High-level policy seminar on

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

How the revised OECD Code can improve transparency, accountability, credibility, and trust

SUMMARY RECORD

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Welcome Remarks

The seminar was opened by **Angel Gurría** (OECD Secretary-General) and **Yoshiki Takeuchi** (Vice-Minister of Finance for International Affairs, Japan). **Mr. Gurría** highlighted some major themes for the seminar, including: a decline in gross international capital flows; capital market fragmentation; continuing progress by emerging markets (EMEs) towards liberalization; and the shifting of financial risk towards non-bank actors. He stressed the importance of the revised OECD Code of Liberalisation of Capital Movements as an essential tool for building much-needed trust and cooperation on international capital flows. **Mr. Takeuchi** welcomed the completion of the review of the Code and recalled the role that the Code has played in Japan's "gradual" liberalization strategy, which accelerated its liberalization process after accession to the OECD.

Introductory Remarks

The introductory remarks by **Laurence Boone** (OECD Chief Economist) highlighted the interdependence between trade, investment, and financial flows. Ongoing trade tensions and increasing trade restrictions have impacts for international capital flows. Tariffs impact exchange rates, which may lead countries towards active exchange rate management; while the focus on reducing current account imbalances may lead countries towards capital controls. Both types of measures restrict international capital flows and distort investment, particularly in the long term. They also risk creating "beggar-thy-neighbour" externalities which damage both global financial resilience and international goodwill. In the present environment of rising tensions and wider economic fragility, multilateral *fora* such as this seminar and rules-based instruments such as the OECD Code are particularly important in providing a space for policy coordination and the reduction of uncertainty.

Session 1: Market fragmentation, financial fragilities, and cross-border spillovers of financial regulatory policies: how to tackle these policy issues collectively?

The first session was chaired by **Ludger Schuknecht** (OECD Deputy Secretary-General). He opened the session by reviewing the backdrop to the seminar. Global capital flows have not recovered to their pre-crisis levels, but this is mostly driven by a reduction in the asset positions of European banks. This may in part be driven by global regulatory reforms. In addition to this financial de-globalization, the post-crisis period has seen more uncoordinated use of a wide range of policies to regulate international capital flows, despite evidence that uncoordinated policy leads to sub-optimal spillovers.

Mr. Schuknecht also explained the functioning of the OECD Code of Liberalisation of Capital Movements. The Code can be adhered to by OECD members and non-members alike. Upon joining, each country commits to full liberalization of its capital flows, with the exception of a list of reservations that is split into a list covering long-term operations and a list covering short-term operations. Amendments to the list of reservations are subject to peer review and scrutiny. Recent revisions to the Code include guidance relating to newly-developed macroprudential policy measures, a commitment to cooperation with other international organisations such as the IMF, and strengthened provisions for decision-making and transparency.

Alexander Karrer (Deputy State Secretary, Swiss Federal Department of Finance) agreed that there has been fragmentation of the international capital market since the great financial crisis, mostly in Europe; in fact, East Asia has seen an increase in cross-border financial transactions. He also agreed that increased regulation of banks in Europe bears some responsibility for the reduction. However, he saw it as only one of several drivers, including diverging standards between national regulators and limits on information sharing due to data protection regulations. He welcomed the revisions to the Code, but thought that there needed to be stronger enforcement of adherence to the overarching objective of capital account liberalization. He also advocated for further standardization of regulation and for development of frameworks for data sharing, to facilitate capital flows, and suggested that the OECD may be the most appropriate institution for this.

The importance of international standards was echoed by the second panelist, **Otávio Ribeiro Damaso** (Deputy Governor, Central Bank of Brazil). International standards such as the Code play a crucial role by creating a level playing field. Brazil is in the process of adhering to the Code. **Mr. Damaso** argued that instruments like the Code must also consider country-specific circumstances and the need to ensure that capital flows do not compromise financial stability, particularly in EMEs, where capital flows have been primarily driven by the international conditions, including those in advanced economies. EMEs also have a role to play in ensuring financial stability by implementing sound policies, and developing good supervisory and monitoring systems, as has been done in Brazil. **Mr Damaso** also highlighted a number of new challenges that will require new tools and further standardization, such as fintech, cyber risks, the role of non-banks in international finance, and technological disruption.

The final speaker was **Benoît de Juvigny** (Secretary General, Autorité des Marchés Financiers). He agreed with the previous speakers on the need for international harmonization of regulation. He argued that when countries act alone to regulate capital flows there can be harmful spillovers to other countries. These can in turn create spillbacks and other unintended consequences that are harmful to the regulating country. **Mr. de Juvigny** agreed with **Mr. Karrer** that data privacy regulation creates problems for the sharing of information relevant to capital flows, and suggested that IOSCO may be able to develop an appropriate information sharing platform. He also agreed with **Mr. Damaso** that we need to be conscious of new challenges, and suggested that ensuring finance is sustainable or green should be added to that list of challenges.

In the open floor session, the issue of information sharing was discussed further. The point was made that it is often difficult to know which policies have been implemented by other countries. **Mr. Karrer** suggested that a mechanism could be created for this purpose under the Code, while **Mr. de Juvigny** advocated close cooperation with the IOSCO on developing a framework for information sharing would be useful. The representative from Norway raised the question of what the appropriate level of capital flows would be, given that the pre-crisis level of capital flows was in part driven by what we now know was excessive leverage. While the optimal level of capital flows is unclear, the panelists agreed that part of the drop in capital flows since the crisis was due to necessary and beneficial bank regulation.

Session 2: Moving international co-operation on capital flows a step forward

The second session was chaired by **Ms. Boone,** who opened by explaining the distinct but complementary roles of the OECD Code and the IMF Institutional View. The OECD Code is a binding multilateral agreement, which commits adherents to liberalization, but does not have universal membership. The IMF Institutional View is a reflection of best advice on the economic appropriateness of capital flow measures, and has wider coverage (incorporating some systemically important countries that are not covered by the OECD Code), but is not binding.

The first panelist of this session was **Masamichi Kono** (OECD Deputy Secretary-General). **Mr. Kono** described how, following the financial crisis, many countries adopted various macroprudential, capital flow management, and currency-based measures in an effort to ensure financial stability and reduce the volatility of capital flows. It is in this context that the project of revising the OECD Code was undertaken. The new Code reflects this by providing more flexibility to respond to capital flow concerns in a transparent way. Certain measures, such as national adaptations of the Basel III tools, are explicitly permitted, while others are reviewed on a case-by-case basis. Countries also have the option of lodging new reservations on short-term capital movements or invoking the derogations clause. However, adherents are still expected to progress towards full liberalisation. While the new Code is greatly improved, further work is required to involve systemically important countries that are not yet adherents to the OECD Code.

Luis Awazu' Pereira da Silva (Deputy General Manager, Bank for International Settlements) began his contribution with a reminder of the virtuous cycle that is expected to arise from financial integration with capital account openness. He acknowledged that in some situations there could be excessive capital inflows; in such situations, a good policy framework can restore the virtuous cycle. The key challenge, then, is to choose policies that minimize spillovers to other countries and avoid producing a "regulatory war". Coordinated regulation of capital flows results in a better outcome for all countries than the Nash equilibrium of a regulatory war. **Mr. Pereira da Silva** suggested that multiple international organisations could contribute to achieving coordination on capital flow management. The BIS in particular expects to contribute by monitoring capital flows, providing data to other organisations, making the case for the benefits of coordination to its members, and by incorporating reciprocity principles in the mechanisms and regulations for which it is responsible, such as counter-cyclical capital buffers.

As the representative of the IMF on the panel, **Petya Koeva-Brooks** (Deputy Director, Strategy, Policy, and Review Department, IMF) focused in her remarks on the relationship between the OECD and the IMF. She largely agreed with the earlier assessment provided by the panel: the OECD Code is a legal framework that commits its adherent countries to capital account liberalization, whereas the IMF Institutional View provides general guidance for countries in a range of circumstances, including those whose economies are not yet ready for the degree of liberalization required for adherence to the Code. **Ms. Koeva-Brooks** praised events like the high-level seminar for increasing awareness of the potential for cooperation between the IMF and OECD, and suggested specific areas for future cooperation including research on the preconditions that make a country ready to join the OECD Code and analytical research on what counts as a capital inflow surge.

Andy Baukol (Deputy Assistant Secretary for International Monetary Policy, US Treasury) echoed the comments of **Ms. Koeva-Brooks** on the complementarity of the OECD Code and IMF Institutional View. He gave the example of the experience of Iceland during the global financial crisis: the IMF recommended the introduction of temporary capital controls, and Iceland was able to do so transparently and without damaging its credibility among international investors by applying for a derogation under the OECD Code. **Mr. Baukol** also echoed the comments of the speakers in the first panel about the need to be aware of new risks to the global financial system and develop new frameworks to respond to them. He repeated the concerns raised by previous speakers about non-bank actors, and mentioned a number of additional concerns including the global savings glut, the prevalence of negative interest rates, and possible protectionist policies to target current account imbalances.

The final speaker of the panel was **Marek Belka** (Professor at the Institute of Global Affairs, London School of Economics, and former member of the Eminent Persons Group on Global Financial Governance). He reflected that when the Eminent Persons Group was preparing its report to the G20 on necessary reforms to the global financial system, a decision was taken to endorse the OECD view that all countries should move towards complete liberalization. While capital flows can sometimes be destabilizing, ultimately there is no chance for development without them; and since state aid constitutes only a small portion of capital flows to the developing world, it is necessary to mobilize private capital. He echoed the BIS in calling for further international cooperation to develop a policy framework that facilitates international capital flows without creating undesirable spillover effects between countries.

Following the panelists' contributions there was a lively floor discussion. **Mr. Pereira da Silva** suggested that the BIS metrics might be of use in answering **Ms. Koeva-Brooks'** question about capital flow surges. Several participants pushed back on an overly enthusiastic view of free capital movements: **Ratna Sahay** (Deputy Director, Monetary and Capital Markets Department, IMF) raised the issue of phantom FDI that is really regulatory arbitrage, serving no productive purpose, while the Governor of the Bank of Indonesia argued that emerging markets must retain the capacity to defend themselves from excessive capital flows. **Ms. Sahay** also suggested that cooperation and avoidance of spillovers might be difficult to achieve when there is little incentive for capital sending countries to implement such policies, given the lack of spillbacks to their own markets. Other participants were eager to delve into more detail on international spillovers and specific areas of future cooperation: the WTO representative gave examples of spillovers from questions of capital account liberalization to trade disputes, and the Governor of the Central Bank of Costa Rica was eager to investigate the scope for cooperation on capital flows to the non-bank sector which is not subject to central bank regulation.

Session 3: Making credible commitments: How economies with a recent history of capital controls can continue progressing on the liberalisation path

In the third session, several representatives of emerging markets were invited to discuss their experience of capital account liberalization. The session was chaired by **Masamichi Kono**, who highlighted previous OECD research showing that the long-term positive effect of capital account openness on growth outweighs the negative effects due to the greater incidence of crises following capital account opening. He emphasized the importance of credible commitment to liberalization for realizing the growth benefits, and noted that the OECD Code is a mechanism for credible commitment. The revised Code also permits the re-introcuction of capital controls to respond to financial stability risks, and encourages adherents to pursue gradual, phased liberalization.

Indonesia implemented full capital account liberalization in 1982, taking what **Perry Warjiyo** (Governor, Bank of Indonesia) described as a "Big Bang" approach. He advised that other countries should avoid this and instead should follow the more gradual approach to liberalization advocated by the IMF. However, despite the bumpy beginning, **Mr. Warjiyo** was unequivocal about the benefits that liberalization had brought to Indonesia. He said that capital flows had filled a savings and investment gap in the country, enabling economic growth. The long-term benefits to liberalization outweigh any short-term gains from capital controls, and he said that Indonesia would never consider introducing such controls. **Mr. Warjiyo** identified four elements to successfully operating under free capital flows: a good reporting system to monitor external flows; a clear policy framework for risk management; deep capital markets to ensure efficient allocation of resources; and an early-warning system in the form of regular high-level meetings between monetary and fiscal policy-makers.

Rodrigo Cubero (Governor, Central Bank of Costa Rica) agreed with **Mr. Warjiyo** that capital account openness had more benefits than downsides. In addition to the increase in investor confidence and FDI inflows – the virtuous cycle earlier described by **Mr. Pereira da Silva** – **Mr. Cubero** said that Costa Rica had also benefited from more competition in the financial sector. Costa Rica hopes that accession to the OECD will enhance these benefits. **Mr. Cubero** noted that Costa Rica has faced some challenges arising from capital account openness, in particular lending in dollars, which both creates financial vulnerabilities and limits the effectiveness of monetary policy. He suggested that currency-differentiated reserve requirements and macroprudential policies might be used to address these concerns.

A dissenting position was taken by **Mridul Saggar** (Adviser, Reserve Bank of India), who argued that complete capital account liberalization is inappropriate for emerging markets such as India. An open capital account entails some loss of control of monetary policy, which is a greater problem for emerging markets with large populations that are especially vulnerable to fluctuations in inflation. Rather than committing to complete capital account openness, India uses a form of soft capital flow management. This includes pre-emptive capital flow measures. **Mr. Saggar** argued that such measures enable an emerging market to find the balance between financial stability and beneficial investment inflows, while also doing less damage to international credibility than emergency measures in response to excessive capital flows. He also criticized continuing advocacy for increased capital account liberalization by countries that are simultaneously restricting trade flows, suggesting that the real economy must come before the capital account.

Then, **Hayrettin Demircan** (G20 Sherpa, Ministry of Finance, Turkey) took an intermediate position in his reflections on Turkey's experience of liberalization. Turkey has adhered to the OECD Code since its institution, in 1961. The commitment imposed by adherence to the Code has helped to attract capital inflows for investment. However, these inflows have also caused appreciation of the lira, which has created problems for Turkey in the past ten years. Additionally, there is increasing concern about phantom FDI, mentioned earlier by **Ms. Sahay**, which is used to evade taxation and brings no real benefit to Turkey.

The final speaker of the panel was **Ratna Sahay**, who shared her views on lessons for emerging markets in the history of advanced economies' capital market liberalisation. Most countries liberalised gradually, and occasionally retreated from liberalisation; this suggests that they encountered risks which they sought to mitigate. Drawing on this history, the IMF today advises countries to liberalise gradually and that liberalisation is not an appropriate goal for all countries at all times. Liberalisation should proceed in a logical sequence, alongside coordinated supporting reforms. Countries should not precommit to liberalisation within a particular window of time, but rather should commit to liberalisation once certain conditions have been met. To enhance credibility and ensure commitment, these conditions should be shared with the public.

Masamichi Kono concluded the session by highlighting the key themes he identified from the panellists' contributions: the importance of having a strategy for managing the capital account was mentioned by several speakers, as was the need to communicate in order to maintain investor confidence. Financial market deepening, effective monitoring, and judicious use of alternative policy such as macroprudential measures can help emerging markets avoid the perceived need for capital flow restrictions.

Session 4: Future vulnerabilities: capital flows and the migration of risks to new corners of the financial system

Tuomas Peltonen (Deputy Head of Secretariat, European Systemic Risk Board) opened the fourth session with an overview of the activities of non-bank actors in the financial system. He first noted that most post-crisis regulation targeted the banking sector, creating an incentive for financial activity to shift out of this sector. In emerging economies, this has manifested in two ways: first, non-financial corporations have increased their issuance of dollar-denominated debt, and second, larger non-financial corporations have begun to act as financial intermediaries. In advanced economies, there is also concern about the role of the shadow-banking sector: in Europe, this sector is growing rapidly, while in the US it is not growing but is already equal in size to the formal banking sector. The shadow banking sector is less heavily regulated than the banking sector and therefore may be a source of financial instability.

The basic weakness of the global financial system, according to **Claudio Borio** (Head of the Monetary and Economic Department, Bank for International Settlements), is its failure to properly anchor financial contractions and expansions. This can be seen by looking at gross capital flows, which globally follow a cycle that coincides with the business cycle. This cyclicality is a source of vulnerability, which could be managed with an appropriate policy regime. Specific sources of risk at the current juncture include US dollar funding, not least off balance sheet via FX swaps, and cross-border flows linked to the asset management industry. The BIS advocates implementing macro-financial stability frameworks, in which monetary policy, macroprudential policy and fiscal policy help address financial imbalances. There must also be cooperation on an international level. While progress has been substantial in developing common standards and a principle of reciprocity in macroprudential policy, there are still gaps in the regulation of asset management and in international coordination of monetary policy.

Mario Marcel (Governor, Central Bank of Chile) reported that in the Chilean context, a major concern is exposure to foreign currency risk. This is seen both on the balance sheets of traditional banks and in the activities of non-bank actors, including institutional investors such as insurance companies and non-financial corporations. He advocated the use of macroprudential measures to manage currency mismatches. **Mr. Marcel** also echoed the comments of some speakers from the third panel by recommending that emerging markets retain the option of using capital controls in exceptional circumstances; he noted that Chile has included some such measures in its list of reservations under the Code, although they have not been used since the 1990s.

Drawing on his academic research, **Ugo Panizza** (Professor of International Economics, Pictet Chair, and Director of the Institute's Centre for Finance, The Graduate Institute Geneva) provided further information about the role played by non-financial corporations in emerging markets. He explained that many corporations have high dollar debts not because they are using the money to invest in the domestic real economy, but because they want to take advantage of the interest rate differential. This contributes to the build-up of currency mismatches and can introduce instability; his research shows that among large firms, those that are more highly leveraged are more fragile. **Mr. Panizza** cautioned that the activities of these non-financial corporations should be closely monitored and that regulation must be carefully designed to ensure it cannot be evaded. He cited the experience of China, where the introduction of limits on bank borrowing by corporations in risky sectors led to large firms in those sectors issuing more debt and then acting as lenders to smaller corporations without access to international debt markets. This effectively shifted he risk originally identified by the regulator in the banking sector to the unregulated non-banking sector.

Further evidence for the increasing importance of non-bank actors to the global financial system was presented by **James Talbot** (Director, International Directorate, Bank of England), who noted that all of the net increase in lending to emerging markets since the financial crisis has come from non-bank actors, with investment funds playing an important role. He highlighted the Bank of England's annual review of financial stability risk and regulation beyond the core banking sector as one way to better understand these risks. In addition, the Bank of England and the UK Financial Conduct Authority (FCA) had recently announced an assessment of how funds' redemption terms might be better aligned with the liquidity of their assets in order to minimise financial stability risks. This could be seen as an example of a step towards policy action in this space that could be replicated elsewhere. However, since non-bank finance is a global market, domestic policy must be supplemented with cooperation at the international level. This is why the Bank of England supported international work on addressing structural vulnerabilities from asset management activities. **Mr. Talbot** noted that there is a clear link between the search for yield among non-bank actors in advanced economies and capital flows experienced by emerging markets. This creates a natural space for policy cooperation between advanced and emerging economies. Advanced economies have incentives to regulate these flows because leveraged lending by non-bank actors is a clear stability risk, with contagion possible due to large exposures of some banks to such actors.

Ksenia Yudaeva (First Deputy Governor, Bank of Russia) agreed with **Mr. Talbot** that there was a fundamental connection between the activities of non-bank actors in advanced economies and the debt levels of non-financial corporations in emerging economies. She suggested that if an international regulatory framework could be agreed for asset managers, the debt of non-financial corporations in emerging markets would be reduced. She recalled the earlier comments of **Mr. Baukol** on the global savings glut, noting that this may in part be driven by central banks accumulating foreign reserves in case they need to intervene in the foreign exchange market to mitigate risks arising from the currency mismatches of domestic firms. **Ms. Yudaeva** reiterated concerns raised by **Professor Panizza** about capital inflows exclusively for arbitrage, rather than for FDI. She also raised the issue of crypto assets, which are largely used to move capital internationally and should be the subject of greater attention in future.

In the open floor session, the US representative requested more information about the Bank of England's steps towards regulation of the non-bank sector, and was in particular interested in whether any regulatory policy had been introduced. **Mr. Talbot** replied that at present the joint FCA/Bank of England review of funds was at an initial analytical stage, but would consider policy options in due course. **Mr. Marcel** also noted the surveillance efforts ongoing in Chile, prompting **Prof. Panizza** to highlight the potential for collaboration between regulators and academia in analyzing the data resulting from such monitoring.

Closing Remarks

Closing remarks were offered by **Greg Medcraft** (Director, OECD Directorate for Financial and Enterprise Affairs) and **Manfred Schekulin** (Chair of the OECD Investment Committee). **Mr. Medcraft** reflected that the themes under discussion at this seminar have connections to many topical issues: financial and trade flows are two sides of the same coin; having an understanding of, and ability to regulate, capital movement is heavily dependent on understanding the role played by offshore financial centres; and as several previous speakers mentioned digital currencies will constitute an important part of future international capital flows. He stressed the importance of cooperation between international organisations on such topics, emphasizing that rather than duplicating work organisations should reinforce each other's specific insights and capabilities. In this vein, the OECD Code plays an important role as a multilateral instrument for regulating capital flows.

Mr. Schekulin continued where **Mr. Medcraft** left off by identifying the key strengths of the OECD Code. He suggested that 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, based on the principles of transparency and mutual accountability that are indispensible for international cooperation. After the successful review of the Code the next task is to broaden its application, and thus to deepen its impact. He encouraged emerging market countries to consider adhering to the Code. **Mr. Schekulin** concluded with a broader call for coordinated action to ensure the continued functioning of the global financial architecture.

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