks like it needs to be renegotiated, should be amended to remove requirements for capital account liberalisation.** This is not equivalent to re-imposing capital controls overnight, but should be viewed a precautionary measure so that countries have the entire range of available macroeconomic and prudential policies in their toolkits should they need them.

In the medium-term:

5. **Rich and developing countries need to coordinate to remove the policy hurdles resulting from investment treaties and free trade agreements.** This will require goodwill from parties to these agreements to renegotiate them to ensure the freedom for countries to pursue prudential policies that can help them meet development goals and prevent financial crises. New agreements can be made, or carve-outs from existing agreements can be strengthened, to ensure capital account management techniques are allowed. There needs to be an end to financial services liberalisation demands in WTO negotiations and an agreement to roll back the existing demands on financial services liberalisation under the GATS annex of trade agreements so that countries have more freedom to pursue prudential policies.

The parlous states of financial systems have imperilled the well-being of people across the globe. This has intensified in the last five years, with dramatic affects on the poor and marginalised. Behind these financial systems are a set of rules that institutionalise the unregulated movement of money across the world, despite there being no evidence that this benefits people and plenty of evidence that it contributed to the risks of crises. It is time for a new consensus, one in favour of pragmatic policies that will seek to channel financial flows for the benefit of people, especially those in developing countries. Given the occurrences of the last few years, it is clear that while the hurdles may be high, achieving finance that works for development is not beyond our reach.

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