INTEGRATION OR FRAGMENTATION?
INTERNATIONAL CAPITAL FLOWS IN
THE POST-CRISIS WORLD

Interventions from the 2019 OECD-G20
High-Level Seminar
Integration or Fragmentation? International Capital Flows in the Post-Crisis World

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Foreword

This collection compiles the contributions of senior policy experts, academics, and economic practitioners on developments in the financial integration and financial regulation of cross-border capital flows since the 2008 global financial crisis, at the OECD High-Level Seminar “Integration or Fragmentation? International Capital Flows in the Post-Crisis World” held in September 2019.

Great hopes were pinned on global financial integration as a tool for growth and economic development, yet the contemporary view of the benefits and risks associated with openness to the global capital market has become more nuanced, particularly in light of the 2008 financial crisis which highlighted the presence of some distortions and vulnerabilities affecting the proper working of the financial system. The openness of the financial system has to be matched with sound domestic policies and with an international framework on capital flows that ensures transparency, trust, rules-based mechanisms, and co-operation, and that minimises information asymmetries. This type of international framework can help countries maintain market confidence and continue to attract the long-term, high-quality capital needed to support growth.

The OECD’s Capital Movements Code, the sole multilateral agreement among states dedicated to openness, transparency, and mutual accountability in capital flow policies, has provided such a framework for over 50 years. The revised Code, adopted in 2019, has strengthened the instrument and adapted it to current requirements for capital flow management. The updated Code addresses current challenges, is more efficient and transparent, and has closer links to other International Organisations, in particular the International Monetary Fund. Following a call by the G20 FMCBF in 2016 for G20 countries that had not yet adhered to the Code to consider adhering, taking into consideration country-specific circumstances, several G20 countries have started the process of adherence to the Capital Movements Code. The 2018 report by the G20 Eminent Persons Group (EPG) notes that the OECD Capital Movements Code offers an aspiration for all G20 countries moving towards greater liberalisation of capital flows at a pace and sequence in line with a country’s circumstances.

In addition to its crucial role as the only legal instrument of its kind, the Code provides value through its peer-exchange and peer-review mechanisms. These allow countries to learn from one another, and enshrine the principles of transparency and mutual accountability that are essential to international co-operation.
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Welcome address by Angel Gurría, OECD

An uncertain global outlook

As we meet today we are faced with a very fragile economic outlook. Global growth has slowed, and the prospects for a rebound have weakened in recent months. Deepening trade tensions have left global trade volumes stagnating and are increasing uncertainty. This is taking a toll on investment and weighing on sentiment in financial markets.

In part as a result of this, gross international capital flows are historically weak, at around 1% of GDP currently. This means that they are lower – in absolute (US dollar) terms, not just in relation to GDP – than they were pre-crisis. Among advanced economies, capital flows are even back to their mid-1990s levels.

The OECD Code of Liberalisation of Capital Movements

The OECD Code of Liberalisation of Capital Movements has been helping us to tackle some of these challenges. It is the only multilateral agreement between states that guarantees openness, transparency and mutual accountability in capital flow policies. For more than six decades, the Code has been used to promote international dialogue on capital mobility. The Code can therefore be considered a "global public good", acting as a conflict avoidance device.

We recently completed a thorough revision of the Code. The revised Code is better adapted to the current requirements of capital flow management of both advanced and emerging economies.

It also provides countries with the flexibility needed to respond to financial stability concerns linked to large capital inflows and outflows without diluting the high standards of openness that it promotes. Moreover, the revision gives the Code stronger governance and transparency, as well as a decision-making capacity, while also providing for closer cooperation with other international organisations.

Tackling emerging policy challenges through the Code

Looking ahead, the Code will be important in helping us to assess numerous emerging policy challenges and developments in the current financial environment. Let me mention just a few.
The post-crisis period has seen a more diverse and uncoordinated use of various financial policies, including capital flow management measures. Such measures tend not only to increase fragmentation globally, but also give rise to cross-border externalities; for example, barriers in one country deflect capital to other countries. Importantly, the Code provides a platform for multilateral co-operation to discourage countries from adopting policies that may be harmful globally.

Another trend, in the opposite direction, is the gradual capital account opening of major emerging economies. The requests by Brazil, South Africa, and others to adhere to the Code are a clear sign that it provides a useful framework for countries’ efforts in that direction. I hope – and trust – that in the future a broader set of countries will be able to rely on the revised Code as they move towards greater capital account openness.

Another relevant issue is shifts in the make-up of our financial sectors. The post-financial crisis regulatory agenda has improved the resilience of the banking sector. There are signs, however, that risks may be shifting to non-bank actors, including shadow banks and institutional investors as well as the non-financial corporate sector, which has seen a boom in leverage in recent years. In the United States, for example, shadow banking is roughly the same size as the formal banking sector; and in the euro zone, it grew by almost 40% between 2012 and 2016. We need to carefully consider whether risks are building up in these unregulated corners of the financial sector.

Finally, looking forward, we need to ask how we can we take international co-operation on capital flows to the next level. I personally think that multilateral co-operation can still be deepened. In this respect, the participation here today of other relevant IOs, including the IMF, the BIS and the Financial Stability Board, is a step in the right direction.

The Code has been guiding us for over 60 years; we are confident that the revised Code will continue to steer our efforts in removing barriers to the movement of capital, while helping us to tackle economic and financial instability.

Today’s discussions, as well as those that we hold regularly in the Advisory Task Force on the Codes, are crucial in helping us to find solutions and achieve consensus on some of the most pressing issues in the international financial architecture.

Angel Gurría
OECD Secretary-General
Welcome address by Yoshiki Takeuchi, Japan’s Ministry of Finance

Capital flow is one of the key components of sound and vibrant economies, and high quality discussions among distinguished experts like you would ensure that we have the right set of policies on capital flows.

Taking this opportunity, let me express my sincere gratitude to the OECD for having helped our G20 in Fukuoka from various aspects. In particular, as you may know, capital flows have been the agenda of the G20 for years, and Japan, as the current presidency of the G20, had the honor of celebrating the revision of the OECD Code of Liberalisation of Capital Movements in Fukuoka. G20 leaders then welcomed the revision in Osaka. It was one of the major achievements under our presidency.

Two Approaches: the OECD Capital Movement Code & the IMF’s Institutional View

In opening my speech, let me reiterate the importance of the Code. It is the only binding international norm on liberalisation of capital movement. For 60 years since 1961, it has served as the driver and guardian of liberalisation.

Of course, even with its long-standing critical role, the Code alone cannot ensure orderly international flows of capital. There are other frameworks that work with the Code and jointly achieve the shared goal. Let me name one example here: the IMF’s Institutional View. The Code and the Institutional View play similar but distinct and complementary roles.

- The OECD Code is a binding international agreement among adhering countries to progressively lift barriers to the capital flows. As such, adherence to the code also comes with strong signaling effect. A country could show to the market its firm commitment to liberalise capital flow. That would attract more capital inflows and international investment.
- The IMF’s Institutional View, on the other hand, serves as a guideline to ensure consistency and evenhandedness of IMF advice on the economic appropriateness of capital flow management measures. In particular, the IV clarifies the conditions to allow countries to impose capital flow management measures. As such, it covers all the IMF members, whereas the Code is primarily for limited number of capable and willing countries.
Given these similar but distinct rules, we believe that the Code and the IV complement each other. Of these different mechanisms, the Code’s role is to show to the world and market the high standards that countries should meet when liberalising capital flows.

We therefore strongly support the continuous review and upgrading of the Code to adapt to the rapidly changing environment. That brings us to the main theme of today: revision of the OECD Code.

*Liberalisation of Capital Flows: Benefits and Risks*

In reviewing the Code, we need to bear in mind that the liberalisation is a means to an end, which is orderly international movement of capital that supports sound economic growth. Of course, liberalisation of capital flows is generally beneficial for both source and recipient countries through improving resource allocation across countries. The prospective benefit of liberalising capital flows include: cross border risk-sharing, accelerated development of domestic financial systems due to greater competition and policy discipline. These would ultimately help enhance growth and welfare.

At the same time, it also carries risks. The key challenge for countries is how to harness the benefits while managing risks.

The principal risks of liberalising capital flows stem from the vulnerability to sudden stops and financial crisis triggered by currency and maturity mismatches.

*Global Financial Crisis, the review of the OECD Capital Movements Code and the G20*

Indeed, the unprecedented accommodative monetary policies in large countries after the Global Financial Crisis in 2008, and the subsequent normalization have exposed a number of countries to large capital inflows and their reversals. Naturally, these countries have introduced capital flow management measures in response to severe balance of payment and banking crisis. We consider such measures should be justified when combating imminent crisis or tackling the uncertainty due to the surge.

Let me give you a couple of examples:

- During the GFC, some countries couldn’t countervail capital outflows, leading to exchange depreciation. Generally the depreciation works as a shock absorber, but it further deteriorated economies when there were huge foreign currency denominated debts of households, banks and governments. Exchange rate depreciation made it harder to service these debts, thereby accelerating further capital outflows. In this case, temporary measures might be allowed. (Iceland)
• After the GFC, source countries implemented unprecedented accommodative monetary policy. Very low interest rates in advanced economies led to a surge of capital inflows to developing and emerging economies. Monetary policy responded with lower interest rate to avoid currency appreciation, but the lower rate led to housing boom. In this case, the authorities might be allowed to decrease loan-to-value ratio, by currency if necessary (Thailand, Malaysia).

These measures, however, could be regarded as violating the OECD Code. That is the reason why we decided to clarify the treatment of capital flow management measures, in particular macro-prudential tools, under the OECD Code.

The G20 and the G20 International Financial Architecture Working Group had served as the platform to discuss how to upgrade the code, adapting to the current environment of international capital markets. Thanks to the fruitful discussions that many of you have contributed to, the Code was successfully revised. It is now more efficient and robust in dealing with risks of capital flows. For example, liquidity ratios like the Basel III type NSFR (Net Stable Funding Ratio) and LCR (Liquidity Coverage Ratio) differentiated by currency are now clearly outside of the scope of the code.

The sequencing of capital flows liberalisation and Japanese experience

Upgrading the Code is an important step, but given its role as the high standard, expanding its coverage is also important. We therefore welcome that several non-OECD countries have started the process of adhering to the Code.

Of course, not all countries are ready to adhere to the Code. We need to consider country specific circumstances and take appropriate steps. Let me take Japan as an example. The code has helped Japan attain robust and continued economic growth.

It is often said that there are two strands of the sequencings for liberalising capital flows, “Gradualism” and “Big Bang”. Japan took the “Gradualism” as many European countries such as France and the Netherlands. We gradually removed restrictions on longer term flows. That is, we first allowed FDI (foreign direct investment) and business related flows before money-market operations and purely financial flows.

The giant leap for Japan is the OECD membership in 1964. After joining the OECD, we had started liberalising capital flows along with the OECD Capital Movement Code. Japan accelerated the process of de-regulating the internal investment and opening Japan’s business markets. Capital outflows by Japanese companies were also gradually allowed. In April 1970, we allowed security companies to incorporate foreign bonds and equities to investment trusts. Then, we orderly de-regulated the foreign investment, from insurance companies to individual investors until November 1972.
Thereafter, Japan continued to liberalise capital flows. It took almost thirty years to have liberalised major restrictions in Japanese economy. During the period of de-regulation, we experienced very high rate of growth. Of course, this is only an example, and I understand that there is no one-size-fits-all approach for liberalising capital flows. However, I hope countries draw some lessons from our experience.

In closing my remark here, let me once again emphasize the importance of capital flow liberalisation. In normal times, countries can reap benefits and cope with risks of capital flows by implementing sound macroeconomic policies including monetary, fiscal and exchange rate policies. Capital flow management measures should not be used to substitute for or avoid macroeconomic adjustment. Japan has placed great importance on the capital flow liberalisation along with the OECD Capital Movement Code. That helped to achieve robust economic growth.

As I mentioned earlier, the Code has worked and will work as a strong signal for countries’ commitment to liberalise capital flows. The important thing here is to continuously discuss issues surrounding capital flows and revise the Code as and when necessary. I hope that you will have fruitful discussions today and continue to make productive discussions, which will help us maintain the central role of the Code in supporting our growth and welfare.
Intervention by Laurence Boone, OECD Chief Economist

My intervention covers three points: i) the current state of the global economy, ii) the policy challenges ahead, and iii) highlight, especially in this context, the usefulness of instruments of international co-operation like the revised OECD Codes of Liberalisation.

The global economic situation

We are meeting at a difficult juncture for the world economy: the global outlook has become increasingly fragile. GDP growth has slowed in many economies, global trade growth is very weak. Our current assessment points to a downgrading in global GDP growth forecasts, likely to be reflected in our updated Interim Economic Outlook published on 19 September. And risks are biased on the downside, including continuous escalation in trade restrictions, uncertain prospects in China, the rising risks of a no-deal Brexit, and financial vulnerabilities from the tensions between slowing growth, high debt and deteriorating credit quality. Meanwhile, productivity growth has been trended down for decades, while ambitions to implement structural reforms have faded, contributing to holding back growth.

Increasing trade disputes have been lifting policy uncertainty for a while now, taking a rising toll on confidence and investment, and weighing on risk sentiment in financial markets. As trade restrictions multiply, they are hitting consumers more and more. In parallel to tariff measures, we also see the use of trade-distorting subsidies increasing, even more strongly. Both disturb value chains, trade flows, investment and ultimately weaken current and future growth.

For the global economy to function well, these tensions need to be tackled. Nobody wins a trade war. We need more open, more transparent and especially more stable rules of the game.

As trade and financial flows are complementary, the weakness in international trade is affecting international capital flows, which in turn is reflected into higher exchange rate volatility. In part, this should happen naturally, as the exchange rate is expected to absorb some of the impact of higher tariffs, but trade wars may induce governments to resort to active exchange rate management. Where countries carry out such policies, and others do not, then “beggar-thy-neighbour” outcomes may ensue, resulting in long-term distortions. In addition, such active exchange rate management may not even provide the expected short-term benefits, as recent BIS research1 demonstrated:

1 Bruno, Kim, Shin (2018) - Exchange Rates and the Working Capital Channel of Trade Fluctuations
if foreign trade flows are not very price elastic, for instance due to widespread invoicing in foreign currencies, exports will not increase.

Another channel we will discuss today, is the link between finance and investment. With trade tensions focussing on tariffs and quotas, some countries may consider capital controls as a mean to reduce current account imbalances. Yet, capital account restrictions create important distortions too, as decades of research have highlighted. Trade and investment are two sides of the same coin. For example the importance of trade finance in supporting global trade has kept growing.

All these channels show that individual countries movement on tariffs, exchange rate or restriction of capital flows may be more detrimental than helpful, especially in the long-run.

_The policy challenges_

As you all very well know, we live in an interconnected world, where business cycles in one country affects the economic situation of others. The contribution of international factors to fluctuations in equity prices, bond yields, and GDP growth has dramatically increased over time. For advanced countries, international factors have passed to explain 47% of the variance of GDP growth in the 1990s to close to 70% in the last 10 years, as recent OECD research demonstrates ⁴.

Such a degree of interconnection creates challenges, but also responsibilities to all. Keeping global trade, financial channels and markets open contribute to ensure productive investment, maintain liquidity and help diversify risks. Global openness is ultimately a public good, of all governments.

Protectionism not only harms the country implementing it, it also has negative spillovers on others. Tariffs, currency manipulation, and capital controls create negative spillovers on other economies. In this field, the famous tale of the butterfly flapping its wings in one place and causing a tsunami in the other end of the world may be true: for example, following the tightening of capital controls, the riskier and more volatile capital is deflected to similar economies, which do not have such controls, as OECD research highlights ⁵. Such short-term “beggar-thy-neighbour” actions may have domino effects that weaken the global financial sector resilience, especially as they usually come from countries refraining from implementing reforms needed to redress imbalances.

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OECD members and the G20, as the prime forum for international economic cooperation, share a responsibility to protect open markets and to resist harmful trade and financial protectionism. That is why, and this will be my third and last point, multilateral frameworks like the Code are so important: by subscribing to the Code’s disciplines, countries, not only enhance domestic growth and resilience, but also commit to put more weight on the long-term benefits of openness for themselves directly, and for others. It is a double benefit as it contributes to lift global growth relative to the potential short-term boosts of inward-looking policies. In this respect, rules-based multilateral instruments allow for reflection, and an overall assessment of policy measures, that benefit everybody in a sustainable way.

That is also why multilateral fora, like this one which has existed since 1961, are crucial: steps to reduce trade barriers and capital controls can help to restore a transparent and rules-based system and reduce uncertainty. International fora may also facilitate necessary policy coordination in the context of global spillovers. This is the case for monetary policy, for fiscal policy, and the OECD Codes of Liberalisation provide biannually such a forum with regards to capital flow management, through the Advisory Task Force.
CHAPTER 1 - MARKET FRAGMENTATION, FINANCIAL FRAGILITIES, AND CROSS-BORDER SPILLOVERS OF FINANCIAL REGULATORY POLICIES: HOW TO TACKLE COLLECTIVELY THESE POLICY ISSUES?

Cross-border financial positions more than tripled as a share of world GDP between the mid-1990s and the global financial crisis, bringing the global economy to an unprecedented level of financial integration. However, increased integration has changed the strength and transmission channels of external shocks and macroeconomic policies. Several policy challenges have intensified since the post-crisis period: first, increasing market fragmentation and a rise in non-bank intermediation; second, financial fragilities stemming from the banking system, as well as the corporate sector; third, new sources of spillovers to countries and to different segments of the financial system. As a policy response to these broad challenges cannot happen at an individual country level alone, establishing and fostering international standards and rules of conduct, along with continued transparency and dialogue, remains essential to build up resilience.

Key questions discussed in this section are:

i) how are global financial integration and vulnerabilities evolving in the post-crisis period?

ii) how can international co-operation help address emerging global challenges?

iii) how can international standards such as the revised Capital Movements Code help strengthen the potential gains from cross-border integration?

1.1. Intervention by Dietrich Domanski, Financial Stability Board

Market fragmentation has been a focus of the FSB’s work in 2019. Drawing on this work, and the June 2019 FSB report on market fragmentation in particular, I would like to comment on the role that international cooperation can play in addressing the risk of harmful market fragmentation.

Less regulation does not necessarily mean less fragmentation

The starting point is to understand the relationship between regulation and market fragmentation. Does less regulation mean less fragmentation? Not necessarily so.
Take international bank lending. Developments since 2008 suggests that regulatory reforms in response to the financial crisis have been supportive of global financial integration.

At the start of 2008, at the height of the financial crisis, banks’ cross-border claims stood at $35.5 trillion. They dropped by about $6.5 trillion, or almost 20%, within one year. Since then, cross-border claims have steadily recovered. The latest figures, for March 2019, show such claims standing at $30.5 trillion globally, close to 2007 levels. And in some regions, notably developing Asia and Pacific, cross-border claims more than doubled, to $2.1 trillion compared with $0.8 trillion at end-2007.

More stringent regulation was a precondition for restoring integrated financial markets. Policy measures aimed at containing systemic risk and strengthening the resilience of the financial system, were key to restoring confidence in internationally active financial institutions in the aftermath of the crisis. In other words: without the increased trust engendered by the reforms there was a real risk of deepening fragmentation of the financial system.

Looking beyond international banking, the FSB’s last annual report from November 2018 concluded that global financial integration continued in recent years. In particular non-financial corporates, have increasingly accessed international debt markets and holding of cross-border securities have been growing. Global financial infrastructures, such as central counterparties that clear over-the-counter derivatives in more than one jurisdiction, have gained in importance.

Identifying instances where regulation may contribute to harmful fragmentation

The relationship between market fragmentation and regulation is complex. Some types of market fragmentation can be seen as a by-product of measures to improve domestic resilience. Such fragmentation can, for instance, be the result of cross-jurisdictional differences in regulations and supervisory practices that reflect domestic policy mandates and responsibilities. In places, such fragmentation of markets can have a positive effect on financial stability. It can reduce the transmission of economic shocks between jurisdictions, and increase the resilience of domestic or global financial markets. Measures that provide reasonable certainty to financial institutions’ host jurisdictions can also help encourage cooperation in a stress, avoiding more harmful forms of intervention at these times.

But there may be instances of ‘unintended’ fragmentation, potentially with adverse consequences for financial stability. Fragmentation may limit opportunities for cross-border diversification and risk management, impair market liquidity or prevent capital
and liquidity from being channelled to where it is needed in periods of stress. Such market fragmentation may reduce the efficiency of cross-border investment and risk management, and thereby increase costs faced by end investors through inefficient resource allocation.

The challenge is to identify and address harmful fragmentation. Recognising this challenge, the FSB report on market fragmentation does not attempt to assess the significance of market fragmentation in specific areas or evaluate possible effects on financial stability or market efficiency. Instead, the report lays out approaches and mechanisms that may enhance the effectiveness and efficiency of international cooperation, and help to mitigate any negative effects of market fragmentation on financial stability.

Addressing market fragmentation through more efficient and effective cooperation

The FSB report highlights the importance of a coordinated international response to fragmentation in the financial system. This includes steps to consider issues around market fragmentation at different stages: as policies are developed; as they are implemented; and when they are being evaluated.

As regards the development and implementation of international standards, the FSB proposes to consider the issue of market fragmentation more prominently and systematically during the standard-setting process. This could be done, for instance, through formal and informal consultations with public and private sector stakeholders, or by providing clarification of specific technical aspects of standards where appropriate and well ahead of their targeted implementation date. This might help reduce unintended differences in the implementation of standards at the jurisdictional level, without constraining jurisdictions’ flexibility to adapt standards to local needs.

Ongoing cross-border communication and information sharing are key. It is important to discuss issues around fragmentation regularly in existing international fora. Cross-border cooperation and information sharing have improved with the establishment of supervisory colleges and crisis management groups, as well as bilateral arrangements in particular in relation to information exchange. Early dialogue, where practicable, of planned national regulatory initiatives can facilitate more efficient addressing of issues. Equally, supervisory fora can be used to align and improve data collections, an issue highlighted as a concern by firms. For example, templates, data models and definitions used to gather data from firms could be shared, compared and – where appropriate – aligned to enhance consistency and understanding across authorities.
Greater comparability of regulatory regimes across jurisdictions can help reduce the risk of market fragmentation, enhance the efficiency of regulation and oversight and facilitate decisions about recognition or deference. Supervisory cooperation supported by the use of memoranda of understanding (MoUs) may help promote the adoption of compatible and comparable regulatory requirements. To help promote this, the relevant standard-setting bodies could, over time, consider developing a central repository of such MoUs. Deference can be a useful tool to reduce the fragmentary impact of inconsistent regulatory requirements. Authorities, with the support of the FSB and standard-setting bodies, could enhance the efficiency of deference or recognition processes through a range of actions.

*International cooperation is key*

G20 Leaders recognise the economic benefits of an open, integrated financial system, and the post-crisis reforms were designed to promote continued integration. Promoting integration is an ongoing task in an evolving environment. Regulatory reform is moving on from policy design to implementation. And the financial system is evolving, not just due to regulation, but also due to technological innovation and changing economic circumstances. That the G20 Leaders welcomed the FSB’s work on market fragmentation and committed to address unintended, negative effects is a strong signal about the importance of preserving integrated markets, and the important role that international cooperation plays in this regard.
1.2. Intervention by Benoît de Juvigny, France’s Autorité des Marchés Financiers

Compared to my esteemed colleagues of the panel from the FSB, Swiss Treasury or central bank of Brazil, as a securities market regulator, we approach this from a slightly different angle as we look much more at the correct application of legal frameworks for financial markets participants. We also try to find the right balance between investor protection by providing adequate safeguards and the need to have the right set of rules for market participants to finance the economy.

To answer the difficult question of this panel, I will start by examining the core question of the “integration or fragmentation” of global markets, before assessing the coming challenges and the tools we can use to face them.

1) Global financial integration or market fragmentation?

Following the great financial crisis, we have seen an unprecedented momentum at the highest level to regulate the financial system. During the successive G20 summits after the downturn of 2008, Leaders agreed to an ambitious agenda of reforms to be implemented in their jurisdictions in order to tackle the identified shortcomings and some of the more structural weaknesses of our financial system in order to make it both safer and sounder.

Against that backdrop, we can identify/observe two intertwined trends in the implementation of international standards which are still at stake today:

First, the work we have achieved so far, helped us to reach an unprecedented level of financial globalisation despite an important slowdown due to the financial crisis. As you know and as we saw during previous crises, countries tend - usually and unfortunately - to adopt national measures, which are insufficiently coordinated and can lead to an even worse output. On the contrary, the G20 was instrumental in coordinating most important economies’ actions and to take countercyclical measures and develop an important agenda of reforms, which has been largely implemented over the past 10 years.

Overall, these reforms have enhanced the resilience and transparency of our financial system. At the same time, we have obviously seen a reduction in crossborder activities in the aftermath of the crisis. As pointed out by my colleagues around the table, it has been more pronounced for the banking sector. However, when I look at the asset management industry, crossborder activities have been growing steadily and I do not really see a reduction in capital flows, on the contrary.
The second trend I wish to point to regards the fragmentation of markets, or as the Japanese G20 puts it the “market fragmentation” issue. While adopting similar frameworks, jurisdictions have tried at the same time to adapt these rules to their respective specific features in order to preserve certain aspects of their economies and financial systems. In doing so, these new rules which aimed at increasing financial integration have sometimes, lead to market fragmentation. Several drivers can be identified such as:

- Regulatory burden – jurisdictions adopting specific rules which diverge from one another, create additional burdens for market participants;
- Competition – fragmentation can create opportunities for regulatory arbitrage, unfair competition and protectionism, in that sense, the need for a timely and consistent adoption by all jurisdictions is crucial;
- Local market and sovereignty – In order to avoid certain rules’ detrimental effects and also to compensate for unintended consequences, jurisdictions can adapt these rules to their financial market architectures.

These divergences create market fragmentation, but can be mitigated up to a certain point. They can indeed become a threat to global financial integration when they lead to harmful unintended effects or create significant problems. This sort of market fragmentation that we wish to identify and attenuate as much as possible, while carefully weighing the pros and cons of regulatory intervention.

2) Looking ahead: cooperate at early stage

The G20 financial reform agenda is very well advanced and most of the key standards are fully implemented by all jurisdictions. However, new challenges have emerged: data protection, sustainable finance and fintech/crypto assets to name just some. The current standard setting bodies i.e. The FSB, CPMI-IOSCO and the Basel Committee, as well as the G20 and G7 as political entities can help us to better address these issues. To be efficient and facilitate market integration at the same time as capital flows, it is important that on these new topics, the standard setting bodies, when possible, cooperate at an early stage in order to avoid diverging approaches or at least by keeping them to a bare minimum.

3) Reacting: using what tools?

As an example, in the EU we have put in place tools to facilitate capital and investment flows. Over the years, the EU has developed one of the most open regional market with a dedicated framework. Some of these tools are dedicated to the internal market
and other are designed to facilitate third-country financial institutions’ access to the EU market.

- within the internal market, it is possible for certain types of institutions and under certain conditions to use passporting rights. This tool facilitates the distribution and marketing of financial products.
- As for external market players, we have put in place equivalence and recognition systems, which allow third-country financial institutions to gain access to our market as long as they respect EU rules or have similar rules.

These mechanisms are playing a key role in enhancing and deepening EU financial markets.

To come back to the core issue our debate tries to address, which are capital and investment flows, I would first stress that the initial step is to define the principles and standards that should govern these flows. They are the foundation for smooth and easy access to our respective markets. However, once these standards have been reflected in our regulatory framework, it is important to check how they are implemented and applied by all parties. In that context, several tools can envisaged notably the use of peer reviews.

At IOSCO level, we can mention the use of peer reviews on IOSCO 3 objectives and 38 principles. To recap, IOSCO objectives are:

- investor protection;
- to ensure that markets are fair, efficient and transparent;
- systemic risk reduction

As for the principles, which are based on the 3 objectives, some specifically concern regulators, others concern issuers, credit rating agencies, market intermediaries, asset managers and funds, as well as and among others, markets and clearing and settlement.

Together with the FSB, IOSCO is also looking at/studying/observing market fragmentation. After the report to the G20 Finance Ministers and central banks governors last June, IOSCO will further study the matter and include it as a regular item of its annual workplan and therefore keeps a close eye on this issue. Other tools can be also mentioned such as bilateral cooperation, supervisory colleges or Multilateral Memorandum for Understanding (MMoU), which provide a framework for cooperation between IOSCO members. The aim of these tools are mostly for supervisory or enforcement purposes, but also help to facilitate the movement of capital.
As a conclusion of my preliminary statement, I would stress that as a securities market supervisor, the reforms adopted so far have made our financial system more integrated thanks to the common standards we have transposed in our jurisdictions and it has allowed market participants to facilitate capital flows.

1.3. Intervention by Alexander Karrer, Swiss Federal Department of Finance

The phenomenon of fragmentation of financial markets is multi-faceted and the costs, benefits and financial stability implications are not yet fully understood. Fragmentation means that the cross-border provision of financial services and capital become more costly at best, but can lead to a reduction or a complete shutdown of cross-border flows at the worst.

On the one hand, the debate about market fragmentation is closely linked to the issue of financial stability. To a certain extent, fragmentation can enhance financial stability. Yet, regulation aiming at financial stability can also lead to unnecessary fragmentation – whether this happens intentionally or without intent. There could even be fragmentation that is detrimental to financial stability.

On the other hand, fragmentation can also create inefficiencies for the real economy. It is important to understand the mechanisms of transmission of financial fragmentation on the real economy, especially the effect on global economic growth. This effect can vary between regions and affect various groups differently with implications for financial inclusion.

I think we are far from understanding all these mechanisms. Therefore, I am very grateful to the Japanese G20 Precidency for having put this topic on the agenda. It is certainly timely, at times when we discuss the backlash to globalization.

Trends and origins of fragmentation

In the post-crisis period, global financial integration has been evolving unevenly. In some parts of the world, we have seen increasing cross-border transactions such as in East Asia. In other parts of the world, especially in advanced economies and the Euro Area, certain cross-border activities have decreased. Financial integration has also unevenly developed in terms of activities. On the one hand, some activities, especially when it comes to using third-party providers, e.g. cloud services, or the international nature of blockchain firms make the global financial system more transnational.
Moreover, some international non-bank activities such as international bond issuance have also increased. On the other hand, a decrease can be observed in certain cross-border banking activities. This uneven development is related to the diverse reasons that drive market fragmentation or integration. Whereas some of the decrease in cross-border activities can be understood as a market correction after an excess before the crisis, other changes have been driven by financial market regulation and policies.

Market fragmentations due to financial market policies differ along the policy intention: Some fragmentation can be an unintended consequence of a policy primarily serving other goals. However, some fragmentations can be intended. The intention could aim at issues like financial stability, but it can also simply be protectionism. Others sources of market fragmentation include the extraterritorial application of national regulations, the uneven or untimely implementation of international reforms or incompatible home and host supervisory and regulatory requirements.

Whether intended or not, what we need to address in my mind are negative effects of fragmentation on financial stability and growth. Regarding financial stability, the FSB has published a first report and agreed on a work program, which is highly welcome. Regarding effects on growth and economic development, I believe we are just at the beginning of analyzing the issue and discussing ways to mitigate negative effects from financial fragmentation. This is of course not within the mandate of the FSB and should be addressed by organizations with a wider mandate such as the OECD.

**Remedies to market fragmentation**

Looking for remedies to market fragmentation, international standards should be the first solution to turn to because they have multiple advantages. First, they can set common standards to reach goals such as financial stability, consumer protection or fighting money laundering. Common standards reduce the risk from cross-border spillovers thereby decreasing the necessity for fragmentary policies. Second, international standards can reduce costs for complying with multiple rules in different jurisdictions, making international services more efficient. Third, international standards can limit regulatory arbitrage. Such arbitrage can increase the inefficiency and the instability of the financial system. Therefore, the work undertaken by bodies such as the FSB, the IOSCO or the OECD to reduce market fragmentation is very important. It seems crucial to attain some tangible results and improvements.
Regarding the OECD, the Code on Capital Movements is a very useful tool, even though it has some obvious limitations, notably regarding its enforcement. On a conceptual level, it is useful that at the core of the code is the progressive abolition of restrictions on movements of capital. Additionally, the principle of getting towards liberalisation while at the same time preserving financial stability is central. The recent revision of the code also made it more relevant to current issues such as macroprudential policies and it improved the decision-making process by adopting a consensus-minus-one decision rule. Looking forward, I think there is room to improve the usefulness of international standards from a market fragmentation perspective. First, we should assess the current standards in terms of market fragmentation and address negative consequences. Second, when it comes to new standards, we should reflect their potential effect on market fragmentation already in the design phase.

Further, cross-border cooperation can help reducing market fragmentation. Most importantly, cooperation can lead to trust among authorities from different jurisdiction. Through regular engagement, regulators and supervisors get familiar with the quality of regulation and supervision in another country. They also get to know different concepts and approaches that might lead to the same result. In this perspective, cross-border cooperation seems the basis for cross-border regimes based on deference, equivalence, or alike.

Yet, we do not always live in a first-best world. Not in all areas an international standard or co-operation are feasible. Or, sometimes there is an international standard without creating the expected benefits as its implementation is uneven. Therefore, it seems worthwhile to look also at national regulation. We should analyze whether certain regulations hinder cross-border activities without creating clear benefits. We can estimate if some financial services in our jurisdiction are more expensive than elsewhere and study the underlying reasons. Finally, we should evaluate the effect of regulation on the governance and stability of international firms. These reflections eventually lead to the question whether it would be advantageous to defer to another jurisdictions’ regime, thereby enabling or facilitating cross-border business. If we analyze these questions, each country can find some opportunities to improve the integration, efficiency and stability not only of its own financial market but also of the global financial system.

Work ahead
The G20’s ambition is to maintain “an open and resilient financial system, grounded in agreed international standards”. We should continue working on this ambition through enhanced co-operation between regulators and supervisors. We further need to reduce intended fragmentation to what is necessary to enhance financial stability. Finally, we should eliminate unintended and negative effects of fragmentation from existing national and international regulations. These efforts should contribute to more transparent, efficient and affordable provision of services and capital across borders and enhance financial stability.

1.4. Intervention by Otávio Ribeiro Damaso, Brazil’s Central Bank

We find ourselves 10 years after the Global Financial Crisis. During this period, we have implemented many reforms in our financial systems domestically and globally, in a coordinated fashion at the international level.

Now seems to be a good time to take stock of how our financial systems have evolved, how the global system has been reshaped by the crisis and by our policies, and how we can best plan our next moves together. In doing this, the issue of market fragmentation is critical, as it presents challenges but also new opportunities.

First of all, it’s important to talk about financial integration and fragmentation and about the role of international cooperation in addressing challenges. Then, the role that international standards should be mentioned, such as the revised OECD Code of Liberalisation of Capital Movements, could play in benefitting all.

On the issue of financial integration and fragmentation, new, stronger regulatory standards were implemented and, as a result, the financial landscape has been reshaped domestically and globally.

The changes were numerous but, in a nutshell, there was an overall retreat, a reduction of exposures in non-core activities and areas, and a global refocus to what was more important to each market player business model. As many financial institutions became more inward-oriented and discontinued non-core activities, the result was fragmentation. Financial systems became more concentrated and domestic. This reduced the benefits of openness, which are numerous and must be preserved. Among them, I can name: more risk sharing, a larger supply of funds, efficient resource allocation, and the transfer of technology and know-how.

But that’s not the end of the story.

With the retreat from non-core activities and areas, new opportunities emerged and new players gained relevance. The post-crisis world gave way to the rise of both old and new types of financial intermediaries, such as investment funds and a large variety of fintech firms. New types of financial services and business models entered the stage
to fill the gap left by incumbents. The flip side is that new types of exposures were set up, bringing along new risks and transmission channels without banks at their hub. The rise of non-bank intermediaries is now a reality, both globally and in many domestic systems.

As a result, a new and growing menu of financial services is now available to firms and households.

Brazil is a good example of this pattern. Large, global systemic banks that did not have my country as the core of their business plan decided to downsize their presence there. Brazil’s financial system became more domestic.

However, there were non-bank intermediaries that were searching for yield under unconventional monetary policies and found outlets in Emerging Markets for their investment appetite. New players, such as fintech entities, have in Brazil a large potential to introduce innovations and displace banks’ customer bases. Technology and mobile communications have almost eliminated the barrier to entry that bricks-and-mortar presence represented. Branches are no longer needed to onboard clients, gather assets, originate loans, and/or distribute advice.

One thing the global financial community has learned in these past 10 years is that we can accomplish more by working together. When the crisis struck, the international community came together to address it in a coordinated fashion. First, we strengthened and enlarged the fora for international dialogue and coordination. The G-20 was expanded with the inclusion of Emerging Markets. The FSB was created by enlarging and empowering the old Financial Stability Forum and became a key institution in promoting the reform of the supervision and regulation of the financial system. At the same time, the Basel Committee has gained renewed relevance.

In these international fora, we set up an agenda to reform a fragile financial system. We designed and implemented Basel III, strengthening the quality and quantity of capital and liquidity that our banks hold. We expanded our toolkit with the inclusion of new macroprudential instruments. I find this a powerful piece of evidence that international cooperation can work.

*International cooperation is an ongoing endeavor*

To ensure continued and consistent observance of standards by jurisdictions, we put monitoring mechanisms in place. Our jurisdictions are committed to undergo evaluation exercises. International bodies such as the IMF, the FSB and the Basel Committee now publicly report the status of financial systems and regulations under its various surveillance vehicles. FSAPs, peer reviews and RCAPs became routine in our jurisdictions. We prepare for them, work hard to meet them, and learn lessons from them. This improves our financial regulation and our supervisory approach.
As we face a new landscape of financial services, we must revisit whether our standards are up to the tasks or need to be adapted. Non-conventional financial intermediaries may pose non-conventional risks. Issues such as the rise of fintech and the use of mobile devices to engage in financial transactions, brought to the center stage concerns with cyber risks and the stability and continuity of market infrastructures. The ubiquity of the internet poses a challenge for financial supervisors, for law enforcement agencies, and, most importantly, for international cooperation. Cybercrime is a typical cross-border activity. International cooperation is unavoidable if we are to prevent and address cyber risks.

The new, non-bank financial intermediaries that are arising to fill the gap opened by fragmentation may also pose other risks, such as the operation without bank-based buffers of capital and liquidity. The absence of such buffers implies different market dynamics and pattern of shock propagation. We must find ways to manage and mitigate these emerging threats. Because each crisis tends to be different from the previous, it is unclear how a new crisis may unfold. However, the international financial community must think outside the box jointly and devise new tools, adapted to the new risks to financial stability. International standards are the best vehicle to engrave the new tools and ensure cross-border consistency.

This lead us to the final topic, the role of international standards and the example of the OECD Codes of Liberalisation, especially the recently revised Code of Liberalisation of Capital Movements. The experience in international cooperation of the past 10 years can work as a blueprint for our next steps as we tackle new challenges. As mentioned, international standards and recommendations are the appropriate vehicles to forge consensus and commitments to principles: they set up a benchmark of behavior for regulators and supervisors against which to ensure discipline and a proactive attitude.

The experience we acquired while designing the post-crisis financial standards reiterated the lesson that international standards must meet at least the following two criteria:

(i) provide for the needed harmonization of rules in each jurisdiction in order to level the playing field internationally; and

(ii) be flexible enough to deal with the singularities of each jurisdiction.

We do believe that the Codes, as an agreement dedicated to openness, transparency and mutual accountability in cross-border capital flow management, play a crucial role.

The Code of Liberalisation of Capital Movements recognizes country-specific circumstances and allows policy flexibility so that each country can cope with
situations of financial instability, which is particularly important for emerging economies such as Brazil.

To conclude, in the wake of the crisis, international cooperation was put in motion, international fora were enlarged, regulatory standards were revised and implemented, and financial systems were reformed. The financial landscape has been deeply reshaped in the past 10 years.

The crisis and the policy reaction to it caused financial institutions to retreat from non-core activities and market segments. Fragmentation ensued. To fill this gap, non-bank players emerged, the pattern of flows and exposures shifted, and new risks became apparent. Going forward, as the industry evolves with technological innovation, disruption will be more frequent and the rise-and-fall of business models will be a constant. To deal with emerging concerns, the experience with international coordination undertaken after the crisis might serve as a blueprint.

Now we need a renewed concerted effort to devise the rules and regulations that will make sense under the new context, where digital platforms are conducive to direct contact between savers and borrowers, and where bank-based buffers are of little usefulness to dampen shockwaves.

The international financial community has proven itself able to deliver coordinated and necessary efforts in dealing with challenges. We believe that jointly we can devise the rules that will mitigate risks and allow jurisdictions to reap the benefits of cross-border integration under this new context.
CHAPTER 2. MOVING INTERNATIONAL CO-OPERATION ON CAPITAL FLOWS A STEP FORWARD

The OECD Code of Liberalisation of Capital Movements and the IMF’s Institutional View are the two main existing frameworks on capital flows. As pointed out in a recent report by the Report of the G20 Eminent Persons Group on Global Financial Governance “The IMF’s formal mandate includes only the current account. On the other hand, the OECD, which has a formal mandate to guide country policies on capital flows, does not have universal membership.” The roles and purposes of the the OECD Code and the IMF’s Institutional View are distinct, and the two approaches can be seen as complementary. The IMF is involved in the work of the Advisory Task Force on the OECD Codes.

Key questions addressed in this section are:

i) how could the current framework for assessing and addressing risks from capital account policies be improved?

ii) how can multilateral co-operation among International Organisations on issues related to capital flows be strenghtened?

iii) how can co-operation involve G20 countries that are currently not adherents to the OECD Codes?

2.1. Intervention by Andy Baukol, United States’ Treasury

When we talk about improving and strengthening the current state of international cooperation in the area of capital flows, we are generally talking about two key frameworks, the OECD Code of Liberalisation of Capital Flows (OECD Code), and the International Monetary Fund’s (IMF) Institutional View, and how they interact. We in the United States are not convinced that at this moment it is the best use of our policy-makers’ and international institutions’ time and effort to attempt an overhaul of the current system.

The recent process to review and revise the OECD Code and User’s Guide took two years and just ended, and we do not see a need to do this process again in the near future. In the case of the IMF’s Institutional view, we believe it provides a useful framework for how to evaluate Capital Flow Measures (CFMs), and it represents a hard-won and delicate compromise.
Some have called for improving how the OECD Code and the IMF’s Institutional View interact. For the United States, the Code and the Institutional View serve two different, though complementary purposes. In our view, there have not been problems with inconsistency between the two frameworks. We can think of a scenario, though rare, in which there may appear to be inconsistencies between the two. For example, the IMF found Iceland’s restrictions on capital outflows to be appropriate during its financial sector crisis, whereas the OECD Investment Committee found them to be not in compliance with Iceland’s commitment under the OECD Code. For crisis situations like this, however, the Code already has built-in flexibilities for countries to request derogations and Iceland availed itself of that process. This example shows that the two processes can lead to somewhat different results, but have a consistent message.

If we do not use scarce resources to try to improve the two main frameworks and how they interact at this time, it allows both the IMF and the OECD to devote more time and resources to help countries appropriately liberalise their capital accounts. Countries and international organizations would be better served devoting their efforts furthering international cooperation by demonstrating the best ways to wield the benefits of freer capital flows.

2.2. Intervention by Masamichi Kono, OECD

Since the latest crisis, challenges related to capital flow management and financial stability have evolved, leading policymakers to broaden the policy toolkit available to deal with those issues. In this context, the time was ripe for a review of the OECD Codes. We started such a revision in 2016, and last May OECD Ministers adopted the revised Codes, concluding the first revision in over 20 years. We have successfully completed this task and produced important answers and updates in a number of areas: the review has made the Codes better adapted to current requirements of capital flow management for both advanced and emerging economies. The revised Codes provide countries with the flexibility needed to respond to financial stability concerns, linked to large capital inflows and outflows, without diluting the Codes’ high standards.

The current co-operation setting is working, but it is not perfect and could be further improved. As was mentioned by Laurence, the OECD has a formal mandate to guide country policies on capital flows, but does not have universal membership; on the other hand, the IMF’s formal mandate includes only the current account. As a result, there may be systemically important countries, especially in the EMEs group, which are not legally bound to the OECD Code and which are opening up their capital account with potential consequences and spillover to other economies.
In this regard, key, large EMEs have become increasingly important in today’s global financial system: EMEs produce about 40% of global GDP at market exchange rates, and contributed about two thirds of 2017 global GDP growth. EMEs have accounted for a growing fraction of international trade and international capital flows.

OECD countries have become increasingly exposed to financial developments in large EMEs as i) global financial integration continued, and as ii) EMEs are taking on a larger role in the financial system.

Also, over the last 20 years, spillovers of emerging market asset price shocks to equity prices and exchange rates in advanced and EMEs have risen substantially, and now explain over a third of the return variations in these countries.

Therefore, in my view, co-operation between the OECD and other IOs, and in particular the IMF, should intensify and focus in particular on countries i) which are still in the process of opening their capital account, and, ii) which are also systemically important for the financial system.

On the question whether there is merit in a “rule-based” approach such as the OECD Codes, complemented also with other frameworks, my response is “yes” and let me give some examples of the benefits of having a rules-based instrument as the OECD Codes and its flexibility mechanisms.

First, there is a “standstill” obligation. With some exceptions, the adherents to the Codes are expected not to regress in their efforts to open their capital account. Second, the “rollback” principle – allows member countries to achieve liberalisation progressively through abolishing restrictions over time and in accordance with their individual situation. Other adherents are informed about the reasons why a restriction is considered necessary and may suggest alternative ways in which the country concerned can address its concerns. The Codes’ flexibility mechanisms are embedded in the system of reservations, which can be lodged at any time for short-term operations, and for the invocation of a derogation clause, for restrictions affecting long-term operations. Also, the revised Codes state that measures on foreign currency-denominated liabilities should be assessed on a case-by-case basis, departing from a purely legal conformity assessment to take into account country-specific circumstances.
Let me mention the concrete example of Brazil: in the post-2008 crisis period Brazil imposed a measure, a tax on capital inflows related to external loans, the “IOF”. Several studies have assessed the impact of this measure, both on Brazil’s exchange rate, and of the spillover to other economies, as capital flows have been deflected to other countries. Now that Brazil has requested adherence to the Codes, an important dialogue is taking place within the Investment Committee to consider whether the measure is still needed or less restrictive alternatives could be considered. This is the value of the Codes and of their peer-pressure mechanism.

Let’s move to another concrete example. The South African authorities have also requested adherence to the OECD Capital Movements Code. While South Africa has an open FDI system, further improvements are needed to reform its current Exchange Control framework. It is key that such reforms are conducted with the appropriate sequencing, for the benefit of the South African economy, but also for the potential consequences. In this regard, the OECD Capital Movements Code brings out a clearly discernible pattern of sequencing. The distinctive OECD process of peer review in a multilateral setting can provide support for policy-makers engaged in liberalisation, by taking into account the specificity of their circumstances, while, at the same time, sharing with them the accumulated experiences of peer countries in similar or parallel policy situations.

To conclude, I think that possible further co-operation could entail work jointly conducted by IMF and OECD on key issues for these systemically important countries, and in particular G20-EMEs, in the area of capital flows. Both organisations have a specific mandate and framework, and it would be interesting to join forces to work on countries that are currently in the process of opening their capital account.
CHAPTER 3. MAKING CREDIBLE COMMITMENTS: HOW ECONOMIES WITH A RECENT HISTORY OF CAPITAL CONTROLS CAN CONTINUE PROGRESSING ON THE LIBERALISATION PATH

As the costs and benefits of capital account liberalisation continue to be widely debated, countries need to ensure that the benefits of capital account liberalisation outweigh the potential costs. In this context, the role of commitments and rule-based frameworks has proven to be key. International agreements enable countries to make their commitments credible, giving a sign that they will not reverse course and ensuring trust. This can buttress the reform effort and can give policy makers more support to move forward on the reforms that need to be made in order to increase the benefits and reduce the costs of liberalisation. The OECD Codes have supported this process since their inception. They can continue serving as a commitment device mechanism for G20 economies. The March 2017 G20 Finance and Central Bank Governors communiqué encouraged G20 countries that have not yet adhered to “consider adhering to the Code, taking into consideration country-specific circumstances.”

Key questions addressed in this section are:

i) what roles can trust and credibility play in long-term capital account liberalisation?

ii) how have OECD countries used instruments like the OECD Codes to progress on their liberalisation path?

iii) how can major G20 countries advance their reform agenda?

3.1. Intervention by Rodrigo Cubero, Central Bank of Costa Rica

After a long history of controls on current and capital account transactions, particularly surrender and registration requirements, the Central Bank of Costa Rica eliminated all these restrictions and opened the capital account in 1992. Financial and non-financial entities were allowed to buy and sell dollars freely among themselves. Banks were allowed to open foreign exchange (FX) accounts, and to borrow and lend in foreign currency.

The Central Bank also decided to float the currency. This, along with the stronger appetite for CR assets following the liberalisation, led to a strong appreciation of the colon. The move to floating was subsequently reversed and the country went back to
a crawling peg regime, even if not explicitly. However, the move to a full capital account liberalisation was maintained.

Costa Rica has greatly benefited from the liberalisation of its capital account. Since the 1982 Latin-American Debt Crisis, Costa Rica has not experienced any financial crisis, as opposed to many other emerging markets. Moreover, capital inflows surged both as a share of GDP and in terms of constant US dollars, particularly—but not only—FDI. Outflows diversified also, as residents began to invest more abroad through FDI and portfolio flows.

Costa Rica’s liberal approach to capital flows, along with other strengths of the country, has allowed it to attract very high FDI flows, as well as other flows, for three decades. Liberalisation attracts flows mainly because it allows those flows to come in more freely in the first place, but also because it creates positive confidence effects, as investors know they can take their funds away if they need to.

Other broader benefits from liberalisation and international financial integration, which themselves may act as “pull” factors for inflows, are:

(i) global risk diversification;
(ii) intertemporal consumption smoothing; and
(iii) a more efficient allocation of global resources; in particular, stronger investment in countries where the savings-investment balance should optimally be negative (typically, developing countries).

As mentioned in previous sessions, additional benefits are:

(iv) enhanced competition in the financial sector—in our view, one of the great benefits of capital account liberalisation;
(v) trade facilitation;
(vi) knowledge (technological, managerial) spillovers from FDI; and, finally
(vii) more disciplined macroeconomic policies. I cannot stress enough the importance of this last factor.

There may also be risks from large capital inflows, particularly for financial stability in partially dollarized economies like Costa Rica’s. Thus, after experiencing a capital inflow surge during the period of high international liquidity (2010-2014), the Central Bank broadened the scope of reserve requirements to cover external liabilities, first short term and later long term as well. This response was prudential in nature: its main purpose was to lead banks to internalize risks from FX exposures. It also helped level the playing field between FX and local currency funding.

Although the authorities avoided imposing capital controls that could affect FDI and other capital movements, the surge was so large and sustained, that in 2013 they decided to take additional measures. A bill of law was drafted and finally passed in
2014 (Law 9227, Law for Discouraging Foreign Capital Inflows), which authorised the Central Bank Board to impose temporary reserve requirements (for a maximum of 6 months) and to ask the Ministry of Finance to impose temporary income tax surcharges on the return from investments held by non-residents. Clearly, if adopted, these would have been considered capital flow management measures. However, the instruments were never used.

**Benefits from the adherence process to OECD: The Role of the Codes**

A key benefit from the accession process to the OECD and adherence to the Codes is to reinforce the country’s commitment to capital account openness and the principle of non-discrimination. This, in turn, strengthens confidence effects and therefore fosters capital inflows, particularly those most exposed to the economy (such as long-term FDI). This is achieved by:

(i) Promoting further liberalisation measures during the adherence process. For example, as part of the adherence process Costa Rica abrogated, in December 2018, the abovementioned Law for Discouraging Foreign Capital Inflows. It also authorised foreign bank branches to operate in the country as of July 2019.

(ii) Locking in the liberalisation commitments, by becoming an Adherent to the Code. This commits members to avoid introducing new restrictions (article 1 of the Codes).

Moreover, the accession process will help Costa Rica continue on the path of promoting measures to strengthen macroeconomic policies and financial stability, and foster financial development. Together, these measures will help reap the gains from capital inflows, attract high quality capital, and mitigate possible risks.
3.2. Intervention by Hayrettin Demircan, Turkey’s Ministry of Treasury and Finance

I want to begin with Turkey’s experience of liberalisation process on capital movements in the last 39 years. Before 1980, Turkey was one of the most heavily protected economies in the world. For example, importing anything into the country required government approval. Import substitution industrialization (ISI) was an economic development strategy in Turkey before 1980.

The Turkish Governments promoted ISI with three policy instruments: government planning, investment policy, and trade barriers. In 1960, the Turkish government established State Planning Organization (SPO) as an organization for government planning and investment policy. SPO also structured five-year development plans for Turkish economy in 1960’s and 1970’s.

Before 1980, there were three main characteristics of Turkish economy. First, the Turkish government implemented a capital control regime and the use of all foreign currencies was permitted through the Central Bank. Second, the Turkish government used trade barriers to control foreign exchange and protect infant industries in order to create local production capacity of the country. Third, the Turkish government implemented strict investment policy in order to control all investment activities in the country.

On the other hand, the Government also created state-owned and mixed ownership enterprises for promoting main economic activities in the country. ISI also generated noncompetitive industries for international markets due to the inefficiencies of the production. In 1980, Turkey exported only $2.9 billion of goods (mainly agricultural products), and imported $7.9 billion of goods (mainly oil and its derivatives).

In 1980, Turkey transformed its economy from import substitution industrialization to a functioning free market economy. In 1980, policymakers had understood that import substitution industrialization had been no more sustainable due its inefficiencies of the production capacity and trade deficits. In 1980, Turkey wanted to unite with the global economy, because there was large scale of unemployment, high inflation, high budget deficit, and high foreign trade deficit.

After 1980, Turkey issued Government Decrees in order to liberalise foreign exchange policies, to promote foreign direct investments, export capacity of the country, tourism industry and financial integration of the country to the World. In 1989, Turkey introduced full convertibility and from 1980 to present day, Turkey implemented day
by day liberalisation process on capital movements. According to main macroeconomic indicators:

- Turkey’s GDP was only 55 Billion USD in 1980 and in 2018 it was 800 Billion USD.
- Export of Turkey was 2.9 Billion USD in 1980 and 168 Billion USD in 2018.
- Import of Turkey was 7.9 Billion USD in 1980 and 223 Billion USD in 2018.
- Cumulative FDI was only 98 Million USD in 1980 and as of 2018 it was 193 Billion USD.

Those indicators clearly show that financial liberalisation gives great contribution to the macroeconomic indicators of the country.

On the other hand, during this period, Turkey faced two main financial crises in 1994 and in 2001. In 1994, Turkish Lira had lost its value nearly 15% and in 2001 Turkish Lira lost its value nearly 75% in six months.

Right now, I want to talk about Turkey’s perspective on the liberalisation path. Although Turkey was one of the main founder members of OECD in 1960, Turkey was not able to adhere all the rules of the OECD Codes until 1986 due to its current account deficits.

Turkey used derogations until 1986. After 1986, Turkey removed derogations and put minor reservations on the Code of Liberalisation of Capital Movements and on the Code of Invisible Operations. Nowadays, there are still some reservations of Turkey within limited scope on the Code of Liberalisation of Capital Movements and on the Code of Invisible Operations. This is also common for the other adherent countries.

As I mentioned before, Turkey faced several financial shocks and several financial instabilities during the liberalisation path of the country but Turkey has never thought about severe restrictions on capital movements. Even during the crises time in 1994, 1998, 2001, 2008 and most recent currency shock in 2018; Turkey implemented no restrictions on capital movements. The fact that the economies of developing countries can be hurt by the volatility of capital movements, capital movement management should be an important policy tool to better benefit from it. After recent currency shock, Turkey has been undergone readjustment process in which we expect less current account deficit and stronger competitiveness in the economy.
Turkey faced current account deficit and therefore Turkey relies on capital flows from all around the world to finance its current account deficit. The ability of Turkey to attract capital flows from all around the World depends upon trust of Turkish economy to foreign investors. In our case, Turkey’s adherence to Codes is one of the most important commitments to foreign investors in order to provide friendly investment environment for the investors.

On the other hand, I also want to add some points within the context of OECD Codes. During the crises time, some countries implemented several macro prudential policies and those policies included capital control mechanisms. In the near past, some countries also imposed some capital restrictions during the crises time.

From my point of view, I support the idea that during the crises period, for their own interests, countries could implement several macro prudential policies. Even though those policies can violate the rules and principles of the Codes, but this is also an area that Codes give flexibility to the countries in order to diminish the effects of macroeconomic instabilities of the countries. Yet, I also support the principle that those macro prudential policies should be temporary based and should not stay forever.

I also expect that current work on revising the Codes would be providing clearer path on how we can use this flexibility in order to clarify the grey areas and discussions upon grey areas. On the other hand, the OECD Codes are amongst well known international instruments on capital movements and adhering to the Codes in this regard makes us a member of prestigious Club in the international arena and Codes provide great importance for investors and policy makers all around the World.

Finally, list A and list B separation provides some flexibility in this vein. After revision of the Codes, we will have more room to introduce necessary respond to the shocks while preserving the spirit of the Codes.

### 3.3. Intervention by Ratna Sahay, International Monetary Fund

*Lessons and Continued Learning on Capital Flow Liberalisation*

The remarks cover three aspects related to capital account liberalisation: (i) country experiences; (ii) the evolution of the IMF’s approach to liberalisation; and (iii) two particular aspects of liberalisation strategies.
In the past two decades, countries have continued to move toward greater liberalisation, albeit slowly. This reflects that countries intend to harness the benefits of capital flows, while aim at mitigating the associated risks. However, liberalisation tends to be subject to setbacks and slowdowns when crises occur. The Great Financial Crisis (GFC) was no exception.

Over time, the IMF has devoted considerable resources to analyzing country experiences with capital account liberalisation. The experience of countries liberalising in the 1980s and 1990s was extensively analyzed by staff with common characteristics identified, particularly related to those countries that experienced financial crises following liberalisation, and those that managed to avoid them. IMF staff found that countries that avoided crisis tended to have common characteristics, despite having liberalised capital flows at varying pace and to some extent even with different sequencing. These countries typically had sustainable macroeconomic policies—in particular, exchange rate regimes that were consistent with other macroeconomic policies—and strong prudential frameworks that allowed their financial systems to safely manage increased capital flow volatility.

On the other hand, countries where large and volatile capital flows played a part in financial crises, tended to have significant weaknesses in their financial systems, short-comings in financial sector policies, unsustainable exchange rate policies, and in some cases—like Korea in the 1990s—had missteps in sequencing by liberalising short-term flows too early in the liberalisation process. The example of the Nordic countries is telling in this respect. They all liberalised their capital accounts and their financial sectors in the 1980s and early 1990s; all except one subsequently experienced crisis. The notable exception was Denmark where the foundations of the exchange rate peg was sound and the prudential framework stronger, leaving banks with sufficient capital to withstand losses without failing.

These experiences helped Fund staff develop the “integrated approach” to capital account liberalisation. This approach stressed the importance of appropriate sequencing in removing restrictions on the financial account, but even more importantly of coordinating liberalisation with supporting reforms and sustainable macroeconomic and financial sector policies. The integrated approach guided staff’s policy advice until after the GFC.

The GFC brought new lessons as capital flows posed challenges to even advanced economies with longstanding financial account openness. Greece, Cyprus, and Iceland all had to resort to wide-ranging capital controls to deal with systemic financial crises. These controls remained in place for years. The Fund provided advice on liberalisation strategies in all three cases—liberalisation roadmaps were developed guiding the removal of controls based on meeting specific macroeconomic, financial stability and structural conditions with key parts of the roadmaps made public.

Following the GFC, the Fund renewed its efforts to strengthen its approach to financial account liberalisation, which culminated in the adoption of the Institutional View (IV) in 2012. The IV was developed through a series of policy papers discussed by the Executive Board over the course of two years. The Board discussions took place against the backdrop of substantial volatility in global capital flows and intense international debate regarding the appropriate policy responses to those flows. The debate was also intense at the Board, but consensus was reached and the IV was adopted in December 2012.

The IV incorporates key elements of the “integrated approach’ from 2001 but with notable additional features. First, the IV explicitly states, that there is no presumption that full liberalisation is an appropriate goal for all countries at all times. Secondly, the IV recognizes that capital flow management measures (CFMs) can be useful in certain circumstances. However, they should not substitute for warranted macroeconomic adjustment.

The Fund has also taken into account new lessons, in particular, regarding the importance of using macroprudential policy to mitigate the risks to financial stability—also in the context of capital account liberalisation. Macroprudential tools can help contain systemic risks from volatile capital flows, even when they do not target capital flows per se, e.g., by increasing resilience to capital flow reversals and constraining the scope for inflows to generate procyclical dynamics. Liberalisation should therefore, be supported by a progressive strengthening of capacity to deploy macroprudential tools.

The OECD Codes of Liberalisation, also allow for re-imposing temporary controls under certain circumstances, including when financial stability is severely threatened. The recent revision of the Codes further increases the flexibility to introduce measures to safeguard financial stability, which we welcome. The experience of Greece, Cyprus, and Iceland (as well as Ukraine to a certain extent) from removing wide-ranging capital controls has also provided valuable insights into the importance of communication. As mentioned before, all three countries published roadmaps that
guided their liberalisation and, I will argue, served as a strong commitment device toward liberalisation.

Effective communication can help build credibility in the overall liberalisation strategy, particularly by demonstrating that the plan is comprehensive, consistent across policies, and flexible to changing circumstances (i.e. condition-based rather than time-bound). Communication can also serve as an important sign of commitment. By publishing a plan, authorities can manage expectations, demonstrate their commitment toward achieving greater openness, and build trust. Effective communication can also foster understanding the interrelations between the liberalisation steps and the supporting reforms, how in particular, the supporting reforms gradually build-up the capacity to safely manage larger and potentially more volatile capital flows. Publication of a roadmap can also forge support for the needed reforms, as it is better understood that they allow for the safe removal of controls.

Finally, let me emphasize that the Fund continues to learn from country experiences and its policy advice continues to evolve. Currently, the Fund is developing an Integrated Policy Framework (IPF). The main impulse for this work came from a tension between the Fund’s advice and policies pursued by part of our membership, particularly on how to deal with swings in capital flows. Several countries have urged country teams to more thoroughly consider country-specific characteristics.

The IPF therefore, is reexamining which policies can best help countries pursue growth and financial stability objectives, particularly in the face of rising spillovers and deepening macrofinancial and external linkages which we know tend to strengthen following capital account liberalisation and recognizing the importance of different country characteristics and policy frameworks. IPF jointly considers the role of monetary, exchange rate, macroprudential, and capital flow management policies, their interactions with each other and with other policy levers. The focus is on taking greater account of the nature of shocks—e.g., real or financial, temporary or persistent, realized or probable—and country characteristics—cyclical and structural—as well as interactions between policies. This is a departure from existing academic and policy work, which generally asks the narrower question of whether policies are effective or not, with little regard for country circumstances or interactions with other policies.

You can therefore expect, that our advice will continue to evolve as lessons are learned and we develop a deeper understanding about the appropriate policy mix that allows countries to harness the benefits of greater openness, while effective mitigating the associated risks.
3.4. Intervention by Perry Warjiyo, Bank of Indonesia

Indonesia started to adopt free foreign exchange system in 1982, followed by liberalisation in other aspects in capital account. Previously, Indonesia’s foreign exchange system was relatively closed, where Bank Indonesia issues approval for the usage of foreign exchange, including for exports and imports activities. In 1982, Indonesia adopts free foreign exchange system to expand the role of the private sector and reduce Indonesia’s dependence on the oil sector (Figure 1). Following the enactment of this law, capital inflows went up substantially and has turned Indonesia into one of the most open economies. In 1999, another act (Act No. 24, 1999) concerning Foreign Exchange Flows and Currency System was enacted. This decree allowed resident to freely possess and use foreign exchange, at the same time the act obliged residents to provide information and data on their foreign exchange activity.

Capital account liberalisation may offer potential benefit for the economy in the form of higher economic growth and better welfare, although it also entails certain risks if not applied properly and gradually, and supported by proper monitoring system and risk mitigation policies. Empirical evidence showed that significantly open capital account system in Indonesia came at a high cost to the economy. Despite enabling Indonesia to finance its national development, excessive capital inflows also put upward pressure on the Indonesian Rupiah and at the same time exposed Indonesia to vulnerability related to capital reversals and crisis. This was exacerbated by the fact that the capital account liberalisation was not supported by proper monitoring and risk mitigation. At the time, credit growth escalated substantially, as banks were allowed to borrow from abroad in foreign currency and use the money to provide credit in local currency. In the absence of proper banking prudential regulation, monitoring, as well as risk mitigation, excessive foreign borrowing resulted in debt mismatch in the banking sector, both in terms of maturity and currency mismatch.

Taking note of the Indonesian experience, valuable lessons to be learnt are:

- Policy maker needs to pay attention to proper pacing and sequencing as well as to couple the liberalisation with structural reform, robust monitoring system, and risk mitigation policy;
- Path of capital flow liberalisation shall be in line with the development of financial market structure, including financial deepening and monitoring system;
- Central bank’s credibility also plays important role in the effectiveness of capital flow liberalisation.
Considering the complexity and the impact of capital account to the economy, Bank Indonesia adopts policy mix to navigate the economy, and implement it with consistent, prudent, transparent, and accountable manner. BI’s policy mix is also supported by solid reporting system, risk mitigation, and reform in the financial market. Solid and sound policy framework and implementation are the key to gain credibility and trust for the economy.
CHAPTER 4. NEXT VULNERABILITIES: CAPITAL FLOWS AND THE MIGRATION OF RISKS TO NEW CORNERS OF THE FINANCIAL SYSTEM

The post-crisis period has seen an increase in financial regulatory reforms primarily in the banking system, but there is evidence that risks are emerging and migrating to new, unregulated corners of the financial system. For example, during the review of the Code currency-based measures applied to banks were considered extensively. On the one hand these currency-based measures appear to strengthen banks’ resilience, but on the other hand they have the effect of shifting a portion of this vulnerability to other sectors, such as the non-banking sector. In this context, the corporate sector, which is currently less regulated than the banking sector, is becoming a new source of systemic risk for the financial system.

Key questions addressed in this section are:

i) which new sources of vulnerabilities are building up a decade after the 2008 crisis?

ii) how to develop a better cost-benefit framework for financial regulations, such as currency-based measures?

iii) which policy actions could ensure the stability of unregulated corners of the financial system, without negatively global financial integration?

4.1 Intervention by Claudio Borio, Bank for International Settlements

This session is about the possible vulnerabilities that capital flows can generate in new – or perhaps less illuminated – corners of the financial system. In addressing this question, I would like to take a broad view. The reason is that we cannot fully understand what the next vulnerabilities are and how best to address them without understanding what is wrong with the international monetary and financial system – or, as the late Tommaso Padoa-Schioppa used to say, “non-system”.

Thus, in my remarks, I will briefly address three questions. What is the Achilles heel of the current international monetary and financial system (IMFS)? Where might the next pressure points or corners to watch be? And how can we address the Achilles heel?
1. The Achilles heel of the IMFS

There is a long intellectual tradition arguing that the IMFS’s Achilles heel is its proclivity to generate large current account imbalances. Think, for instance, of Keynes’ concern with asymmetric adjustments between debtors and creditors or of Bernanke’s savings glut hypothesis.

Certainly, large current account imbalances can be a problem, not least because they give rise to protectionist pressures, as we painfully see today. But to my mind, the real Achilles heel has to do not so much with net capital flows, which is what current accounts represent, but with gross capital flows and the accumulated stocks. It is here where the underlying weakness of the IMFS is most apparent.

That weakness is the failure to anchor effectively financial expansions and contractions, not just across borders but also within countries – cycles that can cause major macroeconomic dislocations and financial crises.

Such financial expansions and contractions take two forms.

First, expansions and contractions in gross capital flows and correlated asset prices, of which Hélène Rey’s “global financial cycle” is the most famous incarnation. As recent BIS research indicates, the length of this cycle roughly coincides with that of business cycles.6

Second, their close cousin, “domestic financial cycles”. These are best captured by strong joint expansions and contractions in domestic credit and, in particular, property prices. These cycles tend to be considerably longer than business cycles (sometimes twice as long) and to cause costly recessions and possibly outright financial crises, such as the recent Great Financial Crisis (GFC).

Importantly, while distinct, these two cycles interact and can amplify each other, especially around financial crises.7


7 See Aldasoro et al, ibid.
Now, the IMFS fails to provide sufficiently strong anchors because of the way it shapes the interaction of domestic monetary and financial regimes.

On the one hand, domestic monetary regimes pay little attention to the build-up of financial imbalances, so that the easing bias spreads from the core economies to the rest of the world. It does so directly, through the extensive reach of international currencies – especially the dollar – beyond national borders. I will come back to this. And it does so indirectly, through policymakers’ resistance to exchange rate appreciation, be these the result of concerns with price stability, financial stability or other considerations. That is, central banks keep interest rates lower than otherwise and/or intervene and accumulate foreign exchange reserves. This way, easing begets easing across the world.

On the other hand, the interaction of financial regimes reinforces and channels these effects through the free mobility of capital across both currencies and borders. As a result, external funding typically amplifies domestic credit booms and exchange rates move too far (“overshoot”). Hence the relevance of the concept of “global liquidity”, ie the ease of global financing, which has been the focus of BIS research.  

What is the evidence for all this? For one, the surges in international credit ahead of episodes of serious financial stress. Think, for instance, of the GFC, of the Latin American crises in the 1980s, of the Asian crisis in the 1990s and of many similar episodes going further back in history, including under the gold standard – the first globalisation era. In addition, both pre- and post-GFC, we have seen historically accommodative monetary policy conditions, which have been a key source of unwelcome spillovers and which could encourage a further build-up in debt globally.

2. **Corners to watch: the dollar and the asset management industry**

So much for the big picture. Let me now focus briefly on two pressure points – or two corners to watch. One is old: the role of foreign exchange funding, and in particular that of the US dollar, to which I have already alluded. The other is newer: market-based finance and the role of asset managers in particular.

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We know that many countries, notably emerging market economies (EMEs), have long relied on foreign exchange funding. And we know that, at the global level, the dollar reigns supreme. But unlike in most advanced economies, in emerging market economies such borrowing often gives rise to currency mismatches, mainly because of costly and sometimes limited hedging opportunities.

This, in turn, gives rise to the so-called “financial channel of the exchange rate”. Currency appreciation flatters balance sheets and encourages further borrowing and appreciation – a self-reinforcing process. The opposite is naturally the case when the currency depreciates. All this blunts the shock absorber function of the exchange rate and makes EMEs especially vulnerable to boom-bust cycles in global capital flows – an aspect we developed in a special chapter of the latest BIS Annual Economic Report on monetary policy frameworks in EMEs.9

Against this background, the sharp increase in US dollar borrowing post-crisis is troubling. The corresponding debt has roughly doubled for EMEs’ non-bank borrowers, to some $3.7 trillion. And this, let me stress, does not include borrowing via FX swaps, which is not covered in the statistics as it is off-balance sheet. That borrowing, according to our estimates, is even larger. Including also advanced economies, the equivalent figure to the on-balance sheet borrowing for EMEs is $11.8 trillion while the one for FX swaps is of the order of $14 trillion or more.10

It would not be surprising, therefore, if the next episode of financial stress had the US dollar segment at its epicentre, just as it was during the GFC.

In all this, the asset management industry is likely to play a substantially bigger role than in the past. The development of domestic currency markets was expected to insulate EMEs from the currency mismatches linked to borrowing in foreign exchange. The evidence so far suggests that, while clearly helping, it has fallen somewhat short of expectations. But, in any case, this would not solve the problem of currency mismatches in lenders’ (investors’) balance sheets. Whenever they invest on a foreign exchange unhedged basis to pick up extra return, investors would lose twice on their long-term bond holdings if the exchange rate depreciated as the domestic currency yields rose – a typical correlation, especially under stress. This would exacerbate the pressure to liquidate portfolios.

9 See BIS, “Monetary policy frameworks in EMEs: inflation targeting, the exchange rate and financial stability”, Annual Economic Report 2019, 2019, Chapter II.

The rapid growth of market-based borrowing post-crisis, as many banks have retrenched, highlights these vulnerabilities.\textsuperscript{11} The share of bank loans in US dollar borrowing by non-banks outside the United States has fallen from around 60% to a bit below 50%. The bottom line: although banks are safer, we should watch closely the vulnerabilities linked to market-based finance.

3. Policy implications

What are the policy implications? Let me just highlight two.

First, we need stronger anchors in domestic policy regimes – ensuring that one’s own house is in order. At the BIS, we have argued for the need to put in place macro-financial stability frameworks, in which monetary policy, prudential (especially macroprudential) policies and also fiscal policy pay greater attention to the build-up of financial imbalances. In the BIS Annual Economic Report chapter on EMEs I mentioned before, we explain key aspects of this framework, notably the role of foreign exchange intervention in the spirit of a macroprudential tool alongside the active use of macroprudential measures. Here, I would stress, in particular, measures targeting currency mismatches and liquidity mismatches in foreign exchange. All this would reduce the scope for unwelcome spillovers – a natural outcome if domestic policies are already fully fit for purpose.

Second, we need stronger anchors internationally – ensuring that the global village is in order. Here, the degree of progress has differed. It has been substantial in prudential regulation and supervision, through international standards and a degree of reciprocity. Still, some gaps remain. In particular, we need to think harder about how to address the systemic risks that the asset management industry raises. A key strategy here would be to calibrate regulation from a macroprudential perspective, i.e., considering institutions not just on a standalone basis but explicitly as part of the system, in analogy with what has been done for banks. By contrast, progress has been very limited in monetary policy, for structural reasons. Here the key question is whether it is possible to go beyond enlightened self-interest. Finally, strengthening the global safety net would be an important complementary step, which would help contain stress when it cannot be prevented. Here, the need for funding in US dollars is critical. One question is whether it would be as forthcoming as during the GFC in the current political environment.

4.2 Intervention by Mario Marcel, Central Bank of Chile

1. The Chilean macro policy framework

In Chile, the current approach to deal with potential vulnerabilities associated to volatile capital flows can be seen as orthodox, as we rely heavily on the importance of a flexible exchange rate (FX) regime and Capital Account openness, in conjunction with a consistent monetary and fiscal policy framework, and a sound banking regulation and supervision. However, it is essential to remind us that the framework has come a long way.

Nearly 40 years ago, Chile faced one of the world's costlier financial crises precisely because of the lack of several of these elements. In particular, FX exposures at a heavily leveraged and unsupervised banking sector contributed to the spread of the banking crisis after the fixed FX regime collapsed in the early 1980s. As a result of this experience, the country substantially upgraded banking regulation and supervision. In 1986, the General Banking Law (GBL) introduced limitations on currency mismatch, constraints on related-party lending, and restrictions for banks to receive goods instead of liquid resources; all of them, elements that were common practice before the 1982 crisis.

During the transition toward fully implementing the current policy framework, Chile experienced a period of capital control. As the literature emphasizes, the unremunerated reserve requirement (URR) implemented in Chile during the 1990s helped to change the composition of capital flows toward longer terms but was less effective in terms of reducing the aggregate level of capital flowing into the country.

After removing the URR by the end of the 1990s and allowing the FX to fluctuate freely, the banking and corporate sector learned to operate in a completely different environment, characterized by extensive use of the derivative market. In particular, corporations have learned to operate in a flexible FX environment by using both natural-hedging and market-based FX risk hedging instruments. This development has been supported by the development of the derivatives market, in which Pension Funds have been key counterparts as well. Banking regulation, in turn, has resulted in limited currency mismatches at the bank level, which have made the introduction of new regulation to deal with FX risk unnecessary, as we have observed in many emerging market economies after the 2008-09 Global Financial Crisis (GFC).

Today, the Chilean financial sector is one of the most developed in the emerging world. In five decades, it has gone from being almost exclusively made up of traditional banks, to include several other market participants, such as Pension Funds,
General Fund Administrators and Insurance Companies, among others. The Chilean financial system relatively outperforms to other comparable countries in dimensions such as market capitalization, number of branches per inhabitant, and participation in domestic credit. On the other hand, the banking system, in particular, is positioned among the strongest in the reference group of emerging countries according to comparable international assessments.

The Central Bank of Chile (CBC) was an early adopter of an inflation-targeting regime, shortly after its independence granted in 1989. Chile adopted a fully floating FX regime in September 1999, and capital controls were abolished as a necessary step to complete a coherent framework to control inflation effectively. Since then, the CBC has kept its commitment of no intervention in the FX market, except when required by extraordinary circumstances.

2. New sources of vulnerabilities a decade after the GFC

From a broader perspective, the changing nature of banks’ business models creates a significant number of new risks and challenges. In particular, those coming from the internationalization of banks’ activities. However, focusing on an emerging market economy, a substantial emerging risk is that associated with the growing importance of nonbank lenders (NBL). In some emerging economies, this may result in credit lending going informal due to a relatively higher cost in credit provision due to regulation. Thus, a reasonable concern is to what extent the low level of FX-risk at the banking sector in Chile has pushed for higher FX-risk in the non-banking sector. We assess that stronger regulation in the banking sector spill over the non-banking sector’s vulnerabilities, but it does not correspond to the evolution of FX risk. The evolution of the non-banking sector’s risks reflects mainly issues of information asymmetries and the fact that some of these institutions can take advantage of direct payroll charges to enhance their consumer credit business.

While NBL provides commercial loans, their main business is to lend to households in the form of consumer and mortgage loans. The household debt issued by NBL has increased a share of total consumer debt. Nonbank loans had a real annual growth rate of 11.5% in the fourth quarter of 2018. In the same period, bank consumer loans grew around 5.7%. Nonbank consumer loans together were equivalent to about 58% of total bank consumer loans. This rate has been stable since 2012, although the composition has changed. The steady growth of the nonbank portfolio is a potential source of vulnerability, given that most of these lenders are outside the consolidated debt perimeter.
Moreover, the banking sector has significant exposure to the NBL, through commercial loans to these institutions. In particular, loans to this segment have increased among medium-sized banks in recent years. Thus, the exposure—to NBL debt—of the large and medium-sized banks, as of February 2019, represented 12.7 and 27.2% of their regulatory capital, respectively.

Although the specific case of NBL, some other risks can emerge from a fast-growing number of less developed financial infrastructures outside the regulatory perimeter. For instance, risks related to disruptive FinTech activities, such as the development of crypto-assets markets, and risks associated with cybersecurity issues.

3. A framework for financial regulation

In the Chilean case, while the banking regulation and supervision arising from the 1980s-banking crisis was restrictive in several ways, it was supported by sound monetary and fiscal policies. While it may be right that other emerging economies have been increasingly active in the implementation of currency-based measures (CBM) in their banking systems, in Chile, we have followed a different approach to deal with FX risk at the banking level.

As part of the overall capital requirements for market risk purposes, banks’ direct FX-currency exposure (currency mismatch) is limited, and indirect FX risk acknowledged through credit provisioning requirements.

In addition, the development of the FX derivative market that has allowed both, banks and corporations to deal with currency exposure without the need of imposing CBM as we have observed in other emerging economies (this includes regulations imposing a different treatment between domestic and FX-denominated operations by banks, such as reserve requirements on FX denominated banks' deposits). In fact, over the past decades and despite global financial turmoil and crises, the size of the Chilean-banking system has increased steadily to reach levels similar to developed economies.

Recent academic evidence on the evolution of capital controls shows that Chile has taken more liberalisation actions than tightening actions on both inflows and outflows. It shows that policymakers use capital inflows tightening for macroprudential concerns while use capital outflows easing for competitive purposes. In Chile, the dynamic of outflows easing reflects, mainly, that Pension Funds' limits on investing overseas have loosened during the last decade. Nonetheless, Chile is among those emerging economies that are less active when it comes to capital control actions over the past decades.

4. Policy actions ensuring the stability of the financial system
Paradoxically, the regulation did not hamper the deepening of the financial system, even though it could have been considered a harsher regulation. Instead, it fostered the solvency and credibility of the banking system and allowed its healthy development in the ensuing decades. At the core of this development was the creation of a funded pension system, and subsequent capital market reforms, together with capital market openness, which dramatically changed the size, composition, depth, and strength of the financial sector in Chile. In fact, in Chile, the main regulatory changes introduced has been the recent modification of the GBL, which constitutes a significant step forward for the local banking industry, in that it will contribute to reducing the gap with international regulatory standards established under Basel III. The new regulatory framework raises essential challenges for the industry in terms of compliance with the new, more demanding solvency requirements, especially for entities with a smaller capital cushion.

Besides the Chilean approach to deal with FX risk at the banking level and the recent trend that has deepened financial liberalisation, the possibility to activate capital controls under extreme circumstances is still part of our constitutional law. In Chile, we are under the process of simplifying our FX regulation, as well as improving our financial market infrastructures, including the FX dimension to them. Thus, the CBC is currently working to allow the clearing of USD denominated large-value payments through its Real Time Gross Settlement payment system. Also, it is developing a Trade Repository for over-the-counter derivatives, and it is about to issue the regulation for FX clearinghouses. Finally, the onboarding of the Chilean Peso into the Continuous Linked Settlement (CLS) System is a priority for the CBC. These measures may contribute to increasing the likelihood of issuance of local currency bonds overseas.

The surge of capital flows is usually associated with booms in asset prices, appreciation, credit booms, and increasing current account deficits. While the sudden stop is associated with asset price adjustment and financial distress, in Chile, free-floating and FX volatility have helped reduce incentives for arbitrage and carry trade. Besides, FX flexibility facilitates asset price adjustment, providing the right incentives for resident investors (Pension Funds and the government) to counteract the non-resident’s behavior, smoothing net capital flows. Nonetheless, sectorial mismatches in banks, nonbanks, and households still need to be monitored. In Chile, as mentioned above, these mismatches are limited due to FX hedging and regulation.

Finally, it is always desirable a high degree of coordination between regulators and supervisors, especially in a co-responsibility scheme in which financial stability preservation is an obligation shared among institutions. As examples of the
coordination needed are the policy actions recently undertaken regarding the provision of high-quality data on a comprehensive registry of household credit and debt, and the beginning of wide-ranging financial literacy and educational programs. These policies are at the core when supporting better decisions both at the financial institutions and household level.

4.3 Intervention by Ugo Panizza, The Graduate Institute Geneva

In the aftermath of the global financial crisis there was a massive increase in leverage in emerging market countries. This was especially the case in the corporate sector, both financial and non-financial (sovereign debt also increased but less than corporate debt).

Corporations borrowed massively both domestically and abroad. Total corporate debt, went from about 50% of emerging market countries GDP in 2007 to over 80% of GDP in 2017. Over the same period, dollar bond issuances by emerging market corporates increased from $50 to $350 billion.

This massive increase in leverage characterized both banks and non-financial corporations. However, non-financial corporations are a particular source of concern because they may end up behaving like shadow banks while eluding prudential regulation. Valentina Bruno, Hyun Shin, and Laura Zhao have convincingly shown that non-financial corporations in emerging market countries often mimic the behavior of banks. In research with Yi Huang and Richard Portes we focus on China and show that large corporations circumvent regulation aimed at reducing the leverage of risky sectors and in research with Julian Caballero and Andrew Powell we show that large corporations in a sample of 13 emerging market countries are more likely to act as financial intermediaries in the presence of capital controls and when returns from carry trade are high. All this evidence points to the fact, that these unregulated institutions engage into regulatory arbitrage and that this may be a source of vulnerabilities.

However, leverage is not necessarily bad. As pointed out by US Fed Governor Jerome Powell. But the rising amount of debt by itself does not tell us whether this debt is excessive and how vulnerable EME corporates are to global monetary and market shocks. For that assessment, we need to drill down deeper into the health of the corporate sector.

In research with Laura Alfaro, Gonzalo Asis and Anusha Chari, we try to do exactly that. We collect data for a large sample of firms in more than 20 emerging market countries going back to the 1990s and use these data to study the drivers of firm
vulnerability. We find that leverage is not necessarily associated with higher level of vulnerabilities. However, we find that leverage is associated with firm vulnerabilities when the domestic currency depreciates and that this is especially the case for large firms and firms in non-tradable sectors. The fact that leverage is positively associated with firm vulnerabilities during depreciations is consistent with the idea that some of this leverage is denominated in foreign currency. The fact that this result is stronger for firms that produce non-tradables is likely to be associated with the fact that firms in tradable sectors have a natural hedge. The finding that this result is stronger for large firms is, instead, puzzling. We suspect that this is due to the fact that only large firms are able to borrow abroad and, in countries with limited financial dollarization, a substantial share of domestic debt is in local currency.

A key question is whether the increase in corporate leverage can have negative macroeconomic consequences with monetary policy normalization in advanced economies.

After having established the basic facts described above, we conduct a back of the envelope exercise to estimate the possible macroeconomic consequences of this increase in leverage.

We start by showing that large firms are particularly important for GDP growth in emerging market countries and then use our estimates of the effect of a currency depreciation on large firms with high leverage to compute how such a depreciation could affect GDP growth. Our baseline estimates indicate that the effect could be very large.

A key policy implication of our research is that we need to monitor the behaviour of non-financial corporations. However, researchers do not have access to good data on the balance sheets of these firms. Central banks do, and it would be good to promote programs which allow the academic community to gain access to these data.

4.4 Intervention by James Talbot, Bank of England
Since the global financial crisis, the radical programme of G20 reforms has made the global banking system safer.\textsuperscript{12} Capital requirements have increased and banks have become less complex. Banks now hold substantially more liquid assets relative to the liabilities that can readily run. While these G20 reforms also eliminated many toxic forms of shadow banking that existed pre-crisis, global capital flows are increasingly gravitating towards non-banks: global assets under management have increased from around $50 trillion a decade ago to over $80 trillion today.

While the rise of non-bank finance makes the financial system more diverse – and therefore more stable and resilient – its growing importance gives rise to new risks. Macroprudential policy makers need to be alert to these emerging risks, which can be outside of the regulatory perimeter. At the Bank of England, the Financial Policy Committee (FPC) carries out an annual assessment of risks and regulation outside of the core banking sector. The FPC can decide certain activities require close monitoring or conduct a deep dive into riskier sectors or activities.\textsuperscript{13} The Bank of England is continuing to develop a “system-wide stress” simulation to consider how a shock could transmit across markets and sectors. Non-bank finance is global, so national monitoring and policy can only get you so far. At the global level, the Financial Stability Board (FSB) is currently reviewing its financial stability surveillance framework\textsuperscript{14} and has set up a system-wide oversight framework to monitor the financial stability risks from non-bank financial intermediation.\textsuperscript{15} Both of these initiatives are important in identifying global risks which may require global policy solutions.

Leveraged lending is a good example of an emerging global risk: the market has been growing rapidly in recent years, supported by accommodative lending conditions. A deterioration in under-writing standards means that investors may not have been compensated for the risks they are taking. Moreover, highly leveraged companies have been shown to amplify downturns in the real economy in the past.

\textsuperscript{12} For an excellent overview of these reforms see “How is the financial system safer, simpler and fairer than before?” Financial Stability Board at: https://www.youtube.com/watch?v=gS7TH7ICMRk&feature=youtu.be
Non-bank investors, including open-ended investment funds, have significant holdings of leveraged loans. Large-scale redemptions during a stress could amplify price falls and markets may not be sufficiently liquid to meet demand from borrowers, potentially restricting corporates from raising funds. FSB Chair Quarles, has recently noted that more information is needed in order to assess the risks to financial institutions of exposures to leveraged loans.  

More broadly, for many open-ended investment funds there is a mismatch between redemption terms and the liquidity of their assets. The Bank of England’s Financial Policy Committee has previously highlighted the vulnerabilities associated with this liquidity mismatch and that the effectiveness of domestic policy measures will depend in part on policies implemented in other jurisdictions given the global nature of this activity. In addition, the FSB recommended in 2017 that funds’ assets and investment strategies should be consistent with their redemption terms. While endorsing the FSB’s recommendation, subsequent principles published by the International Organisation of Securities Commissions (IOSCO) have retained the flexibility for national authorities and the funds themselves to adopt different measures.

This liquidity mismatch in investment funds has the potential to become a systemic issue. In light of that, the Financial Conduct Authority (FCA) and the Bank of England will assess how funds’ redemption terms might be better aligned with the liquidity of their assets in order to minimise financial stability risks without compromising the supply of productive finance. This review will examine how to achieve greater consistency in the design of funds between: (i) the liquidity of a fund’s assets; (ii) the price offered to redeeming investors; and (iii) the redemption frequency or length of notice periods. The review will also assess the effectiveness of measures that are used already to deal with misalignment of redemption terms and asset liquidity, such as swing and fair value pricing and suspensions.

Non-bank financial intermediation is an important component of capital flows to Emerging Market Economies (EMEs), accounting for all the increase in foreign capital flows to these economies.

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lending to EMEs since the Global Financial Crisis. Investment fund flows to EMEs now account for around one third of total portfolio flows, compared to around one tenth pre-crisis. These funds can behave pro-cyclically, with funds being withdrawn when EMEs are under stress.

As noted by Carney (2019), EMEs “keeping their own house in order” by pursuing sound macroeconomic policies is necessary, but may not be sufficient to ensure sustainable capital flows. EMEs may need to turn to capital flow management measures (CFMs) to safeguard financial stability when the Global Financial Cycle turns. These CFMs may be necessary, but they have clear shortcomings and some of them are not permitted under the OECD Code of Liberalisation of Capital Movements. By considering reforms to better align the liquidity of fund redemptions with their assets, we may be able to avoid the need for such measures in a crisis.

4.5 Intervention by Ksenia Yudaeva, Bank of Russia

Let me summarize the discussion and share the Bank of Russia’s experience in addressing dollarization and currency risks. The entire discussion today is about a non-achievable first-best world. Due to insufficient international cooperation, countries have often used capital flow management and capital control measures independently to achieve their domestic macroeconomic goals and thus abandoned the first-best outcome. Later on, such policies are inevitably followed by domestic and global financial stability issues.

We should also keep in mind that security considerations, for example, cyber risk management and anti-money laundering policies, may have consequences for capital flows as well.

However, let us get back to the matters of financial stability. Twenty years ago, FDI and government debts accounted for most capital flows. Ten years later, it was bank-related finance that took the lead. In recent years, we have observed growth and development of market-based finance and proliferation of the so-called passive investing at the expense of active investing, which may have a negative effect on financial stability.

In addition, introduction of certain measures may create regulatory arbitrage. For instance, there are opportunities for arbitrage between Russia and the EU because our Civil Code bans negative interest rates. Another new area of concern for regulators with implications for financial stability is crypto-assets and, in particular, stablecoins. Central banks of emerging market economies (EMEs) have responded to this ever-changing landscape of challenges with a new generation of financial stability tools,

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including the use of FX reserves to provide FX lending to domestic banks, macroprudential measures and, in some cases, capital flow management instruments. However, such country-specific measures as FX reserve accumulation benefit neither financial stability nor growth of the world economy. They increase demand for low-yield assets denominated in a few reserve currencies and thus exacerbate the global saving glut and the problem of zero lower bound leading to higher volatility in the global financial markets.

If macroprudential measures are applied mostly to the banking sector, this may result, as Professor Panizza has explained today, in a migration of risks to other, less regulated corners of economies, such as the corporate sector. In addition, in some EMEs banks are not able to provide sufficient loans in foreign currency, so large companies have to borrow internationally in dollars or other reserve currencies.

Similar to central banks in other EMEs, the Bank of Russia applies macroprudential measures to stimulate de-dollarization of domestic banks on both the asset and liability sides of the balance sheet. In the capital adequacy ratio, banks in Russia have to apply higher risk weights to clients borrowing in foreign currencies, even to exporters, as operations of big exporting companies result in large externalities for the entire economy. Moreover, commodity exporters tend to think that they have a natural hedge thanks to their foreign currency revenues, but it is only true to a certain extent.

Financial operations of large commodity exporters amplify the effects of commodity price changes. For example, higher oil prices make the rouble stronger and, in this case, Gazprom is likely to increase its international borrowing in foreign currencies, thus causing further rouble appreciation. When oil prices go down, the rouble will depreciate and Gazprom may have to pay back its debts, thus bringing the rouble’s value even further down. Therefore, monitoring corporate leverage is important for financial stability. At the same time, judging by various countries’ experience, direct measures aimed at regulating FX corporate debt do not seem to be very efficient: only Indonesia appears to be successful in applying such measures.

Summarizing the conclusions of today’s discussion on international cooperation and coordination, I think we have come to a consensus that host countries should pay more attention to regulation of asset managers. Better regulated and safer investment funds in advanced economies would provide good spillovers for the EMEs, specifically, in the form of smaller leverage of domestic firms.

I would also like to stress that we need more international cooperation in addressing data gaps, as documented in the Financial Stability Board’s reports. For example, the Bank of Russia lacks full knowledge regarding international investors lending to Russian corporates, even though this information is important for us in terms of monitoring financial stability risks.
Concluding remarks by Greg Medcraft, OECD

In my capacity of Director of the Directorate for Financial and Enterprise Affairs I would also like to thank the Japanese authorities, as G20 Presidency, for their support in this precious initiative. Let me put the ideas that we have heard today into a broader perspective.

As we have heard, gross international capital flows appear to be historically weak and have not recovered yet from the “Great Retrenchment” observed in the post-2008 crisis period. This fall has been more pronounced for OECD countries, rather than for EMEs, and driven mainly by a correction of banking flows in the Euro-area, peripheral countries. Indeed, European and US banks most affected by the crisis have faced substantial pressures, from markets and from regulators, to deleverage their balance sheets – as previous balance-sheet positions were unsustainable. We have also witnessed a systemic and European-wide crisis that moved across Greece, where capital controls were imposed in 2008, to Ireland, Portugal, and Italy, with the latter experiencing episodes of severe outflows also in 2018.

Challenges to financial stability in OECD countries have risen amid global trade tensions: global currencies have become a key issue in the US-China trade war. The depreciation of the Chinese yuan versus the US dollar could end up weighing on the currencies of other EMEs. Also, on the EMEs side we are now witnessing Argentina imposing restrictions on access to foreign currency, reversing the decision taken four years earlier to eliminate currency controls. According to the Institute of International Finance (IIF) there are signs that the rapid devaluation of the Argentine peso is spilling over into Brazil and Turkey. Finally, uncertainties are amplified by events such as Brexit, which will have an impact on cross-border payments and capital flows, given the UK’s role as global financial hub.

Living in an interconnected world requires us to change our perspectives. Firstly, we should not look at flows in isolation. As the Chief Economist reminded us this morning, trade and financial flows are very much two side of the same coins. Beyond trade, digitalisation is also part of the picture. Digital currencies may further destabilise capital flows. [Maybe Greg may wish to add something on digitalisation – we leave to his team to fill this]. Secondly, in order to advise policy-makers, we need first to understand. And to understand we should look beyond headlines statistics: living in an interconnected world means that capital transits. Indeed, very much like the trade and value added OECD statistics allowed us to get a better picture of actual exposures by taking global value chains into account, similar work should be achieved regarding capital flows. We know that a large part of capital flows transit through offshore centers or “conduit”
countries, for reasons ranging from tax incentives to regulatory arbitrage. As for FDI, 16 countries now report to the OECD statistics on the ultimate investing country and we expect more to come. Such efforts would enable countries to have a better understand of their exposure and risks in an era when a shock in one country spills to others, and to better track the real impact of financial flows on their economy.

Finally, I am sure that the next crisis will not come from the same place. Therefore, we need to continue monitoring, connecting the dots, and checking where vulnerabilities are building up, for instance in the sovereign, corporate, and non-bank financial sectors in several systemically important countries, leading to significant medium-term risks. Also, the recent sharp increase in house prices in many OECD countries has raised concerns about the possibility of a price correction down the line. These points lead me to the conclusion that, as we have heard in the second panel this morning, co-operation among IOs on all these topics is crucial. We need to act together, not to multiply bureaucracy or duplicate work, but to reinforce each others’ insights and capacities to detect early signs of distress faster and better, and support our memberships being equipped with the appropriate policy-toolkit.

I am glad that the Advisory Task Force on the OECD Codes is working on some of these topical issues, such as the debate on restrictive measures in the real estate sector, the intermediation of capital flows by non-banks, and issues related to financial fragmentation, on which I understand tomorrow you will have a policy discussion. I am also delighted that our Directorate is contributing to the dialogue on the role of cryptocurrencies and I invite you to join the Blockchain Forum taking place tomorrow at the OECD.

The OECD is committed to economic co-operation and rules-based policy-making at a global level. The current risk environment, sluggish growth and capital flow volatility need a framework that boosts transparency, accountability, peer-review and that encourages peer co-operation.

The OECD Code is a time-tested "instrument" that has now been brought up-to-date in response to the emerged policy challenges. Hence, I encourage you to continue supporting and reinvigorating the Code as a multilateral agreement on capital flows. Finally, I welcome the fact that the G20 International Financial Architecture working group followed closely the review of the Code and has encouraged G20 countries that have not yet adhered to the Code to consider adhering to the Code, taking into consideration country-specific circumstances.
Concluding remarks by Manfred Schekulin, Chair of the OECD Investment Committee

In my capacity of Chair of the OECD Investment Committee I would like to offer some reflections, building up on today’s discussion. We have started the day with an overview of the global outlook, which unfortunately is in a fragile spot. As we have heard from the OECD Chief economist, widespread weakness persists in global trade and investment, confidence is declining and policy uncertainty is continuing to rise. There is a risk that the China-US trade conflict which is currently affecting the long-term stability of global value chains may spill into new areas: indeed, restrictions on cross-border investment are rising. It is not difficult to imagine how this situation could further deteriorate and lead to a full-scale implosion of the open global trade and financial system.

With this background in mind, which let me reiterate is not rosy, we have then focused on the financial sector. Has international financial integration stalled? Has the crisis led to financial de-globalisation? And which vulnerabilities are slowly building up? We have then linked these issues to the need for co-operation and the role that revised OECD Code plays in managing capital flows and ensuring financial stability. So in my intervention I would like to respond to this question: why do we need an instrument like the revised OECD Code, in this particular conjecture?

Let me recall that the OECD Code was set up in 1961 with the idea of integrating markets. At that point in time the narrative was different: the predecessor of this Organisation, the OEEC, the “Organisation for European Economic Co-operation”, set up after WWII, was assisting its Western European members to rebuild their economies and to administer the Marshall plan. These were times of buoyant growth and overall optimism.

In the early 1960s many advanced economies began to dismantle capital controls. In 1961 the impetus for liberalisation reshaped the OEEC into the OECD (Organisation for Economic Co-operation and Development) with an extended membership to include the United States and Canada. Members adopted then a legally binding Code of Liberalisation of Capital Movements, which although not committing them to the objective of complete freedom, engaged them in a process of progressive liberalisation, removing restrictions “to the extent necessary for effective economic co-operation”. Since then, this instrument has witnessed a number of events: a reversal of the liberalisation process and two oil shocks in the 1970s, the establishment of the European Monetary System (EMS) in 1979, deregulation in the 1980s, a wave of
globalisation since the 1990s, the convergence of Eastern European Economies, the Asian financial crises of the mid-1990s and the 2008 crisis. I will not turn this into an economic historian’s lecture, but if you visit the OECD’s Archives you will find plenty of documents in relation to the discussions which took place on the OECD Code around these events. It is true that “history does not repeat itself”, but we can learn from previous crises, and above all, we should continue talking and exchanging. We cannot act in isolation.

Let me then underline what I think is a unique feature of the OECD Code: the OECD works with Committees, where delegates from national administrations meet, discuss policy challenges and give recommendations. According to me, the value of the OECD Code lies in its peer-exchange and peer-review mechanisms. Countries have the possibility to share their experiences, explain why they are facing a specific issue, think about their policy tool-kit and learn from each other. It is true that there is no Dispute Settlement Mechanism, but unsolved issues can be reported to the OECD Council, the highest decision-making body of the Organisation. As also mentioned earlier, the OECD Code embeds some important principles, such as the ones of transparency and mutual accountability, which are much needed in today’s conjuncture.

I would like to congratulate the delegates of the Advisory Task Force on the Codes for the excellent work conducted not only in relation to the review, but also on a number of important emerging topical issues. The Task has become an important forum discussing issues related to capital flow management and capital account liberalisation, which hosts Codes’ adherents and G20 economies, which are actively engaged in the discussions.

My final word goes to Emerging Market Economies, which are G20 Members and, as we heard in previous sessions, are “systemically important”. I would like to quote the March 2017 G20 Finance and Central Bank Governors communiqué, and encourage G20 countries that have not yet adhered to “consider adhering to the Code, taking into consideration country-specific circumstances”. I already explained earlier why I think this forum is unique. Fifty years ago Western European countries were also not completely open, and still benefitted immensely from the work conducted by the OECD, through its instrument and peer-mechanisms.

Going forward I think it will be key to broaden the membership of the Code and include Emerging Market Economies. The current governance arrangements already allow non-OECD countries to join the Code. In addition, I believe that work programmes providing more tailored benchmarking against the Code can be conceived for countries which are not yet ready to adhere to this instrument.
Times of uncertain global economic prospects are also times for reflection and reform, and times for enhanced international cooperation. As this day has shown, a lot still needs to be done. And, I will repeat it, we need to act together.

To make the global financial architecture work, we need to have all of you on board and involve all countries, including advanced and emerging economies, around a functioning high-international standard, such as the OECD Code.