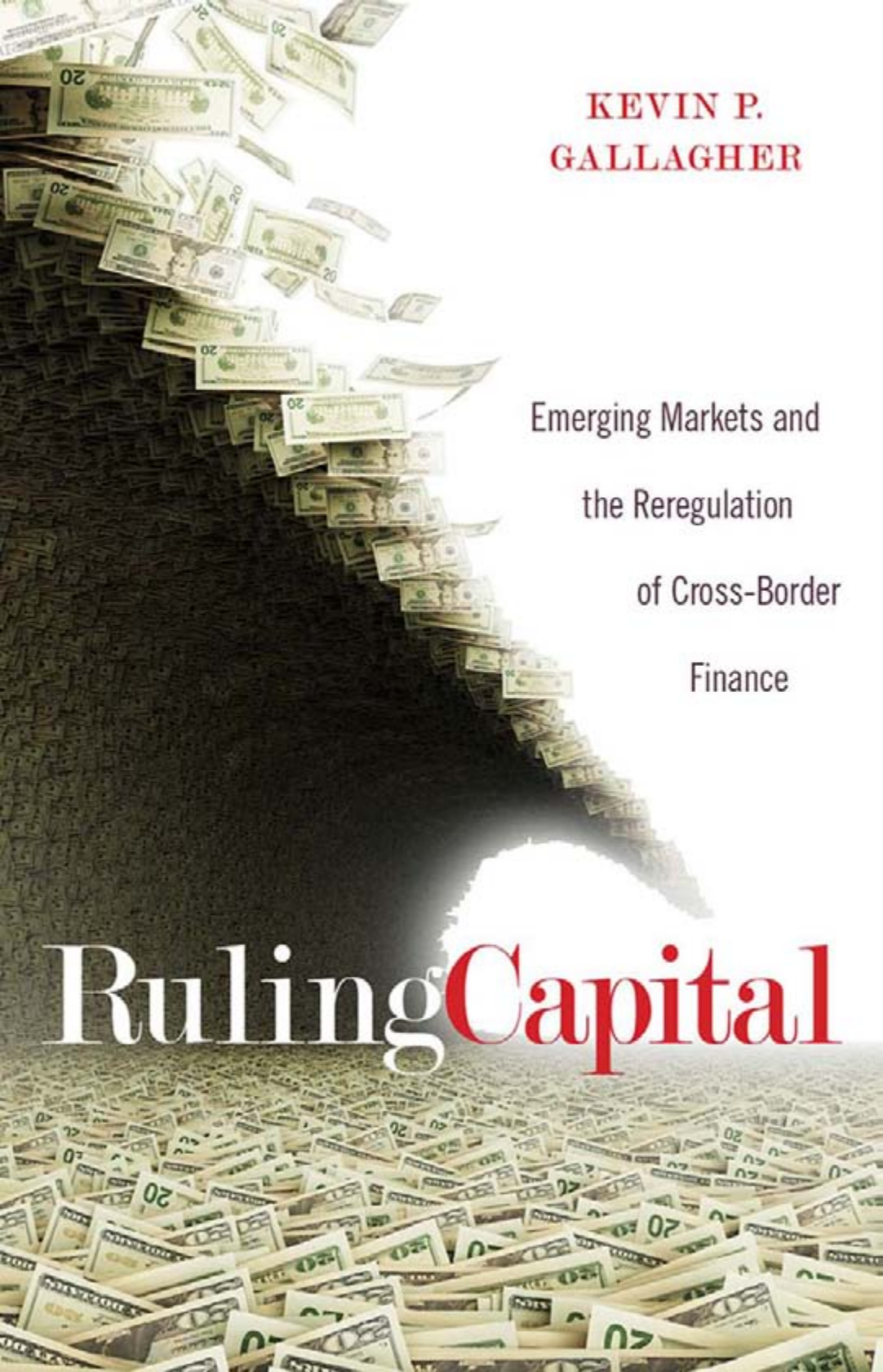
KEVIN P.
GALLAGHER
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the Reregulation
of Cross-Border
Finance
Ruling Capital

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RULING CAPITAL

Emerging Markets and the Reregulation of Cross-Border Finance

Kevin P. Gallagher

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Preface

This book emerged from my participation in a great number of policy, academic, and public engagements on the reform of global economic governance in the wake of the 2008 global financial crisis. While much of the global discussion concerned the impact and governance implications of the crisis on the industrialized world, I and many of my closest colleagues were equally concerned about the implications for the emerging-market and developing countries—where financial fragility is quite different from the experience of the industrialized countries. To name just a few of these engagements, I served on a subcommittee of the US State Department Advisory Committee on International Economic Policy, cochaired and founded the Pardee Task Force on the Regulation of Capital Flows, and engaged on these topics with policymakers at the International Monetary Fund, at the G24, at the United Nations, and in several national capitals.

In this book, I examine the extent to which emerging-market and developing countries have become better equipped to govern the global capital flow cycle at both the domestic and global levels. I find that there have been significant and positive developments. That said, my analysis suggests that such changes have not been adequate to prevent or mitigate the next financial crisis. Nevertheless, an understanding of the economic and political forces that led to these incremental changes may help us understand how more comprehensive reform may be achieved in the future.

Generous grants from the Institute for New Economic Thinking (INET) and the Ford Foundation allowed me to get at arm's length from these discussions and devote a considerable amount of time to thinking more analytically and conducting empirical research about the process of change in emerging markets and in the global system. I thank INET and the Ford Foundation, especially Leonardo Burlamaqui, for this opportunity. With this financial support, I was able to write a first draft in Buenos Aires, Argentina, as a visiting scholar at the Centre for the Study of State and Society. Leonardo Stanley, Martin Rapetti, and Roberto Frenkel couldn't have provided a better atmosphere for writing about the political economy of macroeconomic policy. Thank you.

This work also benefited enormously from engagement with my collaborator, colleague, and friend José Antonio Ocampo. Dr. Ocampo served as finance minister in Colombia and as head of two key United Nations bodies, and he is now perhaps the leading economic thinker on the economics and governance of capital

flows in developing countries. Conversations with and the writings of Ocampo, as well as Stephany Griffith-Jones, Ricardo Ffrench-Davis, Anton Korinek, Jan Kregel, Daniela Prates, Ilene Grabel, and others, were indispensable to me.

But this book looks very different from my previous books because of my dialogue with international political economists. I realized early on that to fully answer the research questions I had set out for myself I would have to seriously confront the political as well as the economic forces of change in the global economic system. I have greatly appreciated the time that Cornel Ban, my colleague at Boston University (BU), took to read an entire early draft of the manuscript and provide advice on how it could engage a broader audience in the political economy literature. William Grimes, also at BU, was an enormous help. I had emptied half his bookshelf by the time this book went to press. I am also enormously indebted to Eric Helleiner, Jeffrey Chwieroth, and Kevin Young, who also provided extensive commentary and advice along the way. Rawi Abdelal's 2007 book was also foundational. Finally, I thank Mark Blyth for asking me to serve on the board of the *Review of International Political Economy* (RIPE). Being on the board of RIPE was a real gift while writing this book; I was able to review cutting-edge research in this field and engage with great co-editors in Juliet Johnson, Leonard Seabrook, Cornelia Woll, Daniel Mugge, Catherine Weaver, Gregory Chin, and Ilene Grabel.

I discussed these issues with a great number of people. I thank Peter Chowla, Aldo Caliari, Sarah Anderson, Lori Wallach, Todd Tucker, Arvind Subramanian, Manuel Montes, Yilmaz Akyuz, Shinji Takagi, Paulo Nogeira Battista, Rakesh Mohan, Atish Ghosh, Sean Hagan, Olivier Blanchard, Jonathan Ostry, Atish Ghosh, Deborah Siegel, Vivek Arora, Amar Bhattacharya, Meg Lundsager, Leonardo Burlamaqui, Hung Tran, Sandrine Rostello, Nelson Barbosa, Barney Frank, Rubens Ricupero, Luis Bresser Pereira, Jose DeGregorio and many others who have asked not to be attributed.

BU continues to be a great home for conducting research. At BU, I codirect the Global Economic Governance Initiative (GEGI), whose mission is to advance policy-relevant knowledge about economic governance for financial stability, human development, and the environment. GEGI is an initiative that spans three entities at BU: the Pardee Center; the Center for Finance, Law and Policy; and the Pardee School of Global Studies. All three have provided me with incredible support. The work for this book is a part of the GEGI Political Economy of Global Finance program. I thank the entire group for engagement, especially my codirector Cornel Ban. Cynthia Barakatt deserves special thanks for her tireless and meticulous work in the production and editing of this project. Victoria Puyat has also been a strong arm of GEGI events throughout this process, as has Jill Richardson, in advancing the work to a broader audience.

Several students assisted in this work, either through GEGI or directly as research assistants. I thank Brittany Baumann, Bruno Coelho, Elen Shrestha, and Xuan Tian for serving as research assistants on five of the core statistical analyses for this book. I also thank June Park, Amos Irwin, Juliana De Costa Plaster, and Alex Hamilton for very strong and useful research assistance. Finally, I thank the graduate students in my December 2012 Global Development Capstone course and my spring 2013 graduate seminar Globalization, Governance, and Development, which I designed entirely around the subjects in this book. Engaging with those students and the material gave me excellent ideas for the structuring of and execution of this work.

I sincerely thank Roger Haydon at Cornell University Press, as well as Eric Helleiner and Jonathan Kirshner, who edit the Cornell Studies in Money. I quickly realized that the majority of the key works in the field had been published in this series and aspired to have my book on their great list.

I am eternally grateful to my family. Kelly, Theo, and Estelle, you are the source of joy and inspiration in my life. I dedicate this book to you.

RULING CAPITAL

1

COUNTERVAILING MONETARY POWER

In 2010, Brazilian Finance Minister Guida Mantega made global headlines by scolding the West for starting a "currency war." Mantega singled out Ben Bernanke, then chairman of the US Federal Reserve Bank, as the most egregious warrior for pushing interest rates down and debasing the dollar relative to the Brazilian real. In response to this, Mantega announced yet another round of capital controls—curbs on short-term financial flows into Brazil—to mitigate the appreciation of the real and to stem growing asset bubbles. Mantega continued such charges, and responses, for the next two years.

As the Republic of Korea (South Korea) hosted the 2010 G20 Summit, it too took almost identical actions to curb a surge in capital flows. Rather than branding its efforts as capital controls, however, South Korea insisted that the measures were "macroprudential" instruments aimed at regulating the build up of systemic risk due to foreign exchange holdings. Indeed, South Korea, Brazil, and other emerging-market and developing countries (EMDs) developed a third generation of regulations to mitigate the harmful impacts of excessive capital flows in the wake of the financial crisis. These countries were able to incorporate their concerns about needing clarity on regulating capital flows into the 2010 G20 communiqué, which said the global community would conduct "further work on macro-prudential policy frameworks, including tools to help mitigate the impact of excessive capital flows" (G20 Information Centre 2010a). Many other nations, including Costa Rica, Indonesia, Peru, Philippines, Uruguay, and Taiwan, had taken action to prevent currency appreciation and asset bubbles by regulating the inflow of capital as well.

Bernanke and central bankers in other industrialized countries repeatedly defended their actions. To them, the expansion of central bank balance sheets was an important tool to recover from the crisis (Bernanke 2013). Bernanke acknowledged that his actions and those of other central bankers triggered capital flow volatility but insisted that such changes were unfortunate side effects of otherwise good and important policies. After all, given that industrialized countries make up more than half the global economy, if the industrialized world didn't recover from the crisis the costs to the EMDs would be high.

When the United States announced in May 2013 that it would eventually taper off its expansionary monetary policy by the end of that year, there was a reversal of capital flows from many emerging markets. Currencies in Brazil, India, Indonesia, South Africa, Chile, and Turkey, which had soared from 2009 to 2012, then nose-dived in 2013 and early 2014. This caused the most alarm in Indonesia, South Africa, and India, countries with significant current account deficits and relatively less foreign exchange reserves than other EMDs. India put in place capital controls on the outflow of capital in an attempt to stem capital flight from the country. Not surprisingly then, economic discussions at the 2013 G20 meetings in Russia were dominated by capital flow volatility once again. In the final communiqué for 2013, the G20 leaders pledged to be clearer and to coordinate monetary policy so as to ease the volatility in global capital markets (G20 Information Centre 2013). If capital flows reversed simply on the announcement of a change in US monetary policy, EMDs were quite concerned about what would happen when the policy actually changed.

Both parties—EMDs and the industrialized countries—were partly right in taking the positions they did. Because of the financial crisis, the industrialized nations wanted to stimulate domestic investment and demand to recover, and they saw expansionary monetary policy as a tool to achieve that goal. Because many EMDs rebounded relatively quickly from the crisis and continued their fast growth, they wanted to ensure that their economies did not overheat. Yet the crisis led the EMDs to get caught in yet another global-capital-flow cycle, one in which too much capital surged into EMDs during good times and too little was available during hard times. EMDs knew all too well that capital flows could surge into their economies in such times, only to suddenly reverse course. Such exogenously determined volatility has played a big role in creating numerous financial crises in EMDs and is responsible for lost decades of growth, lost livelihoods, and lost elections.

So this time around, industrialized nations expanded the monetary base to recover from the crisis, and some EMDs put in place domestic regulations aimed at curbing the negative spillovers from Western monetary expansion. Although incremental, this was a significant change in policy direction. This time, EMDs

boldly reregulated cross-border financial flows in the wake of the crisis. According the International Monetary Fund (IMF), in 2011 164 countries used capital controls, compared to 119 in 1995 (IMF 2012a; Helleiner 1998). This time, the West did not crack down on a bilateral basis or through the IMF when EMDs regulated cross-border capital flows.

In this book, I trace how several EMDs reregulated cross-border financial flows in the wake of the crisis and moved to create more policy space for such measures in global economic governance institutions. I also show how the regulation of cross-border finance has become justified in the economics profession more than ever and how the diffusion of new economic thinking partly enabled the EMDs to achieve policy change. In the book, I also highlight how, at the IMF and at the G20, EMDs have succeeded in creating more room to regulate cross-border finance but have been less successful in opening up space in the trade and investment regimes. These positive steps may not be enough to prevent or mitigate the next crisis, however. The result is a complicated patchwork of overlapping regimes that sends mixed signals to countries looking to regulate cross-border finance.

Global Governance of Capital Flows: What Has Changed?

One of the central pillars of the Washington Consensus of the 1990s has partially fallen. Under the Washington Consensus, developing states were encouraged to liberalize trade and investment and generally reduce the presence of the government in economic affairs. Note that the original articulation of the Washington Consensus did not extend to short-term capital flows (Williamson 1989). That didn't stop the United States, the World Bank, and especially the IMF from pushing for capital account liberalization (the deregulation of restrictions on the movement of cross-border financial flows) throughout the 1990s and early 2000s (Stiglitz 2002).

In comparing the earlier era to today, the central research question of this book is: To what extent has the governance of cross-border financial flows changed in the wake of the global financial crisis of 2008? To fully answer this overarching question, a number of other questions also have to be asked:

- Has economic thinking about the regulation of capital flows, at both the theoretical and empirical levels, changed?
- To what extent has new economic thought diffused into policy circles?
- To what extent have surges of capital inflows, sudden stops, and capital flight continued to be prevalent?

- What political and economic factors led some countries to regulate capital flows and others not to do so?
- To what extent were the measures taken effective at achieving their goals?
- To what extent has the IMF changed its policy regarding the regulation of capital flows?
- To what extent has the G20 emerged as a new forum to coordinate global and domestic regulation of capital flows?
- To what extent has the trade and investment regime supported the ability of nation-states to coordinate global and domestic regulation of capital flows?

The key policy instruments under analysis are regulations of cross-border financial flows. To avoid redundancy, throughout the book I refer to these regulations as *cross-border financial regulations, capital account regulations, capital management techniques, capital controls,* and *capital-flow management measures*. There are three generations of such regulations: (1) outright quantitative controls on the inflow or outflow of capital, (2) price-based measures on financial flows such as taxes, and (3) regulations (either quantity- and price-based) on foreign exchange derivative transactions. In chapter 2, I trace how such regulations had fallen out of fashion in the West to the point of scorn by the 1990s. To manage capital flows, a common recommendation was to float the exchange rate, intervene in currency markets (lightly), reduce public debt, tinker with the interest rate, establish capital requirements for banks, and deepen domestic capital markets. Each of these measures can be important for the management of capital flows. But they often are unavailable, are too costly, take too much time, or are inadequate responses to surges and sudden stops of capital. The need to couple those responses with regulations on cross-border finance is increasingly seen as legitimate and important.

My primary focus in this book is on the international political economy of cross-border financial regulations. Such a focus does not suggest that the other measures are not important or that capital account regulations are a substitute for those measures. I focus on cross-border regulations because they were so strongly out of fashion in many EMDs, in academia, and in global economic governance institutions by the turn of the century but made a comeback after the global financial crisis in 2008.

The period I analyze in this book is roughly 2007 to 2014, with an intense analysis of the period 2009–2012. As shown in Figure 1.1, the period 2007–2013 includes a peak in capital inflows to EMDs (in 2007), a sudden stop and capital flight (in 2008–2009), a surge in capital inflows to EMDs from 2009 to 2012, and another slow down and partial reversal in 2013 and 2014. As I show in chapter 3,

FIGURE 1.1. Capital flows to emerging markets, 2005–2013 (Collyns et al. 2013).

this is a typical capital flow cycle, characterized by surges of inflows, sudden stops, and capital flight.

I deploy a variety of methods to answer these research questions. To answer those questions that are economic in nature, I draw on economics and perform econometric analyses. To answer those questions that are political in nature, I draw from the international political economy (IPE) literature and rely on content analysis, coding, and in-depth interviews with key actors and observers. Finally, to examine the extent to which the regulation of capital flows is permissible under various trade and investment treaties, I conduct a legal analysis. My aim in examining the political and economic dynamics of the 2007–2013 global capital flow cycle is to help understand that turbulent period in global economic history and to help scholars and policymakers think about how to prevent and mitigate further manifestations of capital flow cycles.

I find that the 2008 global financial crisis is indeed associated with significant changes in the governance of capital flows. These changes include that (1) regulating capital flows is now more justified within the economics profession than in

the 1990s, (2) more countries have put in place domestic regulations on financial flows than in past crises or during the boom preceding the crisis, (3) the IMF and the United States are now less likely to be in outright opposition to countries that chose to regulate capital flows, (4) there is at least a temporary understanding at the World Trade Organization (WTO) that nations will not be subject to disputes for regulating capital, (5) free-trade agreements (FTAs) and bilateral investments treaties (BITs) are now seen to be very restrictive in this manner, although a handful of countries have negotiated carve-outs in their trade treaties that allow them to regulate capital flows (or have refrained from signing new ones), and (6) the newly elevated G20 has proclaimed that countries have the policy space to regulate capital flows as well.

These changes are positive, but the international monetary system is still plagued with obstacles that make the reregulation of cross-border finance difficult. Although new thinking in economics is converging on the need to regulate capital flows at the domestic and global levels, many countries across the world lack the political space and the policy space to regulate them effectively. Collective action problems are accentuated by institutional arrangements that make it more difficult for countries to put in place regulation at the domestic level and formulate policy for global coordination. Often the actors that stand to bear the cost of regulation are more powerful and supported by institutions even though the broader benefits of regulation outweigh those costs. These factors play a big role in EMD political economies, and they are compounded by the lack of attentiveness by industrialized countries to the global impacts of their monetary policies, to financial regulatory reform, and to the restrictiveness of their trade and investment treaties. Moreover, the IMF still does not endorse capital controls in many circumstances, the Organisation for Economic Cooperation and Development (OECD) is beginning to brand cross-border financial regulations "investment protectionism" under the auspices of the G20, and a proliferation of US trade and investment treaties restrict and penalize the ability of nations to regulate capital flows.

Outline of the Book

In this book, I draw on a variety of theoretical and methodological approaches from economics, political science, and law to explain the extent to which emerging market and developing countries were able to gain the political and policy space to reregulate cross-border financial flows in the wake of the financial crisis. *Political space* refers to the power of states to act given a convergence of parties and interest groups, institutions, and ideas on a desired policy output. *Policy*

space refers to the flexibility of international institutions to allow sovereign states to deploy and coordinate desired policy outputs (Gallagher 2005; UN Conference on Trade and Development [UNCTAD] 2012b).

From economic theory, I draw on work dating back to the *Tract on Monetary Reform* by John Maynard Keynes (1929) and am also highly guided by new breakthroughs in economic theory stemming from the work of Hyman Minsky, Kenneth Arrow, and Joseph Stiglitz. In addition, a number of econometric exercises are performed to answer questions that form the core of this book.

From political science I draw heavily on the IPE literature, which recognizes that a number of factors can integrate to explain outcomes and attempts to explain how the relative interaction of power (often exercised through interest groups), institutions, and ideas led emerging markets to reregulate cross-border financial flows. For this analysis, in some chapters I rely on case study research in four emerging market countries—Brazil, Chile, South Africa, and South Korea—all of which attempted to preserve the policy space to regulate cross-border finance at the IMF and/or in trade and investment treaties; two deployed capital account regulations on the domestic level, and two did not. For the case studies, I supplemented extensive analyses of major national news outlets with in-depth interviews with key in-country actors, as well as with data analysis.

This book looks at the sudden stop in capital flows that resulted from the crisis of 2008, the surge in capital flows that occurred from 2010 to 2012, and an episode of capital flight in 2013. My aim is to analyze how nation-states respond to these episodes at the national and global levels to understand the political and economic forces that may help prevent and mitigate such surges and sudden stops into the future.

In chapter 2, I frame the previous literature on regulating capital flows from the wake of the Great Depression to the financial crises that plagued EMDs in the 1990s. Eric Helleiner and Stefano Pagliari (2011) characterize international financial regimes as having either strong international standards, where each nation adheres to a uniform standard, or cooperative decentralization, where there is international cooperation across a variety of national standards. The trade regime may be an example of strong international standards; the IMF is an example of cooperative decentralization, at least with respect to capital account regulations. As shown in chapter 2, Article VI of the IMF Articles of Agreement grants nations the policy space to deploy capital account regulations as they think necessary and allows nations to cooperate on such measures across international borders. I trace the literature showing the many challenges to cooperative decentralization since the 1940s, when the regime was established. The regime was challenged during its very inception and throughout the twentieth century, culminating with an attempt to formally change the regime from one of cooperative

decentralization to strong international standards through an amendment to the IMF articles in the late 1990s. The chapter synthesizes the previous literature showing how economic power, institutions, domestic interests, and ideas interacted to erect, challenge, and maintain the regime for regulating capital flows.

At the turn of the twenty-first century, however, thinking and action with respect to regulating capital flows began to change. In chapter 3, I trace the evolution of economic thinking from the early 1900s to 2014 with respect to capital flows. I discusses the major breakthroughs that have occurred in our understanding of how capital flows work in the economy and the extent to which regulating capital flows is justified and effective. Understanding these changes is important in general, but it is also important for tracing the changes in policy that are analyzed in later chapters. Why are these new ideas accepted and advocated by some actors in the global system but not by others? In the wake of more than two decades of financial crises at the end of the twentieth century, a new wave of theoretical and empirical research has ensued. This work has yielded results that challenge conventional thinking about capital account liberalization and the regulation of capital flows. In the econometrics literature, capital account liberalization was shown not to be associated with economic growth or financial stability in EMDs. Moreover, econometric evidence in the 2000s began to show that regulations to mitigate the harmful effects of capital flows have been (at least partly) effective in meeting their goals.

Advances in economic theory began to show the regulation of cross-border finance as the optimal way to correct for inherent market failures in global financial markets. According to this thinking, externalities are generated by capital flows because individual investors and borrowers do not know (or ignore) the effects of their financial decisions on the level of financial stability in a particular nation. This classic market failure argument calls for the introduction of a Pigouvian tax that corrects for the market failure and make markets work more efficiently. Of course, economists such as Keynes argued long ago that capital controls are important to prevent crises and give nations the ability to deploy an independent monetary policy. And the idea of curbing the inflows of capital for financial stability originated in Latin American countries in the 1990s. In the chapter, however, I spell out how it was a breakthrough for such relationships to be shown to hold true in the traditions held by most mainstream economists, central bankers, and finance ministers. These theoretical and empirical advances expanded the political space for emerging markets to deploy capital account regulations because they were increasingly seen as legitimate.

In chapter 4, I shift to the global financial crisis and its aftermath. There I show how loose monetary policy in the United States made the carry trade attractive to investors and exogenously triggered a massive influx of capital flows to EMDs

from 2009 to 2012. This surge in inflows presented those countries with significant currency appreciation and asset bubbles that threatened their recovery from the crisis. Many EMDs put in place capital controls on the inflow of capital to stem the harmful effects of volatile capital flows. Moreover, EMDs such as Brazil, Peru, South Korea, and Taiwan invented a third generation of capital controls that targeted the foreign exchange derivatives market. Cross-country evidence has shown that these measures succeeded in stemming the worst of the crisis and that countries that put such regulations in place after the crisis were less vulnerable and grew faster. After unpacking these dynamics, I present new econometric evidence on the effectiveness of capital account regulations in Brazil and South Korea versus the foreign exchange interventions in Chile and South Africa. As we will see, that capital account regulations had an independent and significant impact on exchange rates and asset bubbles; however, those impacts, although positive, were relatively small. These findings, which are consistent with the published literature on the subject, reinforce the idea that, although cross-border financial regulations are important and useful, EMDs cannot carry the burden of regulating cross-border finance on their own.

In chapter 5, I show how domestic and international political factors led a number of nations to put in place regulations on the inflow and outflow of capital at the domestic level. Nations such as Brazil, Indonesia, Peru, South Korea, and Taiwan have regulated capital inflows; Argentina, Ecuador, Iceland, India, South Korea, and Ukraine regulated capital outflows. Why, when so many nations were faced with similar levels of capital flows and had similar pressures on exchange rates and asset prices, did some nations act and others not? Through case studies of Brazil, Chile, South Africa, and South Korea, I trace the comparative political economy nation-states that exerted such power in the form of capital account regulations and foreign exchange intervention. In each case, the interplay among domestic and international institutions, interest groups, ideas, and party politics led to the use of different instruments in unique ways.

In chapter 6, I examine the political economy of the partial change in the IMF position on the capital account. Prompted by EMD concerns voiced to the IMF and at the G20, the IMF staff was charged with coordinating a process to formulate a new institutional view on managing the capital account that could be used in the IMF surveillance activities and country programs. I base the chapter (and chapter 7 on the G20) on in-depth interviews with the majority of the executive directors at the IMF and their staffs. I also interviewed senior staff in each of the three IMF departments engaged in the institutional-view process and in a similar process at the G20. In addition, I interviewed the director of the Institute for International Finance (IIF), the chief economist of the international division at the US Treasury Department, Representative Barney Frank (D-Massachusetts)

and his staff at the House Financial Services Committee, and staff at a number of nongovernmental organizations (NGOs) that were engaged in the process. In essence, I conduct an analysis to understand what really changed at the IMF with respect to capital account liberalization and the management of capital flows. What is new is that the rationale for these changes is often framed in the language of new welfare economics, discussed in chapter 3. The new IMF view reframes capital controls as capital-flow management measures (CFMs). CFMs are recommended on inflows in the case of surges after other macroeconomic policies have been implemented, such as interest rate and fiscal policy management, the accumulation of foreign exchange reserves, and macroprudential financial regulations. The IMF also sanctions the deployment of CFMs on outflows of capital in the event of a crisis. The IMF notes that this new IMF advice could clash with the trade and investment treaty commitments of members and recommends establishing safeguards granting nations the right to regulate using CFMs without this being in conflict with trade commitments. Finally, and in stark contrast with previous analyses of the IMF position on the capital account, the IMF notes that industrialized countries may need to regulate the outflow of capital in concert with developing countries regulating inflows. The most significant change is that the institutional view is an official board-endorsed view that the staff will incorporate into surveillance activities.

Also in chapter 6, I return to some of the themes in chapter 2 and examine how EMDs and IMF staff interacted in an attempt to preserve the policy space granted by the IMF for capital account regulation. The institutional view looks the way it does because of new ideas among key IMF staff that were partially consistent with the demands of many EMDs—particularly a previously formed coalition of Brazil, Russia, India, China, and South Africa (BRICS). Although the process of rethinking the IMF view of the capital account was prompted by EMDs, it was coordinated and controlled by IMF staff. The final version of the IMF institutional view also reflects a partial acceptance of cross-border financial regulation by some industrialized countries, although the core industrialized countries were initially not supportive of engaging in this process. I show that the BRICS nations punched far above their IMF voting weight throughout the deliberations for three reasons. First, EMDs, especially BRICS, formed a coalition that often had a unified voice. Second, EMDs used *extra-forum leverage* by exploiting networks within the G20 to wedge their views into the discourse at the IMF. Third, given that some IMF staff were pushing a view that overlapped significantly with the EMD positions, EMDs used *intraforum leverage* by using these IMF staff views as a wedge to combat industrialized countries that opposed the BRICS positions.

In chapter 7, I examine the extent to which the newly invigorated G20 nations has succeeded at coordinating global monetary policy to mitigate the volatility of

capital flows in the wake of the crisis and coordinated national financial regulatory reform to prevent the next crisis. The G20 is improvement over the G7 and G8 models of global economic coordination because it now includes some significant EMDs. Through the G20, EMDs—particularly the same BRICS coalition that formed in the IMF—were able to elevate the long-held EMD concern of capital flow volatility, which was reflected in numerous G20 communiqués. Moreover, in 2011 a set of "Coherent Conclusions" (G20 Information Centre 2011b) about the regulation of global capital flows was signed by the G20 that reiterated the right of nations to regulate capital flows as they saw fit. That said, these changes in policy outputs were not matched by changes in economic outcomes. The G20 was also intended to serve as a coordinator of monetary policy and financial reform. With respect to capital flows, five years after the financial crisis those goals are yet to be achieved. The industrialized countries, especially the United States, did not coordinate their monetary policies with or clearly communicate them to other G20 nations, especially EMDs. I also find that important components of financial regulatory reform that could have regulated cross-border capital movements were largely exempted from the US Dodd-Frank bill. Moreover, the OECD rebranded cross-border financial regulations as "investment protectionism" and is publishing annual monitoring reports under the auspices of the G20.

In chapter 8, I trace how capital account liberalization was reconstructed as "trade in financial services" and inserted into various global, regional, and bilateral trade and investment agreements. Using a legal analysis, I show that WTO members must partially liberalize their capital account if they are committed to liberalizing trade in financial services under the General Agreement on Tariffs and Trade (GATT). In the wake of the crisis, however, the exceptions to the General Agreement on Trade in Services (GATS) have been implicitly deemed to provide WTO members with the policy space to regulate cross-border finance to prevent and mitigate a future crisis—even though legal scholars are still concerned about whether such exceptions would survive an actual WTO case. Unfortunately the WTO is losing favor to free-trade agreements (FTAs) and bilateral investment treaties (BITs), especially to those with the United States. These treaties cover financial services and all forms of investment, including currency trades, derivatives, and portfolio flows. Many of these treaties legally mandate that the transfer of investment occurs freely and without delay between signatories and have few or no exceptions.

Also in chapter 8, I show how some EMDs have been able to maintain policy space to regulate cross-border finance at the WTO and in their FTAs and BITs. The most successful saw cross-border finance as something that needed to be regulated and were able to flex their newfound economic power in institutions

that gave EMDs a more equal say. The least successful were not particularly convinced that capital flows need to be regulated or were weaker states in institutional arrangements that favored more powerful states.

In chapter 9, I summarize the key findings of the book and outline some implications for both policy and further scholarship. I then use the concept of countervailing monetary power to hypothesize how global economic governance institutions may change with respect to the governance of capital flows in the future.

Toward a Theory of Countervailing Monetary Power

Throughout this book I argue that the changes in the global economic governance of capital flows were in part a function of *countervailing monetary power*, whereby at the national level EMDs were able to counter political pressure and sophisticated global capital markets to manage their financial stability between 2009 and 2012. I also argue that, at a global level, EMDs were able to somewhat counter hegemonic and state-centric power at the Executive Board of the IMF, at the G20, at the WTO, and, to a lesser extent, in the world of regional and bilateral trade and investment treaties to defend or create policy space to take domestic action.

The theory of countervailing monetary power is not universal, nor was it pervasive in the post-crisis period under study. Countervailing monetary power explains only how *some* EMDs deviated from and countered the structural power of global markets, on the one hand, and the power of industrialized countries in global economic governance institutions that remains pervasive in the world economy today, on the other. The existing literature continues to provide strong explanations for why so many nations did not reregulate at the national level and why advances in global economic governance institutions were only incremental, albeit significant.

There is a strong literature that explains why many nation-states now face serious hurdles when contemplating the regulation of cross-border finance. David Andrews presents a capital mobility hypothesis that "policy options available to states are systematically circumscribed" because of the structural power of global capital markets (1994, 193). Moreover, John Goodman and Louis Pauly (1993) and Benjamin Cohen (1998) argue that the veto power of foreign investors over national regulation (by threatening to exit with their capital) reinforces the structural power of the markets. Foreign investors are bolstered by domestic agents, such as exporters, that are most connected to global markets

and dependent on such markets for finance. Those sectors that benefit the most from capital flows become relatively stronger and support political parties that support the deregulation of the capital account as well (Freiden 1991; Lieteretz 2012). These forces combine to devise institutions that make it harder for other actors to put regulations in place. Finally, technocrats who are placed in those institutions have economic ideas that favor capital account liberalization over capital account regulation. Capital account liberalization becomes the dominant way of thinking within the economics profession and thus permeates the central banks and finance ministries the world over (Fourcade 2006; Chwieroth 2010a. Finally, these actions become supported and sometimes conditional on good relations with the United States and Europe and with the international financial institutions where those nations hold the most voting power and or can exercise their market power (Woods, 2006; Abdelal 2007; Chwieroth 2012; Wade and Veneroso 1998; Narlikar 2003).

But what is perhaps the most significant reason that EMD nation-states fail to regulate the negative impacts of surges and sudden stops of capital flows is largely missing from the literature. This is probably because there is very little literature on the political economy of regulating capital flows in EMDs, while there is a great deal on capital flows in the advanced economies. Because capital flows are pro-cyclical and occur in accentuated surges and sudden stops, all the forces against regulation are precisely at their most powerful during the inflow surge, when capital most needs to be regulated. Exchange rate appreciation allows firms to borrow more in dollars; asset price bubbles make people feel richer and strengthen the economic and political power of global finance. During the subsequent boom, most agents across an economy think that things are going well and this strengthens the case of those who advocate that free-flowing capital is a good thing. New work on advanced economies supports this view, referring to a similar process (although not with the exchange rate effects) as "political bubbles" (McCarty, Poole, and Rosenthal 2013).

In chapter 5, I show how these insights go a long way in explaining why some nations did not reregulate capital flows in the wake of the crisis. In South Africa, the finance ministry and central bank held strong ideas about capital controls not being appropriate and shared the concerns held by the domestic and foreign private sector about the exit of foreign investment if such instruments were used. Indeed, South Africa further liberalized the capital account in its attempt to send the "right" signals to markets. Chile also lacked a strong private-sector voice to regulate cross-border finance. Moreover, the right-of-center political party that was in place put economists who had negative views about regulating capital flows in the central bank. In addition, Chile cited that such regulations would violate its commitments under a trade treaty with the United States.

Industrialized nation-states also exert significant power over EMDs in the economic sphere of global statecraft. There is close to a consensus across most schools of thought that the industrialized nations exert power over EMDs in global monetary relations because of the significant economic power held by the industrialized world and by the global economic institutions that were created to reflect the image and interests of those nations (Cohen 1998, 2007; Andrews 2006 Babb 2009; Copelovitch 2010; Thacker 1999; Wade and Veneroso 1998; Bhagwati 1997). The industrialized countries, or great powers, are seen as holding power due to the large size of their economies. This economic power allows the industrialized world to create institutions and global regulations that solidify and embolden that power (Drezner 2007). When such institutions are created, they are stacked with technocrats and managers who hold ideas that reinforce the dominant ideas held by the great powers (Chwieroth 2010a).

The literature goes a long way in explaining why the hoped-for changes in the global economic governance of capital flows by the EMDs were only partially realized. As I show in chapter 6, the EMDs were able to obtain a formal blessing from the IMF for certain kinds of capital controls. Yet the industrialized countries on the IMF Executive Board ensured that certain kinds of capital controls remained shunned, especially specific references to the need for industrialized countries to coordinate the global governance of capital flows by putting regulations on the outflow of capital in source countries. EMDs were able to get openings in G20 communiqués and other documents that legitimized the need to regulate capital flows, but the industrialized countries were not willing to change their policies so that regulating cash flows would impact economic outcomes in a major way. Larger EMDs were able to maintain the policy space to regulate cross-border finance under the WTO, but weaker states were forced to trade away their right to regulate capital flows when they engaged in bilateral and regional trade deals with the industrialized countries.

Nevertheless, some EMDs did, indeed, reregulate capital flows at the domestic level and were able to work together to carve out or maintain some of the policy space they enjoyed in global economic governance institutions. These exceptions to the currently prevailing literature are what I call countervailing monetary power. The idea of countervailing monetary power over powerful market forces borrows from John Kenneth Galbraith's (1952) concept of countervailing power. In Galbraith´s assessment of post-war US capitalism, he saw a natural tendency for the concentration and accumulation of economic power in large industrial firms. The concentration of such power squeezed the ability of input providers, workers, and consumers to get fair prices for the goods and services they produced or consumed. But economic power could be balanced by countervailing power at the micro and macro levels. At the micro level, workers and

input providers could counter economic power by bargaining collectively with the larger firms. At the macro level, the state could create regulations to introduce market competition or other boundaries that would limit the accumulation of economic power. Indeed, Galbraith saw countervailing power as one of the key characteristics of the post-war era, which that others have called the golden age of capitalism because of its relatively robust and egalitarian economic growth (Marglin and Schor 1992). Interestingly, Galbraith focused on industrial firms and did not discuss the financial sector because it was no longer a symbol of economic power. At the time of Galbraith's seminal work, the financial sector was heavily regulated and cross-border finance was minimal. Thus, he turned his attention to the rebirth of market power in industry. Market power creates distortions in an economy; thus, correcting for such power makes markets work more efficiently. Such a notion has been extended to capital flows by Anton Korinek and others (discussed in chapter 3). Countervailing monetary power is also a way of thinking about traditionally weaker states in global economic governance institutions.

Based on the analyses in this book, there are ten factors that can enable EMDs to exert countervailing power over the structural power of global markets, on the one hand, and in global economic governance institutions, on the other. The first five pertain to countervailing monetary power at the national domestic level, where nation-states exert power over domestic political pressure and capital markets. The second five pertain to state-centric countervailing monetary power in global economic governance institutions.

1. Governments seeking to regulate cross-border finance can exert countervailing monetary power if they have institutions that allow financial regulators to act in a timely and countercyclical manner.

As I show in chapter 3, the short-term benefits of surges of capital flows are associated with increases in aggregate demand. Moreover, firms and households feel richer as asset prices rise and as they have more purchasing power due to exchange rate appreciation. If a government seeks to regulate cross-border capital at this time, it will face steep opposition because all the forces that will oppose regulation are at their strongest.

Both Brazil and South Korea have legislation and institutional frameworks that allow financial authorities (both the finance ministry and central bank) to act quickly and at their discretion to put regulations in place in a countercyclical manner. The financial authorities, thus, do not have to engage in a legislative battle during a boom. Not only would such a battle be difficult to win, but legislation often takes a significant amount of time to enact, at which point the capital flow cycle may have already played itself out.

Having legislation in place also gives a government the institutional space to deviate from the increasing trend in central bank mandates of inflation targeting and price stability. Finance ministers and central banks, if they deem it prudent to regulate in the first place, can do so and only have to justify their actions to the political system rather than go through a full on legislative process.

2. Governments will more likely have the political power to regulate cross-border finance if they are backed by an export sector that is more concerned about the exchange rate than about access to global finance.

At the national level, regulations on cross-border financial flows are a form of countervailing monetary power. In the case of Brazil, countervailing monetary power was in part made possible because of a strong export sector that was very motivated by the need to limit exchange rate volatility. This concern overrode the traditional alliance between exporters and the financial sector in EMDs. Many researchers have shown that the sectors with the closest ties to major cross-border financial actors are the exporters of tradable goods, which are less apt to bite the hand that feeds them through regulating cross-border financial actors (Freiden 1991; Leiteritz 2012). It has been noted, however, that sometimes these two groups of actors have divergent interests because exporters are hurt by exchange rate appreciation while finance benefits from inflows (Frieden 1991). In Brazil, the export sector is not as interconnected with the global financial sector as it is in many other countries. The Brazilian national development bank and the commercial banks have to provide significant levels of finance to Brazilian exporters—often at different terms than global capital markets. The Brazilian industrial export sector was thus very concerned about the exchange rate and provided a well-organized constituency that rallied for government policy change.

3. Governments will more likely have the political power to regulate cross-border finance if they are backed by workers who are more concerned about job security than about the consumption benefits that come with exchange rate appreciation.

As consumers, workers may be less apt to support regulation that would reduce upward pressure on the exchange rate and asset prices. Exchange rate appreciation allows workers to purchase more goods, and asset bubbles allow them to feel more wealthy as well.

In the case of Brazil, however, maintaining job security can override these more short-term concerns. The most organized workers in Brazil are in the export industrial sectors. These workers also form a formidable component of the Brazilian Workers' Party (Partido dos Trabalhadores, PT), which was in power during the entire period when capital controls were put in place in this study.

When the exchange rate appreciated in Brazil, many firms began to lose their competitiveness and shed jobs, thus deviating from one of the fundamental tenets of the PT government. Regulating capital flows became part of a broader job security package and had strong backing from workers. Indeed, the implicit alliance between the export sectors and their workers gave the PT very strong backing.

4. Governments can get backing for the reregulation of cross-border finance by evoking the collective memory of past crises with workers and consumers.

Governments can also evoke past crises to gain further support. There is a large literature on the politics of memory that discusses how past traumatic events (or golden years) play a big role in the decision making of many political actors. The majority of this literature focuses on traumatic political events such as war, genocide, and dictatorship (for a recent analysis, see Berger 2013). Past traumas impact the collective memory of a nation and, in part, shape the identities of political actors. Much has been written about the politics of memory in Germany and Japan after World War II, and about Latin America after the dictatorships of the later part of the twentieth century. What has received relatively less attention is that past financial crises can also impact the collective memory of nations.

The collective memory of national trauma from past economic crises is tapped into by political actors. Indeed, in the wake of the financial crisis the US administration evoked the memory of Franklin Roosevelt during the Great Depression to justify a government-led fiscal stimulus as an instrument for recovery. Although fewer Americans were old enough to remember the Great Depression, the period is such a part of the collective memory that it motivated some to act in ways they might not have in calmer times. In Germany, a significant amount of attention has been paid to the impact of inflation on the German collective memory. Unlike in the United States, leaders in Germany have pushed for more austere responses to the global financial crisis. Those leaders have been able to harness support for this approach by raising the specter of inflation experienced during and after the First World War (Feldman 1997; O'Callaghan 2012; Blyth 2013).

In Brazil and South Korea, the collective memory of past crises is very much on the minds of the populace and of their leaders. This memory played a significant role in the politics of reregulating cross-border finance in both of these countries. Brazil had major financial crises in the 1980s and in the 1990s that were characterized by hyperinflation, capital flight, and many lost livelihoods. Brazilian leaders were very aware of this, which gave them the political space to act more boldly than they might have been able to otherwise. Collective memory of this sort also makes workers reframe their interests with relation to the

exchange rate. Of course, as consumers, workers enjoy exchange rate appreciation because a stronger currency helps consumers purchase more products from abroad. But as workers they also see that their wages and jobs are dependent on the strong performance of the firms they work for. The Brazilian crises are recent enough that the experience of capital flight and high inflation still send shivers down Brazilian spines.

This is case in South Korea, as well. Indeed, the collective memory of national economic trauma turned out to be a stronger determinant in South Korea than in Brazil. South Korea had a center-right political party in power during the crisis and did not have the support of the export sector or the financial sector when the government took action. Key leaders (and their advisor, Hyun Song Shin) went ahead with regulation anyway because they had the legislative authority to act quickly. In defense of their actions, leaders evoked the memory of the crisis in the 1990s. South Koreans still refer to their crisis in 1997–1998 as the IMF Crisis, and regardless of political party, leaders have strived to accumulate reserves and regulate finance so as not to have another crisis (*Korea Times* 2012). The specter of inflation and hardship is strong in the minds of the general public—thus, the public salience of financial stability is much stronger in South Korea than in other nations (Pagliari 2013).

5. Policymakers can temper opposition by reframing regulations in the new welfare economics of capital controls.

The new welfare economics and related thinking about capital controls caught on and are linked to the macroprudentializing of post-crisis regulation that has occurred since the crisis. Andrew Baker sees macroprudential tools as spreading like wildfire since the crisis for four reasons (the four Ps):

> P1. presence—the prior intellectual and institutional presence of ideas;
> P2. professional positioning—advocates of ideas becoming better positioned in professional policy networks;
> P3. promotion and persuasion—individual insiders (norm entrepreneurs) willingly engaging in networking and persuasion strategies, actively promoting ideas when the opportunity arose; and
> P4. plausibility—a seeming increase in the explanatory capacity of those ideas based on their diagnosis of the situation and their advocacy of a feasible programme of action that could be accepted by a range of relevant actors, together with the rising professional esteem, status and standing of the advocates of those ideas, based on their prior analytical performance, which increased the plausibility, both of them as individuals and the ideas they were advocating. (2013, 114)

In both Brazil and South Korea, the new economics of capital controls and the new terminology of macroprudential measures were cloaked to help convince or calm potential opponents. In Brazil, the finance ministry reframed the rationale for regulating cross-border financial flows as the need to internalize an externality to gain the backing of the central bank for regulation. In South Korea, the regulations were formulated by well-known economist Hyun Song Shin from Princeton University. Shin is one of the pioneering economists who has contributed to the new thinking on cross-border financial flows. In press conferences, the Bank of Korea, associated financial ministries, and Shin himself together asserted that the South Korean measures were macroprudential in nature and were pragmatically needed to deal with the massive inflows of capital. Such a reframing calmed investor fears and also distracted the United States and other actors from focusing so much on the regulation (as happened in Brazil).

Figure 1.2 synthesizes the domestic political dynamics of countervailing monetary power using the classic work by Randall Henning (1994), which is very useful for putting the domestic politics of countervailing power in more theoretical terms. In Henning's treatment of exchange rate politics in Germany, Japan, and the United States, he finds that two conditions were necessary for central banks to act to make currencies more stable: (1) a tight alliance between the financial sector and industry and (2)access by that alliance to a finance minister who held sway over central bank decision making on the exchange rate. Henning finds that a tight industry-finance alliance makes the financial sector more apt to support the need for industry to have a competitive exchange rate because competitiveness brings more profits to industry. Figure 1.2 re-creates Henning's matrix, adding my case studies from this book. In Henning's classification, Japan is in the bottom left quadrant because there was a strong industry–banking sector alliance and the central bank was subordinate to the finance ministry. In the top right quadrant, he places the United States, where (at the time) there was a weaker link between finance and industry, and the central bank was very independent. In that case, the United States did not act to defend the exchange rate, but Japan did.

Figure 1.2 shows how the emerging market cases deviate from industrialized countries, given that the key interest group alliance in EMDs is *global* finance and the *export* industry rather than domestic industry and domestic finance (as in the Henning's study). In Brazil (upper left quadrant), there was a weak alliance between global finance and the export industry, and a semi-subordinate central bank (at least for managing capital flows); nevertheless, Brazil regulated. In South Korea (lower left quadrant), there was a strong global finance–export

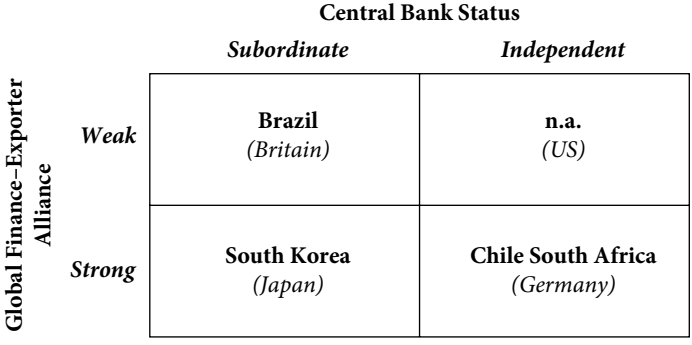

FIGURE 1.2. Political economy of regulating capital flows at the national level. Countries in parentheses are Henning's (1994) original classification. N/A, not applicable (Adapted from Henning 1994).

sector alliance, but that alliance was *against* regulation. This was because, when debt and finance are denominated in US dollars, both the export sector and global finance bear a material cost. South Korea did have a semi-subordinate central bank on these matters, however, and government officials were able to use that mechanism to override interest-group opposition by reframing regulation and by drawing on the collective memory of the broader public.

In the emerging market cases, a significant portion of corporate debt is not issued in the domestic currency and a significant portion (especially during a surge) of the domestic asset accumulation comes from foreigners (see chapters 3 and 4). This puts Chile and South Africa in the bottom right quadrant of Figure 1.2. These actors were tightly allied in that exporters in both rely on global finance for credit. The global banks bear the cost of regulation because controls are an explicit or implicit tax on their activities. Successful regulation also increases costs for exporters, which rely heavily on foreign finance. If a capital account regulation is successful it will reduce upward pressure on the exchange rate and, thus, increase the cost for the firm of paying back its debt when the currency depreciates. As in the case of the United States, the Chilean exporters were not tightly allied with the financial sector.

In Chile, South Africa, and even South Korea, this global finance–exporter alliance was strongly opposed to regulation. The central bank in Chile and South Africa had full independence on these matters but also shared the view of the finance-export alliance. In Chile, the central bank had legislation on the books that allowed it to regulate the inflow of capital; however, a right-wing political party that was in power represented the global financial–exporter alliance and appointed central bankers who were less apt to use that tool. The central bank

alone decides when Chile can draw on its infamous Encaje law, which allows the central bank to put capital controls in place. The central bank at the time was very cautious, having just been reorganized after a conservative government had won an election. The Chilean case was further influenced by the fact that the country had a trade agreement with the United States that would have caused Chile to pay significant damages (and sent concerning signals to markets) if it had deployed capital controls.

In South Africa, there was a tight alliance between industry and finance that was also *against* taking significant action. Banks were against the measures for material reasons. Despite the massive exchange rate pressure, exporters were reluctant to support capital controls because they were very concerned about being punished by the capital markets that fed them. The finance ministry held the same view and was concerned about financing a growing current account deficit. The central bank was very independent and was very cautious about the use of capital account regulations, despite the fact that the IMF suggested that such measures might be in order. These factors overpowered the trade unions, some manufacturers, and IMF recommendations for temporary capital controls.

Again, South Korea is in the bottom left quadrant. In South Korea, there was a tight global finance–exporter alliance. Indeed, chapters 4 and 5 show that South Korean exporters used the carry trade to borrow at low interest rates in the United States to finance their activities and hedge against other risks. These actors were against regulation. The finance ministry and central bank had legislation that allowed them to deviate from the central bank price-stability mandate. Hyun Song Shin and others in the finance ministry and central bank used this mechanism to circumvent the pressure from the global finance–exporter alliance. As discussed in chapter 9, South Korea also negotiated hard to keep the policy space to regulate capital flows under its FTA (Chile did not).

Brazil, in the upper left quadrant, deviates from the traditional Henning model in a different way. In the Brazilian case, there was a wedge between finance and industry because industry received a significant portion of its credit from the national development bank and from private banks operating under heavy regulations to subsidize credit. This wedge made the distribution of the costs and benefits of regulation manifest themselves in different ways in Brazil—and thus led to the formation of different preferences. The international banks were against the regulations because they would have to bear the cost of taxation and regulation. Exporters (and their workers) supported the effort because it would provide exchange rate relief. They did not as rely on foreign loans, which are more easily paid off with an appreciating currency and harder to pay off if the regulations succeed in weakening the currency. Thus, the

Brazilian firms rallied for the government to apply measures to stem exchange rate appreciation. Brazil also had the support of workers and legislation on the books to act quickly.

Henning's model uses the relationship between interest-group pressure and institutions to explain policy outcomes. Such forces are also very strong in the cases examined in this book. In addition, however, the role of ideas and beliefs is also important in our cases, and it is hard to depict such a dimension using Henning's matrix format. In Brazil and South Korea, policymakers also *believed* that capital account regulations were the proper responses to the build-up of systemic risk in their economies, and thus ideas are an interaction term in many ways. South Korea is perhaps the most interesting case because ideas and institutions overrode interest-group pressure. Decision makers believed that regulating capital flows was an appropriate response. They had the power to respond despite interest-group pressure because they had institutional cover to enact regulation on a timely basis. The authorities also evoked the collective memory of past crises to gain popular support. The Brazilian financial authorities also believed that regulating capital flows was appropriate. For them, it was relatively easier to enact regulation because they had the backing of exporters, workers, and the general public through the collective memory of past crises. Moreover, although initially the central bank was not supportive of the measures, the finance ministry had the legislation that allowed authorities to act anyway. In contrast, in South Africa and Chile the key decision makers were less than convinced that regulating capital flows was an appropriate response to the problems at hand.

Henning's formation demonstrates the conditions under which nations might counter the capital mobility hypothesis, outlined by Andrews (1994) for industrialized nations. In this book, I provide further evidence showing that global capital markets do not have insurmountable power over nation-state action. Nevertheless, the conditions in emerging markets are different from those in the industrialized world. In general, subordinate central banks—or legislation that allows central banks to temporarily deviate from price-stability mandates in a countercyclical manner—continue to be important in deploying capital account regulations in EMDs. It is not clear, however, that a tight finance-industry alliance is a precondition, especially when it is a global finance–export industry alliance in developing countries dependent on foreign finance for trade and investment. In such cases, interest groups may have policy positions that are opposite to the ones Henning found in industrialized countries in the 1980s and 1990s. Indeed, the case studies presented here suggest that a nation is more apt to act on the exchange rate when there is a wedge between exporters and the global financial sector that has to bear the cost of regulation or where the finance ministry and central bank act independently and pragmatically to override interest-group

pressure. What still appears to hold strongly for applications of Henning's model to EMDs is that there needs to be a temporary subordination of the central bank to the finance ministry, or at least an institutional arrangement that allows the bank to deviate from its core mandate.

We now move to a discussion of how EMDs can use countervailing power to counter the state-centric power of industrialized nations in global economic governance institutions.

6. Governments will be more likely to attempt to regulate cross-border finance if they have the policy space to do so under global economic governance institutions such as the IMF and WTO.

The final domestic policy condition that allows a nation-state to exercise countervailing monetary power over capital markets is having the policy space to regulate under its global economic governance commitments. To satisfy this condition, EMDs need to enter into the realm of monetary statecraft. In global economic institutions, EMDs are seen to have relatively less power because the industrialized countries have a great deal of economic power and the international financial institutions explicitly or implicitly reinforce that power over EMDs. My research suggests that EMDs can also exert countervailing monetary power over hegemonic and state-centric power at the Executive Board of the IMF, at the G20, at the WTO, and, to some extent, in the world of regional and bilateral trade and investment treaties to defend or create the policy space they need to take domestic action.

7. As EMDs gain more market power, they obtain more conducive policy outcomes in global economic governance institutions.

Perhaps the most significant factor that has allowed some EMDs to either preserve or expand their policy space to regulate cross-border finance is their rising level of market power in the global economy. Up until the 1990s, the industrialized nations made up close to three-quarters of the world economy. As Albert Hirschman (1945) notes, market power gives nation-states significant leverage in global negotiations regardless of whether the voting structure of the particular negotiating body is by consensus. Of course, voting at the IMF is skewed against EMDs because voting power is a direct function of the economic size of members. In institutions such as the WTO where final decision is by consensus vote, however, outcomes are largely determined by market power. When the industrialized world made up three-quarters of the world economy, negotiations were largely over what conditions the industrialized world put on access to those large markets (see Gallagher 2013). Nations, such as Brazil, that had the domestic conditions of countervailing power in place have flourished in global economic

governance institutions where they have a more equal share in voting and decision making. The most significant example of this is in the WTO, where Brazil was able to leverage its significant market power to maintain its ability to regulate cross-border financial regulations when it was negotiating GATS (see chapter 8). Moreover, Brazil has been able to leverage its economic power in bilateral negotiations with industrialized countries. Many EMDs, especially BRICS, have been able to elevate the conversation about capital flows as they have entered the G20, which has a more equal distribution of membership than the G7 does. As EMDs increase the size of their own markets, they can (slowly) gain more say in the traditional international financial institutions as well.

8. EMDs can concentrate their market power through coalition building in institutions where voting power is less equal or by consensus.

Obviously, coalitions of EMDs can further concentrate market power and further advance the ability of nations to create or maintain the policy space to regulate capital flows. At the IMF, a coalition of BRICS countries formed to challenge the quota system for decision making in that institution. This gave EMDs slightly more voting power. During the process of reevaluating the management of capital flows at the IMF, the BRICS coalition was also a useful platform for EMDs to influence the institutional view. These coalitions were able to punch above their voting weight because they leveraged stronger forces in the IMF and in regimes outside the IMF, such as the G20, where the BRICS coalition had more sway. Coalitions also play a key role in the WTO, although the BRICS do not have a formal coalition in that venue. Other coalitions have arisen in the WTO that have limited the ability of industrialized nations to put investment rules into the WTO. As a counterfactual, however, in regional and bilateral deals, where EMDs have relatively less market power (and less opportunity for coalitions), they are often forced to trade measures to ensure financial stability for the market access to industrialized nations.

9. EMD coalitions can exploit the fragmentation of the global economic governance, and institutions can be leveraged by EMDs to exert countervailing monetary power.

The BRICS nations were able to exercise power as autonomy by protecting their ability to exercise cooperative decentralization to regulate capital flows under the IMF and at the G20 (Helleiner and Pagliari 2011). New thinking might lead scholars to see the fragmentation of the international financial legal arenas as a means whereby industrialized countries could further consolidate their power of influence. In this light, Daniel Drezner quotes Eyal Benvenisti and George Downs (2007): "a fragmented legal order provides powerful states with

much needed flexibility. . . . the existence of multiple contesting institutions removes the need for them to commit themselves irrevocably to any given one. This helps them to manage risk, and it increases their already substantial bargaining power" (in Drezner 2009, 67). Instead, EMDs engaged in a financial jujitsu that used multiple fora to defend cooperative decentralization. I show how, contrary to conventional wisdom, it was actually the EMDs that used the multiple contesting institutions to their advantage; they especially used the G20, the eurozone crisis, the establishment of a BRICS bank and reserve currency pool, and the global financial press to forge communiqués and global policymaker opinion to garner support in the club of the IMF Executive Board, where the institution was stacked against their positions due to IMF voting quotas, and at the G20.

Using the realist perspective developed in international relations theory, countervailing monetary power can be seen as the willingness and ability of follower states (EMDs) with plebeian currencies to mitigate the impacts of the economic power exerted by nations at the top of the hierarchy of money and power (Cohen 1998). EMDs gained enough economic growth, armed themselves with alternative ideas, and forged alliances with key parties and interest groups to project their own countervailing power into this international regulatory regime. They did this in the sense articulated by Hirschman (1945), who shows how states with larger economic size use market access to exert power over other nations. Jonathan Kirshner (1995) extends this Hirschmanian notion of power to the monetary realm, a definitional extension that comes in handy in the twenty-first century, a period when EMDs make up more than half of the world economy and are growing faster than industrialized countries. And as industrialized growth stagnates, the new markets are in the emerging markets. Thus EMDs have, for the first time, new leverage points in global economic relations. Granted, some of these states have enjoyed a configuration of domestic politics and international position such that they could reassert this power, but others have not. Countervailing monetary power does not change the fundamental structure or transfer power from one set of agents to another. Still, it is important that this form of power leaves open the possibility that the weaker states can maintain, or at least attempt, stability and autonomy.

If Western powers had their way at the IMF or the G20, there may well have been a new push to make capital account liberalization a global mandate again. Rather than a change in the Articles of Agreement, the result was an Executive Board–endorsed institutional view that translates into the IMF giving nonbinding advice through its country surveillance activities. BRICS were able to use multiple global economic fora to wedge their concerns into the IMF decision-making process. Finally, EMDs wedged similar thinking into and obtained legitimacy from IMF staff, which had undergone its own transformation. In line

with institutionalist perspectives on international economic regimes, BRICS resorted to intra- and extra-forum institutional leverage to punch above their voting weight at the IMF. BRICS have exercised countervailing monetary power to help shape new institutions (i.e., guidelines) for the use of capital account regulations in a manner that did less harm than they might have if such rules had been created solely by the developed countries or had fully exercised the power of industrialized nations over BRICS in the IMF and G20. They achieved this outcome by forging BRICS coalitions, using extra-forum leverage at the G20 and beyond. Moreover, they also used intraforum leverage by highlighting the epistemic alignment emerging between new IMF and EMD thinking—often by working alongside the IMF staff holding similar ideas—and then stressing the differences between these shared positions and the stance of the industrialized nations. The combined efforts of each set of actors resulted in an outcome in which there was no change in the Articles of Agreement and that included some issues proposed by EMDs and IMF staff that would not otherwise have been included in the final institutional view.

The structure of IMF voting power explains why many of the recommendations made by staff and by EMDs did not end up in the final institutional view of the IMF. Nevertheless, EMDs, especially the BRICS, formed a coalition that often had a unified voice and used extra-forum leverage by exploiting networks in the G20 to wedge EMD views into the dominant discourse. Moreover, EMD views were often shared by IMF staff, allowing the use of intraforum leverage.

10. EMDs can reframe and leverage the new ideas and discourse on macroprudential regulation to support their domestic regulations in mitigating capital flows in global economic governance deliberations.

In this book, I also provide insights into theories of ideational change applied to international economic regimes coming from the constructivist tradition in political economy (Chwieroth 2010a; Baker 2013). The IMF senior staff members charged with rethinking capital account liberalization did not simply change their views given the merits of the literature. Although the merits of the literature are surely explanatory, what made the idea of prudential capital controls so widespread across the IMF was that key research in the literature fit into the most cutting-edge thinking in neoclassical economics. Current and former IMF staff members had published papers in the peer-reviewed literature showing that capital account liberalization was not strongly associated with growth and was likely to be associated with banking crises.

But, when it came to regulating cross-border finance, a sea change in thinking overtook the rationale for such regulation. That rationale came from the theoretical breakthrough in welfare economics, a school of thought at the core of the

mainstream neoclassical tradition. The idea of capital account regulation for the sake of financial stability diffused across the IMF from the highest levels of its research infrastructure to Article IV reports because the IMF did the econometric work and the breakthrough, cutting-edge, new welfare economics of capital controls fit right into its mainstream economics.

New work in political science supports this interpretation. Whether it is called "translation" (Ban 2013b) or "constitutive localization" (Acharya 2009), the process that is most likely to enable ideational change is the one in which high-status insiders build bridges between institutionalized ideas and the new ideas. Even though the heterodox (Minskian) developmentalists had ideas and policy recommendations similar to those coming from new welfare economics, the latter were easier to translate quickly into policy advice because of the goodness of fit of new welfare economics with the theoretical apprati already shared by high-status IMF insiders at the time. Scholars have established that, given the increasingly US-centric nature of the international scientific power hierarchy that governs modern economics (Fourcade and Babb 2002; Fourcade 2006) and the staff selection practices of prominent international policy fora such as the IMF (Chwieroth 2010), the holders of prestigious US degrees enjoy higher status capital, superior material resources for research, and easier access to international and domestic policy institutions. This means that new ideas about the regulation of the capital account could nudge the old capital liberalization orthodoxy as long as the ideas resonated with, or were made to resonate with, the neoclassical fundamentals of this epistemic elite.

In line with this argument, I find that this shift happened when empirical research done by economists within the IMF came into contact with empirical work done by academic researchers who came from a school of thought embedded in neoclassical economics (i.e., Olivier Jeanne's and Korinek's welfare economics) and whose work had been endorsed by high-status policy economists such as Olivier Blanchard and Kenneth Rogoff. The new welfare economics and the preponderance of econometric evidence were highly present when the IMF was charged with reevaluating capital account liberalization and the management of capital flows. Jonathan Ostry, Blanchard, and others on the inside, as well as Jeanne, Arvind Subramanian, and others on the outside, now had perfect professional positioning as high-ranking staff at the IMF and highly public experts. Staff members on the inside and outside actively promoted their work—on the inside by working with EMDs and on the outside through blogs, op-eds, books, and beyond. Finally, the plausibility of their ideas had great force because they were founded in a fundamental new breakthrough in economic science.

This speaks to the process through which transformative economic ideas diffuse, shape policy, and perhaps even change the interests of certain agents by

working through mainstream sites of high economic theory and empirical evidence. Innovations within new welfare economics were based on a breakthrough in the core theory that was quickly hot and important. In the case of the econometric evidence on capital controls, such analyses were done using the most mainstream and significant econometric modeling and execution techniques. These two findings in theory and evidence fit right in with the prevailing neoclassical paradigm, making it easier for IMF staff and decision makers to change their minds. The importance of translation is underscored by the fact that, although the EMDs had been articulating a rationale for capital account regulation that was very similar to the policy implications of new welfare economics for over twenty years, they did so using theoretical and evidence gathering apparati that were situated outside the boundaries of neoclassical economics. This translation process resulted in the new welfare economics and related thinking about capital controls catching on and being linked to the macroprudentializing of post-crisis regulation that had occurred since the crisis.

To summarize, the domestic aspects of countervailing monetary power over capital markets have five pillars: domestic institutions that allow financial authorities to regulate in a timely and countercyclical manner; the backing of exporters who are more concerned about the exchange rate than about access to global finance; the backing of workers (and worker political parties) more motivated by job security than by short-term consumption benefits; the backing by a general public haunted by the collective memory of past crises; and the successful translation of economic ideas to decision makers and the general public. The global statecraft aspects of countervailing monetary power have five additional pillars: the policy space in nations to regulate under global economic governance institutions; the market power in the global economy that allows nations to gain policy space; the concentration of market power by nations forming coalitions to leverage the fragmentation of global governance to their benefit; and the translation of new economic ideas to gain leverage.

In many ways, the global governance aspects of the theory of countervailing monetary power confirm and expand classic theories in the negotiation literature. Roger Fisher (1983) and William Zartman and Jeffrey Rubin (2002) argue that, under conditions of power inequality, the parties with more power tend to exploit the weaker states except under special conditions: when the weaker states form coalitions, when the weaker states have similar ideas and ideology, when there are interpersonal relations among coalition members, when there is the power of a good alternative to negotiation, and when there is power of legitimacy. BRICS exercised these special conditions by exerting countervailing monetary power. They formed key coalitions and exploited the fragmented nature of global economic governance, they coalesced around a series of similar ideas,

they worked in networks (many of the same negotiators at the IMF represented their nations at the G20, although not at the WTO), they had an alternative in the form of large levels of reserves and the creation of a development bank and reserve pool, and they had the power of legitimacy in the sense that they were not the cause of the financial crisis and that what they were doing was justified.

Countervailing monetary power has been limited in the wake of the economic crisis, but in this book I unpack the dynamics of those limited changes to draw out lessons for theory and policy. In the rest of this book, I develop this theory in an inductive manner. Through a series of empirical investigations, I show how some EMDs were able to reregulate cross-border finance and to maintain the policy space under global economic institutions to do so. Other EMDs did not reregulate and may have lost the policy space to reregulate cross-border finance. Unfortunately, the gains to the EMDs that did reregulate have been limited by domestic politics, the lack of policy space for such regulation under various global economic governance institutions, and the lack of willingness of industrialized countries to coordinate measures on both ends of the global capital flow cycle.

2

CHALLENGING COOPERATIVE DECENTRALIZATION

Since the demise of the Bretton Woods system, a system where regulations on cross-border capital flows were a global norm, the world community has lacked a forum for governing global capital flows. In the meantime, cross-border capital flows have increased by orders of magnitude, so much so that international asset positions now outstrip global economic output. Most cross-border capital flows occur among industrialized nations, but emerging-market and developing countries (EMDs) are increasing participants in the globalization of capital flows. Although it is widely recognized that capital investment is an essential ingredient for economic growth, there is a growing concern that certain capital flows can be destabilizing to EMD financial systems by causing asset bubbles, that is, exchange rate appreciation during periods of massive capital inflows followed by sudden stops and capital flight that can jeopardize stability and growth (see Ocampo, Kregel, and Griffith-Jones 2007).

There is a long history of debate over volatile capital flows and the appropriate government policies relating to them. The global financial crisis has opened a new chapter in this debate because pro-cyclical capital flows have been characteristic throughout (Chinn and Frieden 2011; IMF 2010a, 2010b). At the turn of the twenty-first century, many international financial institutions and strands of economic thinking remained either hostile to or silent regarding regulating capital movements. In this chapter, I outline a modern history of the governance of cross-border capital flows from the founding of the International Monetary Fund (IMF) to the turn of the twenty-first century.

There is a vast literature on this subject, and by no means is this short chapter to be seen as a comprehensive review of that literature. In this chapter, I synthesize that literature to provide a backdrop for the chapters to come, which examine the global governance of capital flows.

The IMF governance of capital flows is a regime of cooperative decentralization, and this regime has been contested since at least the 1970s. Despite such contestation, EMDs and interests in the industrialized world were able to stave off attempts in the late 1990s to shift the IMF toward strong international standards that would have mandated the free flow of capital under the IMF Articles of Agreement. I discuss the Bretton Woods era and then examine the period from the 1970s until the Asian financial crisis. In the succeeding chapters, I analyze the period from the Asian financial crisis to the global financial crisis and its aftermath.

Cooperative Decentralization: The Bretton Woods Era

The IMF Articles of Agreement, forged at the 1944 United Nations Monetary and Financial Conference in Bretton Woods, New Hampshire, grant nations the ability to pursue their own policies to regulate cross-border capital flows. Moreover, the Articles permit nations to cooperate internationally to enforce such regulations. For almost a quarter century after the Bretton Woods meeting, this regime "functioned more or less as planned" (Eichengreen 2008, 92).

Under the umbrella of the IMF articles, the regime for governing capital flows could be characterized as, to use Eric Helleiner and Stefano Pagliari's (2011) term, *cooperative decentralization*. Cooperative decentralization is a regime where there is interstate cooperation across divergent national regulatory approaches. This stands in contrast with what they term *strong international standards,* characterized by interstate cooperation and global regulatory convergence across national systems of regulation. The IMF Articles of Agreement are actually an example of both. The Articles set out that no country may restrict current transactions—all profits and dividends from foreign transactions must be able to flow freely and without delay among IMF members around the world. This is enshrined in the IMF and is now echoed at the World Trade Organization (WTO), where a nation can restrict current transactions only if the IMF sanctions it. With respect to the capital account, however, the IMF allows for national diversity in terms of regulating capital flows and permits nations to cooperate to monitor and enforce such regulations on a multilateral basis. The distinction is this: strong international standards are universal and cannot

be deviated from; cooperative decentralization allows for arrangements where nations can pursue their own national policies but coordinate them on a multilateral level. Louis Pauly summed up the regime as "reconcil[ing] increasingly liberal external relations with the retention by individual states of their right to intervene in their internal economies" (1997, 80).

Forging the Global New Deal

The Bretton Woods conference was envisioned as resulting in a "New Deal in international economics," according to US Treasury Secretary Henry Morgenthau and other core negotiators at the conference (Helleiner 2011a). In that vision, the meetings yielded an IMF that would help provide what Charles Kindleberger (1986) referred to as the five core public goods to maintain global economic stability while also granting nations the flexibility to pursue their own domestic objectives. Those five public goods are:

- Maintaining open markets during recessions
- Providing countercyclical lending
- Policing exchange rate stability
- Coordinating macroeconomic policy
- Acting as a lender of last resort

The embryo of these ideas was the League of Nations that had preceded the Bretton Woods institutions (Pauly 1997), but it was at Bretton Woods that the creation of the IMF, the World Bank, the General Agreement on Tariffs and Trade (GATT), and the fixed but adjustable exchange rate system was intended to provide such goods in the post–World War II era. The middle three public goods—countercyclical lending, exchange rate stability, and macroeconomic coordination—are, of course, strongly connected with the cross-border movement of financial flows.

The core framers of the IMF Articles were Harry Dexter White, who represented the United States, and John Maynard Keynes, of Great Britain. The differences between these two men and their countries over what a post-war international monetary system should look like were notorious and large (Skidelsky 2000; Steil 2013). Interestingly, relatively less attention has focused on the fact that they agreed on at least two things: that it was important for nations to have the freedom to regulate capital flows and that nations should cooperate to render those regulations effective (Thirwall 1974; Helleiner 1994; Boughton 2002; Abdelal 2007).

Both Keynes and White saw capital flows as concerning. For White, regulating capital flows was a second-best strategy; for Keynes, capital controls were

second nature (Boughton 2002). Both men saw the need to regulate speculative capital flows because of the impact that such flows could have on the policy autonomy of the welfare state and on exchange rate stability (Helleiner 1994). Although the formal Mundell-Fleming model had not yet been articulated (see chapter 3), these economists had the insight to see that the free movement of capital was not compatible with a fixed exchange rate and an independent monetary policy. The free movement of capital can throw off the ability of nations to expand and contract their economies. In such an environment, lowering the interest rate to expand the domestic economy could trigger capital flight rather than domestic investment; raising rates could attract ever more capital at exactly the time when cooling off an economy is called for. Such pro-cyclical capital flows also put real pressure on the exchange rate and can cause balance-of-payments problems. This concern was echoed by the League of Nations report written by Ragnar Nurkse (1944).

Thus, the framers of the IMF saw the regulation of capital as core to sustaining the international monetary system. What is more, they did not see unilateral regulation as sufficient to help nations have policy autonomy and maintain stable exchange rates. As White said, "without the cooperation of other countries such control is difficult, expensive, and subject to evasion" (quoted in Helleiner 1994, 38). Keynes put it this way: "but such control will be difficult to work, especially in the absence of postal censorship, by unilateral action than if movements of capital can be controlled at both ends" (quoted in Obstfeld and Taylor 2004, 149). Indeed, both men articulated that nations must be required to cooperate with each other's capital controls under the auspices of the agreement. After fierce opposition by Wall Street interests, however, the notion of *requiring* cooperation was watered down to simply *permitting* such cooperation (Helleiner 1994; Abdelal 2007).

These proposals drew significant support from EMDs during the deliberations at Bretton Woods. According to new archival work by Helleiner (2014a), Latin American countries wanted to make sure that they could maintain their capital and exchange controls during the negotiations and also supported the need for international cooperation mechanisms on capital flows. China was also very supportive. Helleiner notes that China had its own full-blown plan for a new international system. In it, Chinese officials were also supportive of the US and British plans concerning capital controls, particularly the provisions for the use of cooperation which they hoped might help China to control outgoing flight capital. Each member of the China's Fund would be required "upon request, to cooperate with any other member nation that may regulate international capital movements." Echoing the White plan, each member country could be asked "(1) to prohibit in its jurisdiction acquisition of deposits or other assets

by nationals of any member nation imposing restrictions of capital transfers except upon authorization of the latter nation; (2) to furnish the Government of any member nation on request full information regarding such deposits and other assets; and (3) to consider such other measures as the Board may recommend" (Helleiner 2014a, 195).

Box 2.1 lists the key components of the IMF Articles of Agreement that pertain to global capital flows. The clear language granting nation-states the ability to deploy capital controls is found in Article VI, Section 3: "Members may exercise such controls as are necessary to regulate international capital movements." Article VI, Section 1 allows the IMF to request that a nation put in place capital controls and even permits the IMF to withdraw support if such a request is not granted. In Article VIII, Section 2(b), we find the language on cooperation: "members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective." This language does not *require* cooperation, as White and Keynes had hoped, but it does stress the importance of cooperation. Other parts of Article VIII, in Section 5, grant the IMF authority to collect data on both capital flows and on the nature of capital controls—thus arming the institution with the information that individual nations will not have to help nations identify the sources of capital flows and where to turn for cooperation.

Box 2.1: Capital Controls in the International Monetary Fund Articles of Agreement

Article VI: Capital Transfers

Section 1. Use of the Fund's general resources for capital transfers

(*a*) A member may not use the Fund's general resources to meet a large or sustained outflow of capital except as provided in Section 2 of this Article, and the Fund may request a member to exercise controls to prevent such use of the general resources of the Fund. If, after receiving such a request, a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund.

(*b*) Nothing in this Section shall be deemed:

(i) to prevent the use of the general resources of the Fund for capital transactions of reasonable amount required for the expansion of exports or in the ordinary course of trade, banking, or other business; or

(ii) to affect capital movements which are met out of a member's own resources, but members undertake that such capital movements will be in accordance with the purposes of the Fund

Section 3. Controls of capital transfers

Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(*b*) and in Article XIV, Section 2.

Article VIII: General Obligations of Members

Section 2. Avoidance of restrictions on current payments

(b) Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement.

Section 5. Furnishing of information

(a) The Fund may require members to furnish it with such information as it deems necessary for its activities, including, as the minimum necessary for the effective discharge of the Fund's duties, national data on the following matters:

(vi) international balance of payments, including (1) trade in goods and services, (2) gold transactions, (3) known capital transactions, and (4) other items;

(xi) exchange controls, i.e., a comprehensive statement of exchange controls in effect at the time of assuming membership in the Fund and details of subsequent changes as they occur;

Source: IMF (2013a).

Capital Flows and the Golden Age of Capitalism

As noted earlier, scholars generally agree that the regime of cooperative decentralization for governing capital flows worked "more or less as planned" during the Bretton Woods era but began to break down in the early 1970s. A large number of nations, including the United States, deployed capital controls during this period with some success. Although in a more limited fashion than White and Keynes would have hoped, there was a certain degree of international cooperation on the regulation of cross-border finance as well.

The earliest examples of cooperation on capital account regulations occurred between 1944 and 1947. During that period, a number of bilateral agreements

between Great Britain and several European countries included cooperation on capital controls among the countries. In contrast, Europeans were rebuked when they requested that the United States regulate inflows of capital from Europe to stem capital flight from Europe to the United States during that period because of the interests of the US banking community. Helleiner (1994), however, argues that there was implicit cooperation on the part of the United States during the period because it sent a significant amount of capital back to Europe in the form of the Marshall Plan.

The 1960s have been characterized more as a period of unilateral regulation, although in some ways they could be seen as coordinating rather than explicitly cooperating. During the John F. Kennedy administration, the United States was engaged in expansionary monetary policy and was concerned that low interest rates would trigger excessive capital outflows. The European nations were battling inflation and were concerned that high interest rates might attract more capital at exactly the time when they wanted to cool their economies. Many European nations thus regulated the inflow of speculative capital while the United States regulated capital outflows. And the United States pushed Canada (which was exempt from US controls on outflows) to "plug the hole" that allowed US capital to leak into Europe through the Canadian exception to the US regulation (Hawley 1987). Aside from the US-Canadian case, Helleiner (1994), who has studied this period the closest, does not indicate that nations explicitly cooperated on regulating capital flows. Nevertheless, the United States and Europe had coordinated their actions implicitly, given that they put controls on both ends, as Keynes had suggested.

Indeed, it may come as a surprise to many to learn that the United States deployed capital controls fairly successfully during the Bretton Woods era. The United States regulated outflows of speculative capital for close to ten years (1963–1973).

And for a very brief period, it regulated inflows as well. Between 1969 and 1970, capital inflows from the Euromarket were making it difficult for the US Federal Reserve (the Fed) to limit domestic credit. Thus in 1969, the Federal Reserve restricted the ability of Eurodollar borrowing by US banks. First, the Federal Reserve attempted to have US banks do this on a voluntary basis, but then it officially put a 10 percent reserve requirement on domestic borrowing from US banks in the Euromarket. The Fed attempted to establish a reserve requirement in 1979 as well. Moreover, it pushed hard for the Bank of International Settlements to require that nations cooperate with the US proposal. Both of these later efforts failed (Helleiner 1994).

The most significant capital controls in the United States were controls on outflows. In the 1960s, the United States was engaged in an expansionary

monetary policy (and ramping up for the Vietnam War), but it was also experiencing balance-of-payments problems (Block 1977). After weighing a series of alternative policies, the United States enacted the Interest Equalization Tax (IET), a 15 percent tax on the purchase of foreign equities. For bond trades, the tax variety depended on the maturity structure of the bond, ranging from 2.75 percent on a 3-year bond to up to 15 percent on a 28.5-year bond. Borrowers looking to float bonds would thus pay approximately 1 percent more than interest rates in the United States, thereby flattening the interest rate differential between the United States and Europe (Hawley 1987).

The United States was very shrewd in designing the IET so as to get the act passed by the US Congress. A number of factors have been attributed to this feat. First, the tax was specific to portfolio flows and not also to multinational corporations headquartered in the United States. Thus, there was not a coalition of capital against the legislation among finance and industrial capital. Second, investors had two options that eased the pain: lucrative domestic market alternatives and the Euromarket in London. Third, the US government still operated under a Keynesian rubric that saw regulating capital flows as legitimate. Moreover, by deploying a market-based tool rather than outright quantitative tools, the United States wanted to show other nations that capital could be regulated in a more market-friendly manner (Conybeare 1988; Hawley 1987; Helleiner 1994).

The IET immediately changed the composition of US outflows of capital, but it took longer for it to effect the balance of payments. In an early study, Richard Cooper concluded that "The IET was highly successful in its narrow objective; taxable new foreign issues in the United States virtually ceased, and net acquisitions of outstanding foreign securities by Americans became fairly substantial net liquidations after the tax proposal" (1965, 469). But Cooper went on to note that the IET had not, by 1965, shown a significant change in the US balance-of-payments position. A later analysis by the US Congress concluded, however, that "The Interest Equalization Tax was first made effective in the middle of 1963 and used in conjunction with the limitations on extensions of credit and direct balance of payments problem. Measured on a liquidity basis, the deficit fell from an average of 2.5 billion dollars in the years 1961 through 1964 to 1.3 billion dollars for 1965 and 1966. In 1967 the deficit increased to 3.5 billion dollars and in 1968 a surplus of 93 million dollars was recorded" (Butterworth 1970, 172).

Despite the limited level of cooperation among nations, numerous studies show that capital controls were effective outside the United States during this period as well. Work by Maurice Obstfeld (1993), Richard Marston (1993), and Penti Kouri and Michael Porter (1974) demonstrate that controls were effective to the 1960s in the United Kingdom, Germany, Australia, Italy, and the Netherlands.

As the Bretton Woods system of exchange rates began to unravel in the 1970s, there was a last round of cooperation that led Europe to push for explicitly granting the IMF more power to mandate cooperation on capital controls, as Keynes and White had once urged. France convinced the United States to maintain its capital control on outflows in 1972 so France wouldn't suffer the currency appreciation of heavy inflows of capital from the United States. During the same period, France convinced Germany to tighten capital controls on outflows so France would not to suffer the consequences of excessive inflows of speculative capital. Such efforts did not last long, and efforts to reinstate the requirement to cooperate was neutralized by the US banking community (Helleiner 1994; Webb 1995; Chwieroth 2010a).

The Political Economy of Regulating Capital in the Bretton Woods Era

Why and how did the immediate era following the Bretton Woods era work more or less as planned? A large literature has emerged that attributes these changes to political power and interest-group politics, prevailing economic ideas, and institutions.

Table 2.1 contrasts how these forces interacted during the Bretton Woods era with how they interacted during the period from the collapse of the gold-dollar standard to the turn of the twenty-first century. The Bretton Woods era has been characterized as a period when the United States was a benevolent hegemon, the US financial sector was not as strong as in later periods, Keynesian ideas prevailed, and the world economy largely operated under the rubric of the IMF Articles.

In terms of power, Helleiner (1994) has depicted the United States as a benevolent hegemon with respect to capital controls during this period. The United

TABLE 2.1 The political economy of regulating cross-border capital flows

	BRETTON WOODS	1970s TO AFC
Power interests	US as benevolent hegemon Industry-labor alliance	US (and EU) financial hegemony Finance-industry alliance
Ideas	Keynesian economics Embedded liberalism	New classical economics Neoliberalism
Institutions	Cooperative decentralization Weighted voting	Cooperative decentralization Weighted voting

Note: AFC, Asian financial crisis.

States permitted capital controls in other nations because of concerns relating to the cold war. Policymakers in Japan and Europe saw controls as essential to their growth strategies, and the United States saw enabling growth and maintaining alliances with those nations as a high priority. Moreover, as we have seen, the United States itself deployed controls for over ten years during the period.

It is also important to note that interest-group politics in the United States were starkly different from later periods. With the specter of the Great Depression still looming, domestic employment and production were at the center of US economic policy. Therefore, there was an implicit industry-labor alliance. Firms relied on aggregate domestic demand for profit and production, and therefore, expansionary domestic policy unfettered by external shocks was seen as being in the interests of labor and capital alike (Ferguson 1995). What is more, the entire US financial system was geared toward supporting domestic demand; thus, the financial sector also had a stake (Eichengreen 2008). Finally, investors did have the option of the Euromarket and were able to water down the requirements on cooperation in the IMF Articles (Helleiner 1994).

In terms of ideas, the construction of the Bretton Woods system reflected the prevailing mode of thought (at least in the United Kingdom and United States, where the institutions were framed) of embedded liberalism, the dominant thinking about international economic regimes and domestic policy at the time that stressed the need for nations to strike their own balance between global economic integration and the democratic enhancement of national welfare (Ruggie 1982). "Embedded liberals argued that capital controls were necessary to prevent the policy autonomy of the new and interventionist welfare state from being undermined by speculative and disequilibrating international capital flows" (Helleiner 1994, 4). This thinking was backed by a coalition of Keynesian-minded policymakers, industrialists who gained from such a policy, and labor leaders. Indeed, this period is seen as the heyday of the Keynesian revolution in economics.

The institutional backdrop for the Bretton Woods era was, of course, the IMF Articles of Agreement. These Articles allowed for a regime of cooperative decentralization that did not live up to its full promise but did indeed operate. As discussed earlier, nations deployed a wide variety of regulations to regulate the inflow of capital, sometimes independently at both ends and sometimes in a cooperative fashion.

The Push for Strong International Standards: 1970s to the Asian Financial Crisis

By the 1990s, the industrialized countries had shifted their thinking and action on global capital flows. By end of the century, virtually all industrialized countries

had fully opened the capital account, and many EMDs had followed suit. These changes reflected technological changes in the financial industry, larger global capital markets, and an associated political strengthening of the financial sector, along with new thinking in macroeconomics. As the twentieth century closed, industrialized nations moved to formalize this thinking through strong international standards on all fronts—at the IMF, the Organisation for Economic Co-Operation and Development (OECD), and beyond.

To be sure, this change was sweeping in the industrialized world, but it was only partially transforming among EMDs. An attempt was also made to change the IMF Articles of Agreement to mandate capital account liberalization in the 1990s. That initiative did not materialize because of contests within the United States, within the IMF, and between the industrialized nations and EMDs. The OECD nations now have a clear mandate for capital account liberalization, but such standards are relatively weak and have significant exceptions.

The Organisation for Economic Co-Operation and Development

Informally, many individual countries began advocating for capital account liberalization in the 1970s, but the first formal adoption of such standards are the OECD Codes.[1] Somewhat analogous to the IMF Articles, the original 1964 Codes initially excluded speculative capital on grounds that short-term capital would disrupt the balance-of-payments position of OECD members and make it difficult for nations to pursue independent monetary and exchange rate policies. The original Codes were amended in 1989 when a group of nations led by the United Kingdom and Germany argued that all OECD nations by then had sophisticated enough capital markets that they could withstand the liberalization of short-term flows. The amendment requires capital account liberalization and a prerequisite for OECD accession. Indeed, all nations that have acceded to the OECD since 1989, regardless of their level of development, also liberalized their capital accounts to include short- and long-term maturities. South Korea, in its accession negotiations in 1996, argued that it should have a grace period to gradually open its capital account as it developed. The OECD denied this request, an open capital account a condition of membership, and South Korea eventually conceded (Abdelal 2007).

1. The European Union formalized capital account liberalization in 1988. In this chapter, I focus on global economic governance spanning more than one continent.

That said, the OECD Codes are not very strong in terms of enforceability, and there are fairly broad exceptions in place. Article 7 (in each set of Codes) holds the "clauses of derogation" that govern the temporary suspension of commitments. Under these safeguards, a nation may suspend liberalization. Article 7b allows a member to put in place temporary capital controls to stem what may "result in serious economic disturbance in the Member State concerned, that Member may withdraw those measures." Article 7c is the balance-of-payments exception: "If the overall balance of payments of a Member develops adversely at a rate and in circumstances, including the state of its monetary reserves, which it considers serious that Member may temporarily suspend the application of measures of liberalisation taken" (Organisation for Economic Co-Operation and Development [OECD] 2009). Greece, Iceland, Portugal, Spain, and Turkey have all used the derogation. The OECD permitted them to do so because these nations were seen to be at a lower stage of development than the other members of the OECD (Abdelal 2007).

Rethinking Capital Controls at the International Monetary Fund

Beginning in the 1970s, the IMF was transformed as well. What was once at the core of the international monetary system—regulating capital flows to maintain policy autonomy and to stabilize exchange rates—began to be seen as heresy. Initially the transformation was informal, with a shift in IMF staff and management thinking and, thus, a different level of surveillance and different advice to member countries. In the mid-1990s, the IMF proposed to formally amend the Articles of Agreement to include the liberalization of the capital account. According to an IMF staff report, "the impetus for such liberalization was largely provided by the frameworks of the OECD Code and the EU Directives" (Evens and Quirk 1995, 6). This would have amounted to a revision of Article VI, which grants nations the ability to regulate capital flows. This attempt to impose strong international standards at the IMF did not materialize.

As noted earlier in this chapter, under the Articles of Agreement the IMF has no legal authority to force nations to liberalize their capital accounts. That said, the IMF began changing the advice it gave to its member states during the 1970s and 1980s. According to the IMF Independent Evaluation Office, however, the IMF did not require nations to open their capital account as a condition of a financial program. Indeed, the IMF interpretation of the Articles of Agreement is that it cannot "require a member to remove controls on capital movements" (IMF 2005, 31).The IMF did begin, however, to encourage liberalization through letters of intent and policy memorandum that were not part of official financial

program documents. The IMF Exchange and Trade Restrictions Department recommended capital account liberalization in Nigeria, Guatemala, Egypt, Honduras, Jamaica, and elsewhere. What's more, capital account liberalization figured prominently in the annual IMF World Economic Outlook reports and other publications throughout the 1980s and 1990s. Chwieroth states that "controls were said to harm economic performance, create severe distortions, and delay policy adjustments needed to eliminate balance of payments disequilibria" (2010a, 152). Joseph Joyce and Ilan Noy (2008) econometrically show that such advice was taken—between 1982 and 1998, capital account liberalization was significantly correlated with a nation having an IMF financial program.

Attempts to formalize the new thinking about regulating capital flows at the IMF date back to the early 1970s and were led by the United States. In 1972, the IMF created a Committee of Twenty (C20), and in 1973, a "The Report of the Technical Group on Disequilibrating Capital Flows" was submitted (Pauly 2008). Foreshadowing events in 2011, the "Report of the Technical Group" recommended that the IMF construct a code of conduct for the use of capital controls. The final C20 report that formed the basis for later amendments to the IMF did not include a recommendation to discriminate among kinds of capital control, but US influence steered the report to state that "countries will not use controls over capital transactions for the purpose of maintaining inappropriate exchange rates, or more generally, of avoiding appropriate adjustment action" (quoted in Chwieroth 2010a, 143). The resulting final amendments legalized floating exchange rates, but a consensus on the capital-controls components remained elusive enough that the original Articles, and thus the regime of cooperative decentralization for non-OECD members, remained intact.

Into the 1980s and 1990s, capital account liberalization "had emerged as a social norm" for the IMF (Abdelal 2007, 129). In the early 1990s, the IMF management and staff proposed an official amendment to the IMF Articles of Agreement to codify this norm into strong international standards. According to Rawi Abdelal, the IMF would have rewritten Article VI to state that "Members shall not, without the approval of the Fund, impose restrictions on the making of payments and transfers for capital international transactions" (2006, 189). This was opposed by many EMDs at the Executive Board of the IMF, but the countries lacked the voting power to sway management or other key members of the board. Ultimately, the Asian financial crisis erupted just as the United States was set to renew its funding for the IMF. The US executive director to the IMF and the US Treasury Department had pledged their support for the initiative. But key members of Congress, after extensive lobbying from nongovernmental organizations

(NGOs), threatened to withhold funding for the IMF if the amendments were supported. The Treasury Department withdrew its support, and the amendment was shelved.

The Political Economy of Capital Account Liberalization

How did such a radical change in global policy come about over a relatively short period of time? One of the core principles of the Bretton Woods agreement was the ability of nation-states to regulate capital flows as they saw to be necessary. Moreover, nations were free to cooperate among themselves to make such regulations effective. Beginning in the 1970s, the tables began to completely turn, and capital account liberalization became the norm, at least across the industrialized world.

Revisiting Table 2.1, we see that a confluence of factors integrated to *almost* cause one of the most decisive shifts in modern global monetary history. US foreign financial power (with the European Union close by) came to dominate global economic politics, given the internationalization of capital markets and the associated political strength that came with an ever-growing global financial sector headquartered in the United States and Europe. In parallel were the new economic theories of capital account liberalization (see chapter 3). Michel Camdessus, the new IMF managing director, strode into the IMF bent on capital account liberalization and found an earnest core of IMF staff members who held the same view. This convergence of power, interests, ideas, and institutional structure gave impetus to forming strong international standards that attempted to replace the regime of cooperative decentralization.

Initially, the prevailing explanation for the change in thinking and policy output at the IMF (and OECD) was the strengthened financial sector and its relations with Washington. Cohen (2007) demonstrates that, although the costs of capital controls are directly felt by a handful of politically organized US constituents (Wall Street), the beneficiaries are diffuse and don't feel the direct effects. Thus, a collective action problem persisted when Wall Street organized around capital account liberalization. Moreover, whereas in the Bretton Woods era there had been an industry-labor alliance, that alliance had shifted to an alliance between industry and the financial sector (Henning 1994). Voices as diverse as Robert Wade and Frank Veneroso (1998) and Jagdish Bhagwati (2004) called this the Wall Street–Treasury complex (analogous to the military-industrial complex, a term coined during the Eisenhower era to describe the politics of that time). These authors argued that the US Treasury Department and Wall Street investment houses were pushing for the freedom of capital movements wherever possible, including forcing the IMF into advising capital account liberalization

worldwide and working to codify such a policy in the IMF Articles. Other researchers, such as Kirshner (2003), Mark Blyth (2003), and Manuela Moschella (2011), see interests groups as key in shaping the general change in thinking about capital account liberalization and offer a more nuanced view of the specific role that those powerful interests played in actual IMF policy outputs.

The economics profession had made a profound change in thinking about capital account liberalization. Economic theory went through a fundamental revolution in macroeconomics where Keynesian economics was replaced with new classical macroeconomics. These economists, later joined by the "new" Keynesian economists, saw capital account liberalization as a way to make markets more efficient. Capital controls were seen as not only distortionary but of little use given that consumers and investors would factor them away in their economic decisions. This new thinking in macroeconomics formed the backdrop for a different way of thinking about government altogether—this period is commonly referred to as the neoliberal era, rising with the arrival of Ronald Reagan and Margaret Thatcher in 1979–1980 and cresting with the Washington Consensus advocated by the United States, Europe, and the IMF throughout the 1990s. In general, this era can be characterized as allowing an extremely limited role for the state in economic affairs; the principal role of politics was to carry out the economic view. Mark Blyth (2002) traces the shift from embedded liberalism to neoliberalism in the 1970s:

> In sum, just as labor and the state reacted to the collapse of the classical liberal order during the 1930s and 1940s by re-embedding the market, so business reacted against this embedded liberal order during the 1970s and 1980s and sought to "disembed liberalism" once again. In this effort, business and its political allies were quite successful, and by the 1990s a new neoliberal institutional order had been established in many advanced capitalist states with remarkable similarities to the regime discredited in the 1930s. (2002, 6)

Despite the general interest of Washington and Wall Street in this thinking, newer literature on the subject finds that both Washington and Wall Street were conflicted on the issue and that the direct impetus actually came from within the IMF itself. The US executive director to the IMF during the 1990s was Karin Lissakers, who supported the amendment along with the US Treasury Department. Numerous accounts, however, show that the United States was more focused on gaining financial-market access through the trade regime than at the IMF (Abdelal 2007; Chwieroth 2010a). Whereas the IMF could effectively enforce its amendment only on nations that went to it for a financial program, through the WTO (and later US free-trade and investment deals) the United States would

enjoy strong international standards that were actionable by the United States. (This shift of action on capital account issues from the IMF to the trade and investment regime is the subject of a later chapter.)

The financial industry was also less strident in its support for changes at the IMF than was previously surmised, according to researchers who have interviewed high-level officers at the Institute of International Finance (IIF), the broadest collection of global financial firms and institutions. The IIF had shown some early support for the initiative but then called for caution in the wake of the financial crisis. Moreover, and perhaps more important, more than one source confirms that the IIF was tepid about the IMF initiative because the IIF did not want the IMF to move onto its turf of perceived preeminence in the global economic policy realm (Abdelal 2007; Chwieroth 2010a).

Most recent accounts see the origin of the IMF amendment as coming from the IMF itself (Abdelal 2007; Chwieroth 2010a; Moschella 2011). Abdelal (2007) argues that this change was, in part, exported to the IMF from French socialists, who had originally been big advocates of capital controls. Then controls on outflows in 1983 adversely affected the middle class and led to a change in the party stance. When Michel Camdessus (a prominent French socialist at the time) became the IMF managing director, he found highly sympathetic staff members at the IMF and began to work together with them toward the liberalization of capital controls. Chwieroth (2010a) acknowledges that the French connection was important but stresses that the IMF staff members became key advocates as well. In the early days of the IMF, most staff members had been Keynesians who supported capital controls, but slowly the IMF became populated with US-trained economists who were new classical or new Keynesian economists and who saw capital controls as counterproductive. Chwieroth finds, however, that there were tensions between "gradualist" and "big bang" camps at the IMF. Gradualists advocated gradual capital account liberalization and the selective use of capital controls; in contrast, big bang advocates wanted the rapid liberalization of the capital account. The IMF was largely seen as a big bang advocate, especially to casual observers who saw the IMF looking to change its charter to mandate capital account liberalization and to those who observed IMF country programs where capital controls often had to be eliminated as the condition for an IMF loan. Big bang advocates became outnumbered in the wake of the Asian financial crisis and were then silenced by the actions by the US Congress and the voices of EMDs.

EMDs certainly voiced opposition to the proposed amendment, but the countries had neither the unity nor the voting power to significantly affect a policy outcome that would be ultimately in their favor. Aziz Mohammed (1998) and Helleiner (1994) note that many developing countries were extremely skeptical

of the proposed amendment. The G24, a group of finance ministers from EMD nations, said as much in their 1997 communiqué (Mohammed 1998). The head of an independent panel of academics and policymakers from developing countries wrote, "it would certainly seem premature at this time, and, quite possibly, inappropriate for a much longer time, to consider an amendment to the IMF Articles of Agreement that required all members to commit themselves to the achievement of an open capital account"(Helleiner 1994, 33). Such a view was not held by all EMDs, however. Many EMDs had elected political parties and appointed economic policymakers who shared the Washington Consensus view of global economic policy and had been trained in new classical economics (Gallagher 2013).

The Asian financial crisis in 1997 put an end to discussions about changing the IMF Articles of Agreement to include capital account liberalization. Several EMDs had given the IMF supporters stiff resistance from the beginning. Even some industrialized countries, such as Canada, which had just granted Chile the right to regulate the inflow of capital through a newly minted trade treaty between the two nations, withdrew its support for the change (Chwieroth 2010a). There was also a split among IMF staff members on the amendment. Thus, the required 85 percent vote was simply not there. Then the Asian financial crisis came. The crisis was seen by many to be in large part due to a too rapid liberalization of Asian capital accounts, which the IMF referred to as disorderly liberalization. At the same time, numerous economic studies, including the IMF World Economic Outlook, indicated that capital account liberalization was *not* associated with economic growth (Eichengreen 2004; IMF 2005; Ocampo, Spiegel, Stiglitz 2008). Moreover, many civil society organizations based in Washington began to ally with their EMD counterparts to put pressure on the US Congress to block the initiative (Abdelal 2006; Chwieroth 2010a). When US Representative Richard Gephardt (D-Missouri) got wind of the proposal, his office threatened to withhold US funding for the IMF—right at a time when the IMF was putting together funding programs across the world. That was not the end of the story, just the last chapter of the story of the global governance of capital flows in the twentieth century.

Summary and Conclusion

In this chapter, I have traced the history of governing global capital flows and presented a framework for understanding the first two eras of modern global governance with respect to financial flows. The chapter emphasizes how power,

interests, ideas, and institutions interacted in different combinations to shape each era and to yield different outcomes.

The Bretton Woods era can be characterized as one of cooperative decentralization, during which an order was established that allowed individual nations to regulate cross-border finance on their own and cooperate informally as necessary. That regime worked fairly well, but a confluence of market power, interest-group politics, and new economic ideas led to a push to create strong international standards that would have required the full liberalization of capital flows. That project was partially successful at the national level but failed at the level of global governance. This failure is fairly remarkable considering the consolidation of market and political power that had concentrated in the United States since the demise of the Bretton Woods system, the sea change in mainstream macroeconomics about the economics of capital flows, and the power that the IMF had over EMDs that had experienced over a decade of crises.

Indeed, during the Bretton Woods era, the United States was an internally united hegemon that saw the regulation of capital flows as important to its broader national security and economic interests. The Bretton Woods era was also a period of embedded liberalism, during which nations pursued the integration of goods markets but tempered financial markets in support of national employment and development objectives. Prevailing Keynesian economic ideas supported this view, and the IMF as an institution was codified to preserve cooperative decentralization.

As the cold war ended the United States (and the West in general) was arguably at the crest of its power as a global hegemon. Moreover, the US financial sector had become the true center of global financial power by the 1990s. The economics profession had moved toward a consensus that capital account liberalization was the optimal choice for the global economy. Moreover, the voting structure of the IMF was tilted toward the Western powers. As we might expect, a Wall Street–Treasury alliance arose, proposing an amendment to the IMF Articles that would create strong international standards for capital account liberalization. Indeed, the West had succeeded in revamping the OECD Codes to require capital account liberalization—and had even required disgruntled new entrants, such as South Korea, to sign on to such Codes despite their objection.

Surprisingly, the requirement of capital account liberalization did not happen at the IMF, where the consequences would have been more strongly felt. It was the IMF itself, rather than the United States or the financial sector, that was the originator of the idea of amending the Articles. The United States and the financial sector largely saw the IMF move as an effort to reestablish its waning

global monetary turf and, thus, tempered their support. Within the IMF, there was also significant opposition among the industrialized countries and EMDs alike. Moreover, the IMF staff was divided as well. The US government and the private sector had moved over to the trade and investment arena as a regime—a regime that already had strong international standards. Such a strategy proved to be far more successful for the United States and the financial sector, although a world of full capital account liberalization was still to remain elusive.

3

FROM MANAGING THE TRILEMMA TO STABILITY-SUPPORTED GROWTH

For much of the twentieth century, the dominant view in macroeconomics was that cross-border finance needed to be regulated. This was seen as the way to balance the "impossible trinity" first sketched by John Maynard Keynes in his two books on monetary theory—especially in the post-Depression industrialized countries seeking to achieve full employment. The dominant view in development economics during the same period was that cross-border capital flows needed to be regulated for similar reasons and *also* to mobilize domestic resources for economic development.

A strong tradition remained in the impossible trinity literature as the century went on and is experiencing a revival in the wake of the global financial crisis. In contrast, the view that capital mobility was something to be constrained had fallen out of favor in mainstream economics by the 1980s and 1990s. The dominant view into the 1990s was that international financial flows were efficient and balancing forces, and that regulating capital was inherently distortionary and delayed adjustment.

The experience of numerous financial crises in the past twenty years has spawned new economic theories that re-introduce the notion that cross-border finance can cause financial instability. Two of the new theories are remarkably similar. One strand of new theory picks up from Ragnar Nurske and builds on the work of Hyman Minsky and others. This view has become popular in many emerging market capitals and in the UN system, and in part, it inspired Brazil to regulate capital flows in the wake of the global financial crisis. Another strand of

new theory on capital flows and financial stability comes from modern welfare economics and is gaining ground in mainstream economics, the central banks, and the Bretton Woods institutions. This second strand played a key role in transforming the IMF thinking on capital controls in the wake of the global financial crisis (see chapter 6). In this chapter, I first outline the macroeconomic stability and developmentalist approaches to regulating capital flows that dominated the Bretton Woods era. I then examine the theory and evidence with respect to capital account liberalization and outline the contours of new economic thought in the Keynesian tradition and the new welfare economics of regulating cross-border finance.

The Trilemma: Keynes, Macroeconomic Stability, and Development Economics

Keynes's monetary theories and their extensions became mainstream during the Bretton Woods era. Such thinking pointed to the need to regulate cross-border finance for nations to maintain the Bretton Woods exchange rate regime and to have an independent monetary policies for growth and employment. This line of thinking became formalized in the Mundell-Fleming model and spawned an entire economic subtradition of its own. Economists in this tradition became the dominant macroeconomists in industrialized countries, at the IMF, and at the World Bank.

Development economists writing during the same era extended Keynes's theories, arguing that capital flows needed to be regulated in accordance with the Mundell-Fleming model as well. These economists also developed models whereby foreign capital needed to be regulated to generate resources from domestic sources to channel finance toward a process structural transformation in the economy—while, at the same time, preventing overspeculation that would result in financial crises that could derail that process of transformation and development. These economists came to dominate many of the UN institutions, as well as the finance ministries and central banks of key emerging-market and developing countries (EMDs).

Here I outline these two lines of economic thought to give a context for the movement that discredited these lines of thinking and dismantled the policies associated with it in the 1980s and 1990s. This also helps guide our understanding of the antecedents of the latest breakthroughs in economic theory in support of regulating capital flows.

The Keynes-Mundell Tradition

There is a strong and long-standing literature emphasizing the incompatibility of capital mobility, exchange rate stability, and independent monetary policies.

What was to become known as the "impossible trinity"—that, with fixed exchange rates and open capital markets, there can be little or no autonomy for monetary policy—was a widely held rule of thumb in the 1920s. In economic theory, it was first formulated in Keynes's *A Tract on Monetary Reform* (1929) and *A Treatise on Money* (1930). "National Policy Autonomy" (chapter 36 of *A Treatise*) states:[1]

> Can we afford to allow a disproportionate degree of mobility to a single element in an economic system which we leave extremely rigid in several other respects? If there was the same mobility internationally in all other respects as there is nationally, it might be a different matter. But to introduce a mobile element, highly sensitive to outside influences, as a connected part of the machine which the other parts of which are much more rigid, may invite breakages. It is, therefore, a serious question whether it is right to adopt an international standard, which will allow an extreme mobility and sensitiveness of foreign lending, while the remaining elements of the economic complex remain exceedingly rigid. (Keynes 1930)

In a 1943 article published in the *Economic Journal,* Keynes noted that "The fundamental reason for thus limiting the objectives of an international currency scheme is the impossibility, or at any rate the undesirability, of imposing stable price-levels from without. The error of the gold-standard lay in submitting national wage-policies to outside dictation" (1943, 187).

Barry Eichengreen (2008) and others have noted that this framework was the guiding political economy principal during the Bretton Woods era. In economics, the Mundell-Fleming model was the first to incorporate the regulation of foreign capital into a general equilibrium framework, and it spawned many followers. Indeed, we could characterize Mundell as being to *A Tract* and *A Treatise* as John Richard Hicks was to the *General Theory* in terms of formalizing Keynes. The Mundell-Fleming theory refers to specific articles by Robert Mundell (1961a, 1961b, 1962, 1963) and Marcus Fleming (1962). The model is a Keynesian model of a small open economy in which world prices, incomes, and interest rates are exogenous in the short run (figure 3.1). Other assumptions include a constant price level, so that price rigidity is a feature as opposed to flexible prices. It is an extension of the investment saving–liquidity preference money supply (IS-LM) framework that introduces the international sector, or balance of payments.

1. I am grateful to Jan Kregel for pointing this out to me.

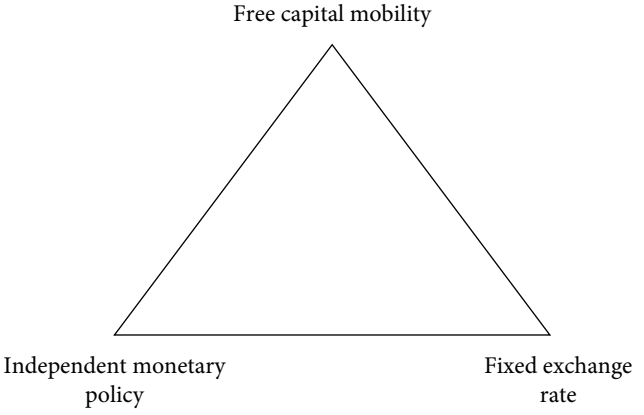

FIGURE 3.1. The Mundell-Fleming model.

These works attempted to uncover the optimal policy mix as well as the optimal exchange rate regime for open economies with mobile capital. One main conclusion of Mundell (1963) is that perfect capital mobility, a fixed exchange rate regime, and independent monetary policy cannot all coexist; countries can maintain at most two of the three. Moreover, the Mundell-Fleming model explicitly verifies that if capital is internationally mobile and the nominal exchange rate is fixed, monetary policy is constrained to only altering the level of international reserves, while fiscal policy can effectively alter output. Fleming (1962) specifically offers these conclusions in his analysis of government policies. The trilemma result of Mundell-Fleming provides a basis for which policy responses to external shocks (e.g., capital inflows and outflows), especially in emerging markets, can be analyzed. Economists such as James Tobin (1978, 1998) sees this trilemma as the rationale for an activist monetary policy in pursuit of full employment. Numerous studies show that capital controls were effective outside the United States during this period as well. Work by Maurice Obstfeld (1993), Richard Marston (1993), and Kouri and Porter (1974) demonstrated how controls were effective in the 1960s in the United Kingdom, Germany, Australia, Italy, and the Netherlands.

Despite the fact that new classical economics came to dominate macroeconomic thinking, work in the Mundell-Fleming tradition still held traction in the profession. Some economists adopted new Keynesian models that borrowed from the new classical models and attempted to use microfoundations to articulate the impossible trilemma, but under sticky wages and prices. Obstfeld and Kenneth Rogoff (1995) continue to follow the tradition of formalizing the trilemma in such a context. A group of economists have formally modeled some of the ideas that could be seen as more in the (new) Keynesian tradition, operating

in a dynamic general equilibrium context with sticky prices and sometimes sticky wages. In addition, a group of empirically based economists have examined the extent to which nations still face a trilemma in the contemporary world. There is an emerging consensus in this new literature that the impossible trinity remains a very real challenge in the twenty-first century and that, in certain circumstances, restricting capital mobility is the optimal route to macroeconomic stability.

There has been a resurgence in this line of thought since the new classical perspective rapidly lost traction in the wake of the global financial crisis. In that tradition, Emmanuel Fahri and Ivan Werning (2013) use a general equilibrium framework with microfoundations and sticky wages and prices that builds on microfounded models of Obstfeld and Rogoff (1995). They find that capital controls are the optimal way to respond to external shocks. Perhaps most interesting is that, in the presence of sticky wages and prices, they find that capital controls may be optimal even with a floating exchange rate.

Another new theory has emerged that models the distortion due to capital controls from a trade policy perspective. In focusing on intertemporal distortions, Armaud Costinot, Guido Lorenzoni, and Ivan Werning (2011) derive optimal capital controls that depend on business cycle dynamics and the trade balance. Their model yields the optimal policy mix either of taxing inflows and subsidizing outflows or of taxing outflows and subsidizing inflows. Specifically, in an expansionary period when there is positive growth in output, the optimal policy is to tax inflows and subsidize outflows. Such results have important implications for high-growth economies that are catching up with the rest of the world.

More empirically grounded work demonstrates that the trilemma continues to be a core trade-off for nations in a globalized economy (Obstfeld 2001; Aizenman, Chinn, and Ito 2010; Aizenman and Pinto 2011). Aizenman, Chinn, and Ito (2010) develop indexes related to the trilemma and test the extent to which there is linearity in the three poles of the trilemma. They find that the weighted sum of the three indexed trilemma policy variables (monetary policy independence, exchange rate stability, and capital mobility) add up to a constant and therefore validate the notions going back to Keynes that there is a real trade-off among these policy options. The trilemma remains a very real policy trade-off for nations operating in the global economy.

The Developmentalists

Keynes also spawned an activist development economics where it is the role of the state to pursue full employment in the process of structural transformation. Although the work of Michal Kalecki may have played a more significant role, Keynes's influence on this theory was very real. Among the pioneers of

development economics were Paul Rosenstein-Rodan, Nurkse, Raúl Prebisch, Hans Singer, Gunnar Myrdal, Albert O. Hirschman, and Arthur Lewis. Virtually all these scholars see the regulation of capital flows as central for macroeconomic stability and structural transformation. Nurkse also sees regulating capital flows as key to maintaining financial stability.

At this writing, perhaps the best-known developmentalist theory is the Lewis model. Arthur Lewis, whose theory earned him the Nobel Prize, observed that EMDs have surplus labor in the agricultural sector that can be attracted into a "modern" manufacturing sector if higher wages are offered. The manufacturing sector will make a profit if companies offer manufacturing wages above the agricultural wage rate. This will attract surplus agricultural workers into the modern sector and, crucially for our purposes, capitalists will reinvest the profits in the form of more fixed capital into the modern sector. Firms in the modern sector will then demand more labor until the manufacturing sector has grown to the point where it has become industrialized. Central to the reinvestment of profits are capital controls on outflows so firms do not invest profits outside the country rather than in the fledgling modern sector (Lewis 1954).

Prebisch, Singer, Myrdal, and others further justify the move to industrialization. Traditional agricultural exports are likely to meet inelastic demand that will weaken the terms of trade over time. Following this thinking, many countries wishing to industrialize formed development banks that channeled credit into seemingly inefficient manufacturing industries, where they perceived the social returns to be higher than the private returns in the short and medium run. Here too, capital and exchange controls limited the ability of such finance to be deployed overseas (Amsden 2001).

New archival work by economists Esteban Perez and Matias Vernengo (2012) has unearthed how Raúl Prebisch, Argentinean economist, oversaw the implementation of countercyclical capital controls during his tenure at the Central Bank of Argentina; they quote Prebisch as saying, "This [short-term] capital went to further inflate the categories of goods or assets that were already inflated, and did not translate, except in very rare occasions, in a real increase in the production of the country. . . . the measures adopted by the government to make an exception, to allow the inflow of these capitals if it is shown that these are oriented towards the increase in real production . . ." (quoted in Perez and Vernengo 2012, 11).

Ragnar Nurkse was a pioneer unto himself in many ways. To the extent that he is studied or remembered at all, it is for his balanced growth theory, which is analogous to the big-push theory developed by Rosenstein-Rodan (Nurkse 1961). To these economists, investments need to go into multiple sectors at the same time to boost the productivity growth, and therefore the demand, that can eventually

lead to the full industrialization of the economy. Like the other developmentalists, Nurkse sees domestic resource mobilization as the key to financing such investments—and thus sees capital controls as a way to steer profits and credit toward the industrialization process. Nevertheless, Nurkse was among the first to also express concern about destabilizing speculation. In the 1930s and 1940s, Nurkse worked for the League of Nations and was the author of a highly influential tract on international finance and currencies in the run up to the Bretton Woods meetings. According to him, "If there is anything the inter-war experience has clearly demonstrated, it is that paper currency exchanges cannot be left to fluctuate from day to day under the influence of market supply and demand. . . . If currencies are left free to fluctuate, speculation in the widest sense is likely to play havoc with exchange rates—speculation not only in foreign exchanges, but also, as a result, in commodities entering into foreign trade" (Nurkse 1944, 137–38). These two traditions became secondary as the twentieth century went on. A new macroeconomics arose that saw financial globalization as a cure, not an ill.

Keynes Had It All Wrong? The Rise and Fall of Capital Market Liberalization

As discussed in the last chapter, backed by new developments in economic theory, interest groups that sought to deepen global capital markets, new technologies, and the International Monetary Fund (IMF), capital account liberalization came into vogue in the 1980s and 1990s (Ocampo, Spiegel, Stiglitz 2008; Abdelal 2007; Chwieroth 2010a). New economic models of capital account liberalization suggested that liberalizing the capital account could lead to economic growth and macroeconomic stability—and characterized the various Keynesian-derived approaches as distortionary. Many of the world's nations liberalized their capital accounts in the 1980s and 1990s.

The economics of capital account liberalization is fairly simple. The basic neoclassical model explains that opening capital markets can accelerate growth in EMDs, which are (thought to be) capital scarce and thus have a higher return to capital (Lucas 1990). The model employs two factors, capital and labor, as well as labor-augmenting technological progress. In defining an equation of capital accumulation and the steady state, the dynamics of the model can be derived. For example, capital will flow into a liberalizing developing country whose interest rate is higher than the world interest rate. The cost of capital in the steady state, before liberalization, is determined by the interest rate and the rate of depreciation. After liberalization, however, the cost of capital is determined by the world interest rate. Hence, the impact of liberalization works through the cost of

capital, which falls on the introduction of liberalization due to the capital inflow. In addition, in the short run, the growth rate of capital and per capital output increase during the transition.

Other arguments in favor of liberalization focus on consumption smoothing and make the argument that capital account liberalization brings collateral benefits to the banking system that are difficult to detect. Rather than being necessary for macroeconomic stability and economic growth, the rational expectations view saw speculation and movements in cross-border finance as efficient and rational responses to market fundamentals. The actions of investors and speculators, according to this view, can help markets become self-correcting (Friedman 1953).

These ideas became commonplace across the industrialized world toward the end of the twentieth century. Now however, econometric evidence suggests that, in EMDs especially, capital account liberalization is not robustly associated with economic growth and may be correlated with financial crises (Prasad et al. 2003; Jeanne, Subramanian, and Williamson 2012). In light of this, the merits of capital account liberalization in developing countries came under great scrutiny in the early 2000s and even more so in the wake of the global financial crisis. Indeed, the most recent research has shown that capital market liberalization is associated with growth only in nations that have reached a certain institutional threshold—a threshold that most EMDs have yet to achieve (Kose, Prasad, and Taylor 2009; Jeanne, Subramanian, and Williamson 2012). This is partly because the binding constraint for some EMD growth trajectories is not the need for external investment but the lack of investment demand. This constraint can be accentuated through foreign capital flows because such flows appreciate the real exchange rate, thus reducing the competitiveness of goods and reducing the willingness of the private sector to invest (Rodrik and Subramanian 2009).

Although there is a wide consensus about these findings, some theorists continue to dispute them. For example, in his investigation of international capital mobility, Peter Henry (2007) explains the predictions of theory and then reviews the corresponding empirical studies, outlining their results, methodologies, and, most important, their limitations. Despite the simplifying assumptions and lack of market frictions in the Solow model (a neoclassical model formulated by Robert Solow), Henry shows that the theory itself still maintains predictive power for the short-run effects of capital liberalization as well as the rates of convergence to steady-state growth rates. The reasons that many empirical studies fail to capture the growth benefits of liberalization relate to their methodologies, Henry says. First, cross-sectional studies measure the *permanent* impact on growth rates rather than the temporary impact. Second, the measure of capital openness is

binary and subject to measurement error; therefore, studies have found no significant impact of binary measures on growth rates. Finally, many of these studies do not separate developed from developing countries in the analysis.

More recent work has addressed these objections but still finds consistent relationships between capital account liberalization and growth in EMDs. Motivated by the vast international capital liberalization of EMDs in the 1990s and their subsequent crises, Joshua Aizenman, Yothin Jinjarak, and Donghyun Park (2011) measure the differential impact of disaggregated capital flows on economic growth before and after the 2008 global financial crisis—paying close attention to and attempting to correct for the concerns raised by Henry. In their study, short-term debt (measured by short-term external debt to gross domestic product, GDP, ratio) has a negative impact on growth. Furthermore, these empirical implications of the impact of external debt correspond to the predictions of numerous theoretical models (e.g., Aizenman 2010).

There is also considerable work demonstrating that capital account liberalization is associated with a higher probability of financial crises. Carmen Reinhart and Rogoff (2010) show that since 1800 capital mobility has been associated with banking crises. In contemporary terms, Aizenman and Brian Pinto note that:

> more than any literature survey, the spate of emerging market crises after 1997 is eloquent testimony to the difficulty of avoiding macroeconomic and financial crises with an open capital account and a high degree of financial integration. In addition to these two features, countries which suffered a serious macroeconomic crisis between 1997 and 2001 were apt to exhibit a fixed exchange rate (all; explicit in some cases as part of disinflation programs, e.g. Argentina, Brazil, Russia, Turkey and implicit in the case of Thailand and other East Asian countries); unsustainable government debt dynamics (Argentina, Russia) or big jumps in government debt as a result of private sector bailouts (East Asia, Turkey); and balance sheet problems (East Asia in particular, also Argentina and Turkey, with liabilities, often short-term, denominated in US dollars and assets in local currency). (2011, 7)

Rising capital market liberalization and the recent global financial crisis has motivated many studies to examine the adverse consequences of highly integrated markets. Joseph E. Stiglitz has been a significant skeptic of capital market liberalization and has presented arguments for intervention in capital flows based on empirical and theoretical findings (e.g., Stiglitz 2000; Stiglitz et al. 2006). The main arguments against full capital market capitalization arise from open markets, increased risk diversification, more pro-cyclical capital flows, increased risk of contagion, increased risk of capital flight, and increased financial instability.

Jeanne, Subramanian, and Williamson (2012) conduct a sweeping meta-regression of the entire literature that includes 2,340 regression results, finding little correlation between capital account liberalization and economic growth. They conclude, "the international community should not seek to promote totally free trade in assets—even over the long run—because (as we show in this book) *free capital mobility seems to have little benefit in terms of long run growth* and because there is a good case to be made for prudential and non-distortive capital controls" (Jeanne, Subramanian, and Williamson 2012, 5; emphasis added).

Let's now turn to that new case for regulating global capital flows.

From Trilemma to Stability-Supported Growth

Cross-border finance has been a key characteristic of the financial crises of the past twenty-five years, especially in EMDs. Hence, an outpouring of empirical and theoretical attention has been applied to analyzing the role of cross-border finance in emerging market financial crises. One strand of thinking extends the developmentalist tradition by drawing on Hyman Minsky and others. Another strand stems from welfare economics and has become known as the new welfare economics of capital controls. In both these strands, thinking has evolved beyond simply the trilemma perspective. These thinkers see monetary policy and financial stability as virtually impossible when a country has a floating exchange rate and capital mobility. Moreover, in this light regulating capital flows is seen as a corrective set of measures that enhance growth rather than distorting it.

Since the early 1980s, international capital flows to EMDs have been both volatile and destabilizing. Figure 3.2 shows the net private (non–foreign direct investment, non-FDI) capital flows as a percentage of GDP to EMDs from 1980 to 2013. During this period, the world has seen repeated crises in Latin America, East Asia, Russia, and beyond. Note the sharp booms in inflows followed by sharp declines. Recent work characterizes large booms in capital inflows as "surges." Such surges can be followed by a sudden stop in capital flows. Figure 3.2 shows that cross-border financial flows have been highly volatile since 1980, with large surges in capital flows peaking with financial crises that trigger a sudden stop (the arrows in figure 3.2 point to the capital flight associated with each crisis).

Atish Ghosh and others at the IMF define a *surge* as a net inflow (as a percentage of GDP) that is in the top thirtieth percentile of observations for both the country and the sample. Ghosh et al. (2012) identify three hundred surges for fifty-six emerging markets in 1980–2009. Whereas that work focuses on inflows, work by Guillermo Calvo (1998) focuses on the sudden stops of capital flows that are followed by rapid outflows of capital—the troughs in figure 3.2 (see also

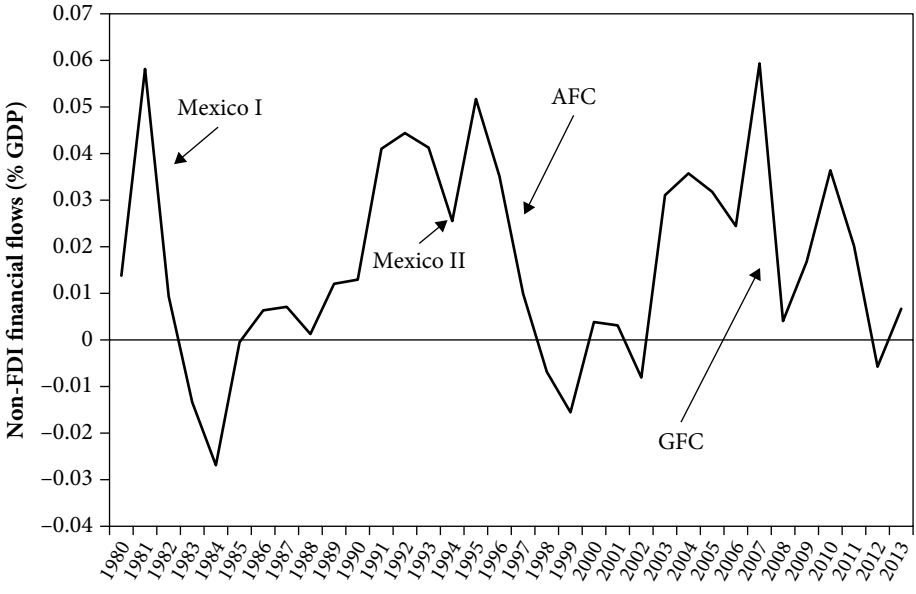

FIGURE 3.2. Net capital flows to EMDs and financial crises, 1980–2013. Capital flows are pro-cyclical. AFC, Asian financial crisis; EMDs, emerging-market and developing countries; FDI, foreign direct investment; GDP, gross domestic product; GFC, global financial crisis (International Monetary Fund 2013c).

Akyuz 2011). Research by Manuel Agosin and Franklin Huaita (2012) shows that capital flow surges are exogenously determined and are not a function of the macroeconomic fundamentals of an economy. Moreover, sudden stops are not determined by the fundamentals either; they find that the probability of a sudden stop is correlated with the length of the surge rather than with the fundamentals. Indeed, the probability doubles when a surge lasts for two years and triples when it lasts for three.

Both of the new strands of economic thinking take these characteristics of capital flows as a focus of analysis. Although the theoretical foundations of each of these perspectives differs, there are numerous similarities between them. Minskian developmentalist thinking lacks a unified apparatus analogous to the general equilibrium context of welfare economics and, instead, has capital accumulation as an end goal. But both examine international financial flows through the lens of financial stability. In so doing, both observe that emerging markets can overly attract inflows of capital that can lead to the bloating of exchange rates and asset positions to unsustainable levels. These forces inevitably unwind, triggering instability and often crises. To prevent such excessive risk, both theoretical

TABLE 3.1 New economic theories of global capital flows

	MINSKIAN DEVELOPMENTALISM	NEW WELFARE ECONOMICS
Economic goal	Capital development	Efficiency-equilibrium
Theoretical frame	Impossibility trinity	N/A
	Mobilizing domestic resources	N/A
	Financial stability	Financial stability
Policy choice	Regulating cross-border finance	Regulating cross-border finance
Timing of policy	Countercyclical	Countercyclical
Target of policy	Inflows and outflows	Inflows
Policymaker	National policy	National policy
Level of cooperation	Regional and multilateral	Regional and multilateral

Note: N/A, Not applicable.

perspectives determine a need for regulating cross-border finance at the national and, sometimes, multilateral levels. Both see the regulation of capital flows as paramount for financial stability and economic growth, although each favors a somewhat different policy mix to do so. These differences are summarized in table 3.1.

Minskian developmentalists are concerned with maintaining monetary autonomy and mobilizing domestic resources while also maintaining financial stability. The new welfare economics of prudential capital controls is squarely focused on financial stability.

The New Developmentalism—Building on Nurkse and Minsky

Economists in the developmentalist tradition—often referred to as post-Keynesian, post-structuralist—have evolved analyses that emphasize how uncontrolled capital flows cause financial instability that can threaten development prospects. To mitigate these risks, these economists argue for a permanent system of countercyclical regulations on cross-border finance.

Many of these thinkers point to Nurkse's work as the first in this tradition to highlight the need for the international monetary system to maintain financial stability for economic growth and the generation of employment. The work of Hyman Minsky has been applied to cross-border finance, as well, to understand the channels whereby cross-border finance can trigger financial instability. Minsky's (1992) financial fragility hypothesis states that (1) economies have financing regimes that are stable and others that are not and (2) that prosperity itself can change an economy from a stable to an unstable state. These two theorems are derived from the Keynesian idea that modern wealth is often represented not by real assets but by monetary claims on assets (i.e., the "veil of money" of Keynes

1929). Minsky adds that money assets can experience high degrees of volatility that can disrupt the balance sheet of both the lender and the creditor. According to Minsky's own synthesis of the theory:[2]

> In particular, over a protracted period of good times, capitalist economies tend to move from a financial structure dominated by hedge finance units to a structure in which there is large weight to units engaged in speculative and Ponzi finance. Furthermore, if an economy with a sizeable body of speculative financial units is in an inflationary state, and the authorities attempt to exorcise inflation by monetary constraint, then speculative units will become Ponzi units and the net worth of previously Ponzi units will quickly evaporate. Consequently, units with cash flow shortfalls will be forced to try to make position by selling out position. This is likely to lead to a collapse of asset values. (1992, 7–8)

Christian Weller (2001) and Philip Arestis and Murray Glickman (2002) extend Minsky's hypothesis more formally to an open and financially liberalized economy. In a financially liberalized open economy without capital controls, an economic boom will significantly attract capital inflows from foreign investors looking for new investment opportunities and enable households, firms, the government, and banks to seek foreign sources of finance. The initial economic euphoria, reflected in rising asset prices, investments, and profits, acts to validate and encourage these foreign borrowings. Capital inflows produce an appreciation of the domestic currency and thus encourage the taking of short-term positions in foreign currency. The euphoria also causes economic units to become more reckless in the risks they undertake and to resort to greater speculative financing.

2. Minsky defines *hedge, speculative,* and *Ponzi units* as: "Three distinct income-debt relations for economic units, which are labeled as hedge, speculative, and Ponzi finance, can be identified. Hedge financing units are those which can fulfill all of their contractual payment obligations by their cash flows: the greater the weight of equity financing in the liability structure, the greater the likelihood that the unit is a hedge financing unit. Speculative finance units are units that can meet their payment commitments on 'income account' on their liabilities, even as they cannot repay the principle out of income cash flows. Such units need to 'roll over' their liabilities: (e.g. issue new debt to meet commitments on maturing debt). Governments with floating debts, corporations with floating issues of commercial paper, and banks are typically hedge units. For Ponzi units, the cash flows from operations are not sufficient to fulfill either the repayment of principle or the interest due on outstanding debts by their cash flows from operations. Such units can sell assets or borrow. Borrowing to pay interest or selling assets to pay interest (and even dividends) on common stock lowers the equity of a unit, even as it increases liabilities and the prior commitment of future incomes" (1992, 7–8).

These authors note, however, that, over time, the initial economic boom and resulting increase in demand also acts to increase costs in the domestic capital goods industries. These rising costs, combined with the surge in speculative financing, act to generate present-value reversals and a decline in asset prices. With an erosion of the profit margin, some speculatively financed units are likely to begin to default, and the chances of more actors following suit increases. Furthermore, the increase in foreign borrowings, particularly short-term liabilities, results in a rising debt-to-reserves ratio. Without capital controls, and given the tendency of short-term capital flows for rapid reversal, both these developments generate a panic among foreign investors, resulting in a rapid flight toward liquidity and a heavy selling of the domestic currency. Capital flight acts to reduce the values of assets, and through possible spillover effects in other sectors, it tends to aggravate the risk of a sharp depreciation in the domestic currency, making a country vulnerable to a financial crisis. This diagnosis of the relationship between cross-border financial flows and financial stability is remarkably similar to the one presented by the new welfare economics of capital controls.

Jan Kregel (2004, 2009) combines insights from Minsky with those of E. Domar (1944), who established that trade surpluses require capital outflows that will generate later interest and profit payments. Thus, capital inflows as a source of development finance can suffice only if the rate of increase of the capital outflows is at least equal to the interest rate on foreign lending. This implies a trade deficit, which can be sustained only if inflows increase at a rate equal to the interest rates paid to industrialized-country creditors. Kregel interprets that condition as what Minsky refers to as a Ponzi investment profile, which accentuates financial fragility with the possibility of a reversal of capital flows and a subsequent crisis. A *Ponzi scheme* is a pyramid game in which the returns to investors are paid from funds paid in by new investors; it is lucrative only if the rate of inflow of new funds meets the outflow promised to the investors. Kregel notes that:

> With respect to the stability of the financial system, it is interesting to note that the Domar conditions for a sustained long-term development strategy based on external financing, on sustained positive net resource transfers are the precise equivalent of the conditions required for a successful Ponzi financing scheme. As long as the rate of increase in inflows from new investors in a pyramid or Ponzi scheme is equal or greater than the rate of interest paid to existing investors in the scheme there is no difficulty in maintaining the scheme. However, no such scheme in history has ever been successful: they are bound to fail, eventually, because of the increasing size of the net debt stock of the operator of the scheme. (2004, 11)

Given the volatile and pro-cyclical nature of free capital flows and their destabilizing effects, economists in the Minskian developmentalist tradition have argued for a permanent system of countercyclical capital account regulations, which would not only regulate capital outflows during financial crises but also control capital inflows during economic booms (e.g., Davidson 1992–1993; Eatwell and Taylor 2002; Ocampo 2002; Ffrench-Davis 2012; Helleiner 1994; Saad-Filho 2007; Palma 2002; Grabel 2006). This could involve regulating the international exposure of domestic banks, regulating the availability of foreign exchange to domestic banks and private-sector residents, and reducing real deposit rates. By helping to avoid overborrowing, such a system provides a means of exercising monetary and domestic credit restraint during economic booms and, thereby, guards against unsustainable exchange rate appreciations and against the occurrence of crises. In the event that a crisis, nevertheless, occurs, regulating capital outflows can help to avoid a sharp currency depreciation and unmanageable increases in debt-service costs. These tendencies were hard felt in the developing world in the late 1990s and early 2000s, as figure 3.2 indicates.

For Ocampo (2003, 2008), the core problem is that capital flows are pro-cyclical and are among the key determinants in EMD business cycles. In addition, Ocampo stresses, pro-cyclical finance is increasingly driven by portfolio decisions made in industrialized nations that are completely de-linked from the demand for capital in the developing world. Roberto Frenkel (2002) adds that the destabilizing effects of unregulated capital inflows (e.g., unsustainable expansions in credit and liquidity, appreciations of the exchange rates, and appreciations of financial and real assets) are exacerbated in EMDs when financial markets are small and not sufficiently diversified. He cites the Latin American experience, where liberalization was introduced into an environment in which the degree of monetization and financial depth was low, banking systems were weak, the menu of financial assets was poor, and credit for the private sector was scarce.

Like economists in the Mundell tradition, the Minskian developmentalist literature also draws attention to the fact that free capital flows severely reduce the degrees of freedom for macroeconomic management and policy autonomy because sustaining private foreign capital inflows requires a strong exchange rate and high interest rates (Palley 2009). A high interest rate acts to discourage domestic investment, while an appreciating exchange rate reduces the competitiveness of the exports of a country. Thus, the ability to stimulate domestic investment (in accordance with national priorities of output and employment) is curtailed, and it becomes difficult for a country to use the exchange rate as a strategic device for gaining entry into the world market for manufactured goods (Nayyar 2002). Moreover, as pointed out by Davidson (2000), in addition to a loss of export-market share, an appreciating exchange rate also threatens domestic firms with a

loss of home-market share because imports become cheaper. By making it more difficult for domestic entrepreneurs to gauge the potential profitability of large investment projects involving significant irreversible sunk costs, exchange rate volatility can have serious adverse effects on domestic investment.

Nayyar (2002) also argues that when short-term inflows, such as portfolio investment, become a major means of financing trade and current account deficits, the resulting appreciation of the real effective exchange rate acts to further widen these deficits. A vicious circle emerges, with these larger deficits requiring even greater portfolio investment inflows. Persistent large deficits may, over time, reduce investor confidence, thus, generating adverse expectations and ultimately resulting in a reversal of inflows and speculative attacks on the domestic currency.

In addition to constraining policies in normal times, free capital mobility also severely constrains policy autonomy during a financial crisis, therefore exacerbating problems of falling output, reduced domestic investment, and unemployment. As Ilene Grabel (2006) argues, a crisis forces a government to resort to contractionary monetary and/or fiscal policies (through higher interest rates and reduced social spending) to reverse a capital flight. This curtails its ability to use expansionary policies (such as government deficits and low interest rates) to stimulate aggregate demand and domestic investment. With respect to the threat of capital flight, Grabel (2006) emphasizes that policies restricting capital account convertibility help to reduce this risk by discouraging foreign investors from buying short-term assets, which are most vulnerable to capital flight, and by restricting their ability to liquidate such investments and send the proceeds out of the country. Furthermore, by reducing the vulnerability to sharp exchange rate fluctuations, capital flight, and financial fragility, capital controls can guard against the risk of contagion due to financial and macroeconomic instability in another economy.

Gerald Epstein and Juliet Schor (1992) develop a macroeconomic model that captures how capital controls allow for macroeconomic management and policy autonomy by controlling the links among the domestic real interest rate, capital flows, and real exchange rate. By providing a safeguard against capital flight, a system of effective capital controls allows a government to pursue an expansionary monetary policy by lowering the domestic real interest rate without significantly affecting the real exchange rate or foreign exchange reserves. By stimulating domestic investment, an expansionary monetary policy can be used to raise domestic output and employment. Similarly, even if an expansionary fiscal policy raises the domestic real interest rate, by restricting capital inflows capital controls will cause the real exchange rate to appreciate less than it would have if the inflows were unrestricted. Less exchange rate appreciation, in turn,

means that export competitiveness is less adversely affected. Finally, by regulating capital outflows, capital controls also insulate an economy from adverse effects on domestic investment and/or export competitiveness due to changes in foreign real interest rates or foreign policies.

Virtually all these authors point to a need for countercyclical capital account regulations (or capital management techniques, or capital controls) that act as "speed bumps" to signal the need to move away from currency and maturities, short-term debt, and smooth exchange rate fluctuation (Ocampo 2003; Epstein, Grabel, and Sundaram 2008). Some economists in this tradition have also argued that such policies should be coordinated regionally by neighboring or similar EMDs to collectively shield them from destabilizing capital flows.

In the policy world, these perspectives come out of pragmatic work derived in the finance ministries and central banks in Latin America and beyond in the 1990s. Ffrench-Davis (2010) was in the Chilean Central Bank when that country devised an unremunerated reserve requirement (URR), which states that a certain percentage of inflows of capital has to be put in a non-interest-bearing account in the central bank. This measure has been widely acclaimed for buffering Chile from many of the crises of the 1990s. Ocampo (Ocampo and Tovar 2003) was finance minister in Colombia during the 1990s and used the URR as well. In general, this view of managing capital flows became championed largely in the UN system, especially in agencies such as the UN Conference on Trade and Development (UNCTAD), UN Department of Economic and Social Affairs (UN DESA), and UN Economic Commission for Latin America and the Caribbean (ECLAC), where Ffrench-Davis and Ocampo worked at one time. In addition, numerous countries have drawn on these insights when putting regulations in place. Indeed, the Brazilian finance and monetary policies were led by economists who refer to their macroeconomic policy as in the Keynesian-structuralist tradition regarding these matters (Barbosa 2011).

The New Welfare Economics of Capital Controls: Building on Arrow and Stiglitz

Path-breaking work in welfare economics has also emerged that shows that financial markets can be made imperfect by the presence of pecuniary externalities. This work consists of a seminal breakthrough in welfare economics, which before this had not proved that pecuniary externalities matter when markets are imperfect. This decades-old problem was solved in the new welfare economics of prudential capital controls and thus establishes a case for Pigouvian taxes to correct for market imperfections due to the financial amplification effects that can be triggered by excessive capital inflows. Extensions of this work establish

the need for EMDs and industrialized countries alike to coordinate their taxes on capital flows to reach optimal levels.

The origins of this work date back to classic work by Kenneth Arrow and Gerard Debreu (1954) that recognizes the presence of pecuniary externalities in an equilibrium economy but notes that such externalities may not be a cause for concern in perfect markets. Indeed, such is one of the seminal insights of the Arrow-Debreu model. *Pecuniary externalities* are externalities that are transmitted through the price system rather than through external channels. For example, a rush to purchase a certain type of asset may cause a price bubble that keeps others out of the market. Nevertheless, the first theorem of welfare economics, developed here, establishes that, if markets are complete, then such a situation can be Pareto efficient because the winners could compensate the losers.

Work by Bruce Greenwald and Stiglitz (1986) takes the work of Arrow and Debreu to another level by demonstrating that information asymmetries and other factors can make financial markets highly imperfect. This led Stiglitz and many others to surmise that cross-border finance is inherently disruptive and that therefore it is justified to regulate it. According to Avinash Dixit (2003), however, Stiglitz was not able to establish the direction of the impact of imperfect markets in this context.

This was achieved by drawing on models of financial crises and has been called the new welfare economics of capital controls (Jeanne, Subramanian, and Williamson 2012). The main motivation of this literature stems from the recent global financial crisis and the capital flow behavior in emerging markets. In the last decade, EMDs have been subject to substantial capital inflows and a buildup of international reserves. Such high levels of external borrowing raise the probability of sudden stops and capital flight. As was observed during the 2008–2009 financial crisis, deleveraging and fire sales of assets can result. Such results are externalities associated with financial contagion but on the international level.

This breakthrough originated in a landmark paper, "Excessive Dollar Borrowing in Emerging Markets: Balance Sheet Effects and Macroeconomic Externalities," by Anton Korinek (2007). The starting point for his work was the third-generation models of financial crises (a.k.a balance-sheet crises), which emphasized that modern financial crises in emerging economies involve feedback loops among falling exchange rates, adverse balance-sheet effects (because of dollar debt, which increases in value), and tightening access to credit (e.g., Krugman 1991). In that paper, Korinek demonstrates that the downward loop in these models can be substantially mitigated if borrowers take on local currency debt rather than dollar debt but that individual borrowers don't recognize that. Each borrower takes the severity of financial crises as given because they take prices (including the exchange rate) as given and the feedback loops during

financial crises are driven by falling exchange rates. A planner recognizes that reducing dollar debt will reduce repayments during bad times, which will reduce the transfer problem and mitigate the declines in the exchange rate and, therefore, the severity of financial crises. The fact that private agents do not internalize this effect in the context of models of balance-sheet crises is a pecuniary externality. Korinek then extended this mechanism to global capital flows and to other kinds of capital flows (Korinek 2011). These interactions are referred to as the financial amplification effect.

The externalities arise because borrowers do not internalize the impact of their behavior on aggregate instability (e.g., systemic risk and the likelihood of fire sales). Likewise, individual investors do not internalize their contribution to the aggregate systemic risk in their investment decisions. Individual participants do not take into account their combined impact on financial fragility. External shocks (or surges) trigger a buildup of foreign debt and an appreciation of the national currency. This is followed by a rise in domestic asset prices and, thus, an increase in the collateral that can be borrowed against. All this can unwind with a shock of a sudden stop. This will lead to capital outflows and thus a depreciation of the exchange rate and a decline in asset prices. Systemic risk becomes heightened by the inability to repay foreign creditors in domestic currencies and the possibility of maturity mismatches in debt profiles given that the value of domestic assets has become depressed.

Working through an entirely different theoretical apparatus, Korinek's financial amplification effect is very similar to the Minskian developmentalist diagnosis of the relationship between cross-border finance and systemic instability. The hedge finance in a Minsky model corresponds to episodes in the financial amplification model when financial constraints are loose, and the Ponzi finance corresponds to episodes when financial constraints are binding and amplification occurs. The turning point is probably during the period of speculation. Moreover, modern financial macroeconomic models do not have many of the features that have irked post-Keynesian economists. Although everything in their models does have a general equilibrium outcome, they do not start by assuming demand and supply. Indeed, the Korinek model is demand-driven; during a crisis, domestic agents no longer have access to credit, and therefore they are forced to cut back on consumption (or investment), aggregate demand collapses, the exchange rate declines, and the economy enters a downward spiral. And there are supply-driven features as well. A crisis occurs when an exogenous supply shock reduces the amount of credit that foreigners are willing to extend to domestic agents, and they force domestic agents to cut back on consumption. Korinek's approach deploys a general equilibrium context, but it is not stochastic. It would thus not be considered "new" Keynesian because such models are almost strictly models

with sticky prices and set interest rates to smooth aggregate demand in a dynamic stochastic general equilibrium (DSGE) context. Korinek and colleagues do not deploy DSGE frameworks. Moreover, these financial models do not assume natural rates of employment and growth—output and employment are fixed.

It is important to draw a distinction, as authors in this literature do, between prudential controls, which attempt to maintain financial stability, and structural controls, which are more permanent in nature and that are part of an apparatus (in the trilemma tradition) to manage an exchange rate (see also Aizenman 2010).

Stiglitz (2010) presents a theoretical framework to assess the optimal degree of integration when an economy is prone to a system failure, that is, a crisis that leads to bankruptcies and output destruction. The main trade-off here is the benefits of risk-sharing weighed against the costs of bankruptcy and contagion. Using this framework, Stiglitz shows that using a system of capital controls called circuit breakers can increase welfare and can even allow for a higher degree of integration than using no controls. An interesting contribution of this theory is that imposing the optimal size of a risk-sharing club, as an alternative to using circuit breakers, would limit contagion. The overall message of the paper is that capital controls can reduce financial instability, thereby reducing the risk of contagion, which poses significant adverse effects to output and growth.

Hyun Song Shin, an economist at Princeton, has arrived at similar conclusions via a more practical route. Shin has pioneered much empirical and theoretical work on the mechanisms that spread risk from industrialized to emerging economies—particularly, modeling how investors engage in arbitrage. His work, along with the work of others, shows how the pro-cyclicality of the banking sector is largely due to its use of cross-border funding. He outlines phenomena related to the financial-amplification effect to argue that countries seeking to stem systemic risk through this channel should regulate the specific channel from which risk is being transported. He subsequently has become an advocate of regulating foreign exchange derivatives markets because they were a key channel that transferred the crisis of 2008 to EMDs and led to a search for yield that proved to be destabilizing in the years following the crisis (Plantin and Shin 2011).

Other work by Korinek and two IMF economists shows how prudential capital account regulations need to be coordinated between recipient and, sometimes, source countries under certain circumstances (Ostry, Ghosh, and Korinek 2012). In other words, the new economics of capital controls justifies regulating capital flows at both ends, as Keynes stated during the Bretton Woods era. Korinek and colleagues demonstrate that the costs of capital controls increase with the intensity of the control and at an increasing rate. They go on to show how a more efficient outcome is to spread the costs across countries rather than make one country pay for all the costs.

Econometric Evidence

At the same time as these theoretical breakthroughs, a consensus was emerging on the efficacy of capital account regulations. The majority of studies suggest that the capital account regulations deployed during the period from the Asian financial crisis until the global financial crisis of 2008 met many of their stated goals.

In the most comprehensive review of the literature, Nicolas Magud, Carmen Reinhart, and Kenneth Rogoff (2011) analyze studies of controls on inflows and outflows, as well as multicountry studies. They ask whether the controls were able to (1) reduce the volume of net capital outflows, (2) alter the composition of flows, (3) reduce real exchange rate pressures and (4) make monetary policy more independent. Magud, Reinhart, and Rogoff also address the issue of methodological heterogeneity by evaluating the methodological rigor of each of the studies. Specifically, the authors give a study a weight of 0.1 if they find the rigor to be "low"; these are studies that consist mainly of descriptive analysis of events and/or time series. They give studies with a rigor they rank "intermediate" a weight of 0.5; these are studies that draw conclusions from a more formal evaluation of events but still lack formal hypothesis testing. Finally, they give studies with a rigor they rank "high" a weight of 1; these have highly developed econometric techniques, with well-defined hypothesis testing. They use the weights to create a weighted capital controls effectiveness index, which they compare to an unweighted capital controls effectiveness index. The authors conclude that, "in sum, capital controls on inflows seem to make monetary policy more independent, alter the composition of capital flows, and reduce real exchange rate pressures" (Magud, Reinhart, and Rogoff 2011, 13). There were fewer studies on outflows to include in the evaluation, and these were mostly studies of the 1998 Malaysian outflows restrictions. In Malaysia, Magud, Reinhart, and Rogoff conclude, controls "reduce outflows and may make room for more independent monetary policy" (2011, 13).

Summary and Conclusion

The various strands in economic theory that have evolved have separately arrived at the same conclusion: that the regulation of cross-border finance is a paramount tool for maintaining financial stability in EMDs. Keynes's *A Tract on Monetary Reform* and *A Treatise on Money* set the stage for thinking about the regulation of international finance. Influenced by this work and by fluctuations in world markets at the turn of the twenty-first century, new economic thinking was spurred by the work of Hyman Minsky and Joseph Stiglitz. Meanwhile, a consensus has emerged in the econometric literature that capital account liberalization is not

clearly associated with growth and may be associated with an increased incidence of financial crises—especially in EMDs that have not crossed certain income and institutional thresholds. Moreover, the econometric evidence concludes that regulating cross-border finance can meet many of its stated goals.

Although coming from an entirely different part of the literature and mathematical apparatus, the new welfare economics is remarkably similar to the Minskian developmentalist analysis. Nevertheless, the solution to the problem differs between the two breakthrough literatures. In both traditions, there is justification for countercyclical prudential capital account regulations. In the Minsky tradition, however, there is a concern for the maintenance of macroeconomic stability, the mobilization of domestic resources for economic development, and financial fragility. Thus, the optimum level of capital account regulation and its duration could be larger and longer to catalyze the export component of a development strategy. In contrast, the new welfare economics of capital controls is focused squarely on financial stability and solves for an optimum rate of regulation in an environment of equilibrium exchange rates and for a rate that is focused solely on inflows.

These new ideas are diffusing into policy circles. Many UN-based organizations and center-left parties in EMDs have been advocating an approach very much in the Minskian developmentalist tradition, at least since the crises in the 1990s—including Brazil (see chapter 5). In addition, the role of Hyun Song Shin was key to the development of the South Korean policies from a more pragmatist, new welfare economics perspective (also in chapter 5). In the wake of the 2008 crisis, the IMF has been very much moved by the new welfare economics of controls, as well as the econometric evidence (much of it generated by IMF staff economists) on the efficacy of capital controls. As we will see later in the book, the similarities between these theoretical frameworks helped form an interesting coalition among IMF staff and EMD IMF board members when the IMF was charged with rethinking IMF policy on capital account management in the wake of the global financial crisis.

4

LET'S NOT GET CARRIED AWAY

Emerging-Market Innovations in the Wake of the Crisis

In the run up to the global financial crisis, emerging-market and developing countries (EMDs) experienced a surge in cross-border financial inflows, followed by a sudden stop in 2008 after Lehman Brothers fell. Capital flows were V-shaped, however, with the developing world experiencing a surge in financial flows once again in the wake of the crisis. Financial volatility of this sort threatened to cause the very financial amplification effects discussed in the last chapter. Exchange rates experienced significant appreciation, and many nations also feared subsequent asset bubbles. Much of the surge was a function of low interest rates and slower growth in the industrialized world and of faster growth and higher interest rates in key EMDs.

In an about face from the 1990s and early 2000s, when many EMDs further deregulated their capital accounts in response to crises, in response to the global financial crisis many EMDs reregulated cross-border finance. Indeed, in an attempt to reduce the harmful effects of this financial volatility, many EMDs developed a third generation of cross-border financial regulations that were specific to the way cross-border finance had become destabilizing in that particular crisis and its aftermath. The econometric literature on the effectiveness of EMD regulations, including two analyses for this book, indicate that these measures were a partial success. Nations that had deployed cross-border financial regulations were among the least hard-hit when the crisis initially came in 2008 and grew faster than countries that had not regulated in the post-crisis period. Moreover,

cross-border financial regulations proved to have some effect in stemming exchange rate appreciation and granting nations monetary independence.

In this chapter, I discuss the role of capital flows in the 2008 crisis, the factors that led to a surge in capital flows from 2009 to 2012, the innovative responses to such flows in many EMDs, and the effectiveness of those responses in four countries that experienced the most volatile capital flows: Brazil, Chile, South Korea, and South Africa. In chapter 5, I go on to examine the political dynamics that led each nation to take the measures it did (or didn't).

The Global Financial Crisis, Global Capital Flows, and the Two-Speed Recovery

The 2000s were characterized by large swings in cross-border capital flows that were highly destabilizing for EMDs. I first trace the large surge in capital inflows running up to the global financial crisis, the sudden stop that followed, and the new surge that arose in the wake of the crisis. I then discuss the measures that many EMDs took to stem the most harmful impacts of these surges and sudden stops, and the literature to date on the impacts of those measures.

Exporting Good Capital, Importing Bad

Cross-border financial flows were characteristic of the global financial crisis—in industrialized and EMD countries alike. Low interest rates, the lack of proper regulation of the financial sector, and the emergence of large public deficits in the United States created a large appetite for capital inflows into that country. Such inflows were supplied by Germany, Japan, oil-exporting states, China, and other EMDs. Those inflows were used by globally connected financial-sector agents to create the housing-backed derivatives that led to the credit boom in the United States that went famously bust in 2009. During the credit boom, many of those derivatives were then sold back to EMD banks and investors. Some observers have referred to this phenomenon as "exporting good capital, importing bad." (Bhattacharya 2011, slide 4). EMDs took their hard-earned savings and lent those savings to industrialized countries; the industrialized countries took the liquidity to make risky derivatives products and then sold them back to EMDs (Bhattacharya 2011).

This backdrop to the global financial crisis is referred to as the global imbalances problem—large current account deficits in the United States, United Kingdom, Eastern Europe, and beyond in addition to significant current account surpluses in East Asia, Germany, and commodity-exporting countries. Menzie Chinn and Jeffry Freiden (2011) document how the demand for these

international capital flows in industrialized countries allowed for and generated large fiscal deficits during the early 2000s in the United States and later spurred a push for deregulation for derivatives and the shadow banking system. This was accommodated by exceptionally prolonged and loose US monetary policy. Indeed, the United States borrowed $5 trillion between 2001 and 2008 from surplus nations to relend to US homeowners in the form of mortgages. The financial sector repackaged those investments into numerous derivatives instruments, and many of these instruments were then sent back to the developing world.

The channel by which EMDs sent capital to the United States was the accumulation of foreign exchange (FX) reserves by EMDs. Haunted by the specter of the crises that occurred in the late 1990s, many EMDs accumulated reserves to self-insure their economies from sudden stops and external shocks. This spike in reserve accumulation began in the wake of the financial crises in Asia and Latin America in the late 1990s. As noted in chapter 2, those crises were acute, with many nations having to resort to the International Monetary Fund (IMF) for assistance. IMF assistance was subject to many conditions that carried high political and economic costs, and the benefits of the IMF programs were not widely seen as outweighing those costs. Moreover, the global community failed to subsequently coordinate an adequate global system to prevent and mitigate any financial crises that would follow. Seen in this light, the incentive to accumulate reserves to defend against external shocks was quite a rational one on the part of the EMDs.

Reserve accumulation had costs for EMDs as well as the industrialized world, however. There was growing concern that the accumulation of reserves represented an enormous transfer of wealth from the South to the North—and that the industrialized nations were not being prudent with the use of those loans by creating risky investment instruments that were then sent back to EMDs. Again, one of the purported rationales for accumulating excessive amounts of FX reserves was increased liquidity, with the reserves acting as a self-insurance policy against potential financial meltdowns. Nevertheless, there is an opportunity cost associated with holding excess reserves, which are often largely invested in short-term US Treasury securities at relatively low interest rates. The social costs of FX accumulation in excess of what is deemed adequate for insurance purposes has been estimated to be as high as 1.8 percent of GDP for EMDs and could be higher than 3 percent of GDP for China (Rodrik 2006; Gallagher and Shrestha 2012).

Indeed, cross-border financial flows to EMDs were pro-cyclical in the 2000s. There was too much capital during the boom(s) and too little during the busts. Between 2002 and 2007, there was a massive surge of capital inflows into EMDs. In addition to accumulating reserves, some countries, such as Colombia and

Thailand, did put in place capital account regulations as well (Ostry et al. 2010; Gallagher and Shrestha 2012; Coelho and Gallagher 2012).

The Sudden Stop

After the collapse of Lehman Brothers, there was sudden stop in capital flows to EMDs that resulted in capital flight to the safety of the US market. EMDs coped with the sudden stop by obtaining central bank swap lines from their own central banks and the industrialized countries, intervening in FX markets, and deploying capital controls on outflows. Note that countries with capital controls on inflows *before* the crisis were among the least hard hit by the sudden stop that occurred when the crisis went global in 2008.

The crisis was very painful for EMDs. These countries were severely hurt from the crisis through three channels (Ocampo 2009). First, countries with the largest exposure to the derivatives markets were directly impacted through the cross-border financial channel. Large companies in those countries were especially hard hit, and the Mexican company CEMEX, one of the world's largest cement companies, is one example. CEMEX had anticipated continued expansion across the world and borrowed heavily in the global capital markets to finance such expansion. When the crisis hit, Mexican currency plunged, and CEMEX was left with lots of debt denominated in US dollars and a weak currency with which to pay those debts—the classic currency mismatch identified in the previous chapter. EMDs were also hard hit through the trade channel. Industrialized countries, such as the United States, are the destination for the majority of EMD exports. The lack of demand for EMD exports that ensued from the crisis affected output, employment, and livelihoods in EMDs while also depreciating their currencies. Finally, EMDs were impacted by a freeze in remittances flows. Many households in EMDs have family members living and working in industrialized countries who regularly send money home. Given that many of the jobs that provided the source of revenue for such remittances fell by the wayside, there was less to send home.

Yet it could have been much worse. The most adverse effects of the sudden stop were stemmed because central banks and the IMF provided significantly large swap lines to EMDs. The US Federal Reserve Bank, the European Central Bank (ECB), and the People's Bank of China (PBOC) provided over $874 billion in available swaps (Aizenman and Pasricha 2009). The United States, China, and the ECB provided a significant number of bilateral swap agreements to EMDs across the world. Indeed, eleven out of twenty-one total agreements were with EMDs, for a total of approximately US$215 billion, or 25 percent of the $874 billion. Swap lines are contracts whereby the Fed agrees to exchange (swap) a certain

amount of US dollars for, say, the Mexican peso with the Central Bank of Mexico. This allows for relief in short-term dollar markets and for financial stability more generally (Baker 2013). The United States offered Brazil, Mexico, Singapore, and South Korea each access to $30 billion in swap lines. This is the first time that the Fed had extended swap lines to EMDs, except for Mexico, its highly integrated neighbor. These lines were highly sought after and highly welcomed by EMDs. As noted in earlier chapters, many EMDs had done all they could to avoid going to the IMF for financing. In past crises, IMF financing came with conditions and policy advice that had hurt their economies and the re-election prospects of the leaders.

Aizenman and Pasricha (2011) conducted an econometric analysis in an attempt to discover the motivations of the Fed for this unprecedented move; they find that US bank exposure to these countries was the most significant factor leading to the swap lines with EMDs. Daniel McDowell (2011) also argues that the United States saw swaps as a move to alleviate upward pressure on the dollar. Chey (2013) suggests that there may have been political motivations as well, noting that bank exposure to Brazil in the wake of the global financial crisis was no larger than it had been during the Brazilian crisis in the late 1990s, when Brazil did not receive swap lines. Chey notes that South Korea originally approached the Fed for a swap line in 2008 but that Timothy Geithner, the New York Federal Reserve Bank president, had initially rejected the proposal on the grounds that the Korean won was not an international currency and that South Korea did not have a AAA credit rating. Chey suggests that, preceding the first G20 meeting, the United States changed its position and offered Korea the swap line, implicitly in exchange for South Korean support for US proposals at the G20 summit. As evidence of this, Chey notes that South Korea did not support calls made by some other countries, such as China and France, for a fundamental restructuring of the international economic order.

The second largest set of swap lines to EMDs came from the PBOC. Like the Fed, the PBOC appears to have had both economic and political motives. The PBOC established six swap lines, all with EMDs. In 2009, the PBOC swap lines amounted to 650 renminbi (RMB), or approximately US$96 billion. As stated by the PBOC, its intentions were twofold: to provide liquidity to key countries and nullify financial stress, and to encourage bilateral trade with China in the currencies of those six countries (Allen 2013). The second motive is consistent with analyses by Kirshner and others, who remark that China started calling for a multipolar currency world in the wake of the crisis. By extending swap lines to key trading partners, it took one step toward that goal (Kirshner 2014). Indeed, as William Allen (2013) points out, the PBOC swap lines were of a much longer term (three years) than those of the Fed.

Between the Fed and the PBOC, the two central banks just about evenly provided over $200 billion in swap lines to EMDs. This move was an unprecedented act of coordination between an industrialized nation and EMDs, on the part of the Fed, and among EMDs, by the PBOC. Extending swap lines has been shown to have played a major role in stemming the sudden stop of capital inflows to EMDs in 2008–2009 and the subsequent capital outflows that followed—even though the lines were often not drawn from.

Many countries also relied on the reserves they had accumulated since the beginning of the twenty-first century (Gallagher and Shrestha 2012). Moreover, some nations, such as Iceland and Ukraine, also put in place capital controls on outflows (Grabel 2011). Among the nations hit least hard from the sudden stop were those that had put in place capital controls on the inflows of capital before the crisis had started. Ostry et al. (2010), at the IMF, conducted an econometric analysis to examine how countries that used capital controls fared as opposed to countries that did not use them in the run-up to the crisis. They found that countries with controls fared better: "the use of capital controls was associated with avoiding some of the worst growth outcomes associated with financial fragility" (Ostry et al. 2010, 19).

Getting Carried Away

The immediate aftermath of the crisis has been referred to as the "two-speed recovery" (IMF 2011b, 37). The industrialized economies, which were at the epicenter of the crisis, were slow to grow. The swap lines, stimulus packages (especially the Chinese stimulus package that ended up creating much demand from other EMDs), and other measures enabled many EMDs to bounce back from the sudden stop and begin to grow again, and at faster rates than the industrialized countries. Meanwhile, the industrialized world struggled to recover. Both the United States and Europe experienced political opposition to fiscal stimulus. The United States put in place a very modest stimulus package. More important for this book, the United States also experimented with very loose monetary policy. Not only did the Fed intervene in financial markets to influence short-term interest rates, it also embarked on quantitative easing by purchasing longer-term securities to bring down long-term rates.

Helene Rey (2013) of the London Business School shows how low interest rates in the United States calm capital markets as measured by the VIX (the Chicago Board Options Exchange Market Volatility Index, an indicator of stock market volatility) and push out capital flows from the United States, creating financial turbulence in EMDs despite the fact that EMDs may have floating

exchange rates. Rey finds that, when the VIX is lowered, there is a significant expansion of bank leverage, credit flows, and equity flows to EMDs. She shows how such flows can be so powerful that they violate the trilemma (outlined in chapter 3). Regardless of whether a country has a fixed or floating exchange rate, says Rey, free capital mobility makes it very hard to have an independent monetary policy in the twenty-first century. The channel by which these flows were transmitted to EMDs in the wake of the crisis is referred to as the *carry trade*. As interest rates were lowered for expansionary purposes in the industrialized world after 2009, capital again began to expand into EMDs, where interest rates and growth were relatively higher. The carry trade was a key mechanism that triggered these flows.

The carry trade is a type of financial process whereby an investor borrows currency in a low-interest-rate country and sells it for currency in a higher-interest-rate country. The interest rate differential is the *carry*. In the world of derivatives trading, the carry trade can be highly lucrative because it can compound profits far above the size of the carry. In the wake of the financial crisis, interest rates in the industrialized countries were at an all time low due to an expansionary monetary policy. Moreover, the industrialized countries were not growing very fast, if at all. EMDs, in contrast, had relatively higher interest rates (due to inflation targeting, risk, and other reasons) and much faster growth. Low interest rates and slow growth in the North, when juxtaposed with higher interest rates and faster growth in the South (the two-speed recovery) were perfect carry trade conditions. From early 2009 to the end of 2011, hedge funds and other actors were borrowing dollars in source countries, where interest rates were low, and investing in target countries, where interest rates were high. They were also going to short the dollar and go long on currencies from countries with healthier economies and higher interest rates. When such agents are highly leveraged, as they were, the profits (and risk) can be enormous. Ten banks control 80 percent of the FX market. Deutsche, Citigroup, Barclays, and UBS are half that market. The result, as figure 4.1 (left-hand scale) shows, was that capital flows returned with a vengeance to EMDs in the wake of the crisis.

The carry trade can be lucrative for investors in at least three ways. The first is the interest rate differential. If the US interest rate is 0.025 percent and the Brazilian rate is 10.50 percent, then the differential could be 10.25 percent (minus transaction costs). The real profits come from leverage and the exchange rate movements. Hedge funds speculate that the higher-rate currency is going to appreciate in addition to earning the interest rate differential. The second way the carry trade is lucrative is that profits can ramp up depending on the leverage factor. A leverage factor of 5 on a 10.25 percent differential is a profit of

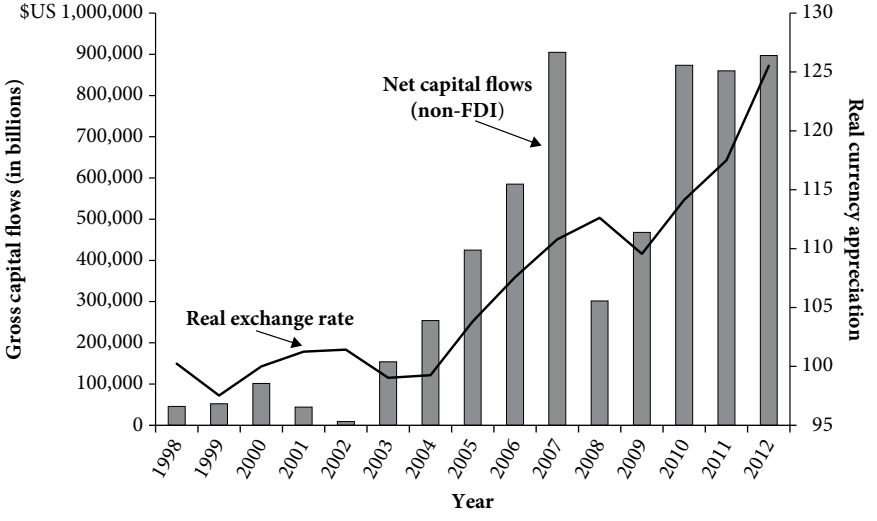

FIGURE 4.1. Capital flows and exchange rates in emerging markets, 1998–2012 (Tiftik et al. 2012).

50.25 percent, and a leverage factor of 10 on a 10.25 percent differential could mean a profit of 100.25 percent. The third way is that those profits come when exchange rates stay stable but can be magnified if when the currency shorted depreciates and the long position appreciates. Given the more robust growth and higher interest rates in emerging markets, the carry trade resulted in another mass inflow of capital to the EMDs in 2009–2011.

The carry trade can also be highly destabilizing in EMDs for at least three reasons. First, if capital flows are large enough, such speculation can cause undue volatility in the exchange rates and asset prices in EMDs. Economists such as Marion Kohler (2010) and Robert McCauley and Patrick McGuire (2009) see the increase in carry trade activity as having fundamentally changed the way exchange rates work in the global economy. In the post-crisis period, sharp currency depreciations in EMD currencies were not due only to lack of demand for EMD exports but also to capital flight from carry trades unwinding. The subsequent appreciations of EMD currencies were partly the result of new carry trade positions taken as interest rate differentials and growth rates diverged in the wake of the crisis.

Second, the carry trade can be destabilizing because relatively small interest rate or currency changes can trigger currency bubbles where an unwinding

of (highly leveraged) positions causes sudden stops and capital flight. Indeed, Hyun Song Shin calls this the "classic pattern," in which the carry trade leads to prolonged appreciation "punctuated by sharp falls" (Plantin and Shin 2011, 23, 33) Both Plantin and Shin (2011) and Brunnermeier, Nagel, and Pederson (2009) argue that carry trades become particularly destabilizing when new global conditions reduce liquidity.

Third, in an environment where nations have open capital accounts, the carry trade can have further destabilizing effects in terms of policy space for independent monetary policy. The dominant tool to stem asset bubbles or inflation is the interest rate. But, because of the carry trade, the intended result can be the reverse if interest rates are low abroad. Given that rates during the crisis were over 10 percent in Brazil and less than 1 percent in the United States, raising interest rates in Brazil to curb asset bubbles and inflation would actually attract more capital flows, not less (Ocampo, Spiegel, and Stiglitz 2008). This is why Rey, Ocampo, and others have argued that it is difficult to have an independent monetary policy with an open capital account and floating exchange rate. Figure 4.1 (right-hand scale) shows the real currency appreciation associated with the increased capital flows.

Financial flows to EMDs far surpassed their precrisis levels and were followed by significant currency appreciation and fears of asset bubbles as well. This triggered the financial amplification effect (discussed in chapter 3). Many EMDs then decided to reregulate cross-border financial flows into their countries in innovative ways.

Third-Generation Regulations in Emerging Market and Developing Countries

This crisis was somewhat different. In response to the crises during the decades preceding the global financial crisis, EMDs had tended to liberalize their capital accounts even further. They did so to send the right signals to global capital markets and to appease domestic and international advocates of reform (Haggard and Maxfield 1996). In the wake of the global crisis, rather than further deregulating cross-border financial flows many EMDs decided to reregulate cross-border financial flows. What is more, a few pioneering EMDs created a third generation of cross-border financial regulations that were fine-tuned to focus on how capital flows had manifested themselves in EMD economies—the FX derivatives market. Here I trace how capital flows reflooded into EMDs in the wake of the crisis and discuss how many of these countries responded to those flows.

Reregulating Cross-Border Finance

In a stark reversal of the policies of crisis mitigation used at the end of the twentieth century, many EMDs moved to regulate the cross-border financial flows that were causing financial amplification effects in their countries. Countries that deployed such regulations were found to be modestly successful in meeting their goals and grew faster than countries that experienced similar surges but did not regulate them.

To review, cross-border financial regulations are deployed to help buffer from a number of risks that come with financial integration. Chief among those risks are currency mismatch risks, interest rate mismatch risks, exchange rate volatility, capital flight, financial fragility, contagion, and monetary sovereignty (Grabel 2003). All these risks were accentuated during the global financial crisis. As previously noted, the uptick in the carry trade from 2009 to 2011 put pressure on currencies and credit markets, and made it more difficult for nations to maintain sovereignty over monetary policy regardless of whether they had a floating or fixed currency.

Economists and regulators usually differentiate between regulations on capital inflows and regulations on capital outflows. These measures have evolved over three generations of regulation. Many of the regulations on cross-border finance that were enacted immediately after the Bretton Woods agreements were quantity-based and can be considered first-generation cross-border financial regulations. These entail outright quantitative restrictions on cross-border finance, and many nations still deploy these today. Examples of quantity-based controls are restrictions on currency mismatches, minimum stay requirements, and minimum end-use limitations. Many of these have been used by nations such as China and India. Price-based regulations constitute the second generation of cross border financial regulations. The United States Interest Equalization Tax was among the first uses of price-based controls in the industrialized world; among the first uses of price based regulation in EMDs was the Chilean unremunerated reserve requirement (URR). On the one hand, the URR is a price-based restriction on inflows; on the other, it also includes a minimum-stay requirement, which can act like a quantity-based restriction on outflows. Other examples of price-based controls include taxes on inflows (Brazil) and on outflows (Malaysia in 1998) (Epstein, Grabel, and Sundaram 2008).

These regulations most often target foreign-currency and local-currency debt of a short-term nature. FDI is often considered less volatile and less worrisome from a financial stability standpoint. The aim of inflow restrictions on currency debt is to reduce pressure on the exchange rate and on the overall level of such borrowing, steer investment toward longer-term productive investments, and thus reduce risk. Moreover, the goal is to give the central bank room to maneuver in setting monetary policy. Taxes on such investment cut the price differential between

short- and long-term debt and thus discourage investment in shorter-term obligations while giving the central bank breathing room. Outflows restrictions and measures are usually deployed to "stop the bleeding" and keep capital from leaving the host nation too rapidly while allowing the central bank to lower rates as necessary. A variety of these techniques were used during the global financial crisis. As previously noted, the IMF found that nations that deployed capital account regulations of this kind were among the least hard hit by the crisis (Ostry et al. 2010).

Table 4.1 provides an illustrative list of EMDs that put in place new cross-border financial regulations in the wake of the financial crisis. The nations on this list experimented with first- and second-generation capital controls. Some also derived regulations on FX derivatives that border on macroprudential regulations. Many of these regulations target the FX derivatives market precisely to regulate the build up of risk in currency, credit, and other markets. In this sense, they form the third generation of cross-border financial regulations. The IMF has noted that there is an overlap between macroprudential regulation and what are traditionally seen as capital controls; the two overlap when regulations on

TABLE 4.1 Three generations of emerging-market and developing country cross-border financial regulations

COUNTRY	FIRST GENERATION (QUANTITATIVE CONTROLS)	SECOND GENERATION (PRICE-BASED CONTROLS)	THIRD GENERATION (FX REGULATIONS)
China	Outright bans or limits on the entry of certain investments		
India	Direct limits on US dollar–rupee trades		Margin requirement on US dollar–rupee forward trade increased to 100%
Brazil		Taxes on portfolio investments	Noninterest reserve requirement on bank short dollar positions in FX spot market
South Korea		Withholding tax on nonresident holdings of treasury and monetary bonds	Numerous restrictions on bank FX derivatives positions
Peru		Taxes on portfolio investments	Position limits on FX short dollar trades and reserve requirements for all FX deposits
Indonesia	One-month holding period on central bank bills		
Thailand		Taxes on nonresident purchase of public bonds	

Note: FX, foreign exchange.

FX derivative markets discriminate on the basis of residency (Ostry et al. 2011). As we see in table 4.1, many of these regulations were deployed by EMDs.

At this writing, three large studies have been conducted that analyze the average impact of these measures across the globe. Shaghil Ahmed and Andrei Zlate (2013) at the US Federal Reserve Board conducted a large quarterly panel analysis of the determinants of capital inflows to twelve EMDs between 2002 and 2012, and of the effectiveness of the measures used to regulate those flows. The Fed economists find that interest rate differentials and growth differentials were the key drivers of capital flows to EMDs in the wake of the crisis. They also find that capital account regulations put in place after the crisis significantly discouraged *both* total flows and portfolio inflows.

Erten and Ocampo (2013), at Columbia University, also have examined a large panel of post-crisis attempts to regulate capital flows. They look at fifty-one EMDs over the period 1995–2011 and find that regulations on inflows were significantly associated with less FX pressure than were regulations on outflows—and that the effects of capital outflow regulations were larger in magnitude than those on capital inflows. They also find that capital account regulations enhanced monetary policy autonomy by reducing the effect of interest rate differentials on nominal exchange rates. Finally, these authors find that countries that increased their use of capital inflow regulations between 2008 and 2011 had higher post-crisis growth rates than nations that did not regulate.

In the third study, Michael Klein (2012) analyzes a panel of forty-four developed economies and EMDs between 1995 and 2010. Unlike the other studies, Klein finds that cross-border financial regulations had little impact on several macroeconomic variables; he also does not find a strong relationship between regulations and GDP growth. It is clear that these particular findings are due to the inclusion of industrialized countries in the sample. Klein's sample consists of twenty-three advanced economies and twenty-one EMDs. Because most industrialized nations did not regulate cross-border finance during the period, Klein assigns them a coefficient of zero, which reduces the significance of the coefficient estimates. Klein also includes other subindices that are assigned zeros coefficients, and this may explain why his study that does not find as much of a positive effect for cross-border controls as the others (Erten and Ocampo 2013).

The Four Case Studies

In this section, I report on the econometric country case studies I performed for this book. As in the aggregate analyses already discussed, the control measures adopted by Brazil and South Korea were found to be associated with less financial

fragility. I delineate how capital flows were attracted to the four key EMDs—Brazil, Chile, South Africa, and South Korea—and evaluate the extent to which the attempts to regulate such inflows were effective in each.

Interest rate differentials were quite large between industrialized countries and EMDs between 2009 and 2012. As discussed earlier, these differentials enabled carry trades that channeled the liquidity triggered by low interest rates in the United States and other industrialized countries. Figure 4.2 exhibits the differentials (between EMD currency and US dollars) in the four EMDs.

Brazil had the widest differential, reaching 10 percentage points in August 2010. South Africa and Chile also saw carries of over 5 percentage points. The interest rate differential with South Korea was just over 3 percentage points. Each of these nations saw a surge in capital flows that also triggered credit booms and currency troubles. Brazil and South Africa saw appreciations of over 40 percent, and South Korea and Chile saw appreciation in the 15–20 percent range during the period. When eurozone jitters became more serious in summer 2011, there was significant capital flight and a subsequent depreciation in currencies.

Stock market volatility was also acute. Volatility in Brazil, the smallest, was over 50 percent in one year, and volatility in South Korea was at over 65 percent. Interestingly, although all four of these nations faced similar levels of capital flows and financial amplification effects, each responded with different policies. Brazil and South Korea deployed cross-border financial regulations, South Africa further

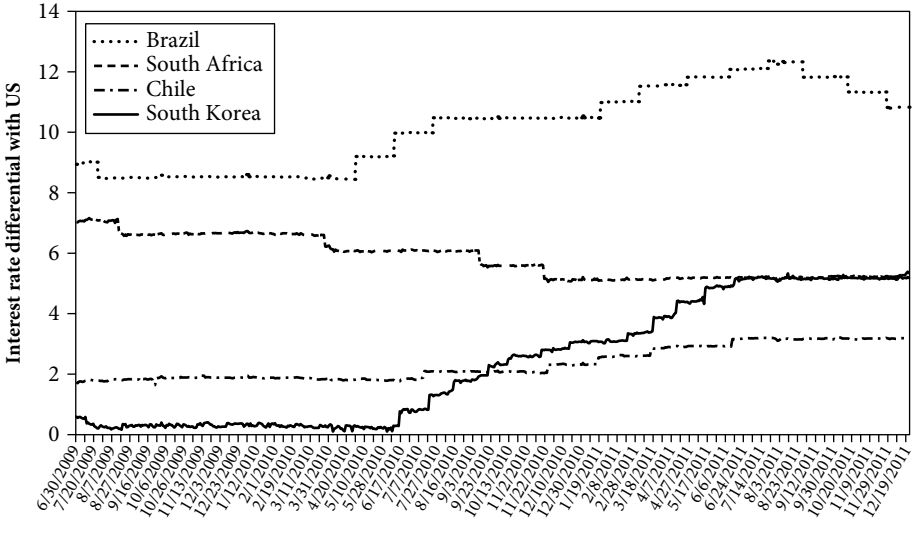

FIGURE 4.2. Post-crisis EMD-US interest rate differentials. EMD, emerging-market and developing country (Bloomberg Terminal, February 14, 2012, accessed April 22, 2012).

liberalized capital flows, and Chile made minor interventions in the FX market. Let's explore the capital account regulations deployed by Brazil and South Korea.

Brazil

Brazil had significantly liberalized its capital account in the 1990s, although it left the option for capital controls on the table. The country exercised that option on numerous occasions between 2009 and 2012. In the 1990s, Brazil adopted a floating exchange rate system, inflation targeting, and capital account liberalization. There was a surge in capital inflows to Brazil, especially after 2006, largely in the form of derivatives and portfolio flows. Then Brazil experienced a sudden stop in 2009, followed by a very large surge in late 2009.

For the reasons discussed earlier, after the sudden stop in non-FDI financial flows to Brazil in 2009, there was another surge in capital inflows from 2009 to 2011, again largely in the portfolio and derivatives markets. As discussed, this was because of the large interest rate differentials, increases in commodity prices, and rapid growth from 2009 to 2011 and also because of its fairly sophisticated derivatives markets.

Indeed, the nature of the Brazilian derivatives market was a key attraction for global investors. In 2010, the real (the Brazilian currency) was the world's second most traded currency in the derivatives market (Prates and Fritz 2012). A key characteristic of the Brazilian regime is its nondeliverable derivatives market. *Nondeliverable* means that investors do not have to deliver purchases, sales, or margins (collateral) of FX derivatives positions in a foreign currency. This characteristic makes the derivatives carry trade in Brazil very attractive for foreign investors. In addition, unlimited access for nonresidents enticed carry trade activities and further increased liquidity. Technically, the domestic banks in Brazil sold short on dollars in the FX spot market offshore and then lent Brazilian reals to foreign investors, who then went long on the real in the derivative and bond markets onshore in Brazil. In other words, a bank in Brazil would sell dollars offshore and bet against them (going short) and then lend reals to a foreign investor offshore as well. The foreigners would then bet on (go long) the appreciation of the real. This investment strategy meant that the foreign investors did not at all have to access the FX markets and made the liquidity of the FX futures market exceptionally higher than the FX spot market (Prates and Fritz 2012).

The FX derivatives market was the specific channel that triggered the massive exchange rate and credit bubbles that occurred in Brazil at the time (IMF 2011b; Prates and Fritz 2012). On numerous occasions, Brazil attempted to stem the negative impacts of these inflows—currency appreciation and credit expansion of over 20 percent per year—through a variety of cross-border financial regulations (Da Silva and Harris 2013). These measures are listed in great detail in table 4.2.

TABLE 4.2 Fine-tuning cross-border financial regulations in Brazil

DATE	MEASURE	DETAILS
19-Oct-2009	2% IOF reinstated on foreign investment in equity and fixed income	Previously, FDI was already taxed at 0.38%, but foreign investment in equity and fixed income was tax-free
18-Nov-2009	Conversion of ADRs into local stocks became subject to 1.5% IOF	The measure closed a potential loophole through which nonresidents could invest in local stocks without paying the IOF
4-Oct-2010	IOF on fixed income raised from 2 to 4%, and extended to cover investment in mutual funds	The measure affected new foreign investment in government bonds and special mutual funds (equity, hedge funds, and derivatives such as interest rate futures traded on the Mercantile and Futures Exchange)
4-Oct-2010	Investors migrating from equity to fixed income subjected to 4% IOF	The measure closed a loophole through which fixed-income investors could pay the lower 2% IOF reserved for stocks
19-Oct-2010	IOF on fixed-income and special mutual fund investments raised from 4 to 6%, extended to derivatives	In addition, the 6% IOF was extended to cover capital inflows for the margin requirements in derivative transactions
31-Dec-2010	IOF on foreign investments in mutual funds lowered from 6 to 2%	All other foreign investments in fixed-income instruments remained taxed at 6%
1-Jan-2011	Investors migrating from FDI, ADR to fixed-income subjected to 2% IOF	The measure closed a potential loophole through which nonresidents could invest in local stocks without paying the IOF
6-Jan-2011	URR on bank short dollar spot positions	URR was set at 60% of corresponding bank liabilities above $3 billion, effective April 4
28-Mar-2011	6% IOF imposed on short-term external loans by banks and firms	The tax applied to the external issuance of bonds and loans with tenors up to 1 year by banks and firms, other than trade credit
6-Apr-2011	6% IOF on short-term external loans extended to tenors up to 2 years	

(*Continued*)

TABLE 4.2 (continued)

DATE	MEASURE	DETAILS
27-Jul-2011	Long-term external loans settled earlier than 2 years made subject to the 6% IOF and penalties	The measure closes a loophole that allowed banks and firms to avoid the 6% IOF on their short-term external borrowings through the early settlement of long-term loans
	1% IOF imposed on the daily increase in foreigners' net long real positions in the onshore futures market if the initial (notional) position exceeded $10 million	The CFM was authorized to raise the IOF on derivative transactions up to 25%, setting the path for possible future increases in response to the real appreciation The new tax replaces the 6% IOF that previously covered just the collateral positions of foreign investors in financial derivatives; it now applies to both domestic and foreign investors The tax aims to discourage speculation but not hedging; for example, exporters with legitimate hedges do not have to pay the tax
18-Aug-2011	6% IOF extended to cover loans from foreign parent companies	To close a potential loophole, the tax authority required Brazilian subsidiaries that receive loans from foreign parent companies with maturities of up to 2 years to pay the 6% IOF
1-Dec-2011	IOF removed for foreign investment in equities (from 2% before) and in certain types of corporate bonds (those financing infrastructure) with duration of 4 years or more (from 6% before)	The 6% IOF for government debt and corporate bonds with duration shorter than 4 years, as well as the 1% IOF for the notional position in currency derivatives were left unchanged
1-Mar-2012	6% IOF imposed on trade financing loans (anticipated payment) with maturities of more than 360 days	The measure, initiated by the central bank, closes a potential loophole in the IOF; to avoid the tax, trade financing loans should be provided directly by the foreign importer to the Brazilian exporter, rather than by foreign banks or trading companies Unlike the anticipated payment loans, the trade credit-related loans are still exempt from the IOF
	6% IOF on external borrowing by banks and firms extended to cover tenors up to 3 years	Previously, the tax applied only to bonds and loans with duration of 1 years or less (from March 2011) and 2 years or less (from April 2011)
12-Mar-2012	6% IOF on external borrowing by banks and firms extended to cover tenors up to 5 years	
14-Jun-2012	Duration of external borrowing by banks and firms subject to 6% IOF reduced from 5 to 2 years	The measure reverses the related moves from March 1 and March 12, 2012

5-Dec-2012	Duration of external borrowing by banks and firms subject to 6% IOF reduced from 2 years to 1 year	On December 4, exporters were allowed to receive anticipated payments 5 years before actually exporting their products without paying the 6% IOF The measure reverses the restriction imposed on March 1, under which the IOF-exempt anticipated payments for exports had been limited to 1 year
18-Dec-2012	Increased deductible for URR on bank short dollar spot positions	The central bank raised the exemption level for the 60%-reserve requirement to $3 billion (from $1 billion)
6-Jun-2013	IOF on foreign investment in fixed income cut to zero, from 6% before	The measure reverses the tax on fixed-income investments introduced in October 2009, amid concerns about the slowing capital inflows
12-Jun-2013	IOF on foreign investment in FX derivatives cut to zero	The measure reverses the tax on foreigners' investments FX derivatives introduced in July 2011
26-Jun-2013	URR on bank short dollar positions removed	The measure, effective on July 1, reverses the URR introduced in January 2011 and tightened in July 2011

Source: Based on Ahmed and Zlate (2013); Prates and Fritz (2012).

Note: ADR, American depositary receipt; CFM, capital flow management measures; FDI, foreign direct investment; IOF, Imposto de Operações Financeiras; URR, unremunerated reserve requirement.

Note that Brazil took these measures alongside instituting monetary and fiscal policies, as well as other macroprudential policies. During the period, Brazil raised its policy tax rate five times and pledged fiscal consolidation repeatedly. Brazil also increased bank reserve requirements and increased capital requirements, in addition to the cross-border financial regulations on the table. The first move of Brazil was a second-generation regulation of a 2 percent tax on bonds and equities purchased by foreigners, referred to as the Imposto de Operações Financeiras (IOF) tax. This was among the first such measures taken in the world economy and was reported widely in the global press. Brazilian Finance Minister Guida Mantega famously referred to these actions as a necessary defense in the currency war started by loose industrialized-country monetary policies and the undervalued Chinese exchange rate. Shortly after the announcement of the measure, Brazilian authorities saw that investors were evading the regulations by purchasing stock on the American depositary receipt (ADR) markets (a mechanism in the United States where foreign stocks can be bought and sold). In an interesting response, Brazil then extended its tax to the ADR market, and then over the course of 2009 and 2010, it ramped up those taxes incrementally while reducing taxes and disincentives on debt and equity with a longer maturity.

It was late in 2010 when Brazil put in place a third generation of regulations, on the FX derivatives market. First, in October 2010 Brazil announced that it would extend the IOF tax on margin requirements for FX derivatives transactions; moreover, Brazilian authorities were no longer able to meet their margin requirements through locally borrowed securities. In 2011, Brazil adopted a URR-like regulation for the FX derivatives market. Brazilian authorities required that 60 percent of a FX derivatives investor's short dollar positions in the spot market be held at no interest. Later in 2011, Brazil created a new regime for FX derivatives trading, requiring that all FX derivatives be registered by clearing houses and putting a mandatory tax on all long positions (betting that the real would appreciate) of up to 25 percent (De Paula and Prates 2013. Throughout 2011, Brazil continued to fine-tune its regulations in response to investor behavior, extending the IOF to loans from foreign patent companies and corporate bonds. As the global capital cycle began to reverse in 2012 and 2013, Brazil eased the majority of these regulations to be countercyclical.

South Korea

Like Brazil, South Korea has also been characterized as a nation that has significantly liberalized its capital account over the past twenty years. Capital inflows to South Korea were also triggered by interest rate differentials and strong growth, as well as by the unique nature of the South Korean FX derivatives market. Unlike Brazil, the Korean FX market is deliverable—purchase, sale, gains, and losses are

liquidated in US dollars (Prates and Fritz 2012; IMF 2011a). Indeed, many banks operating in South Korea relied on overseas credit lines to finance investments in South Korea and secure them in the derivatives market. Then there was a sudden stop of this international credit after the Lehman crisis, and there was a sharp depreciation of the won (the Korean currency).

In the wake of the global financial crisis, capital inflows resumed to South Korea via the carry trade. International banks operating in South Korea were borrowing US dollars short-term and selling these dollars for wons in the South Korean spot market; they were then buying certificates of deposits on other domestic bonds and selling the wons forward for dollars (Prates and Fritz 2012). These banks also engaged in derivative contracts with exporter companies (mainly shipbuilders) in the derivatives market. The FX options allowed firms to sell dollars (hedge) at a fixed exchange rate because they expected the continued appreciation of the won (Lee 2013).

The won appreciated significantly in the years following 2009. South Korean authorities responded with a number of first-, second-, and third-generation capital account regulations (elaborated on in table 4.3). The main objective of

TABLE 4.3 Fine-tuning cross-border financial regulations in South Korea

DATE	MEASURE	DETAILS
19-Nov-2009	Tightened rules on FX derivatives for exporters, effective January 1, 2010	The measure aims to ensure that corporates use forward contracts to hedge FX risk and not to speculate in currency markets; namely, bank FX forwards to exporters were capped at 125% of the underlying export revenues, applying to both domestic banks and foreign branches
1-Jan-2010	Tighter FX liquidity standards for domestic banks	The measure aims to reduce the maturity mismatch between the domestic bank liabilities and assets; thus, the ratio of mid- to long-term financing to lending in foreign loan portfolios was increased to 90% (from 80%)
13-Jun-2010	Tightened rules on bank FX derivative positions, FX forwards to exporters, and FX loans for banks and corporates	The measures include (1) New limits on bank FX derivative positions, set at 50% of equity capital for domestic banks and 250% for local branches of foreign banks, to discourage speculative capital inflows that bet on won appreciation, effective October 9 (for branches, "own capital" is the amount of long-term borrowing from the foreign parents and affiliates) (2) Cap on FX forwards to firms reduced to 100% of exports (from 125%) to ensure that corporates use them to hedge FX risk and not to speculate in currency markets, effective August 1 (3) Stricter limits on FX loans to large corporates, effective August 1

(*Continued*)

TABLE 4.3 (continued)

DATE	MEASURE	DETAILS
18-Nov-2010	14% withholding tax imposed on foreigners' interest and capital gains from holdings of sovereign debt	The tax, effective January 1, 2011, was levied retroactively on all debt earnings since November 12; the impact of the tax was probably dampened by an exemption provided to the residents of countries with double-taxation treaties with Korea, as well as to official investors
5-Apr-2011	Korean National Assembly approved a levy (tax) on bank FX liabilities other than deposits (the plan had been announced in December 2010)	The tax, effective August 1, applies to the FX liabilities other than deposits of local banks and branches of foreign banks; the new tax consists of a four-tiered system that provides higher rates for shorter-term external debt: 0.20% for tenors of less than 1 year, 0.10% for 1–3 years, 0.05% for 3–5 years, and 0.02% for more than 5 years
1-Jun-2011	The Bank of Korea prohibited financial companies from buying FX bonds issued by Korean firms in the domestic market ("kimchi" bonds) if the issuer plans to convert the proceeds into won for local use, effective July 25	The measure aims to curb the accumulation of short-term external debt, which resulted as Korean firms issued FX bonds domestically and converted the proceeds in Korean won; at the time, the outstanding amount of FX bonds issued within South Korea was $17.1 billion, of which three-quarters were held by branches of Japanese and other foreign banks The measure reduced the ability of Korean firms to circumvent an existing limit on borrowing overseas for local use; however, it did not affect the FX bonds issued by non-Korean firms in Korea or the FX bonds issued by Korean firms abroad for use abroad
7-Sep-2011	14% tax imposed on foreign investors' interest earned from holding "kimchi" bonds purchased in Korea	The new tax applies to the local branches of foreign banks, nonresident corporates, and overseas individual investors; domestic investors were already charged a similar tax on interest earned from "kimchi" bonds The tax was approved in late 2011 and became effective on January 1, 2012
27-Nov-2012	Tightened rules on bank FX derivatives, effective December 1, with a 1-month grace period until January 1, 2013	The ceiling on bank FX derivative positions (such as FX forward agreements) was lowered to 30% of equity capital for domestic banks (from 40%) and to 150% for local branches of foreign banks (from 200%)

Source: Based on Ahmed and Zlate (2013); Prates and Fritz (2012).

Note: FX, foreign exchange.

the policy was to curb short-term foreign debt and tighten FX liquidity, both of which contribute to capital flow and exchange rate volatility. Beginning in late 2009, the country levied controls on bank holdings of FX derivatives, forwards, and liabilities. The first policy, implemented in November 2009, required banks to hold a designated amount of high-rated foreign treasury bonds and to reduce trading in FX futures. In 2010, the government lowered the limits on bank holdings of FX derivatives, with stricter limits for foreign-owned banks than for domestic banks. In the same year, subsequent policies included barring foreign

currency loans by banks to local companies for domestic use (a first-generation reform). Second-generation market-based policies were implemented in 2011: a levy on bank nondeposit FX borrowings, with higher levies for short-term debt, and an additional reduction in the limit on bank holdings of FX derivatives. In 2012, South Korea put a tax on FX futures and option premiums, and increased limits on FX derivatives (Baumann and Gallagher 2012; Prates and Fritz 2012; Lee 2013).

In both Brazil and South Korea, authorities followed two strategies. First, they created a third generation of cross-border financial regulation. Borrowing from some of the second-generation regulations, these were extended to the FX derivatives market. Second, authorities closely monitored markets to examine whether the regulations were working and whether they were being circumvented. When they saw loopholes that were being taken advantage of, both countries fine-tuned their regulations to make the regulations more effective. How well did these measures work?

The Effectiveness of New Regulations

Consistent with our previous discussions, many of the post-crisis cross-border financial regulations modestly helped EMDs achieve their goals in stemming the adverse financial amplification effects due to the surge in capital inflows between 2009 and 2012 across the developing world. As background studies for this book, Brittany Baumann (a Boston University graduate student at the time) and I conducted two econometric studies to examine the extent to which the use of post-2008 cross-border financial regulations were effective in Brazil and South Korea. We juxtaposed these analyses with an analysis of two EMDs that did not put capital account regulations in place: Chile and South Africa. As we have seen, Chile and South Africa were faced with a set of challenges similar to South Korea and Brazil, but in response to the surge in capital inflows, Chile decided to intervene in the FX market and South Africa chose to further liberalize its capital account.

To examine whether the measures taken in Brazil and South Korea worked, we performed a number of regression analyses. This approach allowed us to examine the independent impact of a policy measure (an independent variable) on a stated goal, such as reducing exchange rate volatility (the dependent variable). It also allowed us to control for other factors that might impact a dependent variable to determine whether a given policy has an independent impact.

EMDs that put in place capital account regulations were seeking to reduce the overall level of capital inflows into their countries, to alter the composition of capital inflows toward more long-term investment such as FDI, to stem the development of asset price bubbles, to reduce pressure on the exchange rate, and

to allow for a more independent monetary policy. Data for each of these (dependent) variables are available in these countries, often on a daily or monthly basis, as are data on the exact dates of the capital account regulations and on other (independent) variables that would impact capital flows, exchange rates, and so forth.[1] We also examined the extent to which the more conventional measures worked in Chile and South Africa. The general results of these analyses are presented in table 4.4.

The columns show the different policy goals (dependent variables) that we modeled in our regressions. In each case, we examined the independent effects of capital account regulations on each of these goals. For instance, controlling for other factors that impact the level of capital flows (table 4.4, column 1), we found that regulations were associated with an increase in capital flows in Brazil and South Korea.

For Brazil, the introduction of capital account regulations was associated with an increase in total inflows, but the composition was shifted from short- to longer-term inflows. In other words, we found that the Brazilian measures did not stem the tide of capital inflows but channeled it toward more longer-term investment rather than the most volatile types of inflows. Beyond small effects on the day a measure was announced, however, the Brazilian measures did not have the desired impact on asset prices and on stemming asset bubbles. Nevertheless, the Brazilian measures did have a lasting impact on the level and volatility of the exchange rate. Finally, measures taken by Brazil modestly increased the ability of Brazil to pursue an independent monetary policy.

South Korea deployed a mix of traditional capital controls and third-generation measures aimed at the FX markets. The regulations used by South Korea were less successful than those used by Brazil. According to our background studies, the South Korean actions had little effect on the amount or composition of inflows, on asset prices, or on the ability of South Korea to engage in an independent monetary policy. Nevertheless, and perhaps most important, the South Korean measures did have a lasting impact on the volatility of the exchange rate. This was perhaps the largest goal of the South Korean authorities because the FX derivatives market was creating a significant amount of volatility and uncertainty for investors and exporters alike.

The moves made by Chile were more conventional. Chile intervened in FX markets by selling Chilean pesos and buying US dollars. The goal was to make the dollar scarcer and the peso more abundant and thus make the Chilean peso

1. For a more detailed explanation, full model specifications, and specific regression results, see Baumann and Gallagher (2012, 2013).

TABLE 4.4 Effectiveness of capital account regulations in Brazil and South Korea

COUNTRY	TOTAL INFLOWS	COMPOSITION	ASSET PRICES	EXCHANGE RATE	MONETARY AUTONOMY
Brazil	Increased total inflows	Long-run impact: **decreased short-term, increased long-term flows**	Long-run impact: none	Long-run impact: **decreased level and volatility of real**	
		Short-run impact: announcements were in reverse (increased short-term, decreased long-term flows)	Short-run impact: announcements **reduced asset prices,** but the cumulative effect was offset by ADR announcement	Short-run impact: decreased level and volatility only in first announcement	**Increased**
South Korea	Short-run impact: increased flows	Short-run impact: increased non-FDI and short-term flows, derivatives flows	Short-run impact: increased national stock market index	Short-run impact: raised the level of the won	
	No effect	Long-run impact: increased derivatives flows	No effect	Long-run impact: **lowered won volatility**	No effect
Chile	No effect	No effect	Long-run impact: none	Long-run impact: none	
			Short-run impact: **made domestic stock market more independent from the regional index**	Short-run impact: **decreased level of peso after the announcement**	No effect
			Temporary spillover effects for IOF in Brazil	Temporary IOF spillover effects	
South Africa	N/A	N/A	Short-run impact: mixed effects on national stock market index	Short-run impact: lowered the level of the rand	
			Long-run impact: none	Long-run impact: **lowered rand volatility**	No effect

Source: Bauman and Gallagher (2012; 2013).

Note: Boldface indicates that the regulation achieved the desired goal. ADR, American depositary receipt; IOF, Imposto de Operações Financeiras; N/A, not available.

weaker. The Chilean currency interventions were less successful, except on the days when they were announced. Each announcement of currency intervention reduced the level of the exchange rate, but not the volatility, and made the domestic stock market more independent from the region as a whole. The Chilean interventions had no statistically significant impact on total inflows of capital, the composition of inflows, or the ability of Chile to pursue an independent monetary policy. In addition, we found that the cross-border financial regulations adopted by Brazil seemed to increase the capital inflows to Chile for a short period, but this did not last. The Chilean reserve accumulation measures had only temporary effects in Chile and did not withstand the markets over time.

Rather than reregulating cross-border finance, South Africa liberalized capital outflows and intervened in the FX market. Data were not available on total inflows and the composition of inflows, but we were able to test for the impacts of capital account liberalization and FX intervention on asset prices, exchange rate levels, and monetary policy. The South African measures had no effect on asset prices or monetary policy; however, they did reduce the volatility of the South African rand. Why would the seemingly opposite policies of regulating cross-border inflows (Brazil and South Korea) and deregulating cross-border outflows (South Africa) have a similar effect? There are at least two reasons. First, if a nation has relatively strong regulations on capital outflows, the liberalization of such a regime could reduce the net inflows because some investment that had been sequestered in the nation due to outflows controls would thus be able to leave the country. Second, and as Haggard and Maxfield (1996) have noted, sometimes nations will liberalize capital flows during times of volatility if they believe further liberalization will send a positive signal to the markets. This also may be why such measures are not very successful in the long run—investors who were looking to exit do exit, and market sentiment moves on.

The findings reported here are in line with the peer-reviewed literature on capital account regulations previous to the crisis (e.g., Magud, Reinhart, and Rogoff 2011; Ostry et al. 2010). At the time of writing of this book, there were no similar analyses of the South Korean regulations but a number of studies had been published about the Brazilian regulations. The results of the research conducted for this book are also largely corroborated by these studies.

One study (Chamon and Garcia 2013) analyzes the impact of the Brazilian regulations on inflows since 2009, on the prices of financial assets, and on exchange rate appreciation. It finds that regulations were effective in distorting prices by making domestic assets relatively more expensive, thereby making such assets less attractive to foreign investors. Yet the controls did not have a statistically significant effect on the appreciation of the real, although they may have helped to strengthen the effect of the interest rate cut later in the period.

In another study, Eduardo Levy-Yeyati and Andrea Kiguel (2009) quantify the effectiveness of a specific Brazilian control, the IOF, on the Brazilian exchange rate by running regression analyses similar to those of Marcos Chamon and Marcio Garcia (2013), and they also find that the measures had the desired effect. Kristin Forbes and Francis Warnock (2011) examine the IOF tax in Brazil but test only the impact on portfolio flows, using the Emerging Portfolio Fund Research database.[2] Their novel data set gives fund-level investments by country but accounts for only 5–20% of total country market capitalization. They find evidence that the Brazilian regulations reduced investor portfolio allocations to Brazil.

Another study on the Brazilian controls (Jinjarak, Noy, and Zheng 2012) focuses entirely on gross capital inflows, using micro-level data from US and European mutual funds. This study tests the effectiveness of the regulations using counterfactuals and finds that the controls had some short-term impact in reducing inflows, although the effect disappeared a few months after imposition. Finally, Luiz Da Silva and Ricardo Harris (2013) find that the Brazilian measures reduced the volume of loans as well as the maturity level.

Fewer studies analyze the South Korean policies. Valentina Bruno and Hyun Song Shin (2014) conducted an econometric analysis. They find that, after the measures were put in place, South Korea was less sensitive to capital flows triggered by global factors such as the carry trade.

From a policy perspective, we can further confirm that these measures can impact exchange rate appreciation and the development of asset bubbles. Moreover, it is clear from our analysis that such measures should not be adopted alone but, rather, should be part of a wider package of macroprudential policies. From our analysis, capital controls alone will not be sufficient to address the concerns about capital flow volatility unless they are much stronger and better enforced. Indeed, our finding that the controls were associated with a shift toward FDI may lend credence to claims that capital account regulations encourage some investors to circumvent regulation by disguising short-term capital flows as FDI. Finally, our parallel analysis of Chile finds that intervening in currency markets can have an even weaker effect than capital flow management measures and can be costly in terms of the opportunity costs (Aizenman 2010).

This has led to a debate regarding whether nations needed to make the implemented measures stronger or whether nations needed to put more effort into the enforcement of such measures. Other research suggests that EMDs should not be

2. http://www.epfr.com/countryflows.aspx.

left to carry the burden alone. Echoing Keynes, Ostry, Ghosh, and Korinek (2012) make the case that capital account regulations should also be regulated by the nations that are the source of the finance.

Carrying the Burden

So far, I have traced the role that capital flows played in the global financial crisis and its aftermath in EMDs. Cross-border financial flows were highly volatile in the run-up to the global financial crisis and in its wake. Such volatility created significant financial amplification that may have had a longer-term impact on stability, growth, and livelihoods. A swath of EMDs deployed cross-border financial regulations in an attempt to manage capital flow volatility throughout the cycle. Although nations that regulated were less hard hit during the crisis and were more resilient during the crisis' aftermath, the regulations were far from being effective enough to mitigate the associated risks.

It is fairly remarkable that the analyses for this book and in the broader post-crisis literature continue to find some positive effects for cross-border financial regulations given the sheer level of capital flows in today's global economy, the lack of institutional capabilities to govern capital markets, and—foremost—the lack of international cooperation with (or even acceptance of) capital account regulations. Nevertheless, to ensure that these regulations are fully effective, they have to be buttressed by national and global compliance and cooperation. There are at least four challenges to achieving full effectiveness of regulation: designing effective regulations, creating effective compliance with the regulations, harnessing the global coordination of regulation, and, perhaps most challenging, changing the political-economic context of decision making.

First, at the national level, capital account regulations need to be designed to be stronger and to include significant levels of surveillance mechanisms. First-, second- and third-generation regulations may be necessary depending on the circumstances in different countries, or all three types of regulations may be needed at the same time, as in the case of Brazil and South Korea. One of the reasons why some of the more recent uses of regulations appear to be modest in their effectiveness is that they are weak relative to the spread in the carry trade. For example, in the 1990s Chile and Colombia both deployed URRs (mandatory non-interest-bearing deposits in foreign currency at the central bank for a certain period in an amount proportional to the size of the capital flow, here, 30% for Chile and 47% for Colombia). The tax equivalent of the Chilean controls averaged 4.24% and was as high as 7.7%. The tax equivalent of the Colombian controls ranged

from 6.4 to 13.6% (Gallego, Hernandez, and Schimdt-Hebel 1999; Ocampo and Tovar 2003). These tax equivalents were almost two to seven times stronger than the initial Brazilian IOF tax controls.

The second challenge for national governments is the circumventing of controls by investors. One of the most profound ways that controls have been circumvented has been through disguising short-term capital as FDI. In Brazil, for example, investors could create a public company and list it on the Bolsa de Valores, Mercadorias & Futuros de São Paulo (BOVESPA; the São Paulo stock exchange). The investors would own all the company shares and manipulate their price by arranging purchases and sales at low liquidity. The foreign investor could then invest in the public company as a foreigner and deem the investment an FDI investment because it acquired more than half of the shares and then performed interfirm loans that were considered FDI (Carvalho and Garcia 2006). At this writing, there are even more avenues for circumvention. In Brazil, many FX derivatives trades are conducted in offshore nondeliverable forwards (NDF) markets. Because the regulations can impact only domestic banks that have a position in those markets, the regulations can easily be circumvented by going through foreign banks and hedge funds that operate in those offshore markets (Spiegel 2012). As we have seen, Brazil and South Korea repeatedly fine-tuned their regulations in an attempt to stop circumvention (Epstein, Grabel, and Sundaram 2008).

The third challenge is that EMD efforts alone cannot be relied on to regulate capital flows. As Keynes and White articulated when framing the Bretton Woods system, global coordination is the key to effective capital flow management (see Chapter 2). This is of even more importance given the global nature of onshore and offshore FX derivatives markets. If countries such as Brazil cannot regulate FX transactions in their own currency, then industrialized nations need to do so. Indeed, at the G20, countries agreed to regulate derivatives markets and coordinate at the global level. (For an analysis of those efforts, see chapter 9.)

The fourth challenge is that the political obstacles to global coordination and national effectiveness of cross-border financial regulations include significant collective action problems. Although all nations and the actors within them benefit from financial stability, there are individual financial sectors that will bear short-term costs. These "losers" of a capital control regime are highly concentrated and very powerful politically. The "winners," in terms of the general public, are diffuse across the entire system and may suffer from information externalities so that they cannot "connect the dots" among capital regulations, financial stability, and personal welfare to the extent that they will mobilize politically.

In addition, there are free-rider problems. If all nations do not enact cooperation and control regulations, then hot money can cascade where regulations are most lax. Strong regulation in one nation may trigger speculation to its neighbors. Although it is increasingly understood that capital controls help markets "get the prices right," a bigger challenge is getting the political economy right. To these questions we now turn.

5

THE POLITICS OF REREGULATING CROSS-BORDER FINANCE

After more than forty years of expansion and sophistication, cross-border finance has permeated ideology, interest groups, party politics, institutions, and, above all, markets across the world to such an extent that any attempt to counter such power is often considered futile. Against the odds, an increasing number of emerging-market and developing countries (EMDs) that had opened their capital accounts in the 1990s reregulated cross-border finance in the wake of the global financial crisis. Using case study analyses of Brazil, Chile, South Korea, and South Africa, here I examine the political factors that led some countries to reregulate cross-border finance in the wake of the crisis and that limited the ability of other countries to do the same.

Two nations, Brazil and South Korea, established innovative new derivative regulations and extended second-generation capital controls to stem the harmful effects of cross-border finance with modest success. Chile and South Africa saw similar levels of systemic risk and currency volatility and also vigorously debated whether to reregulate the capital account. Both nations ended up not doing so. Instead, Chile intervened in currency markets and South Africa further liberalized its capital account.

Four factors led Brazil and South Korea to overcome the political constraints (as detailed in the traditional literature) when South Africa and Chile could not. First, both countries had legislation that allowed financial authorities to regulate at their discretion and not have to undertake lengthy legislative battles right when opposition to regulation could be strongest. Second, in the case of Brazil,

the government was led by an organized labor party that put job security and expansion before the short-term benefits that could come with exchange rate appreciation and asset price increases. Third, in both Brazil and South Korea, the government drew support from the collective memory of past crises that was ever present in the broader populace. And, finally, in different ways both nations reframed the use of capital controls as macroprudential measures to gain internal and external support for their policy objectives.

I chose these four nations as case studies because each nation received among the largest net capital inflows as a percentage of GDP (6.2 percent in Brazil, 6.6 percent in South Africa, 4 percent in Chile, and 2 percent in South Korea). The four countries also had among the largest amount of currency appreciation, with the Brazilian real appreciating by 40 percent, the Chilean peso by 35 percent, the South African rand by 40 percent, and the South Korean won by 18 percent. Moreover in these four nations there was a significant expansion of credit and concern that asset bubbles would arise, and in each vociferous debates ensued about whether to regulate capital flows between 2009 and 2012 (IMF 2011a).

Two of these nations (Brazil and South Korea) chose to directly regulate capital flows, and two did not (Chile and South Africa). This allows a comparative analysis of a set of countries across the globe that were the recipients of the same type of capital inflows that had similar impacts but chose different instruments to adapt to such inflows. I conducted both fieldwork and news analyses to research the case studies. Fieldwork was conducted in Brazil in 2011, 2012, and 2013 and in Chile and South Korea in 2012. I did not physically visit South Africa, but I interviewed the key players via email, SKYPE, or telephone. To further analyze the domestic politics of capital flows in these countries, I also performed separate investigations of contemporary news articles. In each country, the three most dominant daily newspapers were analyzed. Every article about capital flows, the exchange rate, and related issues from 2009 to 2012 was mapped to learn what specific interest groups were saying on the record about the inflows and the measures taken (or not taken) by the government to mitigate such flows. For the four countries, over 125 articles were analyzed.

I begin this chapter by examining the previous literature on the political economy of capital account liberalization in the 1990s to frame how we might expect the changes to be explained. I then present the four case studies.

The Politics of Regulating the Capital Account

As noted in the previous chapter, the global financial crisis was plagued by accentuated surges and sudden stops in many EMDs. And, as we know, many EMDs

reregulated cross-border finance in attempts to stem the harmful effects of this volatility. There is a significant amount of literature about the deregulation of the capital account in industrialized countries, and also some literature on capital account liberalization in EMDs and the international financial institutions. There is, however, no contemporary literature on the reregulation of the capital account in the nations that liberalized in the 1990s. Here I use the literature on the deregulation of the capital account to draw hypotheses regarding how we might expect nations to reregulate cross-border finance.

The prevailing view that explains how capital accounts became liberalized over the past thirty years is that capital flows became so immense and sophisticated that they were virtually impossible for nation-states to regulate. The sheer power of the markets themselves, and the ability of foreign investors to have veto power over national regulation by threatening to withdraw their capital, eventually tilted national institutions and ideologies to shift in favor of capital account liberalization as well. Those sectors that benefited most from capital flows became relatively stronger and supported political parties that supported the deregulation of the capital account as well. Moreover, capital account liberalization had become the dominant way of thinking within the economics profession and thus permeated central banks and finance ministries the world over. Finally, these actions became supported and sometimes conditioned on maintaining good relations with the United States and Europe and with the international financial institutions where they held the most voting power.

Put more formally, the prevailing view is of a capital mobility hypothesis, where in a world of high capital mobility "policy options available to states are systematically circumscribed" because of the structural power of global capital markets (Andrews 1994, 193). John Goodman and Louis Pauly (1993) and Benjamin Cohen (1998) reinforce this notion by showing how capital mobility empowers the actors that stand to gain the most from deregulating capital account regulations by providing more leverage for private interests over government regulators. Evoking Hirschman (1970), Cohen argues that private finance is empowered with "Exit, voice, and loyalty" (1998, 132). Private finance becomes more equipped to circumvent capital account regulations, thus giving less loyalty to government regulators. They have the leverage of exit or capital flight, and thus their voice becomes more accentuated in the political process. In some sense, capital mobility gives private finance veto power over public policy to manage capital flows. Layna Mosley (2003) shows that such power has its limits in industrialized countries but is stronger in EMDs because investors are more concerned about default and the relative power of global markets over smaller and weaker states.

Freiden and Leiteritz extend this logic to the case of EMDs in separate studies on Latin America. The sectors with the closest ties to major cross-border

financial actors are the exporters of tradable goods and the foreign financial sector. Sometimes those actors have divergent interests because exporters are hurt by exchange rate appreciation while finance benefits from inflows (Frieden 1991). Big exporters, however, often rely on foreign credit markets. Thus they exert pressure against measures to regulate such financial flows and usually push for capital account liberalization (Leiteritz 2012).

Randall Henning (1994) adds that institutional arrangements play a role as well. In an examination of Germany, Japan, and the United States, he finds that countries that relaxed regulations on capital account and exchange rates often had highly independent central banks and a weak alliance between finance and industry, whereas countries that were more apt to intervene had a subordinate central bank and a strong alliance between finance and industry—with finance-industry lobbies putting pressure on the finance ministry to intervene.

These interest groups support right-of-center political parties that seek to deregulate the capital account through dismantling previous regulations and institutions. Scott Kastner and Chad Rector (2003) show how right-of-center parties played a large role in liberalizing capital accounts in nineteen industrialized countries over the period 1951 to 1998. Geoffrey Garret (1995) shows that global capital mobility still leaves room for left-of-center governments to maneuver but that those governments are penalized through higher interest rates than are their right-wing counterparts. Right-of-center governing parties are often advised by experts trained in the new classical tradition (Haggard and Maxfield 1996; Blyth 2002, 2003; Kirshner 2003). These governments appoint economists and policymakers who hold such views to the central banks and finance ministries (Fourcade 2006).

These factors are reinforced by the international financial institutions and by Western governments. Joyce and Noy (2008) find that the International Monetary Fund (IMF) implicitly linked capital account liberalization with its country programs. Abdelal (2007) shows that the Organisation for Economic Co-Operation and Development (OECD) Codes and credit-rating agencies also penalized nations for regulating capital. The US government has also long pushed for capital account liberalization (Wade and Veneroso 1998; Cohen 2007).

One other observation was made during my fieldwork that is not prevalent in the literature. Recall from chapters 3 and 4 that cross-border finance is inherently pro-cyclical in emerging markets and susceptible to large surges and sudden stops. When I talked with policymakers who attempted to put capital account regulations in place, they confirmed that many of the forces identified in the literature were dominant. Moreover, they emphasized that all those forces were most powerful at exactly the time when regulation was needed most—the surge. As we recall from chapter 3, a surge is initially associated with exchange

rate appreciation, asset price increases, and an increase in GDP; thus firms, workers, and households can purchase more goods and services during a surge, feel wealthier due to asset price increases, and see that the economy is growing. In the absence of regulation during the surge, people who believe that regulation is not the optimal policy argue that their observations confirm this. As one regulator communicated, "it is hard to take the punch bowl away when the party is just getting fun!" New research on the United States has pointed out similar dynamics. In an analysis of the political economy of the United States leading up to the 2008 global financial crisis, Nolan McCarty, Keith Poole, and Howard Rosenthal (2013) show that financial bubbles were associated with a political bubble that are also pro-cyclical. During booms, investors think that "this time is different" and that prices and prospects will continue to increase. These researchers show that political actors also take on those beliefs and are thus reluctant to act during a boom. Indeed, during booms more new politicians with ideologies that do not support regulation come into power. Of course, the financial sector itself also becomes stronger during the boom and supports politicians who are against financial regulation.

This integration of forces largely explains why virtually all industrialized countries and many EMDs liberalized their capital accounts during the second half of the twentieth century. These insights can also go a long way in helping to unpack the period of financial volatility in EMDs between 2009 and 2013. By analyzing the extent to which different variables deviate from the relationships established in the previous literature, we can better understand why some nations reregulated cross-border finance in the wake of the global financial crisis.

As noted earlier, political parties were already in place in South Korea and Brazil that had the institutional structures and political backing to intervene in global capital markets. That backing came in the form of interest groups that stood to benefit from intervention, on the one hand, and a collective memory of crises and inflation, on the other. These parties appointed technocrats to the finance ministries who enjoyed relative authority over the central banks on matters related to the capital account. The finance ministry technocrats framed the need to regulate in the terms of the new welfare economics and the pragmatic new terminology of macroprudential regulation. And after some initial push back, these two nations were either blessed or ignored by the Western powers and international financial institutions.

In contrast, in Chile right-of-center parties had just been elected, which led to the appointment of new Keynesian economists to the Central Bank who were relatively not supportive of regulating capital, and the interest groups that were concerned about capital flows were politically weak. Moreover, Chile has a trade treaty with the United States under which the use of capital account regulations is

illegal. In South Africa, the power of the markets was too strong to be countered by the faction of the African National Congress and IMF advisors who recommended regulations on cross-border finance. The Ministry of Finance and the Central Bank were concerned about the possible exit of capital and were backed by similar private-sector concerns. Based on these cases, to exert the countervailing monetary power to regulate cross-border finance in the twenty-first century, political parties with political backing and technocratic expertise need to be equipped with the proper institutions to regulate cross-border finance and need the policy space to do so under their international commitments.

Brazil: Taming the Tsunami

As outlined in the previous chapter, between 2009 and the end of 2012 Brazil introduced measures to manage capital inflows into the country more than eleven times. In October 2009, it put in place a 2 percent Imposto de Operações Financeiras (IOF) tax on inflows of private equity. And throughout the period, the Brazilian authorities fine-tuned the tax to 6 percent and expanded it to bonds, derivatives, and the purchase of stocks on the New York Stock Exchange. When capital inflows began to reverse in 2011 and 2012, Brazil eased off these countercyclical regulations. Brazil and South Korea are among the first countries to devise regulations on foreign exchange (FX) derivatives to stem the harmful effects of capital inflows. There was a great deal of political debate throughout this whole process and in response to each measure. Table 5.1 maps the major actors, their position on capital account regulations, and the arguments used by each actor during the debate. As shown chapter 4, the Brazilian measures are widely seen as being moderately successful.

Each measure was publicly announced by Guido Mantega, the Brazilian minister of finance since 2006. Mantega has long held positions in the Partido dos Trabalhadores (PT; Workers' Party), a center-left party with roots fighting Brazilian dictators and neoliberal economic policies. The PT came to power in January 2003 after two terms of neoliberal policies and a subsequent financial crisis in the late 1990s. The PT ran on a platform of full employment, workers' rights, and productive development. Mantega had been on the economic coordinating council for PT presidential elections in 1984, 1989, and 1998. He also articulated Brazilian policy globally. Throughout the course of speeches on the use of these measures, Mantega repeatedly referred to the capital flows as a "tsunami" that was a result of loose monetary policy in the United States and beyond. He said the IOF tax and related measures were the only defense of Brazil against the tsunami and the "currency war" thrust upon Brazilians by the United States and China.

TABLE 5.1 Regulating capital flows and domestic politics in Brazil

ACTOR	ARGUMENT
Supportive of measures	
Finance Ministry, Central Bank	Asset bubbles, appreciation, Dutch disease
Exporters (FIESP, CNI, AEB, FACESP)	"Something" to control appreciation
Workers' Party	Autonomous monetary and fiscal policy
	Employment generation
	Asset bubbles
	Anti-US rhetoric
Economists/analysts	Prudential measure
	Dutch disease
	Best of bad alternatives
	Buying time (for deficit reduction, interest rates)
Against measures	
Actor	Argument
BOVESPA	Market sentiment
Domestic finance	Evasion too easy, distortionary
International finance	Evasion too easy, distortionary
IIF	Evasion too easy, distortionary
Economists/analysts	Evasion too easy, distortionary
BNDES	Commodities prices
	Focus on innovation, productivity
	US too powerful, okay but "tsunami"
IMF	Tackle budget deficit, interest rates

Note: AEB, Brazilian Foreign Trade Association; BNDES, Brazilian National Development Bank; BOVESPA, São Paulo Stock Exchange; CNI, National Confederation of Industry; FACESP; Federation of the Commercial Associations from the state of São Paulo; FIESP, Federation of Industries of São Paulo; IIF, Institute for International Finance; IMF International Monetary Fund.

In terms of party politics, we should also note that the first three measures were taken in the midst of a heated election campaign that pitted the PT against the center-right *Parted da Social Democracies Brasilia* (PSDB; Brazilian Social Democratic Party). Capital flows and controls played well because they could resonate with the PT base of trade unionists and progressives who had a long history of disdain for the United States, the IMF, and other external forces interfering with the ability of government to conduct pro-growth and employment strategies. Whereas the IMF, many in the banking sector, and the PSDB were saying that Brazil should cut its fiscal budget to deal with capital flows, Dilma Rousseff, the PT candidate, repeatedly argued that the Brazilian budget would not be subject to the whims of foreign finance and she would not let foreigners hold domestic growth and employment "hostage." (Ennis 2010). Employment creation and job security are the central tenets of the PT and drove all major macroeconomic decision making. Thus the exchange rate appreciation and lack

of competitiveness of Brazilian firms became one of the largest concerns of the PT government from 2009 to 2011. Firms were losing competitiveness, shedding jobs, and thus eroding the base of support for the ruling party.

The PT was also backed by the general public, who were well aware of the potential for crises and inflation. Brazilians had experienced at least three major financial crises since the 1980s, and the specter of crises and inflation haunted the memories of many. They thus saw a longer-term view, recognizing that the currency appreciation can lead to the loss of export markets and the subsequent loss of jobs. Moreover, Brazilians remembered the capital flight that often followed. The related inflation was something that no Brazilian wanted to go back to. These memories were strong and were evoked by PT leaders and proponents of capital account regulations throughout the process.

The PT put in place myriad technocrats and policymakers who saw the intervention in capital markets as good policy. Many of these economists came from the Minskian developmentalist tradition (outlined in chapter 3) and had been trained in Brazilian universities and in Western universities where such ideas continued to thrive. The training and background—as well as some post-election turnover—of some of the key players in Brazil provided the basis for the country to design and implement innovative regulation. The thrust of the new ideas—to impose the IOF tax and to create new FX derivatives measures and fine-tune these measures as markets reacted—came from the Finance Ministry. As noted already, the Finance Ministry had long been headed by Guido Mantega. Mantega holds a PhD in development sociology from the Philosophy, Sciences and Liberal Arts School of the University of São Paulo, and he also studied at the Institute of Development Studies (IDS) of the University of Sussex, United Kingdom. Both of these universities have strong developmentalist traditions.

The real mastermind behind of the effort was the deputy minister of finance, Nelson Barbosa de Filho. A younger economist, he was hired by the Brazilian government in 2005 and worked his way up to become the economic policy secretary from 2008 to 2010 before serving as deputy minister from 2010 to 2013. He and his team were behind the design and introduction of the capital account regulations in Brazil. Barbosa (2011) describes his approach to macroeconomic policy in Brazil as structuralist-Keynesian. Structuralism is a deep-rooted school of thought in Latin America, tracing its origins to Raúl Prebisch. The core themes of this school are the need for the state to provide macroeconomic stability and channel finance toward productive sectors that can change the structure of an economy toward higher valued-added and employment-intensive goods. Barbosa studied under Lance Taylor at the New School for Social Research in New York and moves in the same circles as Ricardo Ffrench-Davis and José Antonio Ocampo (both discussed in chapter 3). Taylor, a former Massachusetts Institute

of Technology (MIT) professor of Paul Krugman, among others, is a pioneer of structuralism and has inspired many high-level financial policymakers across the developing world. Barbosa would be quite sympathetic to being considered a Minskian developmentalist.

Paramount to understanding the outcome of innovative capital account regulation in Brazil is an understanding of the varying jurisdictions assigned to different Brazilian institutions. The Brazilian Finance Ministry, like many of its counterparts, has jurisdiction over all tax policy, including any taxes on cross-border finance (Prates 2012). Moreover, all monetary, credit, and exchange rate policies in Brazil must be agreed on by consensus by its *Conselho Monetário Nacional* (CMN; National Monetary Council). Founded in 1964, the CMN has as its members not only of the president of the Central Bank but also the minister of finance and the minister of planning, budget, and management (Paula 2011). The initial IOF taxes were put in place by the Ministry of Finance under its own discretion. It was at the CMN that the Ministry of Finance introduced the innovative measures to regulate FX derivative markets.

During the administration of President Luiz Inacio Lula da Silva, Barbosa was not able to garner support for broader measures in the CMN, and he resorted to the taxation measures that did not need CMN approval. After the election, however, there were moves in the Central Bank that brought individuals to power who saw more eye to eye with Barbosa's team. Henrique Meirelles, who headed the Central Bank through the Lula administration (and the IMF loans), made numerous public statements about being on the "same page" as the Finance Ministry about the measures but privately was much less supportive. Meirelles had been educated in Brazil and at the Harvard Business School and had headed the Brazil operations of BankBoston from 1984 to 1996; he then was head of global finance for FleetBoston Financial in Brazil. Interviewees noted that under Meirelles and Lula the goal was to regain credibility with the markets (Brazil had had a severe crisis under the Fernando Cardoso administration, and Lula had to regain global market confidence thereafter) and that Meirelles was concerned that regulating inflows might send the wrong signals. On Meirelles's watch, Brazil repaid its debts and accumulated enough reserves (enough for almost twelve months of imports, or 90 percent of external debt at the time the IOFs started) by the time consideration of these measures occurred. The Central Bank thought it had the space to act using controls in this post-credibility phase but may not have done so earlier. Indeed, while many nations, such as Colombia next door, had deployed controls on inflows between 2003 and 2009, Brazil had not.

The appointment of Alexandre Antonio Tombini after the election changed things somewhat. Tombini is largely seen as being more flexible in his thinking than Meirelles. Tombini is largely credited (or chastised) for loosening

inflation target scheme of Brazil as he entered office. Tombini had received a PhD in economics from the University of Illinois, Urbana-Champaign. The draw of Urbana-Champaign for Brazilians, far from being a bastion of new classical macroeconomic thought, had long been Werner Baer, a development economist who had graduated from Harvard in 1958. Those Harvard years were a high-water mark for developmentalist thought, with Albert O. Hirschman and many others on the faculty. Tombini had been at the Brazilian Central Bank for some time, negotiating country programs with the IMF throughout the 2000s. Tombini was part of a more pragmatic group in the Central Bank, where there was a long history of using capital controls, even during the liberalization period (Paula 2011; Cardoso and Goldfajn 1998). The amount of inflows became so large that many of those tools were seen as already in use and up against economic and political limits, especially the accumulation of reserves, which were costly given the interest rate and becoming increasingly difficult to sterilize. Finally, according to Barbosa, he had to reframe capital flows as externalities to his colleagues in the Central Bank. To key members within the bank, the welfare economics of capital controls and statements by the IMF (see chapter 7) "spoke the same language" as the Central Bank economists with more neoclassical training than those in the Finance Ministry. This group was much more willing to go along with ideas of Barbosa's team.

In addition to the jurisdictions of the CMN and the Finance Ministry, another institutional feature of Brazilian political economy also played a key role. Exporters in EMD contexts, in cases where debt is denominated in dollars, tend to be against regulating capital flows because if such measures devalue the currency, the value of their debt will increase (see Freiden 1991; Leiteritz 2012). As noted earlier, export industries are often supportive of cross-border finance because they rely on foreign capital markets to finance their trade. But in the case of Brazil much of the export sector received subsidized credit from both commercial banks and the Brazilian National Development Bank (BNDES). This partly explains why many export capitalists in Brazil were supportive of the measures taken to regulate cross-border finance.

The 40 percent nominal appreciation was affecting the Brazilian export industry, and exporters let their voices be heard. All of the major business groups, including the Federação das Indústrias do Estado de São Paulo (FIESP; Federation of Industries of São Paulo), Confederação Nacional da Indústria (CNI; National Confederation of Industry), Fundação de *Amparo* À Pesquisa do Estado de São Paulo (FACESP; Federation of the Commercial Associations from the state of São Paulo), and the Associacao de Comircio *Exterior* do *Brasil* (AEB; Brazilian Foreign Trade Association), made statements throughout 2009–2011 in support of the IOF and related measures. Both Paulo Skaf, president of FIESP, and Armando

Moneiro Neto, president of the CNI, told the press that the measures would save exporters, divert speculators, and prevent layoffs (O Estadao de Sao Paolo 2009). Individual exporters weighed in as well, such as Brasil Foods (BRF), one of the biggest exporters in the country, with external sales around US$5 billion a year. BRF issued a statement that the measures taken by the government to tax derivatives will be "positive for exporters" (Reuters 2011).

The strong party ideology, the technocrats, the CMN institution, and the backing from exporters all integrate to explain how Brazil acted as it did. As the theory predicts, many in the financial sector were not supportive of the measures. The domestic banks, international banks, the Institute for International Finance (IIF), and even IMF all weighed in on the measures. The main narrative of each of these actors, as suggest by Goodman and Pauly's (1993) research, was that the measures would be evadable and thus wouldn't work. They argued that the Finance Ministry and Central Bank should work instead to lower interest rates and trim fiscal budgets.

These interests prevailed over those of the private banking system and international banks, the head of the Brazilian stock market, the IIF, and some international experts from ratings agencies and investment banks. As Cohen (1998), Goodman and Pauly (1993), Frieden (1991), and Kirshner (1995) would predict, these actors stood to gain from inflows of foreign finance and to lose from efforts to curtail such flows. Edemir Pinto, president of the Brazilian stock exchange, was continually telling the press that each measure would hurt the Brazilian futures market and/or be circumvented.

International players weighed in as well. Three representatives from JP Morgan, as well as experts from Barclays, the Economist Intelligence Unit, and Bank of America were quoted as saying that the measures taken by the Brazil were worrisome because they would cause uncertainty among investors about Brazil and also warning that the measures would probably be ineffective in meeting their goals. The IMF, too, was initially not supportive of the Brazilian measures. Instead, the IMF told Brazil that its main problems were with its public budget and public provision of credit; if these two trends were curtailed, the problem would be alleviated. Because the IMF loan to Brazil had been paid back under the Lula government, Brazil was no longer bound by IMF commitments; it therefore had full policy space under the IMF Articles. Moreover, Brazil had not made many commitments in financial services liberalization at the World Trade Organization (WTO; see chapter 8), nor did Brazil have regional and bilateral treaties with neighbors that curtailed its ability to deploy capital account regulations.

In the face of overwhelming capital flows and a well-organized financial sector, Brazil reregulated capital flows and achieved a modest success. A strong PT armed with economists and technocrats that had the power to channel party

policy into the Central Bank were essential factors, as was the ability of the Finance Ministry to reframe the regulations as corrective rather than distortive. The PT had the backing of its traditional workers and general public, and it also had the backing of strong international capitalists who were not as linked with global finance, as they were in other countries, because of the Brazilian national development banks and regulations on commercial banks. Finally, Brazil had preserved its policy space to regulate capital flows at home under the IMF and the WTO.

South Korea: Macroprudential Jujitsu

South Korea put in place and fine-tuned regulations on cross-border finance seven times between 2009 and 2012. Like Brazil, South Korea has an independent Central Bank, but the Ministry of Strategy and Finance (MOSF) also has authority to charge the bank with intervening in FX markets. Like Brazil, South Korea deployed more traditional controls, such as limits on bank loans and levies, but also devised innovative regulations on derivatives to stem inflows. South Korea barred foreign currency loans to local companies for domestic use to reduce short-term debt and to protect local firms from exchange rate risk. It also put caps on bank FX forward operations relative to equity capital and on forward contracts between banks and exporters relative to their export receipts. Unlike Brazil, South Korea is a party to many trade and investment treaties, but South Korea has ensured that these treaties grant it the flexibility to regulate capital flows. Also like Brazil, South Korea reframed regulation in the new economic thinking of the time and continually referred to their measures as macroprudential. But unlike Brazil, South Korea framed its measures in the new language of macroprudential regulation to assimilate into newfound industrialized country views regarding financial regulation on the world stage rather than declaring war on the "tsunami."

Unlike Brazil, South Korea did this under the auspices of a right-of-center party, the Grand National Party. This party had its roots, however, in the Democratic Republican Party of Park Chung-hee, who is largely credited for establishing South Korea as a developmental state (a state where the key role in economic transformation is played by the state). The party had a long history of regulating capital markets. During the days of the developmental state, however, Park Chung-hee's administrations were more apt to regulate capital flows for resource mobilization (the developmentalist tradition discussed in chapter 4; both South Korea and Brazil have strong traditions here; Nembhard 1996) than for financial stability.

The deployment of cross-border financial regulations by South Korea in 2009–2012 was planned and devised by bureaus within its economic and financial

agencies: the MOSF, the Bank of Korea (BOK), the Financial Supervisory Service (FSS), and the Financial Services Commission (FSC). Each time a measure was announced, the measures were echoed by the Blue House (the nexus of the executive branch of the Korean government, analogous to the US White House). Table 5.2 lists the key actors for and against the measures in South Korea and their arguments.

A defining institutional characteristic is the South Korean Foreign Exchange Transactions Act. This law, established in 1961 when Park came to office and amended numerous times (including during 2009–2012) to incorporate new types of regulations, grants South Korean financial bodies authority over FX interventions. Although the act largely gives MOSF and its counterparts the obligation to accelerate the liberalization of exchange rate and related restrictions, it also allows for temporary derogations in times of instability.

The pragmatic ideas about crises held in the MOSF were the origin of change in South Korea and were enabled by the Foreign Exchange Transaction Act. Leiteritz (2012) refers to pragmatism in monetary policy as a shared mental model whereby the government deploys selective but firm regulation that does not over-regulate but sends strong signals to the private sector and markets. Of course, as in Brazil, the recent financial crises loomed over financial regulators in South Korea. South Korea had witnessed massive outflows of capital and a loss

TABLE 5.2 Regulating capital flows and domestic politics in South Korea

ACTOR	ARGUMENT
Supportive of measures	
BOK, MOSF, FSC	Asset bubbles, stability of banking sector, won appreciation
	Macroprudential response
Grand National Party, Blue House	Macroprudential response; financial reform
NGOs	Re-regulation necessary to reform finance
Economists/analysts	Prudential measure
IMF(eventually), FSB	Appropriate response
Against measures	
Exporters	Cut off access to finance
Domestic banks (Shinhan, Hana)	Market sentiment, too much intrusion in private sector
Foreign banks	Could cause capital flight, wrong signal
Economists/analysts	Evasion too easy, distortionary
IMF(initially)	Easily evaded, float exchange rate

Note: BOK, Bank of Korea; FSB, Financial Stability Board; FSC, Financial Services Commission; IMF, International Monetary Fund; MOSF, Ministry of Strategy and Finance; NGO, nongovernmental organization.

in exports immediately after the crisis. But as growth picked up, so did capital inflows and signs of bubbles were everywhere. Because of that history, and the training of ministry officials and their teams, South Korea had a very pragmatic approach to regulating inflows.

Jae-wan Park was the minister of strategy and finance at the time. The FSC was headed by Dong-soo Jin, who has received his degree in economics from Boston University. The BOK was headed by Joong-soo Kim, who had been trained at the University of Pennsylvania. Park's PhD was from the Harvard Kennedy School, which emphasizes a problem-solving approach as opposed to purely theoretical economics. What is more, the economists at the Kennedy School (e.g., Rodrik, Hausmann, and Velasco) are among the leading economists who see a need for the regulation of cross-border finance. The BOK had been dealing with inflows by accumulating reserves and sterilizing them. But, as early as 2005, the BOK had run up against the limits on its capacity for effective sterilizations. What is more, it had accumulated significant reserves already and saw further intervention as risky given the low rate of return on US securities and the economic cost of accumulation. There were few other tools in the toolkit.

When the first of the measures was taken in 2009, it was referred to by Dae-rae Roh, deputy minister of strategy and finance, as capital controls. Korean officials then quickly began to reframe it using the macroprudential terminology surrounding the G20, Basel, and other discussions that were ongoing at the time. Indeed, in a heated exchange with the press in 2010, Hyun Song Shin, former Blue House aide for international economy "dismissed the notions that recent announcement on curbing banks' forward exchanges are controls on capital flows. He restated that it was a 'macro-prudential' measure for banks and that raising interest rates would bring yet more destabilizing inflows into the economy" (*Hankyung Economy* 2010). Recall that Shin is one of the pioneers of the new economics of cross-border financial flows (discussed in chapters 3 and 4). Shin served as aide to South Korea when on leave from the Economics Department at Princeton University (and, more recently has moved to the *Bank for International Settlements*, BIS), where he wrote extensively on carry trades, the volatility of global financial flows, and the need to regulate cross-border finance. From then on, South Korea went out of its way to discuss the measures as macroprudential. Interestingly, South Korea was hosting the G20 in the middle of imposing these measures and was able to insert a clause into the G20 communiqué granting nations the right to deploy macroprudential regulations to deter capital inflows. Such an approach brought approval from both the Financial Stability Board (FSB) and the IMF for the Korean measures (*Asia Today* 2009). Jeffrey Chwieroth refers to how South Korea and other East Asian nations recast their measures as what was becoming the "new normal" across the globe as an exercise

of "productive power" because they were able to reshape the contours of legitimate policy (2012, 2,1).

There was significant opposition to the measures, which was along the lines that theory would predict, but that opposition was muted by the institutional structure of decision making and the ideas and beliefs held by the key decision makers. Again, as Goodman and Pauly (1993) have noted, many institutions in finance, especially foreign finance, threatened exit: "Foreign banks domestic branches mainly make businesses by delivering short-term capital from foreign headquarters for bond market investment and foreign currency lending, if such high rates are applied for our branches here in Korea, these businesses will be transferred to Hong Kong and Korean branches will be left penniless" (*Kyunghyang News* 2010). Baek-soon Lee, president of Shinhan Bank, a domestic bank, warned to the press that South Korea should not resort to the "arrogance of the past" toward financial markets (*Herald Economy* 2010).

There were also civil society voices that expressed a need for regulating cross-border finance as an issue of justice. The Korea Civil Society Network on Financial Reform was a civil society organization coordinating protests around the G20 meetings; one of its main demands was capital controls on inflows (Korea Civil Society Network on Financial Reform 2010). South Korea saw the years after the crisis in the last 1990s as the "IMF years," and a significant portion of the population still remembers that period with disdain—associating it with a period when the IMF forced Korea to deregulate capital flows (Blustein 2001). Thus, the reregulation of capital was seen as beneficial, and the actors used stronger rhetoric, analogous to that used by Brazil.

Initially, the IMF was not supportive of the South Korean actions (IMF 2010c, 19). In its 2010 Article IV report to South Korea, the IMF noted that the control measures were likely to be largely ineffective. Indeed, the IMF argued that the regulations might inspire investors to circumvent them and create a bubble in portfolio flows instead; the best and first line of defense for South Korea was a commitment to a floating exchange rate and monetary tightening. Interestingly, the IMF stance changed as South Korea continued to fine-tune its regulations (and as the IMF changed; see chapter 6). The IMF opposition became less pronounced; the IMF 2012 Article IV report went so far as to say that the measures had a "somewhat positive effect" on short-term external debt (IMF 2012d, 15).

Another key international feature is that South Korea was able to explicitly carve the Foreign Exchange Transaction Act out of the South Korea–United States Free Trade Agreement (KORUS). South Korean authorities noted that the United States had not permitted Chile and other nations to deploy some of the capital account regulations they had put in place in the past (see chapter 8) and worked hard to create Appendix III-A and Annex 11-G to the transfers provisions out

of the KORUS chapter dealing with investment. These exceptions provided a safeguard in the treaty that largely exempts measures taken by Korea under the Foreign Exchange Transaction Act from being actionable under the treaty.

South Korea exhibits many similarities with Brazil, and key differences as well. South Korea had technocrats appointed by the MOSF (i.e., Shin) who understood the source of financial fragility and helped design and frame macroprudential regulations under the rubric of the new welfare economics. These actors enjoyed institutions that gave the MOSF jurisdiction over such polices. The leaders acted given their historical capacities, pragmatism, and the specter of past crises looming in the public's mind. They also had the policy space to do so under the IMF and their trade commitments. They were able to do all this and achieve modest success despite strong opposition from international and domestic banks, exporters, and initially even the IMF.

Chile: Weathering the Storm

The Chilean currency appreciation was not as acute as in its counterparts, but Chile did have one of the more severe asset bubbles. In early 2010, the center-left party of Chile was voted out of office and replaced by a right-wing government headed by Sebastian Pinera, a billionaire. There was considerable debate within Chile about the appropriate course of action to take with respect to the exchange rate and asset bubbles. Some argued that Chile should re-install its Encaje measure, whereas others thought no action was needed. In the end, party politics and a lack of interest-group backing led Chile to intervene in the foreign currency markets with a $15 billion accumulation scheme rather than relying on the famed unremunerated reserve requirement (URR) that had worked for Chile in the past.

Chile's (in)famous Encaje policy, from 1991 to 1995, created the URR. Recall that this measure required foreign investors to put 20–30 percent of their investment in a non-interest-bearing account in the Central Bank for a specific period (ranging from six to twelve months). This measure, in many ways, served as a tax on inflows combined with a minimum stay period that would serve as an outflows measure in the event that there was a sudden stop during the stay period (Ffrench-Davis 2010). Indeed, the Encaje is perhaps the inflows-based capital control that has gained the most legitimacy since then; it has been used in Colombia, Thailand, India, and now (covering derivatives) in Brazil. The majority of econometric evidence sees the Encaje as having positive effects, although some of the analyses by analysts such as Felipe Larrain and others suggest otherwise (Magud, Reinhart, and Rogoff 2011).

The Encaje remains Chilean law but is dormant. The law allows the Central Bank to deploy controls to maintain financial stability (which, unlike in many countries, is part of the mandate of the bank). To be activated, the Encaje needs the votes of at least three of the five advisors to the Central Bank and also requires the approval of the finance minister. If the finance minister vetos such a restriction, it requires the vote of all five advisors to overturn the veto.

As capital flows poured into Chile during 2010, a debate ensued over possible remedies. Some exporters, numerous members of past finance ministries and central banks from opposition parties, and academic economists urged the government to deploy the URR. Pinera's new government would have none of it. Larrain made repeated statements that echoed his earlier academic work—that the URR would be easily evaded, that it may not work, and that it may bring significant costs to certain sectors of the economy. José De Gregorio Reboso chimed in as well, saying the measures might not be effective and could choke the supply of credit to small and medium-sized enterprises.

Unlike South Korea, Chile was not able to safeguard the use of Encaje in its trade treaty with the United States (although it did safeguard its use in treaties with Canada, the European Union, and most other countries; see chapter 8). Miguel Marfán, vice president of the Central Bank, emphasized in the press that the FTA with the United States restricted capital controls in Chile. This concern was also echoed by the editors of *Mercurio*, the conservative newspaper in Chile (*Mercurio* 2011).

Although some exporters did call for controls, others did not or were okay with the reserves accumulation. Ronald Brown, president of the Associatión de Exportadores de Chile (ASOEX; Chilean Fruit Exporters Association), called on the government to institute capital controls to complement its dollar purchasing strategy to control speculative capital, a move that he considered essential to preserving Chilean economic competitiveness (Diario Pyme, 2011b). He suggested controls that would vary according to the interest rate differential between Chile and the United States, the spot and long-term copper prices, and the current and long-term exchange rates. Luis Mayol, president of the Sociedad Nacional de Agricultura (SNA; National Agricultural Society), and Rene Merino, president of Vinos de Chile, by contrast, appeared satisfied with the dollar-buying measures and did not ask for capital controls. Antonio Walker, president of Fedefruta, credited pressure by the fruit industry for the dollar-buying measures and lamented that dollar-buying did not happen earlier; he did not mention capital controls (*Estrategia* 2011).

Interestingly, in its Article IV reports for Chile the IMF did not weigh in on the use of capital account regulations specifically. The IMF did acknowledge the asset bubbles and concern over the exchange rate but focused on the need for

prudential regulation. Miguel Savastano, Western hemisphere subdirector for the IMF, however, did weigh in with the press, saying that Chile did not need capital controls because Chileans could invest abroad, which would enable the country to absorb more capital (Diario Pyme 2011a).

The prevailing thinking by Pinera himself and across his administration was that the markets would eventually correct the problem. Pinera had earned a PhD in economics from Harvard University and spent years teaching economics alongside the infamous "Chicago boys" of Chile. Pinera appointed economist Felipe Larrain as finance minister. Larrain had also earned a PhD from Harvard and had edited a book arguing that capital controls were not very successful and could also be dangerous in the Latin American context (Larrain 2000). De Gregorio stayed on for a short while as the head of the Central Bank. He had earned his PhD from MIT and had worked at the IMF from 1990 to 1994 before returning to academia and, later, government service in Chile. De Gregorio had in the past also written studies that were fairly critical of capital controls but had become more balanced in recent times. But knowing that he did not have the votes for regulation in the Central Bank and that controls would be vetoed by Larrain, De Gregorio was more accommodating to the new party in power.

Many former central bankers and Finance Ministry economists from the opposition were incensed by the outright rejection of controls and repeatedly voiced concern that the full range of options was not being considered. Roberto Zahler, the former president of the Central Bank, argued that the government should consider capital controls as one way to halt appreciation and gain competitiveness. He accused the government of refusing to consider capital controls for ideological reasons (Schwerter 2011).

South Africa: Liberalize More!

South Africa was among the hardest hit by the rapid financial flows during 2009–2012. Like the three other nations, South Africa had a nationwide debate about how to respond to the inflows. In the end, the National Treasury and South Africa Reserve Bank (SARB) overrode other ministries and the labor contingent of the African National Congress (ANC) and chose to accumulate foreign reserves and liberalize the outflows of capital rather than imposing a tax on inflows.

Further liberalizing may seem very counterintuitive. Yet in the early years of the ANC South Africa had gone through a period of significant outflows controls to maintain a dual exchange rate regime and prevent capital flight, a regime that, according to the SARB, had had the desired effect (Farrell 2001). In contexts like this, when nations still have structural capital and exchange controls in place,

liberalizing outflows may reduce the *net* inflows and thus relieve pressure on the exchange rate. In addition, and as Haggard and Maxfield (1996) have noted, sometimes nations will liberalize capital flows during times of volatility if they believe further liberalization will send a positive signal to markets. This is exactly what the South African exporters argued for.

In many ways, the South African case conformed most closely to what the theory predicts. Through institutions, interest groups, and ideas, South African interests that were either most closely tied to or most supportive of cross-border finance gained power over the interest groups that wanted to intervene.

South Africa has the SARB, a central bank that is independent and that lacks the oversight with respect to exchange rate policy that the finance ministries in Brazil and South Korea enjoyed. In South Africa, the finance minister and the SARB president saw eye to eye on which measures to take.

In its 2010 and 2011 Article IV reports, the IMF actually weighed in, suggesting that South Africa consider imposing a tax or something equivalent. It pointed out that doing this might reduce the volatility of the exchange rate. In these two Article IV reports for South Africa, the IMF urged South Africa to continue FX accumulations during the capital flow surge. The IMF did note that the tax might be an option to increase the South African FX reserves but also warned that history had shown that it could easily be circumvented (Isa 2010b). The IMF staff opinion on using controls was that they would probably raise government financing costs and that, absent wage restraint, it was unlikely that this would improve competitiveness. In 2011, however, IMF staff suggested caution in further liberalizing the outflows from resident nonbank financial institutions (South Africa had previously suffered capital flight) (IMF 2010d, 2011d).

As the rand began to appreciate, some exporters and many trade unionists began to loudly complain about the exchange rate effect on exports and employment—unemployment had reached 25 percent. In the run up to a much anticipated ANC policy conference, some ministers and the Congress of South African Trade Unions (COSATU) called for a tax on capital inflows to stem the rise of the rand and to maintain jobs and exports. Seeraj Mohamed was a leading COSATU economist. Mohammed had received his PhD in economics from the University of Masschusetts, Amherst, a department where capital controls were seen as an important part of a Marxist-Keynesian approach to stability and generation of employment. Indeed, Mohammed had cowritten an article on capital flight and capital controls (Mohammed and Finnoff 2006). The debate caused a stir in the global press, and the rand began to slightly decline as news spread.

The banking community strongly supported SARB and the Finance Ministry. Some banks cautioned that an inflows tax might spook investors. John Cairns, head of Rand Merchant Bank in Johannesburg, is reported as saying that an

inflows tax in South Africa "is unlikely to be adopted in the near term due to the complexities involved in calculating a rate that will not induce a massive outflow of funds" (in *Business Day* 2010). Another investor noted, "It would likely be negative in terms of foreign investor sentiment, and whether it would have a meaningful impact on the rand is debatable" (Isa 2010a).

Exporters were very concerned about the rand, but they were more concerned about what the tax would do to market perceptions; therefore their ideas about the markets trumped their immediate material realities. Neren Rau, chief executive officer of the South African Chamber of Commerce and Industry, was wary of the policy because it would appear to be a halt or reversal of the gradual process of liberalization in South Africa. He claimed, "People who have an intention to invest on a sound basis in SA would be discouraged by the tax. It would be difficult to calculate the right rate and it would probably have to change on a frequent basis" (in Isa 2010a). Interestingly, defensive measures taken by exporters were seen by some as accentuating the problem. Jean-François Mercier, Citigroup economist, said that exporters appeared to be sitting on large amounts of FX in hopes that the rand would weaken. "If it doesn't weaken they could throw in the towel and suddenly convert them, pushing the rand stronger" (in Isa 2010a).

Immediately, it began to be reported that the SARB and the National Treasury were "dead set against such a tax idea around inflow restrictions and preferred direct reserve accumulation and other methods" (Times Live 2010a). Lesetja Kganyago, a deputy governor of SARB, quickly dampened the debate in a speech in which he characterized a tax on inflows as "bad economics." "Kganyago made the point that such a tax could push up yields (because it affects the cost of capital) and that high yields were the very reason foreign speculators were parking money in South African assets" (Times Live 2010b). Kganyago has earned degrees from the University of London as well as Harvard University and University of the Witwatersrand. He also had training from the IMF Institute, the World Bank Institute and JP Morgan. Kganyago's comments were often echoed by Pravin Gordhan, the South African minister of finance at the time. Gordham said that South Africa would ease the effects of capital inflows by increasing reserves and increasing the limit on how much capital residents could move outside the country. Because it was a small economy, Gordhan said, South Africa could not successfully offset large global swings in capital flows.

Summary and Conclusion

Political factors integrated to form the preferences that led the four states to use different instruments to address very similar challenges. In the wake of the 2008

financial crisis, Brazil, Chile, South Africa, and South Korea each experienced a surge in capital inflows that led to currency appreciation and concerns about asset bubbles. The memory of the bursting of similar bubbles in previous crises loomed large for governments and for domestic actors in these countries, such that heated debates ensued regarding which instruments should be used to stem the surge in capital inflows. Two countries, Brazil and South Korea, deployed both traditional and innovative capital account regulations. Chile made slight interventions in its currency market. And South Africa actually accelerated the liberalization of its capital account.

Table 5.3 outlines the prevailing factors that led Brazil and South Korea to regulate and that led Chile and South Africa to not do so. Both Brazil and South Korea had strong political parties backed by key interest groups or a public that had experienced grave financial crises that had been costly in economic

TABLE 5.3 Domestic politics of capital controls: Prevailing factors

	BRAZIL	SOUTH KOREA
Institutions	Central Bank subordinate to Finance Ministry	Central Bank subordinate to Finance Ministry
	Development Bank allocates credit to exporters	
	No trade treaty	Carve out in trade treaty
Power interests	Exporters concerned about exchange rate	Exporters concerned about exchange rate
	Governing political party commitment	Governing political party commitment
	Elections looming	Elections looming
Ideas	Memory of past crises	Memory of past crises
	Anti–Washington Consensus evocations	Global justice (NGOs)
	Minskian developmentalism	New welfare economics/pragmatism
	New welfare economics/pragmatism	
	CHILE	**SOUTH AFRICA**
Institutions	Central Bank vote	Central Bank–Finance Ministry alliance
	Restrictive trade treaty	
Power interests	Weak noncommodity exporters	Weak noncommodity exporters
	Conservative party and appointments	Weak unions
Ideas	New classical/Keynesian	New classical/Keynesian
	Conservative technocrats	

Note: NGO, nongovernmental organization.

and political terms. Technocrats in each country reframed the need to regulate capital flows in the rationale of the new economics of capital controls (outlined in the chapter 3). Both countries had institutional arrangements that made the central banks somewhat subordinate to the finance ministries, where these technocrats were employed and devised policy. Finally, when the controls did not result in disaster, Brazil and South Korea were (eventually) not shunned by Western countries and the international financial institutions, as they had been in the past. Table 5.4 maps the extent to which different actors in each nation either supported (top panel) or were against (bottom panel) regulating capital flows.

The theories outlined earlier explaining why countries deregulated their capital accounts also go a long way in showing how some countries did the opposite in the twenty-first century. In Brazil and South Korea, both the governing parties and their finance ministries wanted to regulate capital flows. In the case of Brazil, this was due to interest-group pressure by exporters concerned about the exchange rate and due to political representation in that the governing Workers' Party that wanted flexibility in monetary policy to spark growth and employment. In Brazil, the prevailing ideas held in the Finance Ministry were Minskian developmentalism and the new welfare economics of capital controls. Barbosa's team held Minskian developmentalist views of the issue and translated these views into the language of the new welfare economics to gain their acceptance by the Central Bank. Brazilian authorities were concerned about appreciation, asset bubbles, monetary autonomy, and potential Dutch disease. In South Korea, the prevailing ideas were the new welfare economics of capital controls and new thinking on macroprudential policy, as advocated by Hyun Song Shin.

Chile and South Africa were different. In Chile, the Finance Ministry and Central Bank were not supportive of regulating capital flows, and they had the final say. Moreover, the political clout of concerned exporters was weak relative to other voices in the economy. In South Africa, the SARB had the high authority and the Finance Ministry and SARB both saw controls as heterodox and risky. In South Africa, such ideas were supported by the export industry, which was dependent on foreign finance to support its trade.

In a study of exchange rate politics in the United States, Germany, and Japan, Henning (1994) stipulates that the degree to which interest-group preferences are translated into policy is a function of the nature of the institutions that govern the exchange rate and the extent to which the private sector is united with the banking sector in the need to manage the exchange rate. Both Brazil and South Korea had laws that granted the finance ministries significant leeway with respect to managing the exchange rate. What is more, Brazil did not have trade

TABLE 5.4 Domestic politics and capital account regulations in four emerging markets

		BRAZIL	SOUTH AFRICA	CHILE	SOUTH KOREA
Supportive	Government	Finance Ministry Central Bank (eventually)			Finance Ministry Central Bank
	Private sector	Governing party Exporters		Opposition party Exporters	Governing party
		Trade Unions	Trade unions		NGOs/Trade unions
	Economists/experts	Some economists	Some economists	Some economists	Some economists
	International	IMF (eventually) US	IMF		FSB, IMF (eventually)
Against	Government	Central Bank (initially) Development Bank	Finance Ministry Central Bank Governing Party	Finance Ministry Central Bank Governing Party	
	Private sector	Finance	Finance Exporters	Finance	Finance Exporters
	Economists/experts	Some economists	Some economists	Some economists	Some economists
	International	IMF (initially), IIF			IMF (initially)

Note: FSB, Financial Stability Board; IIF, Institute for International Finance; IMF, International Monetary Fund; NGO, nongovernmental organization.

treaty commitments that hindered its ability to exercise its laws, and South Korea explicitly and successfully got an exception written into the KORUS so that it could use its exchange rate law.

In Brazil, the traditional alliance between the private sector and banking broke down for two reasons. First, private-sector exporters wanted action to control the exchange rate so their products would remain competitive and thus were generally inclined to support policy action. Given that the channel causing exchange rate appreciation was through international financial flows intermediated by banks, it was the banks that would have to pay the price in terms of regulatory costs—making the banking sector less inclined to ally with the private export sector. Brazilian manufacturing exporters were especially keen to split from the private banking sector because they rely less on private-sector banks. Brazilian banks received a significant amount of subsidized credit through the government development bank and through requirements for targeted lending by private financial institutions. The second reason there was a split between international finance and private exporters was that international credit presented currency mismatches that could accentuate balance-sheet pressures in the event of a sudden stop. The memory of such events in 2008 and during earlier crises in the 1990s led to a more pragmatic approach in the finance ministries and central banks in both Brazil and South Korea and led them to be more responsive to private-sector concerns.

Perhaps more interestingly, South Korea took action despite a center-right party being in power and despite the measures having little support from exporters or domestic and international financial actors. South Korean financial authorities were driven by a sense of pragmatism given their experience with the East Asian financial crisis in the 1990s and the global financial crisis in 2008. Moreover, their chief advisor was Hyun Song Shin, one of the leading economists in the new welfare economics of regulating capital flows. These pragmatic ideas could be channeled into policy action because of the special law that allowed financial authorities to act at their discretion during times of turmoil.

Brazil and South Korea also had the policy space to take these actions under their international commitments. Moreover, nations such as the United States and institutions such as the IMF did not publicly condemn Brazil or South Korea when they took the actions they did. As we will see in chapter 8, Brazil did not make major commitments on trade in financial services at the WTO and did not ratify any bilateral investment treaties that would make its measures actionable. South Korea had exceptions under the OECD to take the measures it did and also made sure it had exceptions under its trade agreement with the

United States. Although the IMF was initially critical of the measures taken in both countries, it began to change its tune as IMF thinking about managing capital flows evolved after the crisis. In the next three chapters, I outline how EMDs sought to preserve and expand this policy space in global economic governance institutions.

6

RULING CAPITAL

The New International Monetary Fund View of the Capital Account

As we have seen, the orthodox thinking about capital controls in the International Monetary Fund (IMF) and global monetary system during the Bretton Woods era (Keynes 1944) had changed in theory and practice by the 1970s, the shift going so far that there was an attempt to change the IMF Articles of Agreement to mandate the deregulation of cross-border finance. Now the pendulum has swung back once again, although not as far as in 1944. With much fanfare, after a two-year process the IMF embraced a 2012 new institutional view that endorses the reregulation of cross-border finance under certain circumstances. Although the IMF remains wedded to eventual global capital account liberalization, it now acknowledges that the case for the free movement of capital rests on a much weaker intellectual foundation than does the case for free trade.

To be sure, Board members from industrialized country, many emerging-market and developing countries (EMDs), and many outside experts were not thrilled with the final outcome—although for very different reasons. One senior official interviewed for this book reluctantly remarked that, thus, "it must be pretty good."

The IMF staff was intent on making some official room for the use of cross-border financial regulations. Many EMDs, particularly the BRICS countries (Brazil, Russia, India, China, and South Africa), were not happy that there was an official process on this matter. They were concerned that it might lead to a narrowing of their ability to use capital account regulations under the IMF Articles of Agreement. So, BRICS formed a coalition that sought to defend such policy space and to put some of the burden of regulating capital flows on to the

industrialized countries. The industrialized countries were not fully supportive of a process toward an institutional view either and, thus, sought to maintain an emphasis on the benefits of capital account liberalization and to ensure that the process didn't get out of hand—especially in the form of endorsing capital controls for undervalued exchange rates in China and beyond.

There was something in the institutional view for all these perspectives. The IMF is now officially charged with making recommendations regarding the management of capital flows under its surveillance functions. As of 2013, staff members are required to recommend caution concerning capital account liberalization and to recommend capital flow management measures (CFMs), the new IMF term for capital account regulations, under certain circumstances. The EMDs now have an official blessing, in some cases, for their use of capital account regulations. And the final view does not draw a clear line between controls for exchange rate management and cross-border financial regulations for ensuring financial stability. The industrialized countries were able to maintain an emphasis on the benefits of capital flows in general and capital account liberalization, in particular, and were able to temper calls for their concerted collaboration with EMDs on CFMs.

All three parties had their misgivings as well. IMF staff members were generally pleased with the outcome but were concerned that the political process led the final language in the institutional view to be murky in spots, which will make it hard for the IMF to give clear advice. BRICS were concerned that the final document did not emphasize fully the role of source countries in generating spillovers and the role that source countries should play in mitigating such spillovers. Industrialized countries also very reluctantly endorsed a last-minute push to delete implications that CFMs should be used only as a last resort.

In this chapter, I analyze *what* has changed at the IMF with respect to managing capital flows and *how* those changes came about from the perspective of political economy. At first glance, we might think that the institutional view would reveal the preferences of industrialized countries—assumed to be for unbridled capital account liberalization—given the structure of the voting power in the IMF and the way that the deliberations were structured within the IMF. IMF voting power reinforces the power of industrialized countries in the international monetary system. The IMF staff coordinated the process and set the agenda; and traditionally, IMF staff members had largely been seen as reinforcing the views of industrialized countries when it came to capital flows and other matters (Thacker 1999; Abdelal 2007; Copelovitch 2010; Chweiroth 2010a; Moschella 2011).

In fact, however, the final institutional view incorporates a much more middle ground. It looks the way it does because of new ideas among key IMF staff and

because the staff that was able to set the agenda for the view. The final document also reflects a partial acceptance of cross-border financial regulation by some industrialized countries. Significantly, BRICSs punched far above their voting weight throughout the deliberations as well. There are three reasons for this: (1) EMDs, especially BRICS, formed a coalition that often had a unified voice at the IMF Executive Board; (2) EMDs used extra-forum leverage by exploiting networks within the G20 to wedge emerging market views into the discourse at the IMF; and (3) given that some IMF staff members were pushing a view that overlapped significantly with the BRICS positions, the BRICS countries used intraforum leverage by wedging these IMF staff views into the discussion to combat the opposition by the industrialized countries to the BRICS positions.

In this chapter, I first pinpoint the changes that have occurred in the new institutional view of 2012 compared to a 2005 Independent Evaluation Office (IEO) report on the IMF view of capital account liberalization. I then analyze the political economy of how these changes occurred: the influence of the IMF as an institution and the ideas of the IMF staff, the positions of the industrialized countries at Executive Board meetings, and how BRICS engaged in coalitions that leveraged power from both within and outside the IMF to punch above their voting weight.

The International Monetary Fund and the Capital Account: What Has Changed?

Following the Asian financial crisis, the IMF took a more gradual approach to capital account liberalization and even supported the use of capital controls in some situations. After the global financial crisis, the IMF expanded and officially clarified that position with an institutional view on liberalization and regulation, and then went beyond merely supporting cross-border financial regulations to recommending them. To examine the extent to which the IMF has changed its view on the capital account since the global financial crisis carefully, I examine a 2005 IMF report on the official IMF view as a basis for comparison and then juxtapose those findings with an analysis of the 2012 IMF institutional view.

In 2005, the IMF IEO conducted an assessment to evaluate and synthesize the IMF approach to capital account liberalization from the Asian financial crisis to 2004. The IEO concluded that the IMF position had begun to evolve after the Asian financial crisis. In contrast to the 1990s, the IMF policy stance on capital account liberalization during this period still saw capital account liberalization as a key goal; however, the IMF also now recommended that the liberalization of the capital account be gradual and sequenced. In addition, the IMF recognized that

temporary capital controls could be a part of the transition to eventual capital account liberalization (IMF 2005).

After the global financial crisis struck in 2008, the IMF underwent a formal process that resulted in an official clarification of its stance on capital account regulation. In addition to the staff position note (discussed in earlier chapters) that found that nations that deployed controls were among the least hard hit during the crisis and recommended, therefore, that controls be part of the toolkit, the IMF reiterated its support for the use of capital account regulation in its "Global Financial Stability Report" and in its *World Economic Outlook* (IMF 2010a, 2010d; Grabel 2011). Those reports discussed the need for regulating financial inflows; during the global financial crisis, the IMF also recommended, or at least sanctioned, controls on outflows in Iceland, Latvia, and the Ukraine (Grabel 2011; IMF 2012a).

The impetus and dynamics that led to the new institutional view are discussed in more detail later in this chapter. In a nutshell, the IMF started a process to officially evaluate its view on the capital account in 2011, which culminated in an official document that represented the official IMF view on the capital account that would be applied to the IMF surveillance activities and country programs. The key elements of the final document, "The Liberalization and Management of Capital Flows: An Institutional View" (IMF 2012b) are outlined in box 6.1.

Box 6.1: Elements of the International Monetary Fund Institutional View of Managing Capital Flows

Capital Account Liberalization

- Liberalization should be a goal, but the appropriate level of liberalization depends on institutional thresholds and country-specific circumstances.
- Nations should be cautious and sequenced when liberalizing the capital account, first liberalize FDI, then longer-term portfolios, and then short-term flows.
- Under certain circumstances capital controls (now referred to as CFMs) need to be part of the process of liberalization.

Managing Capital Inflows

- Nations should respond to inflow surges with appropriate macroeconomic policies such as:
  - Allowing the exchange rate to appreciate
  - Accumulating reserves

- Tightening fiscal policy
- Managing interest rates

- Nations should use CFMs if:
  - The exchange rate is not undervalued
  - Reserves are at optimal levels or too costly to accumulate further
  - The economy is overheating and there is little scope for fiscal tightening
  - CFMs can buy time for the first three
  - Inflow surges raise systemic risk
- Nations should give precedence to CFMs that do not discriminate on the basis of residency.

Capital Flow Management Measures on Capital Outflows

- After a country has substantially liberalized its capital account, CFMs on capital outflows can be considered:
  - In crisis or near-crisis conditions
  - To provide breathing space while more fundamental policy adjustments are implemented
- Nations should give precedence to measures that do not discriminate on the basis of residency.
- CFMs should be temporary and should be lifted when the conditions for their removal have been met.

Multilateral Aspects of Managing Capital Flows

- Source countries (where capital flows originate) and nations deploying CFMs should be conscious of the multilateral aspects of their policies.
- Nations should strive for reciprocity when macroprudential policies are being deployed.
- The design of policies should "minimize the scope for regulatory arbitrage."
- The IMF recognizes that its advice on CFMs may be at odds with international trade and investment commitments of IMF members.

Sources: Based on IMF (2011a, 2011c, 2012a, 2012b, 2012c).

In the institutional view, the IMF reiterates its support of capital account liberalization as a long-run goal but slightly qualifies that support. The IMF now states that capital account liberalization is optimal only after a nation has reached a certain threshold of financial and economic development and that liberalization should be sequenced, gradual, and not the same for all countries at all times. Indeed, it offers a sequenced, stepwise process for the liberalization of capital flows for its members. The IMF also has new terminology for capital account regulations—CFMs. In the IMF view, CFMs can be part of liberalization and

sequencing. The guidelines on inflows recommend that countries deploy CFMs after such measures as building up reserves, letting currencies appreciate, and cutting budget deficits. The IMF also recommends that controls not be discriminatory among residents. The guidelines for the use of controls on capital outflows suggest that, by and large, they should not be used but can be considered in crisis or near-crisis conditions (IMF 2012b).

Table 6.1 compares the new institutional view with the 2005 IMF IEO assessment in terms of the kinds of measures related to capital flows. As we can see, in 2012 the IMF remained wedded to the eventual liberalization of the capital account of a country but now recognized that the case for free transfers of investments rests on much weaker ground than does the case for free trade. The IMF now recognized (as discussed in chapter 3) that nations need to cross a certain institutional threshold before liberalization. What is more, the IMF now acknowledged that there are risks as well as benefits to cross-border financial flows; capital flows are particularly prone to sharp inflow surges followed by sudden stops that can cause a great deal of financial instability.

What are new are the specific reference to surges and sudden stops and, more important, that the rationale is often framed in the language of the new welfare economics (see chapter 3). The new IMF view reframed capital controls as CFMs, which were recommended on inflows in the case of surges after the institution of other macroeconomic policies such as interest rate and fiscal policy management, the accumulation of foreign exchange (FX) reserves, and macroprudential financial regulations. The IMF also sanctioned the deployment of CFMs on outflows of capital in the event of a crisis. In addition, the IMF noted that new

TABLE 6.1 International Monetary Fund policies on regulating cross-border finance, 2005 and 2012

MEASURE	IEO, 2005	INSTITUTIONAL VIEW, 2012
Capital account liberalization	Fully support	Fully support
Capital controls on inflows	Partially support	Partially support
Rationale	Impossible trinity, transition	Impossible trinity, transition Financial stability
Nomenclature	Capital controls	Capital flow management measures
Capital controls on outflows	Partially support	Partially support
Source countries	Not mentioned	Partially support
Trade exceptions	Partially support	Fully support
Legitimacy	General behavior	Official board view

Sources: IMF (2005, 2012b).

Note: IEO, Independent Evaluation Office.

IMF advice could clash with the trade and investment treaty commitments of its members in and recommended establishing safeguards granting nations the right to regulate using CFMs without being in conflict with trade commitments. Finally, and in stark contrast with the IEO report, the IMF noted that industrialized countries may need to regulate the outflow of capital in concert with EMD regulation of inflows. The most significant change is that the 2005 IEO report witnesses and summarizes the general behavior of the IMF but the institutional view is an official Board-endorsed view that staff must incorporate into surveillance activities. Indeed, in 2013 the IMF issued a staff guidance note that provided guidelines regarding how IMF staff should discuss capital flows during surveillance activities (IMF, 2013b).

Surveillance activity at the IMF is most expressed through Article IV consultations. To write an Article IV report, IMF staff members visit a country, conduct an assessment of the economy, and make a series of recommendations. In July 2012, the Executive Board adopted a new decision that allowed staff members to discuss with its member states their capital account policies and provide recommendations. The new institutional view officially guides staff in that task. As a former senior counsel at the IMF states with respect to the new guidelines, "In surveillance consultations, any recommendations drawn from this framework would constitute policy advice, which is not obligation but still an essential part of the IMF's oversight role in the context of surveillance discussions and its ongoing relationship with members" (Siegel 2013, 73). Although surveillance is not mandatory, it has been shown to be highly influential in states where the IMF has a country program. Moreover, surveillance reports can influence other actors in global markets, such as credit-rating agencies, that have impact on countries. Finally, it is also possible that surveillance could lead to socialization and learning effects in countries (Lombardi and Woods 2008; Chwieroth 2010a).

To review, the new IMF institutional view is significantly different than its previous view in that it is now official policy, the economic rationale for regulating capital has expanded to maintaining financial stability, the nomenclature on capital controls has shifted to CFMs, and the IMF notes the needs to regulate capital on both ends. All this is significantly different from the view in the 2005 IEO report; also the new view goes into much greater detail about the nature of capital account liberalization and the specific conditions for the use of CFMs. Although incremental, the substantive changes break significant ground. In particular, the IMF view has significantly broadened with respect to the multilateral aspects of regulating financial flows—recognizing the role of source-country spillovers and the lack of consistency between the guidelines and trade and investment treaties.

The Power of the International Monetary Fund: Be Careful What You Wish For

After reading chapter 2, we might have expected that the structure of the IMF as an institution would predetermine that the IMF institutional view would be a blueprint for capital account liberalization. After all, the IMF voting structure is weighted toward the industrialized countries, and the industrialized countries initially did not support the idea of formulating an institutional view in fear that it might delegitimize capital account liberalization and legitimize capital controls. Moreover, the management and coordination of the process was put in the hands of IMF staff, which had become a leading proponent of capital account liberation at the turn of the century. But, surprisingly, that the IMF staff had significantly changed the way it thought about the capital account. This fact, and the crafty efforts of EMDs, caught industrialized countries a bit off guard and led to a more even set of rules on the capital account.

The origins of the institutional view come from both outside and within the IMF. In response to EMD pressure, the 2010 G20 Seoul Summit documents "called on the FSB, IMF and BIS to do further work on macro-prudential policy frameworks, including tools to mitigate the impact of excessive capital flows" (Montpetit et al. 2012). Later in 2010, French President Nicolas Sarkozy assumed the role of host and head of the G20 for 2010–2011, a period of excessive capital market volatility (see chapter 4). Sarkozy saw the myriad uses of capital controls and called for a global code of conduct, setting the IMF the task of proposing a set of guidelines for reform:

> A code of good conduct, strong guidelines and a common framework governing the possibility of implementing capital controls where necessary must define the conditions under which restrictions on capital movements are legitimate, effective and appropriate to a given situation. If we agree on these rules, ladies and gentlemen, it will be a major evolution in the doctrine of the IMF, to the benefit of the emerging countries, which suffer from excessive volatility of capital movements. Is it reasonable, today, given the increasing impact of capital movements, that the IMF can issue recommendations to a country only as concerns its current account balance of payments and not concerning its capital account? I would like someone to explain to me why a recommendation about one is legitimate and a recommendation concerning the other is illegitimate. Expanding the supervision of the IMF to include theses aspects strikes me as crucial. In the longer term, France—and I'm saying this now—is favorable to a modification of the IMF's Articles of Agreement to broaden its supervision mandate. Yet if we decide on

> more coordination, more rules and more supervision, we then need to decide which organization is in charge of enforcing such rules and conducting such supervision. For France, it's clear. It's the IMF. (quoted in Batista 2012a, 99)

Evocative of the 1972 call by the United States and C20 for an IMF code of conduct (discussed in chapter 2) that might bind nations to appropriate (versus inappropriate) uses of capital controls, in the wake of the global financial crisis, the IMF embarked on creating a new code of conduct for the use of capital controls.

People working at the IMF had already been thinking along the same lines. In the wake of the crisis, Dominique Strauss-Kahn, IMF director, assembled key staff members and inspired them to rethink many of the core ideas of the IMF. Strauss-Kahn wanted the IMF to become a major player in post-crisis activities, but to do so it needed fresh thinking and new ideas. What is more, as in the case of the G20, EMDs had been asking the IMF whether their use of capital account regulations in response to the crisis was considered okay. Strauss-Kahn encouraged Olivier Blanchard, IMF research director, to foster new thinking in research. This new atmosphere permeated the IMF, prompting Jonathan Ostry and other economists to take steps they wouldn't have thought of in previous years. Ostry and colleagues decided to conduct an analysis examining how well nations with capital controls on inflows had done during the crisis (resulting in Ostry et al. 2010). He found that nations that had controls had fared better during the crisis than those without. To provide cover for this controversial view, Strauss-Kahn elevated what was to be a seminar presentation of the paper to a full IMF symposium on the study. The paper sparked significant controversy within the IMF, especially within the Capital Markets Division. Nevertheless, it was approved as an example of this new thinking by the managing director and inspired further work on capital flows.

The atmosphere of new thinking also met with the practical, on-the-ground fact that many IMF members, largely EMDs, were asking whether it was permissible in the eyes of the IMF for them put capital account regulations in place in the wake of the crisis. More than one account notes that Stanley Fischer, governor of the Bank of Israel at the time (and formerly deputy managing director of the IMF during the turbulent 1990s), expressed concern in late 2009 that he didn't know how else to handle the massive surge in inflows that was starting. Moreover, an internal and early post-crisis assessment discovered that IMF country teams were giving different and inconsistent advice to member countries on this matter. Thus the IMF Strategy, Policy and Review Department started to think that the IMF needed to speak in a uniform voice through its Article IV surveillance activities on this matter. This was communicated across the IMF, and the managing

director went to the International Monetary and Financial Committee (IMFC), which in 2011 had assigned the IMF the task of developing an official institutional view on capital account liberalization and the management of capital flows that would unify IMF surveillance on the issue.

Thus, the impetus for the rethinking of IMF policy came from both the outside (the G20) and the inside (member requests and staff analysis). Both were prompted by EMD inquiries. To some extent, however, the very fact that the G20 and the IMFC delegated the discussion and the official reevaluation of the management of capital flows to the IMF ensured that EMDs would not get carried away. The French had long looked to the IMF to set boundaries on capital account liberalization and capital controls (Abdelal 2007). Sarkozy had been looking to regulate cross-border finance starting in 2004 when he was the French minister of economy. Later, in 2008, Sarkozy called for a Bretton Woods II that would revamp the entire international monetary system in the wake of the crisis (Helleiner and Pagliari 2009). Indeed, some sources I interviewed speculated that Sarkozy saw the rapid proliferation of capital account regulations in 2009–2010 as needing to be contained within specified boundaries. Given that the industrialized nations control the voting power at the IMF, Sarkozy powerfully circumscribed the range of debate in this decision by placing the effort in the IMF.

Under this dual direction, the IMF staff conducted research and wrote staff-level background papers that were then compiled into and approved as official papers for Executive Board discussion at numerous board meetings from 2011 to 2012. The Board discussed and debated each of these papers, often sending them back for revision based on those debates, and then eventually endorsed them officially. The Executive Board formally endorsed a set of guidelines on inflows in April 2011; guidelines on capital account regulations and controls on outflows were drawn up in March 2012 and discussed at the Executive Board in April 2012. The official IMF papers to this end were synthesized into a final document representing the full institutional view of the IMF in October 2012 and the full package was endorsed by the Executive Board in December 2012.

The IMF staff steered the process. An interdivision group drafted the background research papers and the board papers. The three divisions involved were the Monetary and Capital Markets Department, the Strategy, Policy and Review Department, and the Research Department, all with input from the Legal Department. The Monetary and Capital Markets Department was the most wedded to capital account liberalization, and the Research Department was most wedded to establishing a new role for capital account regulations. Strategy, Policy, and Review played a coordinating role and balanced these disparate views into the papers presented to the Board for discussion and debate.

This structure dictated that the industrialized nations and EMDs alike had to react to staff ideas rather than setting their own agendas, which would be subject to internal reaction. Table 6.2 presents the results of a textual analysis of the background research papers, papers submitted to the Board, EMD critiques or alternative proposals to the Board papers, and the final institutional view. This analysis shows that the Research Department was quite supportive of the sequenced liberalization of the capital account and the use of CFMs. The initial research papers characterized CFMs on inflows as a tool to manage the process of macroeconomic adjustment, although only after other adjustments had been made. Perhaps most significantly, the Research Department also endorsed CFMs when there was a buildup of financial fragility, saying that there was "no unambiguous welfare ranking of policy instruments" (Ostry et al. 2011, 4).

The Board paper on inflows, however, downplayed the use of CFMs in the case of financial fragility and emphasized that CFMs on inflows should be used only after the exchange rate had appreciated, the interest rate had been adjusted, and interventions in the FX market had been made by a central bank. This was interpreted by most executive directors as endorsing the use of CFMs only as a last resort and became perhaps the most contentious issue in the deliberations. Indeed, there was an outcry on this issue from BRICS capitals and from nongovernmental organizations (NGOs) across the globe as well (see chapter 7).

The Research Department had been convinced of many of the new arguments and rationales for regulating cross-border finance. Thus, to the surprise of other

TABLE 6.2 Political economy of the International Monetary Fund institutional view on regulating capital flows

MEASURE	STAFF PAPERS	EMDS	BOARD DRAFTS	FINAL IMF VIEW
Capital account liberalization	N/A.	Not supportive	Fully supportive	Partially supportive
Regulating inflows				
Sequencing	Part of toolkit	Part of toolkit	Last resort	Part of toolkit
Temporary/ permanent	Temporary	Permanent	Temporary	Temporary
Residency-based	Supportive	Supportive	Not supportive	Partially supportive
Regulating outflows	N/A	Crisis management Deterring inflows Resource mobilization	Crises only	Crises only
Source countries	Supportive	Supportive	Not supportive	Partially supportive
Trade-treaty exceptions	Fully supportive	Fully supportive	Partially supportive	Fully Supportive

Notes: EMDs, emerging-market and developing countries; IMF, International Monetary Fund; N/A, not applicable.

staff departments and the executive directors from the industrialized countries, the research papers, especially, and many of the Board papers were making strong cases for CFMs on inflows and outflows, even suggesting that source countries regulate capital flows as well!

The IMF was charged with redefining its cognitive map, which had long held capital account liberalization as a core principal (Moschella 2012a). A number of personnel factors explain how there was such a change in position among staff members from the one held in the late 1990s and early 2000s. Many of the economists in the Research and other departments who had done empirical research on the impacts of capital account liberalization had risen to more senior positions by the time of the global financial crisis. In addition, Research was headed by Olivier Blanchard, an MIT economist known to be pragmatic but who was also at the center of and sensitive to new developments in theory. Blanchard was very close to Strauss-Kahn and was the first to embrace the charge by Strauss-Kahn to infuse new thinking into IMF operations. What is more, the IMF was seeking to show more of a human face, in general, because its reputation had been severely tarnished in past crises—and particularly with respect to the issue at hand (Grabel 2011).

All three departments involved in the Board papers, although with varying degrees of conviction, had accepted the empirical literature on capital account liberalization, growth, and crises. Indeed, many economists in the IMF Research Department had contributed to that literature. Moreover, a significant turnover had occurred at the IMF since the 1990s, and many big-bang liberalizers had left, especially those who had been in leadership positions. Many staff members used the mandate from Strauss-Kahn and the G20, new economic ideas, and the flexibility of the IMF Articles to reinterpret, or incrementalize, its thinking on capital controls (Moschella 2012a). Current and former staff members conducted some of the more rigorous econometric analyses showing that capital controls had helped stabilize EMDs in the run-up to the global financial crisis and had helped mitigate the worst of its aftermath (Magud Reinhart, and Rogoff 2011; Ostry et al. 2010; Chwieroth 2012). So, as a practical matter, many staff members saw CFMs as a part of the toolkit, although certainly not part of a first response. Monetary and Capital Markets Department staff members and some in Strategy Policy Review continued to see capital account regulations as fundamentally distortionary but necessary in extreme situations.

What is most remarkable is that the Research Department began to articulate the view that capital account regulations are Pigouvian ways to correct for market failure. In other words, Research staff began to articulate that capital account regulations were not distortionary but could instead make markets work better. This view was not held by Monetary and Capital Markets nor by many in Strategy

Policy Review. This explains, in part, why Research staff had strong convictions about regulating cross-border finance.

Key staff in Research were influenced by and collaborated with economists who had developed a new welfare economics of capital controls. As discussed chapter 3, Anton Korinek, Olivier Jeanne, and others developed a new way of thinking about capital flows and capital controls (Jeanne, Subramanian, and Williamson 2012; Korinek 2011). According to this research, externalities are generated by capital flows because individual investors and borrowers do not know (or ignore) the future effects of their financial decisions on the financial stability of a particular nation. A better analogy than protectionism is the case of an individual firm that does not restrict its contribution to urban air pollution. In the case of pollution, the polluting firm can accentuate the environmental harm done by its activity; in the case of capital flows, a foreign investor might tip a nation into financial difficulties and even a financial crisis. This is a classic market-failure argument and calls for a Pigouvian tax that will correct for the market failure and make markets work more efficiently.

Ostry in many ways was a norm entrepreneur inspired by Strauss-Kahn's charge to incorporate new thinking. And, if understood well, the economics was a very powerful set of ideas that fit right in with the existing theoretical apparatus adopted by IMF economists such as Ostry and his group. Indeed, the theory of Korinek and others is a major breakthrough and innovation in economics as a whole. Because this major breakthrough was so adaptable—in that it was in a welfare economics framework and articulated in clear neoclassical terms—it was quickly adopted by the profession and diffused throughout the IMF. Let us contrast this with the breakthrough on this issue from the more Minskian tradition (see chapter 4) that had happened a few years beforehand and that had a similar theoretical rationale and similar policy recommendations. Theories from this tradition, which do not have elaborate modeling and didn't fit in a general equilibrium framework, did not get any traction at the IMF at all. The new welfare economics added a new rationale for capital account regulation—financial stability. The earlier rationale at the IMF rested on the use of cross-border financial regulation as a bridge to capital account liberalization or to work within the parameters of the impossible trinity. This view still sees cross-border financial regulations as distortionary, although necessary in the short term. But from the perspective of the new welfare economics of capital controls, such measures fix markets, not distort them. Ostry's papers began citing Korinek and Jeanne's work as early as 2010, when Korinek's work was still in the form of working papers. Korinek was then invited to serve as a visitor at the IMF, and Ostry, Korinek, and others wrote a key paper that articulated that, under certain conditions, it would also be prudent for source countries to regulate the outflow of capital during

inflow surges to EMDs. Again, this was a neoclassical and formal articulation of the notion that capital needed to be regulated at both ends, as Keynes and White had noted long before. This idea made it through into the Board papers and was strongly supported by EMDs. Many industrialized countries, in contrast, were very taken back and significantly watered down the final language on this matter.

Indeed, there is some evidence that, even before the direction to formulate an institutional view, the IMF had begun using the term *CFM* and advising countries to use CFMs because research and Board papers on these topics began to appear. As shown in table 6.3, the IMF began recommending or endorsing CFMs after the Lehman crash in 2008. The 2005 IEO report analyzes IMF advice on capital account regulations from 1990 to 2004 and serves as a guide and the baseline for the analysis in this table. The IEO labels the IMF "not supportive" if the IMF either recommended that the nation not put capital account regulations in place or recommended that a nation dismantle its current regulations. It labels the IMF "partially supportive" when it either partially supported regulations implemented by a nation or recommended that a nation put in place regulations but with some hesitation. The label "fully supportive' is applied when the IMF either praised a nation for implementing cross-border financial regulations or suggested that a nation deploy such regulation without any hesitation.

Table 6.3 presents an illustration of findings from another econometric analysis performed for this book that examines IMF advice on capital flows before and after the global financial crisis for eight countries. These eight countries were among the largest precrisis and post-crisis recipients of capital flows. Although there was a significant sudden stop in 2008 and 2009, the IMF either did not recommend regulations or urged nations not to put in place regulations on capital flows. The starkest changes occur after the crisis. Although in 2008 and 2009, the IMF was still not very supportive of attempts to regulate capital flows, beginning in 2010 there was a significant change. During the post-Lehman surge in capital inflows, the IMF either actively endorsed the use of capital account regulation or, in some cases, actively recommended that nations deploy regulations. Indeed, numerous times the IMF recommended that Colombia and Mexico put capital account regulations in place, although these nations refrained from doing so. Interestingly, when South Korea and Brazil started to implement the third-generation capital controls, the IMF was initially not supportive or only partially supportive. Later, for both these countries the IMF eventually became fully supportive of regulation.

Table 6.3 is illustrative of the broader findings of another econometric analysis. With Yuan Tian and other graduate students at Boston University, I coded Article IV reports from 1999 to 2013 for all significant emerging markets. We found that the IMF was significantly more apt to diagnose capital flows as a concern

TABLE 6.3 International Monetary Fund advice on regulating capital flows before and after Lehman crash

YEAR	BRAZIL	CHILE	COLOMBIA	INDONESIA	MEXICO	PERU	SOUTH AFRICA	SOUTH KOREA
2004			Not supportive					
2005								
2006								Not supportive
2007			Not supportive					Not supportive
				Lehman crash				
2008			Not supportive					Not supportive
2009	Not supportive			Partially		Partially		Not supportive
2010	Supportive		Partially*	Partially		Partially	Supportive	Not supportive
2011	Supportive		Partially*	Partially	Supportive*	Partially	Partially*	Partially
2012	Supportive				Supportive*		Partially*	Partially

Note: * indicates situations in which the IMF recommended the use of capital account regulations but they were not deployed by the host country. In all other cases, the IMF gave some level of support for the measures initiated by the host country.

in the post-crisis period and that the IMF was more likely to support the use of CFMs after the crisis as well (Gallagher and Tian 2014).

In summary, the IMF, surprisingly, became the source and supporter of new thinking about regulation of capital flows; capital account regulations were now characterized as necessary and important parts of the financial stability toolkit. This was largely due to a spirit of fresh thinking within the IMF and a few key researchers who matched that spirit with pioneer thinking in the economics profession. An inter-IMF process incorporated many of these ideas into final Board papers. The starting point of Executive Board discussion was, thus, much more enthusiastic about regulating capital than we would expect from the thinking of the IMF staff in general and, especially, from an organization in which power was held by nations that were not supportive of capital controls.

Industrialized Countries: From En Garde to Off Guard

Industrialized countries were not very supportive of either the entire project or of specific proposals by the IMF staff. The task given to the IMF staff to articulate a new institutional view for debate by the Executive Board set the goals for the discussion of the issue of the capital account at the IMF. Industrialized countries—chiefly the United States, the European Union, and, to a lesser extent, Japan—thus were put in a position of reacting to the agenda rather than setting or controlling it.

As we saw in chapter 2, the US executive director to the IMF, the US Treasury Department, and the private financial sector were not the originators of the process in the 1990s to change the IMF Articles of Agreement. The US Congress and NGOs, however, were opposed to changing the Articles (Abdelal 2007). Thus, the United States was far from a monolith on this subject. In the process for formulating the institutional view, the roles were different. The US executive director's office was originally opposed to a process of formulating an institutional view, and the private sector was much more engaged this time. The US Congress was not involved in the process at all, and most NGOs were not attuned to the deliberations either.

Indeed, the United States was not very supportive of the proposal to engage in the process of an institutional view from the very beginning. The crisis in Europe and global efforts toward a recovery were at the top of the US agenda. Discussions about a policy change on capital account liberalization were considered a distraction. Moreover, given the mood at the time, the United States was concerned that the process would get out of hand and achieve a momentum that could lead to a

full endorsement of capital controls the world over. That said, the United States did not attempt to shut down the deliberations for two reasons. First, the United States had long called for a cleaner differentiation between capital controls used to manage exchange rates and cross-border financial regulations used to enable financial stability (see chapter 2). The US Treasury and many in the Congress were very concerned about the Chinese exchange rate policies. Even so, many of the economists in the US Treasury at the time were aware of and quietly endorsed the new economics of capital controls and the econometric evidence supporting the use of regulations. Second, the United States also recognized that the IMF had been giving inconsistent advice on these matters through its Article IV reports.

The European Union was not happy with the process either. The European Union had outlawed the use of capital controls in its founding treaties and did not want situations to arise where the IMF would recommend that nations violate those core commitments. The United States and the European Union, then, stood as a bloc during the deliberations on the new institutional view. Their priorities were to stress the benefits of capital flows and capital account liberalization, and to be sure that capital controls were not endorsed for exchange rate manipulation. Both parties were much more engaged, however, in internal crisis management, especially the European Union; the United States was also more concerned with the Dodd-Frank regulations (the US financial regulatory reform bill after the crisis) and with securing market access for financial firms in pending trade negotiations.

Although the private sector had largely ignored the IMF in favor of strong international standards in the trade and investment regime (see chapter 7), some key actors did engage in the process of articulating the new institutional view. For example, the Institute of International Finance (IIF) represents the interests of the world's largest commercial banks and investment funds. In the 1990s, the IIF had not been involved in the move to change the IMF Articles (Abdelal 2007; Chwieroth 2010a); this time, however, the IIF did engage in the process of creating a new IMF institutional view.

The IIF launched a series of meetings on Principles for Stable Capital Flows and Fair Debt Restructuring in 2004. The IIF position was that capital account liberalization is an efficient way for nations to attract savings that can be deployed for economic growth. In addition, countries should implement appropriate economic policies to avoid macro-imbalances, such as large and persistent budget or current account deficits and high inflation. These policy measures would help to sustain stable capital inflows. The IIF was active in promoting this policymakers and the general public. Given its proximity to IMF headquarters, the IIF engaged in discussions with the IMF on a variety of issues of mutual interest, including fostering stable capital flows as related to the deliberations for the

new institutional view. In an interview, Hung Tran, executive managing director at the IIF in 2013, said that "at this point we agree with the IMF's eclectic approach. The IIF sees capital account liberalization as a smart policy, but one that may need to be properly sequenced. We agree with the IMF that measures can be taken to regulate capital inflows after sound macroeconomic policies, macroprudential measures, and a hierarchy of other steps have been exhausted as long as they are a last resort and temporary. Importantly, these capital flow measures should not be viewed as substitute for appropriate macroeconomic policies or necessary reforms."

Abdelal (2007) notes that in the 1990s members of the US Congress, such as Representatives Maxine Waters (D-California) and Barney Frank (D- Massachusetts), under pressure from NGOs, had became involved in the effort to change the Articles of Agreement. This time, both actors had moved on to other issues and were not aware of the deliberations at the IMF. Waters and, especially, Frank were immersed in the Dodd-Frank bill, and when I spoke to them about the IMF institutional view, it was the first that either office had heard of it. Representative Frank had shifted as early as 2003 to critiquing US trade policy for putting strong international standards on to capital account management through trade and investment deals (see chapter 8). Indeed, when Frank's office learned of the IMF deliberations, it used the IMF institutional review to try to wedge space for capital controls into US trade and investment treaties. Perhaps this lack of attention to these issues at the IMF was due to these distractions and to the fact that this time very few NGOs campaigned on the IMF new institutional view process. Only the Bretton Woods Project, a UK-based NGO, launched an official campaign on the institutional view. Other groups based in the United States had shifted their focus to Dodd-Frank and to the G20.

Countervailing Monetary Power: Brazil, Russia, India, China, and South Africa Punch above Their Weight

In many ways, EMDs put the reregulation of cross-border capital back on the international agenda. EMDs had put in place many regulations at home and had pushed the G20 to take on these issues as well. Moreover, EMDs had been quietly seeking assurances from the IMF that their reregulation efforts would be blessed, or at least ignored, by the IMF. Nevertheless, the IMF voting structure and a general level of mistrust of IMF staff led some EMD executive directors—led by a coalition of the BRICS—to be wary of the entire process. EMDs enjoyed the policy space in the Articles to engage with the capital account on their own terms

and did not want to lose that policy space during this process. EMDs largely had three key positions: (1) to ensure that capital account liberalization was not enshrined in the document, (2) to preserve their ability to regulate capital flows under the Articles, and (3) to put more of the burden of regulation on industrialized countries so that there could be cooperation on capital flows at both ends.

The final institutional view noted that capital account liberalization should be country-specific and should be sequenced. It also noted that CFMs were appropriate for financial stability and to buy time for macroeconomic adjustment—thus taking away most of the insinuations of controls being used as a last resort in earlier board drafts. The language on the role of source countries, however, was limited to stating that source countries should take into account the negative impacts of their policies on EMDs, not that they should actually cooperate on regulation at both ends. I outline next the EMD critique of early board drafts and discuss how EMDs were able to punch above their voting weight to make significant changes in the final version of the IMF institutional view.

Critique of Capital Account Liberalization and the Use of Capital Flow Management Measures as a Last Resort

The biggest concerns to EMDs during the deliberations were that the IMF still retained the implications that capital account liberalization was a goal, that CFMs should be used as a last resort, and that source countries were not held responsible for the negative spillovers they caused in terms of capital flows.

EMDs were particularly concerned that the IMF continued to advocate the eventual liberalization of the capital account despite the fact that the current literature overwhelmingly found no strong correlation among capital account liberalization, growth, and financial stability—especially in EMDs. Olivier Jeanne and Arvind Subramanian, former IMF economists, conducted a meta-regression on the literature and conclude that "the international community should not seek to promote totally free trade in assets—even over the long run—because (as we show in this book) free capital mobility seems to have little benefit in terms of long-run growth and because there is a good case to be made for prudential and non-distortive capital controls" (Jeanne, Subramanian, and Williamson 2012, 5).

The IMF view of managing inflows of capital was also seen as limited. It stresses that priority should be given to letting the exchange rate appreciate, accumulating reserves, and tightening fiscal policy to reduce the amount of capital flowing into an emerging market; CFMs should be used as a complement to or after such efforts. Recall that there is no substantive economic basis for this claim. The new research in economic theory (see chapter 4) shows that implementing capital controls can be the optimal policy for internalizing the externalities associated

with risky capital flows (Korinek 2011). In addition, econometric analyses by the IMF, National Institute of Economic Research (NBER), and others have all shown that capital account regulations have been effective in meeting many of their stated goals. Indeed, research by the IMF itself shows that nations that deployed controls were among the least hard hit by the global financial crisis; these studies do not differentiate the sequence of use for the different measures, nor do they distinguish whether such measures were market-based and temporary (see Magud, Reinhart, and Rogoff 2011; Ostry et al. 2010).

Some EMDs and economists see regulating capital flows as an alternative to reserve accumulation—rather than seeing CFMs on inflows as an option after reserves have been accumulated, as the IMF Board papers suggest. Accumulating reserves can be costly to EMDs in terms of the opportunity cost of investment and sterilization, and some central banks may not always have the capacity to sterilize flows without adverse effects (Gallagher and Shrestha 2012; Rodrik 2008; Aizenman 2010). Daniela Gabor (2012) also argues that reserve accumulation creates a demand for such activity and thus could actually increase inflows. Moreover, the accumulation of reserves by EMDs also resulted in global costs in the form of global imbalances that played a role in the global financial crisis (Eichengreen 2007).

Tightening fiscal policy also may not be ethical, optimal, or possible in the short term, and capital account regulations can buy time to make such an adjustment. First, it has been argued that it is undemocratic for fiscal policy to be managed for the benefit of global investors over local needs (Batista, 2010a). Second, and more pragmatically, adjustments to fiscal policy are often long drawn-out processes that require legislation. The fiscal balance cannot be changed overnight, but a central bank or finance ministry can put in capital account regulations overnight to either buy time for (or put up with) a slow-moving fiscal cycle.

Finally, it is not always clear that a nation should wait for the exchange rate to float to a certain level before using capital account regulation. As Gabor (2012) points out, exchange rate over- or undervaluation is fairly difficult to adequately measure, especially ex ante. In addition, if nations continually intervene in FX markets, investors will price that in and the interventions will not have the desired effect. Also, it should be recognized that some nations see a need for a competitive exchange rate as part of an export-led development strategy (Rapetti, Razmi, and Skott 2012; Rodrik 2008). EMDs wanted to preserve the right to use capital account regulation for financial stability and to manage the exchange rate to mobilize resources—coming at the issue from both the new welfare and the Minskian developmentalist angles.

The stressing by the IMF that such measures be temporary and not discriminatory was also a source of major contention. For regulations to be part of a

countercyclical macroeconomic policy, EMDs argued, nations have to have permanent authority to use measures as inflows and outflows occur. And by their very nature, most capital account regulations are discriminatory between residents and nonresidents. The IMF recommendations, thus, contradict the IMF staff's own findings about the kinds of measures that work. In econometric analyses that show a significant impact of capital controls on limiting exchange rate volatility, changing the composition of inflows, and allowing monetary policy to be more autonomous, there is no such hierarchy of when a nation used controls, what form they took, and how long they lasted.

On the management of outflows, EMDS pointed out that the IMF ignored its own research showing that measures on capital outflows could be useful in preventing excessive inflows of capital. In addition, many countries in transition to more openness or in the process of development may need to deploy measures to curtail outflows to steer credit toward productive development (Epstein 2012; Lewis 1954; Ocampo 2012). Instead, the IMF sanctioned measures on outflows only in the middle of a financial crisis. But a focus on outflows is particularly important for the poorest countries. The least developed countries often do not experience massive inflow surges, but they do experience massive outflows (UNCTAD 2012a).

The IMF concern about the spillover effects of the prudential use of capital controls is also unfounded. Korinek (2013) has shown that regulating capital flows in an efficient manner may cause increases or decreases of capital in neighboring countries that may not necessarily be negative spillovers, in the economic sense. By design, an optimal tax on inflows lowers demand for inflows, and thus, interest rates may drop and cause more inflows in neighboring countries. This is the invisible hand at work. The inflows to neighboring countries may not be negative—whether they are really depends on the stock and composition of the investments of any neighboring country, the depth of its capital markets, its current account balance, and its level of regulation. And, even if a nation chooses not to put regulations in place, the cost of a negative spillover may be far outweighed by the benefit of not being the recipient of contagion in the form of crisis.

The EMDs said the IMF was right to point out that source country policies "have likely affected the volume and volatility of capital flows to both advanced and emerging market economies"(IMF 2012c, 22). Nevertheless, too much of the burden was being placed on EMDs and not on the source countries. The BRICS argued that the IMF new institutional view lacked the same levels of specificity about and scrutiny of source-country policies as there was for EMDs. Whereas the new view scrutinized the exact types of capital account regulations in EMDs, it did not examine to an equal extent which types of monetary and regulatory policy trigger the most risky capital flows from developed to developing countries.

The IMF suggested that its new institutional view could help guide future trade treaties and that the IMF could serve as a forum for such discussions. Indeed, it is important that the IMF recognized that many nations lack the policy space to implement new policy advice from the IMF; however, given that the IMF view is overly narrow, EMDs saw it as imperative that future safeguards for trade and investment treaties not simply defer to the IMF on capital account regulations. Although the IMF has legal authority on current transactions, this new view did not grant the IMF authority over the capital account.

Crafting Coalitions

Many significant EMDs saw unprecedented growth in the period between the Asian financial crisis and the global financial crisis. This newfound economic power balanced the global discussion on regulating cross-border finance. BRICS and other nations are now part of the G20, have (a little) more voting power at the IMF and World Bank, and generally have asserted more sway given their market power and dynamism (Chweiroth 2012). In contrast to the late 1990s, when the BRICS were 9 percent of global GDP and all but China had an IMF country program, by 2012 the BRICS were 34 percent of world GDP and none had an IMF program.

Many of these nations deploy capital account regulations and see them as part of preserving autonomy for domestic objectives. Some of these countries, to varying degrees could be classified as neodevelopmental states or, at least, a hybrid version of developmental states and neoliberal approaches that to some degree are trying to reembed markets (Ban 2013a; Gallagher 2012). As pointed out in chapter 5, these nations (especially Brazil) house many important interest groups that saw the threat of export decline due to exchange rate appreciation and supported national efforts on capital controls after the global financial crisis.

The key EMD executive directors who had formed a coalition at the IMF and addressed the institutional view were from Brazil, Russia, India, China, and South Africa, with the Brazilian director as leader and spokesperson at the Executive Board meetings. This BRICS coalition had already formed in efforts to reform IMF voting quotas and was ready-made to collaborate on the capital account issues. Brazil already had an open capital account but had a long and uneasy relationship with the IMF and, exactly at that time, was experimenting with the many capital account regulations (see chapter 5). Brazil wanted to make sure that it would be able to maintain the policy space to deploy such regulations. India, China, South Africa, and Russia, in contrast, were in various stages of gradual capital account liberalization and were using capital controls as part of their regulatory strategy. These nations did not want the IMF to send signals to

markets that their approaches were somehow wrong. The coalition had worked together in 2008 to improve the IMF quota system (Woods 2010). Although this group still lacked significant voting power, its collective voting power was highly symbolic—at 16.75 percent of the vote at the IMF Executive Board, the coalition had just as much voting power as the United States.

Collectively, this group of EMDs was highly concerned with the effort to create guidelines for capital account liberalization and capital controls. Sarkozy's original speech mentioned the effort as ending in an amendment to the IMF Articles of Agreement, and that sent shivers throughout the developing world. Even without an amendment, the guidelines were seen as narrowing the flexibility under the Articles given that the institutional view would be firmly incorporated into surveillance and Article IV operations at the IMF. Some openly criticized the vote of endorsement on the inflows framework, arguing that it was a vote of the weighted majority in that the industrialized countries that were the source of the capital outflows had voted to restrict the ability of EMD recipients of the subsequent inflows to act on them. No EMDs voted for the measure (Batista 2012a).

Indeed, led by Brazil, EMDs expressed real concern about the entire project at an April 2012 meeting of the Executive Board.

> We have warned that the Board was embarking on a slippery slope that "possible frameworks," "guidelines" and "tentative proposals" would eventually creep into Fund surveillance and gradually become binding constraints for membership. We reaffirm our opposition to any attempt to establish "rules of the road" that, directly or indirectly, at this time or in the future, constrain country authorities' discretion to adopt policies that they consider appropriate to their national economic and financial circumstances, as guaranteed by Article VI of the Articles of Agreement. This Article establishes that "members may exercise such controls as are necessary to regulate international capital movements." (Batista 2012b, 2)

China, India, South Africa, and the G24 all made similar statements about the new IMF institutional view (Seria 2011). BRICS and other EMDs informally attempted to act as a bloc during the development of the institutional view. The BRICS executive directors and others met regularly to coordinate their positions and tactics throughout the process, often with the executive director of the G24. One of their strategies was to slow down the process. EMDs came to the Executive Board meetings with detailed critiques of the draft Board papers and collectively insist that no vote be taken on the Board papers until their changes were incorporated. The group also attempted to stall the process by insisting that other

pressing matters (e.g., the European crisis) be discussed at Board meetings rather than the latest version of the institutional view.

Extra-Forum Leverage: G20 "Coherent Conclusions" and Communiqués

Some of the views of the EMDs were expressed in writing and orally at the Executive Board meetings. In addition, BRICS craftily traded across regimes by leveraging their position within the IMF with actions taken in other international regimes where the countries had more equal power at the table—particularly at the G20 and the G24. Indeed, by comparing G7, G20, and G24 communiqués and politics, we can see the revealed preferences of industrialized nations (in the G7), of the EMDs (G24), and of a subgroup of EMDs and industrialized countries (G20).

The 2011 G20 meeting was held in Cannes, France, during an acute period of the eurozone crisis that captured the attention of most negotiators. In addition, a working group was formed to take the capital flows issue to the highest level. Headed by Germany and Brazil, the group forged the "G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences" (G20 Information Centre 2011b). The document was endorsed by the G20 finance ministers and central bank governors in October and then endorsed by the G20 leaders themselves in Cannes. The effort was spearheaded by Brazil (and many of the same people in the G20 working group were also part of the Brazilian IMF effort, as was the case with other BRICS as well) and accepted by Germany. At the Cannes meetings, Germany was seeking EMD support to build a firewall around the eurozone to prevent further crises there through contributions by EMDs to the European Central Bank or some other mechanism. This environment gave EMDs significant negotiating power.

The IMF Executive Board had just examined and voted on a set of guidelines on regulating capital inflows that many of the BRICS countries disliked. The G20 conclusions were an attempt to get a high-level endorsement of an alternative view so that this view could be wedged back into the IMF process. In contrast to the IMF guidelines, the G20 conclusions say, "there is no 'one-size fits all' approach or rigid definition of conditions for the use of capital flow management measures" and that such measures should not be solely seen as a last resort (G20 Information Centre 2011b), as the Executive Board papers had stressed. Instead, the G20 conclusions call on nations to develop their own country-specific approach to managing capital flows. This document was repeatedly used as a reference point to contrast with Board papers in Executive Board sessions thereafter.

BRICS also worked hard to insist that official G20 communiqués included language on the need to regulate capital flows—thus exhibiting a global consensus that could be leveraged in discussions at the IMF. My interviews with key BRICS players confirmed this; in addition, EMD preferences are revealed by comparing G7 and G20 communiqués before and after the crisis. Often G7 communiqués occurred shortly before G20 meetings. The G7 communiqués tended to stress the need for flexible exchange rates and the free flow of capital; in contrast, the G20 communiqués between 2009 and 2012 stressed the volatile capital flows to EMDs and the need to regulate them.

Nearly every G7 communiqué from 2005 to 2012 has language that is identical to or a variant of the following:

> We reaffirmed that exchange rates should reflect economic fundamentals. Excess volatility and disorderly movements in exchange rates are undesirable for economic growth. We continue to monitor exchange markets closely and cooperate as appropriate. In this context, we emphasize that more flexibility in exchange rates is desirable for major countries or economic areas that lack such flexibility to promote smooth and widespread adjustments in the international financial system, based on market mechanisms. (G7/8 Finance Ministers Meetings 2005)

In contrast, G20 communiqués, especially after 2009, have language such as this:

> We underscore the importance of rigorous surveillance on exchange rate policies and support a more ample coverage of surveillance activities, where relevant, including global liquidity, capital flows, capital account measures, reserve and fiscal, monetary and financial sector policies that could have an impact on external stability (G20 Information Centre 2012).

As Brazilian Finance Minister Guida Mantega said at a 2011 G20 meeting, "We oppose any guidelines, frameworks or 'codes of conduct' that attempt to constrain, directly or indirectly, policy responses of countries facing surges in volatile capital inflows." Mantega added that capital controls were "self-defence" measures: "Ironically, some of the countries that are responsible for the deepest crisis since the Great Depression, and have yet to solve their own problems, are eager to prescribe codes of conduct to the rest of the world, including to countries that are overburdened by the spillover effects of the policies adopted by them"(in Reddy 2011). My interviews with G20 representatives confirm that the different language in the G20 communiqués compared to the G-7 communiqués was included on the insistence of nations such as South Korea, Brazil, India, and Argentina.

The G24 (formally the Intergovernmental Group of Twenty-Four on International Monetary Affairs and Development) was established in 1971 (G24 2011a). The group coordinates EMD positions on international monetary and

development issues, particularly at the IMF and G20. Indeed, the G24 often had a seat at the IMF Executive Board meetings on the institutional view. Moreover, the G24 served as a host and provided technical support for the many EMD coalitions examining the institutional view. It also acted as a conduit between EMDs and IMF staff during deliberations.

In addition to having a representative at the IMF annual and spring meetings, the G24 convenes the finance ministers from its membership and delivers its own communiqués to the press and the world. Here is where we find the starkest statements in favor of the need to regulate volatile capital flows and critical of the IMF process. A group of many key EMDs in the World Bank and IMF published a communiqué in the wake of the 2011 meetings echoing the views it had expressed in communiqués since the crisis:

> Ministers stressed that the IMF must adopt an open-minded and even-handed approach to the management of capital flows and take into account policies in capital-originating countries, especially systemically important financial centers, as well as specific circumstances of capital-receiving countries. Ministers did not agree with the proposed framework for staff advice to member countries on managing capital flows and its inclusion in Fund surveillance. Policymakers of countries facing large and volatile capital flows must have the flexibility and discretion to adopt policies that they consider appropriate and effective to mitigate risks through macroeconomic policies, prudential measures and capital controls, as stipulated in the Articles of Agreement. (G24 2011b, 55)

This was all part of a strategy to acquire cover at the IMF forum, where EMDs had less bargaining power.

Intraforum Leverage: Strategic Use of International Monetary Fund Staff Positions

Another channel that the EMDs used to exercise countervailing power and punch above their weight within the IMF was the use of IMF staff papers and opinion to wedge EMD positions into the discussions. As we have seen, on many of the issues that the EMDs contested, the IMF staff had views similar to those of the EMDs. EMD executive directors and staff repeatedly cited this consistency in their critiques of many of the Board papers and arguments made by industrialized nations. Given that the IMF staff has long been a trusted supporter of industrialized-country positions on capital flows (Chwieroth 2010a; Abdelal 2007), this was yet another way for EMDs to punch above their voting weight.

Note that, on the issue of capital account liberalization, there were no new public staff papers written and published in the midst of the reevaluation. The

initial draft of the paper that dealt with managing outflows and capital account liberalization did include an analysis of the literature on capital account liberalization, but that analysis was different from analyses in many previous staff papers. Whereas earlier analyses of the literature had argued that there was no clear relationship between capital account liberalization and growth, these new papers argued that such a relationship might exist. And indeed, in the middle of the reevaluation Olivier Jeanne and Arvind Subramanian, two former senior IMF staff (along with John Williamson), published a report at the Peterson Institute for International Economics (Jeanne, Subramanian, and Williamson 2012) that not only reviewed the literature and drew different conclusions from the initial draft but also performed a meta-regression analysis of all the former econometric studies and found no clear positive relationship between capital account liberalization and growth. EMDs, wary of discussion in the 1990s about codifying the need to liberalize all capital flows, were vehemently against the language in the drafts that hinted that such a route was the optimal one.

The most contentious issue outside the liberalization of capital flows was the extent to which nations should regulate capital inflows. In addition to the February 2010 staff position note (Ostry et al. 2010), the IMF staff published a detailed analysis of the conditions under which nations should deploy capital account regulations (Ostry et al. 2011) that stood in stark contrast to the initial and final Board drafts on the issue. This paper was used by EMDs and outside experts to highlight the extent to which industrialized-country interests were overriding IMF analyses.

Two issues stood out. First, the staff papers were not so strident about whether nations should regulate cross-border finance in a discriminatory manner on the basis of residency. Second, the staff papers did not say that regulations should be solely price-based regulations.

The issue that was the most contentious, however, was whether capital controls should be used only as a last resort or alongside other measures. Early papers (Ostry et al. 2011) and the Board drafts indicated that regulations on the inflow of capital should occur only as a last resort after the exchange rate had appreciated, FX had been accumulated, fiscal policy was tightened, and macroprudential measures had been put in place. Those drafts also said that, after such a sequence of events, regulations should not discriminate on the basis of residency and that they should be price-based. The staff background papers, however, were more nuanced, and EMDs called attention to wording such as "there is no unambiguous welfare ranking of policy instruments (though non-discriminatory prudential measures are always appropriate), and a pragmatic approach taking account of the economy's most pertinent risks and distortions needs to be adopted" (Ostry et al. 2011, 5). EMDs also singled out staff papers that noted that sometimes

capital account regulations may need to discriminate on the basis of residency and that price-based capital controls may not be as effective in the face of uncertainty; according to these papers, under such circumstances quantity-based controls may be appropriate: "when the authorities face information asymmetries and uncertainty about the private sector's response, it can be difficult to calibrate price-based measures appropriately" (Ostry et al. 2011, 27).

BRICS were quick to highlight these differences in Executive Board meetings, through the G24, and elsewhere, as were outside experts. When EMDs invited the independent task force to brief the full Executive Board, Olivier Blanchard and Rex Ghosh were asked to provide commentary. Both agreed publicly that capital account regulations should not be used only as a last resort. An internal IMF debate ensued, and the final institutional view has no mention of the term *last resort*. The final language notes that CFMs should not be a substitute for macroeconomic adjustment but endorses their use to buy time in the process of adjustment. This final battle represents a loss of sorts for the industrialized countries that wanted a clear delineation between capital controls for exchange rate management and cross-border financial regulation for financial stability.

Another key issue where the EMDs and staff saw eye to eye at one level was on the need to regulate capital flows at both ends (see chapter 2). IMF staff, along with Anton Korinek (see chapter 4), published a technical paper outlining that in some circumstances source countries should regulate capital flows to EMDs (Ostry, Ghosh, and Korinek 2012). This was repeated as a core component of EMD demands at the Executive Board. Interestingly, after the IMF staff published its very technical paper, Olivier Blanchard, the IMF research director, and Jonathan Ostry, the deputy director, published a popular version of the article that clearly echoed much of what the EMDs had been arguing for and was evocative of the 1944 arguments made by Keynes (see chapter 2):

> In thinking through the circumstances in which capital controls may be appropriate, a multilateral perspective is essential. Indeed this was a key tenet of the IMF's founding fathers, Keynes and White. Keynes considered that managing capital flows would be much more difficult by unilateral actions than if movements of capital could "be controlled at both ends" of the transaction. White concluded that capital controls would be ineffective unless there was cooperation across countries in their implementation.
>
> The perspective of Keynes and White is very much alive today. The G20 for example in its Coherent Conclusions on capital flow management last year urged that national policies to deal with capital flow volatility take account of potential cross-border spillovers. Many emerging

> market countries worry that policies in source countries are increasing the challenges of managing capital inflow cycles for them, underscoring the potential gains from cooperation. (Blanchard and Ostry 2013)

Finally, the last issue on which there was consensus between EMDs and IMF staff was the need for the trading system to make room for the use of CFMs. This is the subject of chapter 7. Here we need only note that, since the early 2000s, the United States had reformulated capital account liberalization as the liberalization of trade in financial services and inserted into its trade and investment treaties the requirement that signatories deregulate cross-border finance. The IMF staff, EMDs, and outside experts saw that this led to an inconsistency between the new thinking on capital account regulations and existing trade and investment commitments. As a key IMF staff document notes:

> There are about 2,500 BITs, as well as bilateral and regional trade agreements that provide legal protection for foreign investments. These agreements usually liberalize inward investments and provide for the free repatriation of that investment. They typically include "most-favored nation" clauses. Most BITs and FTAs either provide temporary safeguards on capital inflows and outflows to prevent or mitigate financial crises, or defer that matter to the host country's legislation. However, BITs and FTAs to which the United States is a party (with the exception of NAFTA) do not permit restrictions on either capital inflows or outflows. (Ostry et al. 2011, 20)

This was echoed by EMDs, but the final Board draft had relatively weak language on the matter. The final institutional view, however, states that these agreements in many cases do not provide appropriate safeguards or proper sequencing of liberalization, and could thus benefit from reform to include these protections (IMF 2012a, 8).

In the week proceeding the final vote in fall 2012, new and former BRICS executive directors convened numerous times to get to know each other and devise a collective plan to either continue to block or to collectively vote against the institutional view. One of the executive directors in the coalition claimed that it would be impossible to get approval from his national capital on such short notice and thus noted that he would remain neutral during the vote the next day. Although the rest of the BRICS made statements critical of the final institutional view during that last Executive Board meeting, their lack of a unified no vote made it difficult to fully counter the insistence by the industrialized countries on a final vote and end to the process.

At the very end of the process, the industrialized nations and upper IMF management used their power within the institution to ensure that no further deliberation would occur. EMDs had successfully postponed the final vote on the guidelines in their meeting before the Tokyo 2012 annual meetings. The IMF management and industrialized nations insisted, however, that the vote occur during the first meeting after the annual meetings. This put EMDs at a disadvantage for two reasons. First, after the Tokyo meetings there were also G20 finance minister meetings, and the executive directors had little time to meet before the final vote was scheduled. Second, the first Board meeting after the Tokyo annual IMF meetings ushered in a new crop of executive directors, many of whom were unaware of the reevaluation process and had little relationship with some of the coalitions. Although the EMDs were able to stall the final vote on these grounds, they were able to do so for only one week.

The final chapter of the process occurred in April 2013 when the Board discussed the staff guidance note put together by IMF management for the staff to use as guidelines in Article IV reports and when putting together country programs. Interestingly, the staff guidance note makes some significant improvements around the edges of the institutional view. The guidance note gives much more credence to advising IMF staff to be in tune with specific country conditions. The guidance note also reemphasizes that source countries in the North have a real responsibility to be mindful of the spillover potential of their own policies. The guidance note is also looser with respect to whether a CFM should discriminate based on residency and should be temporary. These were all key tenets of the EMDs position. Many of the Western Board members felt that the battle was largely over and that the guidance note would merely be a summary of the institutional view. But, there was some leeway for interpretation, and the staff was able to insert some of its earlier preferences. Such moves were praised by the EMD coalitions at the April meetings.

In the end, in part because of interventions exercised by Brazil and other nations, the IMF made clear that the institutional view would not be binding or entail a change to the IMF Articles of Agreement. For the time being, this countervailing power resulted in a successful defense of cooperative decentralization. Although the IMF may not verbally agree in Article IV reports (because of the new institutional view) with measures taken by each of its members, those nations still have the freedom to deploy measures they see fit.

The final institutional view did reveal many of the preferences of EMDs, however, and more so than we might have expected given their lack of voting power at the IMF. The symbolic importance of the EMDs, creative coalition building among them, the use of extra-forum shopping, and the ideational alliance with

many IMF staff ideas allowed countervailing monetary power to be expressed at the IMF and enabled EMDs to punch above their voting weight and get more than they otherwise would have. That said, the EMDs were only half-pleased with the final outcome and pointed to their lack of voting power as a reason for the result.

Summary and Conclusion

The IMF institutional view on capital account liberalization and the management of capital flows is a step forward compared to the inconsistent and unofficial view of the IMF at the turn of the twentieth century. The IMF now officially recognizes that capital account liberalization is not always optimal for every country, that countries should deploy capital account regulations when under pressure from global markets, and that source countries should be more aware of the impact of their policies on capital flows across the globe. This change was a function of new ideas in the IMF Research and other departments, which were then bolstered to support similar EMD positions. EMDs were now able to react to recommendations about when they should deploy regulations as opposed to recommendations about whether regulation should be imposed at all. EMDs wedged their views into the process by leveraging IMF staff positions and other agreements originating outside he IMF, such as the G20 "Coherent Conclusions."

In part, this chapter tells a story about how some EMDs—namely the BRICS coalition—used countervailing monetary power to defend cooperative decentralization in regulating capital flows. Recall that cooperative decentralization is a financial regime in which there is interstate cooperation but across a divergence of national regulatory approaches (see chapter 2). This stands in contrast to strong international standards, which are characterized by interstate cooperation and global regulatory convergence across national systems of regulation. The IMF Articles of Agreement allow for national diversity in terms of regulating capital flows and permit nations to cooperate to monitor and enforce such regulations on a multilateral basis.

EMDs exerted their countervailing power in attempts to defend and gain back some of their policy space to deploy capital controls. As we have seen in chapter 5, EMDs exerted countervailing monetary power in the form of regulating the structural power of global markets; this change in policy also yielded a modest change in economic outcome. Here and in the next chapters on the G20 and the World Trade Organization (WTO), we see how EMDs exerted countervailing monetary power on the power of the industrialized states in global economic institutions. EMDs had even more success in changing policy at the G20.

7

GOOD TALK, LITTLE ACTION

The Limits of the G20

Immediately following the outbreak of the global financial crisis, there appeared to be a renewed willingness to engage in global cooperation to mitigate the crisis and prevent the next one. Rather than the United States and the IMF taking center stage as in previous crises, the G20 was elevated to a global leaders' forum where world leaders from industrialized countries and emerging-market and developing countries (EMDs) came together and pledged to coordinate. Through the G20, a new institution was created, the Financial Stability Board (FSB), and the International Monetary Fund (IMF) was revitalized with new funding. Directly and indirectly, this newfound coordination also addressed issues related to cross-border finance. In some sense, the G20 became another forum for cooperative decentralization. Nation-states would independently regulate their financial systems and devise macroeconomic policies, but with a coordinated eye on the global implications of these policies. How did it fare?

The most significant success with respect to cross-border capital flows at the G20 was in terms of discourse and official communiqués. Particularly significant was the negotiation of a set of "Coherent Conclusions" on the regulation of capital flows that was agreed on and signed by G20 finance ministers, central bank governors, and then heads of state in 2011. The same BRICS coalition (Brazil, Russian, India, China, and South Africa) that resided in the IMF (often staffed by the same negotiators) organized at the G20 on these matters. As we have seen in chapter 6, the coalition also was able to include language in the highest-level official communiqués on the need to regulation capital flows and on the need for source countries

to be more cognizant of the spillover impacts of their monetary policies. Another major success, not so related to short-term financial flows, was the absence of a major move to put up tariff barriers across the world; the G20 repeatedly made global pleas to that effect. Yet that major step forward was followed by two steps backward. In the spirit of avoiding a rash of trade protectionism, the Organisation for Economic Co-Operation and Development (OECD), under the auspices of the G20, constructed the term *investment protectionism* and started issuing annual monitoring reports seeking to identify such protectionism. In these reports the G20 singled out many cross-border financial regulations as protectionist despite the fact that the G20 "Coherent Conclusions" justified the same policies—and despite there being no economic reason to call such measures protectionist.

All these communiqués and reports were not paralleled by coordinated policy action on the regulation of global capital flows. The real promise for collaborating on both ends was the G20 coordination of financial regulatory reform. At the 2011 G20 Summit in Cannes, France, leaders pledged to regulate the global derivative markets by putting them in clearinghouses and placing harmonized margin requirements on their use. This pioneering move had great promise of becoming an avenue for cooperation on the regulation of cross-border finance at both ends. But, deep into the negotiations over the rules of the US Dodd-Frank act, the United States exempted important foreign exchange (FX) derivatives from the bill. As we have seen in chapter 4, the FX derivatives market was one of the key channels that allowed the crisis in 2008–2009 to become global and was the source of turbulence and financial amplification effects in the 2009–2012 period. The result was a "hypocrisy trap" (to use the term in Weaver 2008), whereby the G20 made great strides in making new policies and outcomes in some situations but completely contradicted them in others.

In this chapter, I first discuss the emergence of the G20 in the wake of the financial crisis. I then analyze G20 policy with respect to capital flows. Last, I evaluate the political economy of EMDs in the G20 and beyond.

The Rise and Promise of the G20

The Bretton Woods institutions and subsequent coordination among the industrialized nations were intended to provide a number of public goods to the world economy to prevent and mitigate financial crises. EMDs were initially shut out of the principal global economic-coordination bodies in the post-Bretton Woods period. At the turn of the twenty-first century, however, the G20 was formed and then was elevated to prominence in the wake of the global financial crisis. The G20 is the most inclusive of these groups formed thus far, and it held great promise in the wake of the global financial crisis.

Following the collapse of Bretton Woods in the early 1970s, a group of finance ministers began to meet on a regular basis in an attempt to coordinate macroeconomic policies and pursue other objectives. That group became known as the G5 and consisted of the United States, United Kingdom, France, Germany, and Japan. Later, Italy, Canada, and Russia were invited in, and by the end of the 1990s, heads of state became regulars and the group became known as the G8. There had long been critiques of the lack of inclusiveness of these bodies, and in response to the Asian financial crisis and other crises in the late 1990s, the G20 was born as a ministerial-level grouping (Bradford and Linn 2011).

According to Colin Bradford and Johannes Linn (2011), it just so happened that a G20 meeting was scheduled for November 8–9 in São Paolo, Brazil, in 2008. On the advice of Gordon Brown, then UK prime minister, it was decided to elevate the G20 to a leaders' forum and hold the meeting a week later in Washington, DC. The meeting was hastily assembled after the Lehman collapse and then the election of Barack Obama. The G20 leaders' summit in Washington was a show of force by a large group of leaders in unison. The hope was to temporarily calm markets and put in place a larger process for reform. That larger process fell to the United Kingdom and Gordon Brown, who took over for the second leaders' summit, which took place in London in April 2009.

The London summit was truly historic. G20 leaders came together to signal that global fiscal and monetary expansion was okay, and they led by example with over $5 trillion in fiscal stimulus packages. The IMF was also given new funds, and new special drawing rights were issued; $250 billion in trade finance was pledged to EMDs, and the Financial Stability Forum was elevated to a new global institution called the Financial Stability Board (FSB) (Woods 2010). Moreover, the G20 developed a core agenda to work on in years going forward that focused on macroeconomic coordination for recovery, strengthening national and global regulations on financial markets, and reforming the international financial institutions (Bradford and Linn 2011).

All three components of the core agenda of the G20 could be perceived to provide greater justification for world leaders to coordinate on the regulation of cross-border finance. Indeed, the actions of the G20 and the central banks of the industrialized members of the G20 immediately after the crisis all constitute attempts by the global community to allocate the five public goods outlined by Kindleberger (1986) as necessary for a stable international system (see chapter 2): maintaining relatively open markets during recessions, providing countercyclical lending, policing exchange rate stability, coordinating macroeconomic policy, and acting as a lender of last resort. Kindleberger saw these as public goods because every nation benefits from stability regardless of whether a country provides such goods. Indeed, this allows countries to free ride on the production of

public goods by others. Kindleberger thought these public goods needed to be provided by a hegemon, the United States. Others thought these goods could be provided through new institutional arrangements (Keohane 1984). Remarkably, the G20 and its members became a forum to coordinate and communicate on all five of these public goods.

The G20 and the Regulation of Cross-Border Finance, 2008–2013

To what extent did the G20 serve as a forum for the global coordination of the governance of global capital flows? There was an unprecedented elevation of issues impacting global financial flows, clearly initiated by the EMDs. Whereas capital flows, exchange rate volatility, and spillovers were sometimes not mentioned in the communiqués of G7/8 meetings, such issues became the cornerstone of G20 communiqués. What is more, Brazil and Germany brokered an explicit declaration on the management of capital flows that went well beyond the IMF institutional view on capital flow management. But these significant new policy statements were not matched by positive economic outcomes. On exchange rates, the period following the Lehman collapse became known for its "currency wars." The United States defended its loose macroeconomic policy and took no measures to mitigate the negative spillovers associated with its policy.

When we compare EMD clout at the G20 and the IMF, it is clear that EMDs had more leverage at the G20; at the IMF, voting was and is skewed against them (at the G8, they are not present). An analysis comparing G20 and G8 communiqués and subsequent interviews with key G20 negotiators reveals that EMDs brought capital flow volatility to the forefront of global coordination discussions and were even able to shape policy language in terms of communiqués, statements, and declarations.

The G20 communiqué form the Seoul Summit broke ground first. As discussed in chapters 4 and 5, South Korea engaged in traditional and third-generation cross-border financial regulations throughout the post-crisis period. Indeed, in 2010 South Korea was in the midst of implementing some of its stiffest regulations. Although 2010 is characterized as a key year in the capital inflow surges to EMDs, the G8 communiqués did not mention the issue. In contrast, at the Seoul Summit, South Korea, Brazil, and other countries wanted to ensure they had the policy space to deploy their domestic regulations and moved to put the issue on the agenda. The final communiqué of the 2010 finance ministers meeting states, "we have agreed to prioritize the following issues on the agenda for the Seoul Summit: . . . Further work on macro-prudential policy frameworks, including

tools to help mitigate the impact of excessive capital flows" (G20 Information Centre 2010a). At the Seoul Summit, this was reiterated by the formulation of an action plan that in part resulted in the IMF institutional view; it stated, "In order to deal with systemic risks in the financial sector in a comprehensive manner and on an ongoing basis, we called on the FSB, IMF and BIS to do further work on macro-prudential policy frameworks, including tools to mitigate the impact of excessive capital flows"(G20 Information Centre 2010b).

The 2011 G7 summit also revealed little discussion of the issue, but it did note the following in the communiqué: "Excess volatility and disorderly movements in exchange rates have adverse implications for economic and financial stability" (G7/8 Finance Ministers Meetings 2011). At the G20 that year, capital flows were much more explicitly incorporated into finance ministers' communiqué: "Today we agreed on a work program aimed at strengthening the functioning of the IMS [international monetary system], including through coherent approaches and measures to deal with potentially destabilizing capital flows, among which macroprudential measures, mindful of possible drawbacks" (G20 Information Centre 2011a).

As we have seen, at the 2011 G20 meetings EMDs proposed and, together with industrialized country leaders, presented the "G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experience"(G20 Information Centre 2011b; see chapter 6). The "Coherent Conclusions" was signed by finance ministers and central bank governors, and subsequently by the G20 heads of state. This document stands in contrast to the IMF institutional view and to any documents solely articulated by the G7/8:

> Capital flow management measures may constitute part of a broader approach to protect economies from shocks. In circumstances of high and volatile capital flows, capital flow management measures can complement and be employed alongside, rather than substitute for, appropriate monetary, exchange rate, foreign reserve management and prudential policies.
>
> Both push and pull factors, such as global liquidity conditions, long-term growth prospects, and global risk perception, play a role in determining size and composition of capital flows. Any country that has the potential to affect others through its national policy decisions (including, in this particular context, exchange rate management policies, monetary policy in reserve currency issuing countries and regions, regulatory and supervisory policies, and capital flow management measures) should take the potential impact of such spillovers into account when weighing different policy options consistent with national

> macroeconomic frameworks. These policies should be the object of regular, credible and even-handed multilateral surveillance to assess both their individual impact and aggregate spillover effects. (G20 Information Centre 2011b)

This effort was initiated by Brazil at the G20 and co-authored with Germany. Germany had sought EMD financial assistance at the 2011 meetings for Greece and other eurozone countries in crisis. Brazil capitalized on this to leverage the "Coherent Conclusions." During this period of cross-border financial turbulence, this is a milestone; an EMD had proposed and brokered a significant declaration justifying the use of cross-border financial regulations and significantly less restraining than the IMF institutional view. As noted earlier, this document was used to wedge open more maneuvering room at the IMF, where EMDs had less voting clout.

Finally, in 2013 the BRICS led an effort to have the industrialized nations acknowledge and pledge to monitor the spillover impacts of their monetary policies. In early 2013, the US Federal Reserve had begun to signal that it would taper off its loose monetary policy. This created jitters in many EMD markets, and capital began to flee, resulting in India, Brazil, Indonesia, Turkey, and South Africa seeing significant depreciations in their currencies. The 2013 G7 summit reaffirmed the commitments of the industrialized countries to their macroeconomic policies. In contrast, the G20 finance ministers' statement was starkly different: "Monetary policy should be directed towards domestic . . . and continuing to support economic recovery. . . . We commit to monitor and minimize the negative spillovers on other countries of policies implemented for domestic purposes" (G20 Information Centre 2013). At the G20 meetings in Russia, BRICS had simultaneously negotiated the details of a reserve currency pool that would leverage $100–500 billion in reserves. This gave the coalition significant leverage at the meetings, with even the industrialized-country finance ministers wanting to go to the BRIC side meetings. The specter of this pool was used as intraforum leverage to get more concessions at the G20.

These significant changes in new policies on capital flows gained by EMDs at the G20 were not matched by positive economic outcomes, however. Macroeconomic policy across the industrialized nations and EMDs remained uncoordinated despite G20 pledges. In the absence of currency coordination, 2009–2011 became a period of "currency war"—with the United States, Japan, and China debasing their currencies to some extent and many EMDs following. In the absence of macroeconomic policy coordination, many EMDs were shocked when the Fed announced that it would taper off its loose monetary policy in May 2013 and were equally surprised when the Fed did *not* taper off those policies

in September 2013. These moves by the United States caused, in part, significant exchange rate volatility and subsequent financial amplification effects across EMDs. During the G20 meetings from 2008 to 2013, there was a full sudden stop in 2009, a massive surge from 2009 to 2011, and significant capital flight in 2013, all causing economic disruption. But this time the United States did not shun EMD efforts to mitigate the harmful impacts through the use of cross-border financial regulations, as it had during past crises.

The Rise of Investment Protectionism?

The G20 can partially take pride in preventing the adoption of a rash of trade barriers in the wake of the crisis. At every G20 summit since the global financial crisis, the final communiqué committed to restraining member nations from taking protectionist measures. It is a remarkable achievement that no country had a "Smoot-Hawley" moment, putting major protections in place that would have distorted world trade and growth. The US Smoot-Hawley tariffs had been imposed on US imports during the Great Depression to great detriment to the world economy. Recall that, according to Kindleberger (1986), one of the key public goods is keeping markets open during recessions. As proposed at the 1944 Bretton Woods meetings, the establishment of the General Agreement on Tariffs and Trade (GATT; which later became the World Trade Organization, WTO) in 1947 as an attempt to provide this collective good. Indeed, institutional arrangements at the WTO provided EMDs a mechanism to push back the United States when it attempted to put "Buy America" provisions into the fiscal stimulus package. From 2008 to 2011, the WTO and numerous independent assessments saw no significant moves toward protectionism. The WTO considered this its greatest victory in what otherwise was a difficult period (during which it was in the midst of a gridlock in its longest running negotiation in its history). After 2011, however, both the WTO and independent analysts started to see protectionist measures adopted. But, although these studies show that there was an increase in trade measures, there was little significant impact on actual trade flows in the world economy (World Trade Organization [WTO] 2011; Evenett 2013; Montpetit et al. 2011; Drezner, 2014).

As we will see, however, the G20 then overgeneralized this observation by misdiagnosing the regulation of cross-border finance as "investment protectionism" in its further efforts to monitor trade policy in the wake of the crisis. Following the G20 call against the rise of "protectionism," the OECD and UN Conference on Trade and Development (UNCTAD) constructed the concept of investment protectionism and extended their monitoring of protectionist measures

to investment policy. These efforts specifically targeted cross-border financial regulations, among many other policies. The term *investment protectionism* dates back to a 2008 article by the right-of-center US think tank, American Enterprise Institute (AEI). In an article published shortly after the crisis, Claude Barfield made a case that measures blocking foreign investment were just as significant as trade measures and called on US President Barack Obama to lead an effort to prevent such protectionism (Barfield 2008). This language was adopted by the G20 when the OECD (a longtime supporter of the deregulation of investment markets) and UNCTAD produced a joint 2009 report on investment measures in response to the G20 communiqué calling for restraints on protectionism (OECD-UNCTAD 2013). Between 2009 and 2012, the OECD and UNCTAD issued nine reports to the G20, and they continue to do so. In addition to restrictions on FDI, the OECD-UNCTAD reports singled out cross-border financial regulations as protectionist—including measures used in Brazil, South Africa, and many of the countries discussed in this book.

This move was largely missed or ignored by outside observers, but it made EMD governments very uneasy. Two independent groups monitoring trade policy in the wake of the crisis, Global Trade Alert and the G20 Information Centre, continued to use the traditional definition of *protectionism* as trade measures in their analyses.

The G20 redefinition of investment regulation as protectionist goes far beyond economic theory. As we have seen in chapter 3, the economic case for deregulating cross-border financial markets is far weaker than for trade; this has repeatedly been echoed by Jagdish Bhagwhati (1997), an eminent trade theorist. Alan Beattie, *Financial Times* columnist, was one of the few outside observers who picked up on this redefinition early. Writing in the *International Economy,* Beattie (2008) rightly argues that calling investment regulation "protectionism" is conceptually and theoretically weak and urges that the term *investment protectionism* not be used for sake of clarity. What is most inconsistent about this G20 approach is that G20 leaders at the highest level endorsed a set of "Coherent Conclusions" justifying the very policies that G20 reports are currently singling out as protectionist.

Regulating Derivatives at Both Ends?

The G20 had implicitly promised to regulate capital flows at both ends, as Keynes and White had articulated in the run-up to the Bretton Woods conference (see chapter 2). To date, the G20 has failed in this effort by standing quiet as the United States violated the G20 agreement to harmonize margin requirements on derivatives across the countries in the group.

As early as 2009, the G20 committed to regulate over-the-counter (OTC) derivatives by forging rules that would require derivatives to be traded on an exchange or be subject to higher capital requirements. At the Cannes summit in 2011, the G20 agreed to harmonize margin requirements on derivatives products as well. The US Dodd-Frank Act was among the first reforms in the industrialized countries to regulate derivatives in this manner. Under Dodd-Frank, the United States will subject derivatives to a central clearing requirement that will require all derivatives dealers to register with a clearinghouse and be subject to margin requirements. Posting margins would increase the cost of leverage and effectively reduce the amount of capital available when engaging in the carry trade. Central clearing has the potential to regulate the carry trade on both ends as well.

As noted in chapter 4, FX derivatives instruments have been an important part of the carry trade, and exceptions create the incentive for investors to restructure their carry trade positions toward the exempted parts of the market. According to the Bank for International Settlements (BIS), the daily turnover rate for FX transactions is now US$5.3 trillion, up from US$1.2 trillion in 2001. Figure 7.1 shows that the largest and fastest growing area of the FX market is FX derivatives in the form of foreign exchange swaps. As we have seen, FX derivative markets played the decisive role in creating financial fragility.

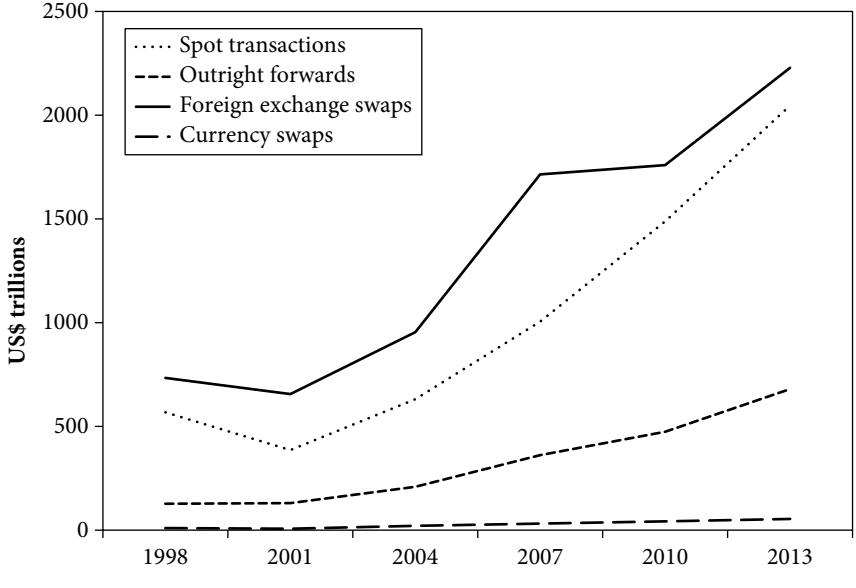

FIGURE 7.1. Daily foreign exchange turnover in the world economy, 1998–2013 (Bank for International Settlements 2013).

Requiring that US financial entities place margin requirements on FX derivatives would implicitly be a form of regulating capital flows on both ends, as discussed by White and Keynes. The third-generation capital account regulations put in place by EMDs are a form of regulating the harmful aspects of the FX derivatives trade on the EMD end. Because of the sheer magnitude and sophistication of those markets, however, they have proved difficult for EMDs to regulate on a sustained basis. We have seen that such regulations have some positive impact (see chapter 4) but not enough to fully stem financial instability. The Brazilian FX derivatives regulations had only a partial impact given that the Brazilian market is nondeliverable and largely conducted offshore. Thus, the Brazilian regulations had jurisdiction only over financial entities based in Brazil that had one side of a particular position in the FX derivatives market. The regulations created an incentive for investors to engage not with counterparties located in Brazil but, rather, with large investment firms in the United States and Europe. If the United States and Europe instituted higher margin requirements for FX derivatives and derivatives had to be traded openly, this would raise the cost of the carry trade and implicitly be a form of regulating the market on both ends.

But a blow was struck to these possibilities in November 2012 when the US Treasury Department exempted FX swaps and forwards from the Dodd-Frank Act. Nondeliverable forwards, FX options, and currency swaps are still subject to regulation, however (Brush 2012). Timothy Geithner, then treasury secretary, argued that FX swaps and forwards were not a key part of the crisis in the United States and were already traded in a transparent market. To the contrary, in-depth investigative reports have shown that these exemptions were the result of an intense lobbying effort by financial interests in the United States and abroad. Deutsche Banke, the Bank of New York Mellon Corp, UBS, Goldman Sachs, and other financial lobbyists entered into over 1,000 contacts with US regulators on these issues and attended more than one-third of the 2,100 sessions held by regulators. The Securities Industry and Financial Markets Association paid upward of $3 million to lobbyists for these efforts (Brush and Schmidt 2013).

Political Economy of Global Cooperation on Capital Flows

Despite some remarkable strides in constructing new policies in goals, communiqués, and declarations, in the wake of the crisis the economic outcomes in terms of the provision of public goods were not well provided by the United States or the G20. As we have seen, including EMDs as part of coordinating bodies yielded some significant new policy language that, indeed, allowed a loose

regime of cooperative decentralization. Nation-states pledged to recover from the crisis and put in place financial regulatory reforms to prevent future crises, not through strong international standards but in ways pertaining to their own national circumstances. They also pledged to coordinate these efforts to ensure they were consistent enough so as to restore financial stability to the global system. Moreover, EMDs broadened the conversation about the global economy compared to the discussion and subsequent statements made in the G7/8. They used the G20 as an opportunity to negotiate an official declaration on the governance of capital flows. The "Coherent Conclusions" on the management of capital flows sent a significant signal that EMD efforts to regulate capital flows were sanctioned. It also provided fodder for EMD efforts at the IMF.

There were significant economic outcomes as well. For the first time, some EMDs were able to obtain liquidity from outside the controversial and stigmatized IMF. By providing bilateral swap agreements to EMDs, the United States and China were able to mitigate the sudden stop that occurred immediately after the financial crisis. Another positive policy outcome was that EMDs were able to use the WTO to (partly) stem some of the protectionist measures in the US stimulus bill. In hindsight, however, the most significant economic outcomes remained elusive. Currency swings were rife throughout the period, finance was pro-cyclical, and financial fragility became accentuated.

Moreover, there were also significant setbacks in terms of a lack of new policies. The redefinition of investment regulations as investment protectionism was, until recently, largely missed by EMDs. As we have seen, reports issued to the G20 were initiated by the OECD and UNCTAD based on a broad interpretation of G20 communiqué language about the need to resist protectionist acts in the wake of the crisis. The OECD and UNCTAD have long been advocates of investment liberalization in general and of capital account liberalization in particular. In fact, there is no economic theory that equates investment liberalization to trade liberalization. And, of course, branding capital account regulations as protectionism is inconsistent with numerous G20 communiqués and the "Coherent Conclusions."

A second and potentially more damaging setback was the exemption of certain FX derivatives from the Dodd-Frank Act. As we have seen, the FX derivatives market was one of the primary channels that allowed the crisis to become global and that caused a surge in capital inflows in the wake of the crisis. The regulation of FX derivatives in developed countries, especially the United States, would significantly to regulate capital flows at the source countries, and, with EMD regulation, regulate them at both ends. The G20 still says that those sectors that are exempted will have to post higher capital requirements. Yet most FX derivatives transactions occur off balance sheet and sometimes even in offshore nondeliverable forward markets—areas very hard to target.

Why did the major steps forward in inclusiveness and discourse not lead to subsequent gains in economic outcomes? Different combinations of power, institutions, and ideas explain both the gains and setbacks with respect to the political economy of global coordination on cross-border financial flows. Perhaps the best way to summarize the state of the G20 on the issue of providing public goods related to cross-border financial flows is that it is caught in what Catherine Weaver (2008) refers to as a hypocrisy trap. Weaver, in an in-depth analysis of the World Bank, defines a *hypocrisy trap* as the "persistent failure [of an institution] to act in accordance with its own ideals" (2008, 2) that results in "distinct and observable gaps or inconsistencies between the theories, goals and 'best practices' organizations claim to uphold and the actual policy agendas and instruments they employ" (2008, 176–77).

Power and connectedness go a long way in explaining both the inconsistent gains and setbacks for EMDs with respect to the coordination of capital flows. The relative gains in market power, financial interconnectedness, and reserve accumulation gave EMDs more bargaining power with the Fed, the People's Bank of China (PBOC), and at the G20. Key EMDs were able to secure liquidity lines outside the IMF, through the Fed and PBOC, because they were key trading or investment partners with the United States—their fates had become tied, and it was now in the interests of the United States and China to provide help. If those countries had also had major financial crises, it would further hurt the United States and China. There is also some evidence that the United States used this to its advantage by making EMD alignment with US positions at the G20 a condition of EMD participation in the swap lines.

At the G20, the market power of BRICS was accentuated by the nature of the G20 as an institution. Unlike in the IMF or in the asymmetric bilateral bargaining forums at the G20, members of the BRICS coalition have an equal say. Key EMDs, especially BRICS, were able to consolidate this power by working in a coalition at the G20 and by exerting both intraforum and extra-forum leverage to achieve some of their objectives. As we have seen, EMDs at the G20 exerted intraforum leverage by forging the "Coherent Conclusions" on capital flows. In this case, EMDs had the upper hand because the Western members of the G20 were actively seeking funds from EMDs to help save certain eurozone countries from collapse. They made the negotiation of the "Coherent Conclusions" a condition of discussing EMD finance for the crisis in Europe. Exerting extra-forum leverage, BRICS negotiated a reserve currency pool agreement and a BRICS development bank on the sidelines of the G20. This gave EMDs the clout to insert language about capital flows and the negative spillovers of Western monetary policies into G20 communiqués.

Market power, the interconnectedness of financial and trade systems, and the broad institutional mandate of the G20 allowed for a more balanced North-South give and take there than in the IMF or in FTAs and BITs. For the first time, the industrialized countries needed the EMDs for trade, to prevent internal collapse, and for external finance for Europe. Because of the nature of power and institutional arrangements, EMDs and industrialized nations were able to agree on certain new policies despite the fact that they had different ideas about the nature of their individual policies. On swaps and the sudden stop, EMDs, the PBOC, and the Fed were all on the same page—they agreed that the costs of not extending swap lines outweighed the benefits to all parties—thus, there was a strong policy outcome. The spillover effects of US monetary policy and the right to regulate capital flows were another matter. The United States had a different idea bout the costs and benefits than did EMDs. The industrialized countries, particularly the United States, thought that the global benefits of a loose US monetary policy outweighed the costs (Bernanke 2013). Some EMDs thought those costs were too high to bear, but EMD leverage was able to extract concessions only in terms of forging new policy. US power prevailed in the economic outcomes.

The EMD gains in new policy language did not fully translate into gains in economic outcomes because the United States still maintains primary economic power in the world economy. The fact that the US dollar is still the core reserve currency and that the US economy is still the major source of foreign trade and finance puts EMDs at a structurally weaker bargaining position despite the seemingly even institutional distribution of power at the G20. This is accentuated by the power of the financial sector in the West. As we have seen with the FX derivatives exemption in the Dodd-Frank Act, the US financial lobby has an enormous amount of resources and clout.

Moreover, the institutional structure of the central banks further solidifies the current power dynamics. The US Fed acted in what it saw as in its interests and in its mandate of maintaining stable prices and full employment in the United States. If the United States instituted a more rigorous and targeted fiscal stimulus, the Fed believed that it could achieve both objectives—and perhaps help the world economy because the subsequent economic growth would trigger the demand for global goods. The Fed has no explicit institutional mandate to think about world policy. And even if the Fed did agree with EMDs on the need to cooperate on financial flows, it would have had a hard time explicitly doing so.

Ideas about the coordination of capital flows were not aligned either. As already mentioned, the Fed thought that if the US government had a stronger fiscal position, the benefits of a US recovery would outweigh the costs of the negative spillovers from US monetary policy. Moreover, there was a lack of constructive

ideas in terms of policy alternatives on the part of the EMDs. Brazil and others at G20 meetings criticized US monetary policy in particular, implying that the United States should raise interest rates or stop quantitative easing. Such talk was unacceptable to the United States, and for good reason. Some independent experts did suggest some measures that would have allowed the United States to cooperate more actively. Robert Pollin (2012) suggested a maximum reserve ratio on US commercial banks that would require them to lend. If coupled with tax credits to small and medium-size enterprises in the United States, US banks would have had a better incentive to lend for employment-based growth activities in the United States rather than to hoard cash or send it to EMDs. Others emphasized that margin requirements on FX and other derivatives would implicitly help steer investment away from areas of greatest turbulence (Griffith-Jones and Gallagher 2011a, 2011b). The maximum reserve ratios were proposed to the Fed but were not carried further. The margin requirements on FX derivatives could have been a cornerstone of G20 financial cooperation but fell prey to the US financial lobby and the lack of attention to the matter by EMD G20 members. There are no public comments from EMDs to the rulemaking bodies of the Dodd-Frank Act on this matter.

What was left, then, was indeed a very different policy output than in crises past. The United States and other Western powers officially acknowledged through G20 communiqués and the "Coherent Conclusions" that there were negative spillovers from industrialized country monetary policies and that EMDs had the policy space to regulate cross-border finance to mitigate the harmful aspects of those spillovers. This is a major step forward from past crises but not enough to provide the key public goods necessary to prevent and mitigate financial fragility in the world economy.

8

TRADING AWAY FINANCIAL STABILITY

Reconstructing Capital Account Liberalization as Trade and Investment Policy

Brazil and South Korea were able to reregulate cross-border finance, in part, because they were careful to carve out the policy space to do so in their trade and investment treaties. And, as we have seen, the United States was divided in its support for amending the International Monetary Fund (IMF) Articles of Agreement because it had moved to forge strong international standards for free capital movements in the trade and investment regime (see chapter 2).

Capital account liberalization was then resurrected and reconstructed as "trade in financial services" by powerful interest groups and countries still hoping to obtain strong international standards for the movement of capital. As we have seen, some emerging-market and developing countries (EMDs) were able to maintain the policy space in the trade and investment arena that they had fought hard to protect under the IMF. The most successful saw that cross-border finance needed to be regulated and were able to flex their newfound economic power in institutions that gave EMDs more equal say. The least successful were either not particularly convinced that capital flows needed to be regulated or were weaker states in institutional arrangements that favored the more powerful. In the wake of the global financial crisis, there was a revived effort to maintain and expand policy space for regulating cross-border finance at the World Trade Organization (WTO) and in free-trade agreements (FTAs) and bilateral investment treaties (BITs).

At the multilateral level, that is, at the WTO, the project was only partially successful. The majority of industrialized nations, which already had open capital accounts, agreed to liberalize trade in financial services, and only a limited

number of EMDs followed them. What is more, the WTO has safeguards that may give nations the flexibility to regulate flows under some circumstances. But a proliferation of FTAs and BITs were enacted between industrialized countries and EMDs in which many EMDs agreed to restrict their ability to regulate cross-border finance. Interestingly, many EMDs still enjoy the policy space to regulate capital flows under the WTO, but their FTAs and BITs leave them far less flexibility to regulate cross-border finance—especially those treaties signed with the United States.

These differences between the WTO and FTAs/BITs are summarized in Table 8.1. The WTO allows nations to deploy regulations on both inflows and outflows as long as the nations have not committed to the liberalization of certain financial services. If a nation has made commitments in financial services, restrictions on capital flows are not permitted without being subject to claims. There are safeguard measures that may be applied, however. If a nation that has liberalized financial services does restrict capital inflows or outflows, that nation could be subject to a dispute filed by another nation-state. In addition, trade sanctions can be put in place if the nation is found in violation of WTO rules.

In contrast, and unlike the treaties of other industrialized countries, US BITs and FTAs do not permit restrictions on inflows or outflows. If a nation does

TABLE 8.1 Policy space for cross-border financial regulations

	IMF	WTO	US BITS/FTAS	EU AND OTHER INDUSTRIAL BITS/FTAS
Regulations permissible?				
Current account	No	No	No	No
Capital account				
Inflows	Yes	No[a]	No	No
Outflows	Yes	No[a]	No	No
Safeguard provisions?				
Current account	Yes[b]	Yes[b]	Yes[b]	Yes[b]
Capital account				
Inflows	N/A	No	No	Yes
Outflows	N/A	Yes	No	Yes
Number of countries covered	186	69	58	
Dispute resolution format	Member vote	State-to-state	Investor state	Investor state
Enforcement instrument	Loss of membership	Retaliation	Investor compensation	Investor compensation

Note: BITs, bilateral investment treaties; FTAs, free-trade agreements; IMF, International Monetary Fund; N/A, not applicable; WTO, World Trade Organization.

[a] Regulations fully permissible for nations that have not committed to liberalize cross-border trade in financial services.

[b] Permitted only under IMF approval.

restrict either type of capital flow, it can be subject to investor-state arbitration whereby the government of the host state pays for the "damages" accrued to the foreign investor. The BITs and FTAs of other major capital exporters, such as those negotiated by the European Union, Japan, China, and Canada, either completely carve host-country legislation on capital account regulations out of the agreements (therefore, permitting them) or allow regulation as a temporary safeguard on inflows and outflows to prevent or mitigate a financial crisis. The treaties with the United States do not have either measure, except in a few cases that include a grace period in which foreign investors are not allowed to file claims against a host state until after the crisis has subsided.

EMDs were able to preserve such policy space at the WTO because the nature of the institution allows for consensus and, thus, interesting coalitions among EMDs have arisen (for a good discussion of policy space, see Mayer 2009). In contrast, in both FTAs and BITs between an industrialized countries and EMDs, asymmetric bargaining power and collective action problems often lead EMDs to trade away their ability to reregulate cross-border finance.

In this chapter, I trace how, in the late twentieth and early twenty-first centuries, industrialized nations moved the forum for capital account liberalization to the trading regime; I also analyze the extent to which nations must liberalize the capital account and the extent to which nations have the ability to regulate cross-border financial flows under the WTO, BITs, and FTAs. I then examine how some nations are attempting to reclaim or preserve their policy space for regulating cross-border finance in the wake of the global financial crisis and discuss the political economy factors that led some countries to trade away the policy space to regulate cross-border finance.

The World Trade Organization

By the late 1990s, industrialized countries were also effectively restricting the ability of EMDs to regulate capital flows through their trade and investment treaties; this has been almost completely overlooked in the literature on the political economy of governing capital flows. Most industrialized countries granted each other market access through the General Agreement on Trade in Services (GATS; a WTO treaty that came into force in 1995), particularly through the Annexes on Financial Services to the GATS, agreed on in 1997 and put into effect shortly thereafter.

The United States had spearheaded a move to include services in global trade negotiations for the WTO Uruguay Round (1986–1992). Because of the strong US financial lobby, the United States particularly took the lead role in the

Box 8.1: General Agreement on Trade in Services Modes and Financial Services

Mode 1: Cross-border supply is defined to cover services flows from the territory of one Member into the territory of another Member (e.g., banking or architectural services transmitted via telecommunications or mail);

Mode 2: Consumption abroad happens when the consumer travels outside of the country to access a service such as tourism, education, health care, and so forth;

Mode 3: Commercial presence occurs when the user of a financial service is immobile and the provider is mobile, implying that the financial service supplier of one WTO Member establishes a territorial presence, possibly through ownership or lease, in another Member's territory to provide a financial service (e.g., subsidiaries of foreign banks in a domestic territory); and

Mode 4: Presence of natural persons are when financial services are supplied by individuals of one country in the territory of another.

liberalization of financial services (Hoekman and Kosecki 2009). Indeed, services used to be referred to in the economics literature as *nontradables* but were reconstructed as "trade in services" in the GATS under four modes of supply (see box 8.1) Under the GATS, nations can liberalize across these four modes of financial services. The two most important modes in terms of the capital account are Mode 1 (the cross-border supply of financial services) and Mode 3 (the establishment of a commercial presence by financial service providers).

The GATS provides a general framework for disciplining policies affecting "trade in services" and establishes a commitment for periodic future negotiations. The GATS is divided into "General Obligations" and "Specific Commitments." General obligations bind all members. These include the obligation to provide most-favored-nation treatment to all WTO members (Article II) and some disciplines on nondiscriminatory domestic regulations that are still being fully developed (Article VI). Specific commitments apply only to the extent that countries choose to adopt them by listing them in their country-specific schedules. These cover primarily the disciplines of Market Access (Article XVI) and National Treatment (Article XVII) (Raghavan 2009).

Generally speaking, GATS negotiations and commitments follow a "positive list" approach, in which nations commit to bind only to specified sectors to GATS disciplines. This stands in contrast with a "negative list" approach, which is more common in goods negotiations and in most FTAs. In a negative list (or top-down) approach, negotiators assume that all sectors will be covered in some

way, except a handful that are listed by particular nations. WTO members have recourse to binding dispute settlement procedures, in which perceived violations of GATS commitments can be challenged and retaliatory sanctions or payments can be authorized as compensation.

For this discussion, I focus on three effects of the GATS:

- Nations that did not make Mode 1 or Mode 3 commitments under the GATS are free to regulate cross-border capital flows.
- Nations that did make Mode 1 or Mode 3 commitments are not permitted to regulate cross-border finance if it is part of the service that has been liberalized.
- Member countries may be able to temporarily derogate from such commitments through two exceptions written into the GATS.

Capital Account Liberalization, Cross-Border Financial Regulations, and the General Agreement on Trade in Services

Unbeknownst to many, GATS commitments require the opening of the capital account. Nations that make commitments under Modes 1 and 3 for financial services are required to permit capital to flow freely to the extent that such capital is an integral part of the service provided. GATS Article XVI on Market Access references capital liberalization:

> If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I [i.e. Mode 1] and if the cross-border movement of capital is an essential part of the service itself, *that Member is thereby committed to allow such movement of capital*. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I [i.e. Mode 3], *it is thereby committed to allow related transfers of capital into its territory*. (Article XVI, footnote 8; emphasis added)

Liberalizing financial services under the GATS does not require the wholesale liberalization of the capital account per se. Sydney Key notes that "the bottom line is that if a country makes a commitment to liberalize trade with respect to a particular financial service in the GATS, it is also making a commitment to liberalize most capital movements associated with the trade liberalization commitment" (2003, 20). In 2010, the WTO reiterated that liberalizing cross-border trade in financial services (Mode 1) may need an open capital account to facilitate

such trade that, of course, results in international capital flows. A similar scenario can be outlined for Mode 3 liberalization. A loan extended by a foreign bank to a domestic client requiring capital to be transferred from the parent company of the foreign bank to its subsidiary abroad would also require an open capital account (WTO 2010).

The IMF cites the following Mode 1 example, where a loan extended by a domestic bank to a foreign customer using internationally raised capital creates international capital flows and international trade in financial services. To the extent that a financial services transaction involved an international capital transaction, the capital account needs to be opened for the former to take place freely (Kireyev 2002). Another paper by an IMF official provides examples of how the GATS Mode 1 essentially requires the liberalization of a capital account:

> to the extent that a member restricts its residents from borrowing from non-residents, a member's commitment to allow banks of other members to provide cross-border lending services to its nationals would require a relaxation of this restriction. Similarly, if a member also makes a commitment to permit non-resident banks to provide cross-border deposit services, such a commitment would require the member to liberalize restrictions it may have imposed on the ability of residents to hold accounts abroad. In these respects, the GATS serves to liberalize the making of both inward and outward investments. (Hagan 2000, 24)

That said, if a nation has not listed cross-border trade in financial services (Mode 1) or the commercial presence of foreign services (Mode 3), that country may be free to regulate capital flows as it sees fit. Indeed, numerous EMDs have listed neither the liberalization of cross-border trade in financial services nor Mode 3 commitments under the GATS. According to the WTO, the majority of EMDs made relatively fewer commitments in financial services related to capital markets (WTO 2010). At the conclusion of the GATS, IMF analysts found that about sixteen countries had significant Mode 1 commitments in financial services, while around fifty had significant Mode 3 commitments for the sector—this included most OECD countries and just a few EMDs (Valckx 2002; Kireyev 2002).

Table 8.2 lists the nations that are most committed to open capital accounts under the WTO-GATS. These thirty-seven nations have committed to scheduling the liberalization of some combination of Modes 1, 2, and 3 under the last round of GATS negotiations. (New negotiations are currently underway; Valckx 2002). These are also the nations that are most prone to being disciplined under the GATS. Note that there is not a reassuring record of countries successfully invoking exceptions at the WTO.

TABLE 8.2 Countries most vulnerable to actions against regulating capital flows under the General Agreement on Trade in Services

Argentina	Kuwait	Qatar
Australia	Kyrgyz Republic	Romania
Bahrain	Latvia	Sierra Leone
Canada	Macau	Singapore
Ecuador	Malawi	Solomon Islands
Estonia	Mauritius	South Africa
Gabon	Mongolia	Switzerland
Gambia	Mozambique	Tunisia
Hong Kong	New Zealand	Turkey
Hungary	Nigeria	United Arab Emirates
Iceland	Norway	United States
Indonesia	Panama	
Japan	Philippines	

Source: Valckx (2002).

If the capital account regulations of a member nation are found to be in violation of its GATS commitments, the ability of the nation to invoke one or more of the exceptions in the GATS text is a matter of significant legal debate and is thus far untested by an actual WTO tribunal. A first option may be to claim that the measure was taken for prudential reasons under Article 2(a) of the Annex on Financial Services. This exception reads, "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement." It is also possible to argue that inflows controls, such as unremunerated reserve requirements or inflows taxes, were of a prudential nature, especially given the new economics of capital controls (see chapter 9).

Legal scholars and EMDs have expressed concern that Article XII may not pertain to regulations on inflows to prevent crises and that the language in the prudential carve-out may pertain only to *micro*prudential (individual financial institution) stability rather than macroprudential financial stability (Hagan 2000; Viterbo 2012; Tucker 2013). Moreover, the sentence stating that prudential measures "shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement" is regarded by some as self-cancelling and thus of limited utility (Tucker and Wallach 2009; Raghavan 2009). Others, however,

do not see the measure as self-contradictory but rather as a means of catching hidden opportunistic and protectionist measures masquerading as prudential (Van Aaken and Kurtz 2009). Nations have requested that the WTO elaborate on what is and is not covered in the prudential exception, but such requests have fallen on deaf ears (Cornford 2004).

If the capital account regulations of a member nation are found to be in violation of its GATS commitments in financial services, it may also be able to invoke Article XII, "Restrictions to Safeguard the Balance of Payments," which states:

> In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments. It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition. (Article XII, para. 1)

The next paragraph in this article of the GATS specifies that such measures can be deployed as long as they do not discriminate among other WTO members, are consistent with the IMF Articles (thus, pertain only to capital account controls), "avoid unnecessary damage" to other members, do "not exceed those necessary" to deal with the balance-of-payments problem, and are temporary and phased out progressively.

It may be extremely difficult for a capital account regulation to meet all these conditions, especially the hurdles dealing with the notion of "necessity," a slippery concept in trade law that countries have had difficulty proving. Moreover, concern has been expressed about the extent to which the balance-of-payments exception provides nations with the policy space for restrictions on capital inflows that are more preventative in nature and may occur before "serious" balance-of-payments difficulties exist (Hagan 2000; Viterbo 2012; Gallagher and Stanley 2013).

In a nutshell, if a nation has not committed to liberalizing Modes 1 or 3 financial services, then it is free to regulate cross-border finance as it sees fit. If it has made such commitments, it will find cross-border finance more difficult to regulate, although some untested exceptions may apply. What about for FTAs and BITs?

US Bilateral Investment Treaties and Free-Trade Agreements in Comparative Perspective

FTAs and BITs, especially those engaging the United States, increasingly restrict the ability of nations to regulate capital flows. The investment provisions of US trade treaties (which are mimicked in US BITs) require that all forms of capital "move freely and without delay" among the parties to the treaty. Moreover, whereas GATS negotiations are of a positive list variety, FTA and BIT negotiations deploy a negative list approach. At the GATS, disputes are settled between nation-states, but trade and investment treaties increasingly have provisions for an "investor-state" dispute settlement that allow a private investor to directly file a claim for damages against a signatory nation that regulates capital flows. Perhaps most concerning is that, for the most part, there are no exceptions or safeguards in the US treaties. This stands in contrast to EU, Japanese, and Canadian treaties that provide exceptions for the use of capital controls under certain circumstances or carves them out altogether.

Investment Provisions in US Bilateral Investment Treaties and Free-Trade Agreements

The United States has engaged in investment treaty-making since its War of Independence through what were called Friendship, Commerce, and Navigation treaties. The successors to those agreements are the BITs, which the United States has been negotiating since 1977. The United States did not invent BITs; Europeans had BITs going back to 1959. Indeed, there are now more than 2,000 BITs in existence. Beginning with the North American Free Trade Agreement (NAFTA) in 1994, US FTAs also have investment provisions analogous to those found in BITs. In addition, BITs and FTAs include provisions on financial services.

BITs and the investment provisions in US FTAs have evolved over time. Normally, through an interagency process and with input from outside experts and interests, the United States puts together a Model BIT[1] that serves as the template for negotiations for BITs and FTAs: "The model would be tendered to the other party at the beginning of negotiations with the hope that agreement would be reached on a text that did not differ substantively or even in a significant stylistic

1. US Model BIT. Washington, DC, 2004. http://www.state.gov/documents/organization/117601.pdf.

way from the model. If too many departures from the model were demanded by the other party, then no BIT would be concluded" (Vandevelde 2008, 1).

Scholars have characterized the model BITs and subsequent treaties as occurring in three waves:" from 1981 to early 1989, when thirty-five BITs were negotiated; from the early 1990s to 2002, when the NAFTA and a handful of BITs were signed; and from 2002 to the present, when FTAs with Chile, Singapore, and Central America were negotiated (Vandevelde 2008). In 2009, the United States engaged in a review of the 2004 Model BIT that formed the core of most US BITs and investment components of FTA. A new model was released in 2011.[2]

In terms of coverage, whereas the earliest BITs and FTAs focused almost solely on foreign direct investment, contemporary (third-wave) treaties cover both inflows and outflows of virtually all types of investment, including equities, securities, loans, derivatives, sovereign debt, and the financial services facilitators of such flows. According to Kenneth Vandevelde (2008), there are five general components of US BITs and subsequent provisions in US FTAs (listed in box 8.2). In addition to these core elements, US treaties often include some "exceptions," such as for essential security and for matters related to taxation (governed under another body of US international law). Finally, post-2004 BITs have putative limitations on the ability of host states to reduce environmental or labor laws to attract foreign investment.

Box 8.2: Key Provisions of US Bilateral Investment Treaties

Minimum standard of treatment. An investor should enjoy a minimum standard of treatment, including national treatment and most-favored nation-states in both the preestablishment and post-establishment rights. On an absolute level, US investors are to receive "fair and equitable treatment and full protection in accordance to customary international law."

Restrictions on expropriation. BITs and FTAs strictly forbid the direct or indirect expropriation of US investments absent prompt and full compensation.

Free transfers. US nationals and firms must be permitted to freely transfer payments in and out of a host country "without delay."

No performance requirements. US BITs forbid nations from imposing performance requirements such as local content rules, joint-venture and research-and-development requirements, export requirements, and rules related to personnel decisions.

2. US Model BIT. Washington, DC, United States Department of State, 2010.

Investor-state arbitration. In stark contrast to dispute settlement under the WTO and all other aspects of FTAs other than investment rules, US firms have the right to binding arbitration of disputes related to violations of the agreements. As is the case with most BITs worldwide, foreign firms do not have to file claims through governments but can take a claim to an arbitral panel, often the International Centre for the Settlement of Investment Disputes (ICSID) at the World Bank, for any perceived violation of the principles.

Source: Vandevelde (2008).

Before we move forward, it should be underscored that these treaties elevate foreign investor rights over domestic investors in that they do not require the host-country firms to liberalize their investments, nor do they permit host-country investors to use investor-state arbitration (Hagan 2000).

Capital Account Regulations in US Trade and Investment Treaties

The United States has concluded forty-six BITs since 1977, and more recently it has used language that is very similar to BIT wording as part of the investment chapters of twelve US FTAs (Vandevelde 2008). These US-style investment rules include many more limitations on the ability of nations to regulate cross-border finance. Specifically, US investment rules:

- Do not permit restrictions on both capital inflows and outflows.
- Provide no clear safeguards for balance-of-payments exceptions, although some FTAs provide a grace period for filing investor-state claims.
- Elevate the rights of US capital investors over domestic capital investors. US investors can file claims against violating parties through an investor-state dispute settlement process and receive financial compensation for violations, but domestic investors do not have this right.

The free transfer of funds to and from the United States is a core principle of US BITs and FTAs, as well as those of most other capital-exporting countries. When a host nation violates that principle, or if capital transfers violate the other principles, the host nation could be subject to an investor-state arbitration claim and be sued for damages. All US BITs and FTAs, therefore, restrict the ability of host nations to regulate capital flows (Anderson 2009a; Gallagher 2011), and all US BITs and FTAs require host nations to permit free transfers without delay of

all types of covered investments. Moreover, financial services are covered in BITs and are included in a separate chapter in FTAs. Analogous to the GATS, if a nation commits to liberalizing financial services, it commits to the free flow of such investment as well. Note, however, that under the services chapters of US FTAs, dispute resolution is state to state.

Over the years, US treaties have listed numerous types of investments as being covered, such as securities, loans, FDIs, bonds (both sovereign and private), and derivatives. Treaties also make a point of stating that such a list is not exhaustive. Taken together, the transfers provisions, along with the other principles of the agreements, ensure that an investment can enter and leave a nation freely. If the investment is restricted for some reason, the host nation can be subject to investor-state arbitration.

With one exception (NAFTA), US treaties do not include a balance-of-payments exception, as does the GATS. They do, however, have a prudential exception, similar to the one found in the GATS Annex on Financial Services (2010):

> Notwithstanding any other provision of this Treaty, a Party shall not be prevented from adopting or maintaining measures relating to financial services for prudential reasons*, including for the protection of investors, depositors, policy holders, or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of this Treaty, they shall not be used as a means of avoiding the Party's commitments or obligations under this Treaty.
>
> * It is understood that the term "prudential reasons" includes the maintenance of the safety, soundness, integrity, or financial responsibility of individual financial institutions or cross-border financial service suppliers.

Many have expressed the same concerns about this exception as they have about the one in the GATS. Like the GATS, the last sentence of this prudential exception may be self-canceling (Key 2003; Raghavan 2009; Tucker and Wallach 2009; Van Aaken and Kurtz 2009; see also Robert Stumberg's congressional testimony[3]). Even more concerning is that the term *prudential reasons* has a footnote that specifically defines it as "the maintenance of the safety, soundness, integrity, or

3. Testimony of Robert Stumberg: Reform of Investment Protections. US House Committee on Ways and Means, Subcommittee on Trade. Washington, DC, May 14, 2009. http://waysandmeans.house.gov/media/pdf/111/stumberg.pdf.

financial responsibility of individual financial institutions or cross-border financial service suppliers." Thus, the more macroprudential regulations of inflows of capital do not apply to US treaties (Gallagher et al. 2013).

Indeed, the United States has repeatedly said as much to its negotiating partners. As discussed earlier, Chile deployed capital account regulations with some success. The United States negotiated FTAs with Chile and Singapore at the turn of the twenty-first century, and both went into force in 2004. But the limits on capital account regulations included in the US model became major sticking points for both Chile and Singapore. In fact, Robert Zoellick, head of the Office of the US Trade Representative (USTR), had to intervene with the finance minister of Chile to salvage the negotiations over this issue (Saez 2006). During those negotiations, the United States negotiated a "compromise" (the inclusion of a "cooling-off" provision under which a US investor cannot file a claim for a period of one year after the provision has been deployed) that, with some variations, has also been used in agreements with Singapore, Peru, and Colombia. Interestingly, however, it has not become a matter of practice. Such a cooling-off period was not included as a provision in the 2004 or 2011 Model BIT or in the Dominican Republic–Central America–United States Free Trade Agreement (DR-CAFTA) or the FTAs with Panama and other nations.

The compromise cooling-off periods are illustrated in an Annex to the investment chapter of some agreements, such as the US-Chile Free Trade Agreement. The rationale is that the host nation may need to address or stem a financial crisis and that it should not be subject to claims in the middle of such action. However—and this is important—the cooling-off period allows a foreign investor to sue for damages related to capital controls that were deployed *during* the cooling-off year, although the investor cannot file the claim until after that year. To be clear: the claim for damages can be for a measure taken by the host country taken during the cooling-off year (Hornbeck 2003). Note also that these provisions are not mutual. The cooling-off period is only for investors filing claims against "a Party other than the United States."

Two US treaties do stand out. The NAFTA has a balance-of-payments exception and the South Korea–United States Free Trade Agreement (KORUS) has an annex to its investment chapter that grants South Korea the ability to deploy temporary capital account regulations. Article 2014(1) of NAFTA is the balance-of-payments exception and is very similar to the GATS exception; it can be invoked when the host states "experience serious balance of payments difficulties, or the threat thereof." Like similar exceptions at the WTO, use of the exception must be temporary and nondiscriminatory. The NAFTA provisions have thus raised concerns similar to those voiced about the balance-of-payments exception in the GATS. Although it may be possible to regulate the outflow of capital under

this provision when there is a serious crisis, regulating inflows as a preventative measure may be more difficult (Nadal 1996).

Beyond the academic community, the IMF has expressed concern that US FTAs and BITs do not provide enough flexibility to regulate the capital account. Around the time of the Chile and Singapore negotiations, senior IMF officials in the legal department wrote articles arguing that BITs should have at least temporary derogations for balance-of-payments difficulties and that the cooling-off period was not sufficient. Sean Hagan (2000) expressed concern that, if one nation forbids a host country from using capital controls on a temporary basis but the host country is permitted to use controls under agreements with other nations, then the controls will be discriminatory in nature and lead to distortions. Deborah Siegel (2004), who called the cooling-off provisions "draconian," expressed concern that the US transfers provisions raised jurisdictional issues with the IMF. The US provisions call for free transfers of all current transactions, but unlike WTO treaties and those of other capital exporters, the US provisions do not include mention of the ability of the IMF to recommend capital controls as part of a financial program. Siegel argues that FTAs "create a risk that in complying with its obligations under the FTA, a member could be rendered ineligible to use the Fund's resources under the Fund's articles" (2004, 4). As we have seen in chapter 6, the IMF institutional view states, "The limited flexibility afforded by some bilateral and regional agreements in respect to liberalization obligations may create challenges for the management of capital flows. These challenges should be weighed against the agreements' potential benefits. In particular, such agreements could be a step toward broader liberalization. However, these agreements in many cases do not provide appropriate safeguards or proper sequencing of liberalization, and could thus benefit from reform to include these protections" (IMF 2012b, 8).

Not only does US policy deviate from the GATS, but the investment provisions in US FTAs and of US BITs stand in stark contrast to the treaties of other major capital-exporting nations. The European Union, Japan, Canada, and increasingly China are major capital exporters. Each of these capital exporters has numerous BITs and FTAs with nations across the world. And loosely, the BITs of these nations have the same general characteristics found in US BITs. In contrast to the US treaties, however, regarding the use of capital account regulations to prevent and mitigate financial crises, all BITs and investment provisions of the FTAs of these exporters contain either a broad balance-of-payments safeguard exception or a controlled-entry exception, which allows a nation to deploy its domestic laws pertaining to the management of capital flows. Examples of the balance-of-payments approach can be found in the European Union–South Africa and European Union–Mexico FTAs, the Japan–South Korea BIT, and the

Association of Southeast Asian Nations (ASEAN) agreements. The Japan-Korea BIT has language that clearly allows for restrictions on both inflows and outflows, presumably inspired by the 1997 crisis. The BIT states that the nations may violate the transfers provisions (Salucuse 2010; Viterbo 2012).

As mentioned, another way capital account regulations are treated by other capital exporters in their FTAs and BITs is a controlled-entry exception (in which the domestic laws of the host nation regarding cross-border financial regulations are deferred to). The FTAs that Canada and the European Union have with Chile and Colombia each have a balance-of-payments safeguard *and* a controlled-entry deferment. As an example of a controlled-entry exception, is in the Annex of the investment chapter of the FTA between Canada and Colombia: "Colombia reserves the right to maintain or adopt measures to maintain or preserve the stability of its currency, in accordance with Colombian domestic legislation."[4]

Controlled-entry provisions are to be found in BITs as well. The European Union does not sign many BITs as an entity, but its member states do. For example, the China-Germany BIT states that transfers must comply with Chinese laws on exchange controls (Anderson 2009b). China has to approve all foreign inflows and outflows of short-term capital (IMF 2009b).

Interestingly, EU member-state BITs vary a great deal. Some, such as the China-Germany BIT and the UK-Bangladesh BIT, allow for a nation to defer to its own laws governing capital controls. In contrast, Sweden and Austria at one time had US-style BITs with no exceptions whatsoever. But the European Court of Justice ruled in 2009 that these BITs of Sweden and Austria with EMDs were in violation of their obligations under the EU treaty. Although the EU treaty requires EU members to allow for free transfers, it also allows members to have exceptions. The Court found that the Swedish and Austrian treaties were incompatible with the EU treaty and that such treaties must be renegotiated to include exceptions to the transfer provisions (Salacuse 2010).

It should be clear from the our discussion so far that the regulation of cross-border finance is in fundamental violation of the core principal of US trade and investment treaties requiring the free transfer of funds without delay. That said, the United States does not have a large number of treaties at the time of this writing. Table 8.3 lists the countries that currently have the full policy space to regulate capital flows because they have not liberalized financial services under the WTO and do not have a trade or investment treaty with the United States.

4. Canada-Colombia Free Trade Agreement. Winnipeg, Canada, 2009. http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/colombia-colombie/can-colombia-toc-tdm-can-colombie.aspx.

TABLE 8.3 Nations with the most policy space to regulate capital flows

Afghanistan	Guinea-Bissau	Russian Federation
Algeria	Guyana	Rwanda
Angola	Haiti	St. Kitts and Nevis
Antigua and Barbuda	India	St. Lucia
Bahamas	Iran, Islamic Republic of	St. Vincent and the Grenadines
Barbados	Iraq	Samoa
Belarus	Kenya	San Marino
Belize	Kiribati	São Tomé and Príncipe
Benin	Kosovo	Saudi Arabia
Bhutan	Lao People's Democratic Republic	Serbia
Bosnia and Herzegovina	Lebanon	Seychelles
Botswana	Lesotho	Slovenia
Brazil	Liberia	Somalia
Brunei Darussalam	Libyan Arab Jamahiriya	Sudan
Burkina Faso	Macedonia	Suriname
Burundi	Madagascar	Swaziland
Cambodia	Malaysia	Syrian Arab Republic
Cape Verde	Maldives	Tajikistan
Central African Republic	Mali	Tanzania
Chad	Malta	Thailand
China	Marshall Islands	Timor-Leste
Comoros	Mauritania	Togo
Côte d'Ivoire	Micronesia	Tonga
Cyprus	Montenegro	Turkmenistan
Djibouti	Myanmar	Uganda
Dominica	Namibia	Uzbekistan
Equatorial Guinea	Nepal	Vanuatu
Eritrea	Niger	Venezuela
Ethiopia	Pakistan	Vietnam
Fiji	Palau	Yemen, Republic of
Gabon	Papua New Guinea	Zambia
Ghana	Paraguay	Zimbabwe
Guinea		

Sources: IMF, "IMF Members' Quotas and Voting Power, and IMF Board of Governors," March 2014, http://www.imf.org/external/np/sec/memdir/members.htm; OECD, "Member and Partners," n.d., http://www.oecd.org/pages/0,3417,en_36734052_36761800_1_1_1_1_1,00.html; Export.gov, Helping U.S. Companies Export, "Enforcement and Compliance, July 2012, http://tcc.export.gov/Trade_Agreements/Bilateral_Investment_Treaties/index.asp; Office of the United States Trade Representative, "Free Trade Agreement, n.d., http://www.ustr.gov/trade-agreements/free-trade-agreements.

The first column of table 8.4 lists countries that may have the least amount of policy space to regulate capital flows; they have signed and ratified US FTAs or BITs with the United States. Only one of those countries, South Korea, has successfully negotiated a controlled-entry clause for its regulations on cross-border finance. A handful of countries have annexes that allow for the cooling-off period for investor state disputes. Mexico, under the NAFTA (signed in 1994), is the last nation that the United States granted a balance-of-payments exception to.

TABLE 8.4 Countries with US free-trade agreements and bilateral investment treaties, current and pending

RATIFIED[a]	PENDING	TIFA (SELECTED)
Chile[b]	Brunei	Angola
Colombia[b]	Malaysia	Algeria
Costa Rica	Vietnam	Bahrain
Dominican Republic	India	Brazil
El Salvador	China	Georgia
Guatemala		Indonesia
Honduras		Iceland
Jordan		Kuwait
Mexico[c]		Liberia
Morocco		Mauritius
Nicaragua		Mozambique
Oman		Nepal
Panama		Pakistan
Peru		Sri Lanka
Republic of Korea[d]		Thailand
Singapore[b]		South Africa
Uruguay		

Note: TIFA, trade and investment framework agreement.

[a] Countries most vulnerable to actions related to regulating cross-border finance.
[b] Treaty includes cooling-off provision.
[c] Treaty includes balance-of-payments exception.
[d] Treaty includes partial carve-out for home-country regulations.

The second column in table 8.4 lists countries with pending negotiations under BITs and the Trans-Pacific Partnership Agreement (TPP) as of January 2014. The third column is a longer wish list of countries with which the United States currently is holding preliminary discussions.

Reclaiming and Preserving Policy Space after the Global Financial Crisis

As nations have sought to reregulate capital flows in the wake of the global financial crisis, many have attempted to reclaim or preserve the policy space to do so in trade and investment treaties. Between 2010 and 2012, there was an assessment of the GATS exceptions under the WTO. In terms of FTAs and BITs with the United States, there was a concerted effort by EMDs to preserve their policy space under two East Asian trade and investment treaties.

In the wake of the global financial crisis, Ecuador led an effort for the WTO to adopt interpretations of existing treaty language to ensure that existing treaties granted policy space for a variety of financial regulations. Both the WTO and FTAs/BITs have a process for including interpretive notes or amendments that could clarify or change existing language in current treaties. Article IX: 2 of the GATS allows the Council for Trade in Services to make official interpretations that can be adopted by either the WTO Ministerial Conference or the General Council, with a three-quarters majority vote. For example, an interpretive note could clarify that language under the GATS so that the balance-of-payments exception and the prudential carve-out would cover the use of cross-border financial regulations.

Ecuador engaged with the Committee on Financial Services in a process that would have led to an interpretation of this kind. Ecuador had put in place a number of regulations on the financial sector following the global financial crisis. In that process, the country found that capital was fleeing to nations without such regulations and thus began to control the outflow of capital. In response, the flow-recipient nation threatened to file a WTO case against Ecuador on grounds that Ecuador was violating the GATS. The process at the Committee on Financial Services was hotly contested. It centered around the vague prudential measures exception in the GATS that I have outlined. Ecuador and many global civil society organizations wanted an illustrative list of regulations that would be permitted under this exception. On the other side, industrialized countries (including the United States) and EMDs such as Brazil argued that it was better to leave the language vague. They worried that listing some measures and not others would implicitly disfavor those that were not listed. In the end, this loose agreement between some EMDs and the industrialized nations outnumbered the countries supporting the Ecuadorean proposal. This outcome could be positive for nations hoping to regulate capital flows, given that disputes are settled between nation-states using a state-to-state dispute-resolution system at the WTO, rather than the investor-state system in US FTAs and BITS. Thus, countries such as the United States can keep their word, or be held to their word, in the Committee on Financial Services meetings because the state is the actor that makes the decision about whether to file a claim. In FTAs and BITs, in contrast, governments and regulators have no say about when a private investor will file a claim.

Cross-border financial regulations also became contentious issues in two East Asian trade negotiations with the United States. The first was the South Korea–United States Free Trade Agreement (KORUS). KORUS was negotiated during the George W. Bush administration but did not enter into force until 2012. As noted previously, South Korea has an open capital account but has long reserved the right of the Finance Ministry to regulate capital flows under its Foreign

Exchange Transactions Act. As Chile, Colombia, Singapore, and other nations had proposed during their negotiations with the United States, South Korea asked for a controlled-entry clause for its law in the FTA. Unlike Chile and the others, however, South Korea (almost) got its way.

The KORUS, Chapter 11, deals with investment, and its Annex 11-G pertains to transfers. The annex is essentially a controlled-entry clause stating that nothing in the financial services or investment chapters of the treaty will restrict the ability of South Korea to use the special powers under its Foreign Exchange Transactions Act. The treaty imposes some limitations on the ability of South Korea to use the act, however. The annex notes that the measures cannot be imposed for more than one year and that they are subject to the "national treatment" provisions in the KORUS—thus making it harder for Korea to discriminate based on residence.[5] Nevertheless, this annex is the first time in the history of US trade policy that such a carve-out has been permitted.

The second contentious negotiation began in 2008, when the United States was negotiating a FTA—the TPP—with several Pacific Rim countries. The nations engaged in the negotiations (at the end of 2013) were Brunei, Chile, New Zealand, Singapore, Australia, Peru, Vietnam, Malaysia, Mexico, Canada, and Japan. As in previous negotiations, the United States proposed investment language based on its Model BIT. The language required that all capital move freely and without delay among the parties to the agreement and did not include an exception for regulating the inflow of capital or a balance-of-payments exception. Furthermore, the agreement specified investor-state dispute resolution.

During the TPP negotiations, Chile sought to obtain a controlled-entry clause for its Encaje legislation, which permitted Chile to deploy its unremunerated reserve requirement (URR) when necessary. Chile had obtained this flexibility under its agreements with Canada and the European Union, but not the United States. Given that the TPP was likely to supersede the United States–Chile FTA, Chile hoped that the TPP would rectify the FTA limitations. In an opinion article published in a Peruvian newspaper, coinciding with TPP negotiations, Rodrigo Contreras, the outgoing Chilean chief TPP negotiator, said, "Our countries need the flexibility that has been recognized by multilateral trade negotiations on issues such as intellectual property, environmental protection, capital controls, and the proper balance between the rights of investors and the state"; furthermore, "The International Monetary Fund has reiterated that one of the main challenges for Latin America is to restore the ability to apply financial safeguards. In the TPP

5. South Korea–United States Free Trade Agreement. Washington, DC, 2012. http://www.ustr.gov/trade-agreements/free-trade-agreements/korus-fta/final-text.

it does not make sense to further liberalize capital flows, or deprive countries of legitimate tools to safeguard financial stability" (Contreras 2013).

Malaysia tabled a balance-of-payments clause to the TPP. The clause, as confirmed by leaked text of the chapter under Article XX.3, is very analogous to the balance-of-payments wording found in the GATS and many Asian FTAs.[6] Such a safeguard would allow the use of regulations on the outflow of capital during a crisis, as Malaysia had done in the wake of its crisis in 1997–1998 (Gallagher et al. 2013).

The USTR received significant push-back on this issue throughout the period 2008–2013. Moreover, as of 2013 the United States had not changed its position that the TPP should not include a prudential measures exception that covered cross-border financial regulations, should not include a balance-of-payments exception, and should not include a controlled-entry clause for Chile (as the KORUS with South Korea does); in addition, it should not even include a cooling-off provision, which had been included in smaller US FTAs in the past.

Barack Obama, when he was a candidate for the presidency, committed to renegotiate the NAFTA and also said he would not sign NAFTA-like deals when in office. To that end, he appointed several interest-group representatives and experts to lead a reevaluation of the US Model BIT and to make recommendations to the president that would lead to the new Model BIT. The group was referred to as the Subcommittee on Investment of the US State Department Advisory Committee on International Economic Policy. Among other issues, the group was specifically asked to examine whether US treaties should be adapted in the wake of the financial crisis. Some members of the subcommittee immediately zeroed in on the limited nature of the prudential exception (and the language of the cooling-off provision) and the lack of a balance-of-payments exception. Other members of the subcommittee, who represented financial and business interests, were vehemently opposed to changes or reinterpretations of the language on these matters. In the end, the subcommittee remained split on the issue and was not able to provide uniform advice to the president on this matter.[7]

One group of civil society organizations and academic experts issued its own set of recommendations. That document recommended that future US BITs

6. Leaked text of the TPP Investment Chapter. Citizens' Trade Campaign. 2012. www.citizenstrade.org/ctc/wp-content/uploads/2012/06/tppinvestment.pdf.

7. "Report of the Subcommittee on Investment of the Advisory Committee on International Economic Policy Regarding the Model Bilateral Investment." Washington, DC, September 30, 2009. http://www.state.gov/e/eeb/rls/othr/2009/131098.htm. The author was appointed to this subcommittee.

and FTAs include a safeguard provision to allow the imposition of temporary capital controls, as well as a balance-of-payments safeguard (Anderson et al. 2012). The State Department and the USTR took all these inputs and released the 2011 Model BIT, which did not contain an expanded prudential exception or a balance-of-payments safeguard. The US position on these issues regarding the TPP was thus codified in the new model BIT.

Members of the US Congress and others in the civil society that hotly contested this policy throughout. Representatives Barney Frank and Sander Levin (D-Michigan) wrote numerous letters to the USTR and to the Treasury Department and met with senior staff at the both departments as well.

Also in 2011, more than 250 economists from across the globe signed a letter informing the US government of the new economic evidence on the efficacy of regulating cross-border finance and calling on the United States to place safeguards in its trade treaties (Global Development and Environment Institute 2011). In response, lobby groups representing eighteen different interests groups also wrote a stiff letter to the US government arguing that its existing regime was already flexible enough. They noted that nations could indeed impose regulations when they saw fit but would have to compensate private investors for doing so if the investors sued those states in private investor-state tribunals. They also argued that capital controls hurt US jobs and cited evidence suggesting that regulating cross-border financial flows was ineffective. The groups signing this letter included the Financial Services Roundtable, the National Association of Manufacturers, the Business Roundtable, the US Chamber of Commerce, and the US Council for International Business.

In rebuttal, Representatives Frank and Levin cited the new thinking at the IMF and in academia about capital controls (specifically mentioning the letter) and the need for a more stable world in the wake of the crisis. Frank enjoyed significant clout on the issue given that he was the co-author of the Dodd-Frank legislation on reregulating the US financial industry after the crisis. Letters were exchanged and meetings were held in the beginning of 2012 and then in late 2012 after the IMF changed its institutional view on regulating cross-border finance. In formal responses to the representatives and the economists, Timothy Geithner, then secretary of the treasury, echoed the concerns of the financial sector, saying that US treaties already gave nations the leeway to regulate. Moreover, Geithner argued that other measures, such as interest rate manipulation, capital requirements, and reserve accumulation, were more appropriate for nations looking to manage capital flows.

When this book went to press, negotiators had completed work on several provisions of the TTP. But several key issues such as intellectual property, environment and labor, investor-state dispute settlement, and safeguarding cross-border financial regulation were still "bracketed" (i.e., under contention).

The Political Economy of Policy Space for Capital Account Regulations in the Trading System

The United States, backed by financial interests, sought to bring issues of the capital account into the strong international standards of the trade and investment regime. How did the issue of capital account liberalization move into the trading system, and why did so many nations agree to liberalize their capital accounts under trade and investment treaties? I next explore how the nature of the trade and negotiating institutions, issues of market power, and ideas integrate to explain the various outcomes. The key factors are summarized in table 8.5.

At the WTO, many EMDs were able to refrain from committing to the liberalization of financial services because of the nature of the WTO negotiating system, because they had more bargaining power there, and because their domestic constituencies were still freshly concerned about the myriad financial crises that had hit the developing world in the 1990s. This also led to EMD coalitions that crafted some of the exceptions discussed earlier. The United States is able to extract more concessions in its FTAs and BITs because of the asymmetric bargaining power it has relative to the nations with which it negotiates, the very strong financial lobby in the United States, and the fact that it has signed treaties largely with nations that view capital account liberalization in the same way as the United States.

The World Trade Organization–General Agreement on Trade in Services

The GATS negotiations had limited reach with respect to EMD commitments in financial services. The GATS negotiations on financial services liberalization were the result of domestic lobbying efforts by financial firms that (rightly)

TABLE 8.5 Political economy of capital account regulation and the trading system

	WTO	FTAS/BITS
Institutions	One country–one vote	Small number of parties
	Positive list approach	Negative listapproach
Power interests	Bargaining power less asymmetric	Asymmetric bargaining power
	US financial interests	US financial interests
	Emerging market coalitions	Collective action problems
Ideas	New classical macroeconomics	New classical macroeconomics
	The idea of history	Coalition of the willing

Note: BITs, bilateral investment treaties; FTAs, free-trade agreements; WTO, World Trade Organization.

convinced the US government that it had a comparative advantage in the export of financial services. But, with the exception of the handful of EMDs, most of the commitments were made by industrialized nations that had already opened their capital accounts.

By and large, EMDs did not liberalize trade in financial services because of "fears of the implications of liberalization for weak domestic financial institutions, a perceived absence of reciprocity given that many developing countries are importers and not exporters of financial services. Another concern revolved around the implications of GATS rules for the management of capital flows and prudential regulation and supervision" (Hoekman and Kostecki 2009, 349). EMDs were able to exercise such preferences at the WTO because of the nature of the institution. The positive list approach tilted the negotiating table toward a discussion of liberalizing those sectors that a nation already saw as ready or willing to liberalize. Many EMDs exercised intra-forum leverage (see chapter 6). They refused to liberalize financial services but were still able to put together a larger WTO deal because there were other sectors (within services negotiations and, more important, in manufacturing) that EMDs were willing to liberalize and that the United States and other industrialized nations coveted.

EMDs also crafted significant coalitions to help block proposals by the industrialized countries and to craft some of the exceptions. The prudential exception in the Annex on Financial Services was initially submitted during the negotiations by the South East Asian Central Banks and Monetary Authorities (SEACEN), a coalition headed by Malaysia and consisting of Indonesia, South Korea, Malaysia, Myanmar, Nepal, Philippines, Singapore, Sri Lanka, and Thailand. These negotiations occurred at the height of the East Asian financial crisis (Narlikar 2003). These exception clauses were also supported by financial regulators in the United States (Key 2003; Hoekman and Kostecki 2009).

Furthermore, key EMDs such as Brazil and India agreed to enter into long-term discussions about the liberalization of financial services but did not commit at the time. The WTO negotiations as a whole were seen as a grand bargain. Industrialized nations agreed to liberalize tariffs in textiles and apparel and agreed to eventually reduce agricultural subsidies; in exchange, EMDs agreed to liberalize manufacturing tariffs and agreed to eventually liberalize services (Narlikar 2003).

US Free-Trade Agreements and Bilateral Investment Treaties

The United States was frustrated by its inability to forge a consensus at the WTO, where decisions must be made on consensus, and at the turn of the twenty-first

century, it largely abandoned multilateral trade liberalization in favor of a new strategy officially referred to as "competitive liberalization." The goals of the strategy, adopted under US President George W. Bush and continued by President Barak Obama, are to "overcome or bypass obstacles; exert maximum leverage for openness, target the needs of developing countries, especially the most committed to economic and political reforms" (Evenett and Meier 2008, 36). Explicitly, the United States wanted to sign FTAs and BITs with nations that would be willing to negotiate on the deeper issues (such as investment) where the United States was not gaining ground at the global level.

As we saw earlier, limiting the ability of nations to regulate cross-border finance has been a cornerstone of US trade policy. The United States has been able to accomplish this using FTAs and BITs, and not at the WTO, because of the asymmetric bargaining power it enjoys in such negotiations, compared to those at the WTO; also, many of the nations that chose to sign such agreements with the United States have the same idea about capital account liberalization.

Capital account regulations and FTAs became a highly controversial issue during negotiations between the United States and Chile and between the United States and Singapore in the early 2000s. Chile is well known for its URR (under which a certain percentage of capital inflows must be deposited in the Central Bank for a minimum period of time). This measure has been shown econometrically to have buffered Chile from the acute crises that struck the region in the 1990s. The requirement was also quite controversial among EMD partners. Chile pushed hard for an exception to the investment chapters of FTAs so that it could use its famed capital account regulations. It had succeeded in its negotiations with Canada to have its law carved out of their agreement. Indeed, Canada was one of the few nations that did not support amending the IMF Articles of Agreement to liberalize capital flows precisely because it had safeguarded the ability of Chile to deploy regulations under a trade treaty (Chwieroth 2010a). In contrast, the United States would not budge on this issue, and the Chilean authorities had to settle for the cooling-off provisions. In the 2013 TPP negotiations, Chile tried to re-open the issue, hoping that an exception in the TPP would supersede the older United States–Chile FTA.

Singapore saw that Malaysia had successfully deployed controls on outflows in the wake of the Asian financial crisis and wanted to reserve that option. The Bush administration negotiated similar deals with Peru, Panama, South Korea, and Colombia. The Obama administration maintained the position taken by the Bush administration. As discussed previously, in response to a letter signed by more than 250 economists urging the Obama administration to provide flexibility for capital controls in US trade deals, the United States replied that it did

not intend to change its treaties in that direction. This position was echoed by numerous financial services coalitions in the United States (Drajem 2011).

The cooling-off language triggered controversy in the United States, leading to hearings specifically on the subject back on April 1, 2003, before the Subcommittee on Domestic and International Monetary, Trade and Technology of the US House Committee on Financial Services.[8] The committee was chaired by Representative Michael Oxley (R-Indiana), the majority head; the minority head was Barney Frank (D-Massachusetts). In general, the hearings revealed that most Republicans were against the use of capital controls, whereas Democrats favored more flexibility. The hearings were very lively, to say the least. The leading advocate for restricting capital controls was John Taylor, then undersecretary for international affairs of the US Treasury in the Bush administration. As a Stanford University economist, he had become famous for the Taylor rule, which sets a formula for inflation targeting. Insiders thus began referring to the cooling-off provisions as the "Taylor provisions." Interestingly, the hearings included harsh rebuttals to Taylor by Nancy Birdsall of the Center for Global Development, Jagdish Bhagwati of Colombia University, and Daniel Tarullo, then of Georgetown University and now on the Board of Governors of the US Federal Reserve System. These individuals are staunch supporters of free trade in goods but argued that capital account liberalization without exception is dangerous from both economic and foreign policy perspectives. Representative Carolyn Maloney (D-New York; now chair of Joint Economic Committee) argued in favor of flexibility. At the hearings, Barney Frank famously remarked that "ice is in the eyes of the beholder," arguing that the cooling-off period still effectively restricts Chile and Singapore from using capital controls. In the end, the Democrats and their supporters were outnumbered.

Hirschman (1945) showed more than a generation ago that asymmetric bargaining power and influence can play a big role in determining the outcome of trade negotiations. Kirshner (1993) extends such logic to monetary affairs. Negotiators from large nations with large markets have significant leverage over negotiators from smaller countries. The average size of the US economy relative to its negotiating partners is orders of magnitude larger. Therefore, trade negotiations at the bilateral or regional level in large part focus on the classic market-access-for-regulatory-reform equation (Shadlen 2005, 2008; Gallagher

8. Subcommittee on Domestic and International Monetary, Trade and Technology of the US House Committee on Financial Services. "Hearing on Opening Trade in Financial Services—The Chile and Singapore Examples." Washington, DC, April 1, 2003.

2008). At the WTO, this is more balanced because of the one country–one vote and consensus nature of the institution and because of the newfound market power held by many larger EMDs. Now it is access to the EMD markets that the West really covets.

At the WTO, many smaller EMDs could coalesce around Brazil, India, and China on these issues, but that is much more difficult in a two-country negotiation. Of course, when a nation such as the United States negotiates a deal with a nation such as Uruguay, Uruguay has little bargaining power and a Hirschman-like analysis (rightly) predicts that Uruguay will pretty much have to "sign on the dotted line" on US proposals—this is true especially when a small country has to deal with the negative list negotiating format in which everything must be liberalized except those sectors pinpointed by an EMD to be protected.

This power is accentuated by collective action problems. From a national welfare perspective, it is in the interest of any government negotiator to ensure that his or her country has the policy space to ensure financial stability. But financial stability is more of a public good; thus the losers in trade deals that restrict the ability of the government to regulate capital flows (the general public) are dispersed. In contrast, the winners are concentrated—they are the highly organized banks and firms that will not have to bear the cost of regulation (Shadlen 2008; Gallagher 2008).

The US trade deal with South Korea was different, however. South Korea is a large and growing market, with many capital goods sectors where powerful US firms sell goods as inputs; it also provides a large consumer market and a hub for shipping services. Remember that, when Chile negotiated with the United States, it wanted a special carve-out for its Encaje, but the United States would not grant an exception. In the case of the KORUS, however, the United States (against its wishes) allowed South Korea to carve its Foreign Exchange Transactions Act out of the agreement. The United States had enough market power of its own to push back but not as far as it could in the agreement with Chile. The United States grants South Korea the ability to deploy its law, but under certain conditions. One of those conditions is that the act be deployed in a manner consistent with national treatment (Kelsey 2011).

Nations that believe capital flows should be regulated have been successful at keeping the policy space to do so when they have significant market power—or can form coalitions with other nations that do—in institutions where that power can be channeled. The WTO has a one country–one vote voting system and nations have to reach a consensus on all provisions in an agreement. Large nations such as Brazil and India can leverage their newfound economic power to avoid making significant commitments under the GATS. Doing this in

bilateral negotiations is difficult, as Hirschman pointed out so many years ago. Nevertheless, South Korea has many sectors that the United States coveted, and its market power and trading across issues caused the United States to make an unprecedented concession on capital account regulations in their FTA that other nations in the TPP negotiations were seeking to duplicate in 2014.

9

THE FUTURE OF COUNTERVAILING MONETARY POWER

As we have seen, many emerging-market and developing countries (EMDs) were able to reregulate cross-border finance and to create more policy room to maneuver in global economic governance institutions. These significant changes in policy, however, did not result in significant enough economic outcomes to fully mitigate the surges and sudden stops of capital flows in the wake of the crisis. The domestic and international political forces that some countries were able to countervail are the reason that some nations were not able to regulate at home and why there is still inadequate policy space to regulate capital flows under the current system of global economic governance.

Reregulation of Cross-Border Finance

During the surges of capital flows that led to the financial crises of the 1990s, most EMDs either liberalized their capital account further or managed capital flows through less controversial means, such as intervening in the currency markets. If countries did put regulations in place on the inflow or outflow of capital, they were ridiculed by the International Monetary Fund (IMF), the US Treasury Department, and the financial press. The 2008 global financial crisis was a different matter. In the wake of the crisis, many EMDs reregulated cross-border finance to handle the surges in cross-border financial flows. Significantly, this time the international financial institutions and industrialized countries did not ridicule EMDs

for taking such actions. In fact, many tacitly supported this new ad hoc regime in which the industrialized countries pursued loose monetary policies and EMDs buffered the harmful effects of such policies using capital account regulations.

Regulation enjoyed greater legitimacy in the eyes of the economics profession because of breakthroughs in economic thinking that now saw the regulation of capital flows as market-correcting mechanisms to achieve stability and growth—not as distortionary moves to defer necessary adjustment. Moreover, years of econometric analysis proved that capital account liberalization was not strongly correlated with economic growth and tended to trigger banking crises in nations that had weaker institutional frameworks. Economists were even modeling the regulation of capital flows and recommending that countries cooperate on regulation on both ends of the capital flow cycle. Pioneering economists such as Nelson Barbosa in Brazil, Hyun Song Shin in South Korea, Anton Korinek in the United States, and Jonathan Ostry at the IMF all translated this new thinking for their respective policymaking circles.

These control measures met with some success. Nations that had regulations in place when the global financial crisis occurred were among the least hard hit. And the majority of the research shows that countries that reregulated cross-border finance after the crisis were able to change the level of inflows, reduce exchange rate pressure, have a more autonomous monetary policy, and grow faster than countries that did not.

EMDs also sought to ensure that they had enough policy space to deploy such regulations under the global economic governance institutions. At the IMF, the BRICS coalition (Brazil, Russia, India, China, and South Africa) worked to defend the regime of cooperative decentralization, in which, under the IMF Articles of Agreement, member states may regulate capital flows as they see fit. At the G20, EMDs elevated the importance of regulating cross-border finance to the highest level by inserting it into communiqués and negotiating an explicit document granting legitimacy to reregulating capital flows. In the trading regime, a regime with strong international standards where some countries have moved the discussion of capital account liberalization, many EMDs have been less successful. Large countries such as Brazil have been able to avoid commitments under the General Agreement on Trade in Services (GATS) that make it harder to regulate capital flows, and countries that already have commitments may have recourse to exceptions under the World Trade Organization (WTO). In contrast, countries that have chosen to engage in free-trade agreements (FTAs) and bilateral investment treaties (BITs), especially with the United States, have traded away their ability to regulate cross-border finance without being subject to claims under those treaties. South Korea is an exception to this; it has been able to carve some of its regulations on capital flows out of its FTA.

But these changes in domestic and global policy were not enough to significantly change economic outcomes. Yes, many EMDs would have been even worse off from the post-crisis surges and sudden stops of capital flows than if they hadn't regulated those flows. Still, the regulations had only a modest effect because of their lack of strength and the lack of cooperation between source (mostly, industrialized) countries and EMDs. The result was what Grabel (2011) refers to as productive incoherence, where many positive developments have been tempered by the lack of political and policy space to effectively regulate capital at both ends.

Countervailing Monetary Power

The EMDs that were able to reregulate cross-border finance and maintain the related requisite policy space under the global economic governance institutions were able to do so, in part, by exercising countervailing monetary power. As we have seen in chapter 1, countervailing monetary power can operate in two arenas. At the national level, countervailing monetary power can be used by a country to overcome political and economic forces and counter the structural power of global capital markets. At the international level, countervailing monetary power can be used by relatively weaker states to counter the realist power and institutions crafted by stronger states.

On the home front, EMDs that were successful in regulating cross-border finance exerted countervailing monetary power supported by five pillars: domestic institutions that allowed financial authorities to regulate flows in a timely and countercyclical manner, the backing of exporters who were more concerned about the exchange rate than access to global finance, the backing of workers (and worker parties) motivated by job security over short-term consumption benefits, the backing by a general public haunted by the collective memory of past crises, and the ability to translate economic ideas to decision makers and the general public. Countries that were not able to put adequate regulations in place did not have the support of enough of these five pillars to overcome the traditional obstacles to regulation.

First, in both Brazil and South Korea, there were institutions in place that allowed the governments to channel new ideas and political backing into central bank policy. Although both countries had independent central banks, they had institutions that gave financial authorities a partial say as well. Second, in Brazil, exporters were more sensitive to the exchange rate than to a loss of international financing because Brazil offered several public and privately regulated options for finance. Thus, when the exchange rate rose during a surge in inflows,

exporters were more disposed to regulating finance for material reasons. When exporters rely on international finance for the majority of their financing needs, regulations on the inflow of capital will hurt their ability to raise capital and strengthen the political alliance between industry and finance, which will be opposed to regulation. Third, in Brazil organized labor (which forms the core of the party in power) was more concerned that exchange rate volatility would threaten their employment prospects than they were about the temporary benefits of exchange rate appreciation during a surge. Fourth, in both Brazil and South Korea, policymakers drew on the collective memory of financial trauma to gain political backing for their actions. Both countries had been plagued with severe crises that are very alive in the memories of workers and citizens. Under normal circumstances, workers and citizens enjoy exchange rate appreciation because it allows them to purchase more goods. In these two countries, however, workers and citizens knew too well that exchange rate pressure and credit bubbles can lead to lost jobs, high debt, and inflation. And fifth, policymakers had the idea of expanding the mitigation toolkit to include cross-border financial regulations and were able to gain support for their actions by framing it in the new economics of capital controls (see chapter 3). In Brazil, the Finance Ministry, although coming from a Minskian developmentalist framework, reframed its rationale for regulation to the Central Bank as "externalities" to conform to the language of the Central Bank. In South Korea, Hyun Song Shin and others framed regulations as pragmatic approaches to stem systemic risk at the major source—cross-border banking operations. Moreover, when South Korea spoke about its measures to the world, it defined them as macroprudential regulations on the foreign exchange derivatives market, not as capital controls on global finance (as Brazil had).

Many EMDs, especially the BRICS, also led a charge in global economic governance institutions to expand or preserve their policy space to regulate cross-border finance and to gain the cooperation of the source countries of the capital flow. As summarized in table 9.1, the global statecraft aspects of countervailing

TABLE 9.1 Pillars of countervailing monetary power

National level	Institutions for timely countercyclical regulation
	Less reliance on global finance
	Strong organized labor and affiliated parties
	Evocation of the collective memory of past crises
	Reframing control as macroprudential regulation
Global level	Larger levels of preexisting policy space
	Exerting market power
	Creating coalitions
	Leveraging fragmentation
	Leveraging new ideas

monetary power also have five pillars: nations need policy space to regulate under global economic governance institutions, nations are more apt to gain policy space as they gain market power in the global economy, nations can concentrate such market power by forming coalitions, these coalitions can leverage the fragmentation of global governance to their benefit, and they can leverage global governance through the translation of new economic ideas.

EMDs were able to obtain or preserve the most policy space at the WTO and the G20. In both these institutions, at least on paper, members adhere to a one country–one vote system that operates by consensus. Of course, equal voting power does not translate fully into more power. Perhaps even more important than the institutional structure in these two forums was the ability of EMDs to use their increased market power to the most advantage within the institutional structures. At the WTO, Brazil, South Africa, India, and China (Russia did not join the WTO until August 2012) all had large markets that were coveted by the industrialized countries. In a one country–one vote system operating by consensus, these countries were able to employ intraforum leverage significantly—they would not liberalize services unless the industrialized countries did so on agriculture. What is more, EMDs formed numerous coalitions at the WTO. At the G20, they were able to do the same. BRICS formed a coalition within the G20 and were able to employ intraforum leverage, getting concessions in exchange for being willing to discuss EMD participation in the euro crisis. By negotiating an alternative BRICS reserve pool and development bank on the sidelines of the G20, they were also able to employ extra-forum leverage to get the G20 to acknowledge the negative spillovers of the monetary policies of the industrialized countries.

The increasing EMD market share also played a role at the IMF. In contrast to the late 1990s, when all BRICS countries (except China) had undergone an IMF country program and they collectively had 9 percent of global GDP, in 2012 no BRICS had a country program and they represented 34 percent of GDP. The IMF quota system had been improved in this light but only slightly, and some reforms were yet to get through the US Congress during the proceedings of the IMF institutional view. On an institutional level, significantly, the IMF management and staff took an initial position that already met the EMDs halfway on capital account regulation. The spirit of new thinking at the IMF and the diffusion of new ideas throughout the staff were key on this issue. This was a complete contrast to the 1990s, when the IMF management and staff and the industrialized countries were all pursuing capital account liberalization. This time, the management and staff were in charge of setting the agenda and endorsed the kinds of capital account regulations pursued by EMDs. Moreover, the industrialized countries had

been nudged toward viewing more favorably capital account regulations used for prudential reasons, although they were still vehemently opposed to regulations used to mobilize domestic finance through a heavily managed exchange rate regime. BRICS were able to use intraforum leverage by strategically siding with the IMF staff during key parts of the process. They also employed extra-forum leverage by using their gains on capital account regulation made at the G20 to wedge their positions into the IMF deliberations.

Of course, the distribution of power and institutional structures also explain why EMDs didn't fully achieve their goals and, in some cases, lost more policy space. At the WTO, smaller states had to liberalize much of their financial services sectors. At the IMF, the industrialized countries were able to temper language that called for the industrialized countries to regulate capital flows at the source of the capital flow cycle. The most significant case is the use of FTAs and BITs by the United States. Bilateral negotiations between a large economy and a small one are tilted in favor of the large economy because the large economy can make agreeing with its objectives a condition of access to its markets. The United States was able to put such conditions into its FTA with Chile, even though Chile had managed to avoid such conditions in its treaties with Canada and the European Union. In contrast, South Korea had a larger economy than Chile and had many sectors that the United States wanted access to. As a result, South Korea was able to use intraforum leverage and make maintaining its innovative law granting its financial authorities the ability to put capital account regulations in place a condition of entering into an FTA with the United States.

Policy Recommendations for Countervailing Monetary Power

EMDs can put in place several policies and strategies that can accentuate their ability to exert countervailing monetary power at the national and international levels. There are ten policies or strategies that may help these states regulate the structural power of capital markets in their own economies and maintain or expand the policy space for regulation and cooperation in global economic governance institutions.

1. Put in place permanent but countercyclical regulations on cross-border finance.

Both Brazil and South Korea have legislation in place that grants the finance ministries the authority to make quick decisions on the regulation of cross-border

finance. This is politically important because it avoids wasting time on major legislative battles in the midst of a boom, when the political forces against regulation may be strongest. Such regulations should be made permanent but should be countercyclical in nature. The regulations should be tightened when there is a rise in inflows or systemic risk related to cross-border finance, and they should be eased as capital becomes scarcer. Countries also have to build the institutional capacity to fine-tune regulations as the capital cycle persists. Both Brazil and South Korea were constantly adjusting their regulations on inflows (see chapter 4). That said, it appears that the capacity of South Korea to regulate flows is the stronger of the two because South Korea did not experience a sudden stop in capital flows, as Brazil and other nations did in 2014.

2. Foster institutions to diversify sources of finance.

Economic diversification is, of course, the key to long-run growth and development. If such diversification is fueled by a variety of financing sources, both public and private, then sectors in the industrial economy will not be as tied to the international financial sector. This is important for economic reasons—the real economy will be less susceptible to the surges and sudden stops of international finance. It is also very important politically—industry may be less likely to collude with international finance against regulation because it will be more sensitive to exchange rate volatility than to its links to the international financial sector. The development of domestic bond markets is essential here, but not enough. In early 2014, 50 percent of domestic debt in EMDs was held by foreign investors and can thus be subject to surges and sudden stops as well. Reviving national development banks is yet another way to provide domestic financing, as in Brazil, along with regulations requiring the private banks in the country to earmark certain types of long-run investments on favorable terms.

3. Foster institutions to enable organized labor to collectively bargain and engage in political parties. Leaders should emphasize job security over exchange rate benefits.

If there is a relatively small industrial working class and the workers are not organized, politics may favor households and consumers driven by consumer benefits rather than job security. Organized labor tends to concentrate on job security and wages, and sees exchange rate fluctuation as a threat to those objectives. Households and consumers, in the short term, often see exchange rate appreciation as an income and sometimes as asset boost and thus organize against regulation. Therefore organized labor should be supported to this end.

4. Engage with the general public to evoke the collective memory of past financial crises.

Financial crises have been associated with significant trauma. Remembering this trauma can help the general public take a longer-run view of certain policy outcomes. As we have seen, the collective memory of past financial crises really resonates in Brazil and South Korea—two nations that have been plagued with severe crises. The general public can sometimes be re-oriented from what might seem rational in the short term toward longer-run objectives. That is, lack of regulation of capital flows may benefit individual citizens in the short term through an appreciated exchange rate, but if the public is reminded that the financial amplification effect can kick, with the rising exchange rate tied to job losses and its subsequent fall causing massive inflation, citizens are more apt to support the regulation of cross-border finance.

5. Reframe the need to regulate cross-border finance at home and abroad.

It is important to devise country-specific regulations that target where the cross-border financial risk is coming from. Sometimes it will be the foreign exchange (FX) derivatives market, the bond market, equities market, or the currency market itself. Sometimes hard, quantity-based capital controls are the best way to prevent and mitigate the risk associated with cross-border finance; at other times, price-based second-generation regulations are more appropriate. Increasingly, third-generation regulations on the FX derivatives market, on highly interconnected banks, and other sectors may be more appropriate. This family of regulations are better referred in a broader sense for economic as well as political reasons. If the measures are reframed as regulations to maintain stability for productive growth that are inherently corrective, rather than distortionary, such framing may go a long way to making them acceptable at home and abroad. Brazil branded its regulations in this manner to gain the acceptance of the Central Bank. Yet when Brazil announced its policies to the world at large, it called them "capital controls" to stem a "tsunami" of money from US monetary policy. This put the investment community on alert, tempting investors to exercise their exit option. Indeed, as capital flowed out of Brazil in 2013, many investors, when asked to come back to Brazil, asked for a guarantee against future capital controls. In contrast, South Korean authorities, both internally and externally, framed and referred to their policies as macroprudential policies aimed at stemming systemic risk being transmitted through cross-border banking. This conformed to the language of the new economics of capital controls and the new lingo in the global financial regulatory reform circles—and put investors and the industrialized countries alike at ease.

6. Build on coalitions of market power.

The BRICS coalition and other EMD coalitions in the WTO can be built on and better coordinated to preserve and gain the policy space for regulation in global

economic governance institutions. The outcomes of agreements are often determined by the distribution of market power among parties to the agreement—those having the most market power obtain the largest benefits. EMD market power has increased significantly since 2000, and consolidating that power via coalitions can help EMDs leverage their objectives in a more optimal manner.

7. Continue to push for quota reform at the IMF.

As we have seen, the more say that EMDs have in deliberations, the more their policy objectives will be achieved. As EMDs, in general, and the BRICS coalition, in particular, gain economic momentum, they should strive to increase IMF quotas along with those increases in economic output.

8. Continue to build alternative institutions, and leverage those institutions for a more balanced global system.

In addition to quota reform at the IMF, EMDs should continue to develop and expand alternative institutions that better serve their mission and needs. This will not just help EMDs provide each other with the public goods they are not obtaining through the traditional international financial institutions. For example, the creation of a BRICS development bank and a BRICS reserve currency pool helped those countries to employ extra-forum leverage in the traditional institutions to achieve their goals and to balance quota systems.

9. Reform the trade regime for stability-supported trade and investment.

When there is national legislation in hand, it is easier to leverage such legislation in international trade and investment negotiations. At the WTO, a nation can make notifications that such new regulations are in place and that the member country sees them as prudential in nature and thus falling under the WTO exception for prudential measures. In further negotiations, such regulations should not be offered in a future positive list for liberalization; the country should attempt to have them carved out of FTAs and BITs, as Chile did in its FTAs with Canada and the European Union, and South Korea has been able to do in its FTA with the United States. For nations without regulations already in place, strong balance-of-payments exceptions and prudential measure exceptions are needed in future treaties and probably should be inserted into past or renegotiated treaties.

10. Devise and propose coordination mechanisms to regulate cross-border finance on both ends.

The global financial crisis has reinvigorated the rationale for cooperation in the regulation of cross-border finance on both ends. For pragmatic reasons, EMDs

alone cannot carry the burden of regulating flows, given their institutional capacity relative to the size and sophistication of global capital markets. Advances in economic theory also justify regulating cross-border finance at both ends. Although there are sophisticated new rationales for regulating at both ends, a clear set of policy proposals regarding what that cooperation might look like is still lacking. Previous proposals have included controls on outflows of capital in source countries and an ad hoc cooperation mechanism based on the global anti–money laundering regime (see Helleiner 2002). Recent articulations have suggested that, under the auspices of the G20, the *cooperative* in cooperative decentralization be emphasized. At the G20, all countries agreed to coordinate their financial regulatory reform efforts so as not to cause negative spillover impacts caused by the actions of individual countries. As noted in previous chapters, if the G20 simply coordinated and mandated regulations on FX derivatives for banks and nonbanks, such an action would go a long way toward achieving cooperation at both ends. At this writing, there has been little official coordination, and domestic regulation has been driven by domestic politics. The truth is no clear and coherent proposals with a particular emphasis on the instability of cross-border finance have come forth in the wake of the crisis. This is an important topic for many of the new institutions to take up, and for the UNCTAD and IMF as well.

The countries that were most successful in the post-crisis period had some combination of these ten policies, which are largely drawn from the ten tenets of the theory of countervailing monetary power outlined in this book. That said, with perhaps the exception of South Korea, no country has used such policies to their full potential. In late 2013 and early 2014, when the US Federal Reserve Bank began moving away from its loose monetary policy, there was a sudden stop in many of the countries we have discussed. At this writing, it appears that South Korea will prove to be the most resilient during the sudden stop; however, the measures used by Brazil, Chile, and South Africa do not seem to be enough to stem the outflow of capital and subsequent financial fragility. These nations needed a stronger policy—and coordination with the West.

According to most accounts, at least five of today's EMDs will be among the ten largest economies in the world by 2050. Most projections put China, India, Brazil, Mexico, and Indonesia among the largest economies in the world at that time (for projections and a review of the literature, see Dadush and Shaw 2011). If these nations continue to exercise countervailing monetary power to craft national policy and to balance global economic governance institutions, they may be able to achieve a more stable international monetary system than the one that has been orchestrated by the great powers since the demise of the Bretton Woods system. For a truly balanced system, they will need to remember what it was like to be vulnerable to the economic policies of large powers. Thus, on the

way up, they need to craft new institutions and reform the traditional ones to enable countries to maximize the benefits and mitigate the risks of cross-border finance. If they follow the path laid by the great powers since the demise of Bretton Woods, there may be even more instability and polarization in the future world economic system. It is my hope that this volume can shed light on how weaker countries can overcome many obstacles to regulating finance at the national and global levels.

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