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The Liberalisation of Capital Flows

Cross-border capital flows have long played an important role in the world economy and as such have been described as the 'connective tissue of the international financial system'.[1] Yet foreign capital brings both benefits and risks to host countries. On the one hand, the progressive development of global trade and the related increase in financial transactions have permitted market expansions and created wealth in both industrialised and emerging economies. On the other hand, cross-border capital flows and freer capital movements can worsen economic conditions and deepen monetary instability.

Several financial crises over the past two decades have made numerous countries acutely aware of such risks. In particular, the Asian Financial Crisis of the late 1990s served as a wake-up call for many economists, policymakers and academics, but this crisis was quickly followed by another financial crisis in Argentina and elsewhere. Being the largest crisis, the GFC in 2008 generated such concern among policymakers that a variety of countries proactively attempted to stave off economic decline and preserve the soundness of their financial systems by regulating cross-border financial flows.

As a result, while capital account liberalisation and the free flow of capital were once almost universally praised as the solution to foster global economic growth, they have now come under serious scrutiny for stability and security reasons. In effect, there is an emerging consensus among policymakers and academics that a more careful and balanced approach to the management of cross-border capital flows is warranted, especially

[1] Rawi Abdelal, *Capital Rules: The Construction of Global Finance* (Harvard University Press 2007); Annamaria Viterbo, *International Economic Law and Monetary Measures: Limitations to States' Sovereignty and Dispute Settlement* (Edward Elgar Publishing 2012); Adam Feibelman, 'The IMF and Regulation of Cross-Border Capital Flows' (2015) 15 *Chicago Journal of International Law* 409.

for the health and stability of the international monetary and financial system.[2] Stated differently, while financial liberalism in the form of free financial flows has long been the dominant doctrine for the international community, some restraints are now being put into place to limit the excesses of the system.

Before we explore these restraints and the legal and policy framework in which they have evolved, it is necessary to first provide a general overview of the current global financial landscape. This chapter thus begins by introducing the key pillars of the system – capital flows, the IMF and financial liberalisation – before elaborating on why this traditional approach to free capital flows has slowly but consistently shifted over time.

1.1 The Three Pillars: Capital Flows, the IMF and Financial Liberalisation

Before delving into the substance of this book, we must first introduce and explain the three pillars of the current economic and financial landscape. We begin with an explanation of the concept of capital flows before introducing the most relevant and important international actor in the field, the IMF. Finally, we discuss the IMF's traditional approach to issues relating to financial liberalisation and capital flow management.

1.1.1 Pillar One: Cross-Border Capital Flows

Capital flows are at the heart of the policy debate on financial stability; thus it is necessary to define and understand the term. Simply put, capital owners tend to make inward and outward transactions on either a short- or long-term basis to suit a variety of purposes. The term is therefore often used in a very generic way to describe the movements of capital from one economy to another, but what is often lost is that there are various types of capital flows.

The main considerations when it comes to defining capital flows are their geographical dimension, time dimension and nature. Inward flows describe the capital flows entering a domestic market and originating

[2] Martin Wolf, *Why Globalization Works* (Yale University Press 2004); Dani Rodrik, *The Globalization Paradox: Democracy and the Future of the World Economy* (WW Norton & Company 2011); Adrian Blundell-Wignall and Caroline Roulet, 'Macro-Prudential Policy, Bank Systemic Risk and Capital Controls' (2014) 2013 *OECD Journal: Financial Market Trends* 7.

from a foreign economy, whereas outward flows refer to capital leaving a domestic economy to be invested abroad.

In regard to the time dimension, capital flows can be regarded as short or long term depending on the type of operational transaction, investment and transfer. Examples of short-term capital transactions are debt or portfolio investments – encompassing trade in securities such as stocks, bonds, bank loans, derivatives and various forms of credit.[3] Due to their 'stop and go' nature, short-term capital flows tend to be considered as speculative and volatile liquidities.[4] As such, they are risky as 'hot money' may enter or exit markets rapidly when high return or risky positions are identified (i.e. currency valuation or devaluation opportunities and changes in monetary and fiscal policymaking). In contrast, long-term capital flows correspond to flows of foreign direct investment (FDI), which are generally more sought after for their ability to finance development through the financing of joint ventures, local businesses and infrastructure projects.[5] Long-term capital flows significantly differ from the short-term flows, as they tend to have a much longer life span and can accommodate and mitigate short-term variations and developments.

Hence, not only do short- and long-term capital flows differ in terms of operational functions, they also tend to have a different impact and influence on economic development. Due to their speculative nature, short-term capital flows can have negative impacts because inflows can quickly turn to outflows – and vice versa – when the market conditions deem such a positional change to be required. Such a reversal typically occurs when the situation in the host economy degrades, or when a situation improves in another country which economically justifies an investment pivot.[6] For instance, sudden or progressive exchange rate depreciation tends to

[3] Christopher J Neely, 'An Introduction to Capital Controls' (1999) 81 *Federal Reserve Bank of St. Louis Review* 14.

[4] IMF, 'Pursuing Equitable and Balanced Growth' (International Monetary Fund 2011) 9 www.imf.org/en/Publications/AREB/Issues/2016/12/31/Pursuing-Equitable-and-Balanced-Growth; IMF, 'The Fund's Role Regarding Cross-Border Capital Flows' (International Monetary Fund 2010) 3, 7 www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/The-Fund-s-Role-Regarding-Cross-Border-Capital-Flows-PP4516.

[5] OECD, 'Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs' (OECD 2002) www.oecd.org/investment/investmentfordevelopment/1959815.pdf.

[6] See for instance Philip J MacFarlane, 'The IMF's Reassessment of Capital Controls after the 2008 Financial Crisis: Heresy or Orthodoxy?' (2015) 19 *UCLA Journal of International Law and Foreign Affairs* 167; L Kaminsky Graciela, 'International Capital Flows, Financial Stability and Growth' (United Nations, Department of Economic and Social Affairs 2005) DESA Working Paper ST/ESA/2005/DWP/10, www.un-ilibrary.org/economic-and-social-development/international-capital-flows-financial-stability-and-growth_6f7080e3-en.

increase outflows for two reasons – depreciations both reduce the value of assets on international markets and tend to limit the capital owners' access to credit because, with money being devaluated, the lender's investment (the collateral) loses its value. The limitation of credit availability also brings negative impacts, such as reducing investment in domestic firms which depend on external funding for development, deterring foreign investors from investing locally or, in a worst-case scenario, providing the same foreign investors incentives and encouragement to cash out of the economy by taking their gains or mitigating their losses and re-investing the funds in more favourable economies.[7]

Long-term capital flows also have drawbacks. In particular, and especially in FDI-seeking countries, long-term capital flows may create imbalances on the country's capital account (which measures the country's balance of physical and financial assets), especially when domestic capital leaves the economy in significant amounts.[8] Long-term capital flows may also generate deficits to the current account (which measures the country's balance of trade, weights the net income originating from abroad and assesses net current transfers) when the profits generated by foreign capital exit the economy due to foreign investors altering their positions. This is most often the case where political tensions or exchange rate depreciations threaten the foreign investors' positions on the domestic market.[9]

1.1.2 Pillar Two: International Monetary Fund

In 1944, with the Second World War nearing its end, forty-four nations met at Bretton Woods in order to begin reconstruction. Among their key roles was to avoid the reappearance of the economic and financial instability which characterised the period and led to economic and physical destruction.[10] Hence, included in the reconstruction was a blueprint for international financial and monetary relations,[11] and for the creation of what was by then described as a liberal 'postwar

[7] On balance sheet effects and falling aggregate demand loops, see Anton Korinek, 'The New Economics of Prudential Capital Controls: A Research Agenda' (2011) 59 *IMF Economic Review* 523, 53. See also Neely (n 3).
[8] Ajit Singh, 'Capital Account Liberalization, Free Long-Term Capital Flows, Financial Crises and Economic Development' (2003) 29 *Eastern Economic Journal* 191.
[9] See for instance MacFarlane (n 6) 172. See also Stijn Claessens, 'Portfolio Capital Flows: Hot or Cold?' (1995) *The World Bank Economic Review* 172.
[10] Joseph P Joyce, *The IMF and Global Financial Crises: Phoenix Rising?* (Cambridge University Press 2012) 20.
[11] Ibid.

economic order … designed to prevent economic nationalism by fostering free trade and a high level of international interaction' capable of guaranteeing peace.[12]

Practically speaking, the Bretton Woods conference led to the creation of the International Bank for Reconstruction and Development (IBRD), more commonly known as the World Bank, and the IMF. The two institutions were designed to function in different and distinct ways. The Bank was charged with financing reconstruction in Europe and fostering development through the promotion of foreign investment,[13] while the IMF's mandate focused on promoting international monetary cooperation, facilitating a balanced growth of international trade, ensuring exchange stability and supporting the facilitation of global transactions while eliminating exchange restrictions. In this regard, Article I of the Fund's Articles of Agreement provides:

> The purposes of the International Monetary Fund are: (i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems; (ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy; (iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation; (iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

[12] Jeffrey A Hart and Joan Edelman Spero, *The Politics of International Economic Relations* (6th ed., Routledge 2013) 15.

[13] Articles of Agreement of the International Monetary Fund and International Bank for Reconstruction and Development, United Nations Monetary and Financial Conference, Bretton Woods, NH 1 to 22 July 1944 at Article I. Purposes (Article I. Purposes provides that 'The purposes of the Bank are: (i) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war …; (ii) To promote private foreign investment by means of guarantees or participations in loans …; To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labor in their territories'.), http://siteresources.worldbank.org/EXTARCHIVES/Resources/IBRD_Articles_of_Agreement.pdf.

As far as financial developments were concerned, the dominant approach – formulated by the famous British economist and government representative John Maynard Keynes – was that the coordinated regulation of capital was essential to national security interests and key to the stability of the overall framework.[14] This approach reflected the position held by many during the early stages of liberalism that nations needed the flexibility and space 'to strike their own balance between global economic integration and the democratic enhancement of national welfare'.[15]

As we will see throughout this book, the IMF has come to play an important role in building and maintaining the current financial and monetary system.[16] In so doing, the Fund has provided the international community with two major 'international public goods' – economic and financial stability.[17]

The IMF was originally conceived and designed as an international organisation capable of 'provid[ing] information and resolv[ing] problems of cooperation among its members, thus lowering the transaction costs to collective action'. Behind this position was the idea that policies with a global reach would otherwise be impossible to implement by isolated members.[18] What has changed over time, however, is the global monetary landscape within which the Fund operates.

Under the system created at Bretton Woods,[19] the value of currencies was fixed on a 'parity' basis with the Gold Standard or the United States (US) dollar (USD).[20] To ensure that the system functioned, the exchange rates of members' currencies could not differ by more than

14 On Keynes' approach to monetary and financial cooperation, see also Otto Hieronymi, 'From "Global Finance" to the Crisis of Globalization', *Globalization and the Reform of the International Banking and Monetary System* (Palgrave Macmillan 2009) 47; Kevin P Gallagher, *Ruling Capital: Emerging Markets and the Reregulation of Cross-Border Finance* (Cornell University Press 2015) 32–33.

15 Gallagher (n 14) 39.

16 See Chapter 3.

17 Joyce (n 10) 10.

18 Ibid. 9.

19 For a detailed explanation of the Bretton Woods system, see Hart and Spero (n 12) 12–20.

20 On the role of the dollar, see for instance Hart and Spero (n 12) 12 ('After World War II, the US dollar became the key international currency. Dollars were held as reserves by central banks; the dollar became indispensable for international trade, investment and finance; and dollars were used to intervene in exchange markets to influence exchange rates'). On the Gold Standard, see also Michael Melvin, *International Money & Finance* (7th ed., Pearson/Addison-Wesley 2004) 41–47.

1 per cent from this parity requirement.[21] Hence, the IMF initially acted as an entity to monitor the exchange rate regime.[22] In the early 1960s, however, the role of the IMF began to shift. Major European countries began to implement Article VIII of the Agreement, which aimed at lowering restrictions on current payments, reducing discriminatory currency practices and ensuring the greater convertibility of foreign-held balances.[23] At the time, the goal of those members was to guarantee the convertibility and functionality of their respective currencies on the international market while reducing dependency on the USD. As a result, other IMF members similarly began to question the use of the USD as the reserve currency.[24] In 1971, and with the treasury under pressure, President Nixon abandoned the gold convertibility policy under which the US had until then committed to providing gold in exchange for dollars. As a result, members were forced for the first time to discuss ways to reorganise currency exchanges in light of increasing cross-border financial flows.[25]

With the changes in the currency regime, however, also came changes to the role and operations of the Fund. The IMF's original mandate was to act as what some have called a 'credit union'; members would contribute to a fund, which would over time be used to provide them with financial assistance when necessary.[26] This became insufficient, however; hence the Fund slowly transformed its mandate to include a supervisory role. This transformation will be considered in more depth later in this book.

1.1.3 Pillar Three: Financial Liberalisation

The third pillar of the book is the dominant approach to financial liberalisation from the 1980s onwards, that being the liberalisation of capital flows – or the facilitation of capital flows across borders through the lifting

[21] Articles of Agreement, Article IV, Sections 1, 3 and 5. ('The par value of the currency of each member shall be expressed in terms of gold as a common denominator or in terms of the United States dollar of the weight and fineness in effect on July 1, 1944' … 'The maximum and the minimum rates for exchange transactions between the currencies of members taking place within their territories shall not differ from parity' … 'A member shall not propose a change in the par value of its currency except to correct a fundamental disequilibrium'.). See also Hart and Spero (n 12) 13–15.
[22] Joyce (n 10) 2.
[23] Article VIII, Sections 2, 3 and 4.
[24] Joyce (n 10) 21.
[25] Ibid. 21, 32, 49.
[26] Ibid. 25–27.

of capital restrictions. For the past several decades, the IMF has served as the chief architect and enforcer of the liberalisation of capital flows. Before that, however, various types of restrictions on capital flows were commonly employed by countries, with the most prevalent controls being restrictive outgoing capital flow policies in relation to a balance of payments crisis and restrictive inflow policies to avoid speculative bubbles.

In the 1990s, financial liberalism became the way forward. The IMF and others positively viewed and preached that the liberalisation of financial flows and policies aimed at reducing controls on capital flows would lead to an increase in inbound capital, growth and wealth creation. As many developing economies had lost access to capital markets funding over the past two decades due to successive economic crises,[27] these countries therefore embraced the shift to financial liberalism as a way to prevent destructive rounds of financial instability. This shift in economic mindset became known as the 'Washington Consensus' – a much-discussed and misunderstood concept. At the time, the Consensus was nothing more than a term of expression created by economist John Williamson to simplify and summarise a list of ten 'good polic[ies] to help the debtor countries' (i.e. in South America) to 'overcome their debt burden'.[28] Such policies, he suggested, would indeed be more likely to be approved by Washington-based decision makers and donors. More recently, Williamson described (and commented upon) his own 'consensus' list in the following terms.

[27] See for instance IEO IMF, *IMF Response to the Financial and Economic Crisis* (International Monetary Fund 2015) 24, 29, www.imf.org/en/Publications/Independent-Evaluation-Office-Reports/Issues/2016/12/31/The-IMF-and-the-Crises-in-Greece-Ireland-and-Portugal-An-IEO-Assessment-42404. See also Hart and Spero (n 12) 223–27. On the theory of 'surplus' flows, see also Daniela Gabor, 'Paradigm Shift? A Critique of the IMF's New Approach to Capital Controls' (2011) 48 *Journal of Development Studies* 714; MacFarlane (n 6) 188; Neely (n 3) 15; Manuela Moschella, 'The Institutional Roots of Incremental Ideational Change: The IMF and Capital Controls after the Global Financial Crisis' (2015) 17 *The British Journal of Politics and International Relations* 442, 449; Maria Socorro Gochoco-Bautista and Changyong Rhee, 'Capital Controls: A Pragmatic Proposal' (2013) No. 337 ADB Economics Working Paper Series; Neely (n 3) 15; Feibelman (n 1) 432. But see IEO IMF, 'The IMF's Approach to Capital Account Liberalization: Revisiting the 2005 IEO Evaluation' (International Monetary Fund 2015) 10, https://ieo.imf.org/en/our-work/Evaluations/Updates/The-IMFs-Approach-to-Capital-Account-Liberalization (providing a counter-argument which emphasizes a lack of consensus as to the benefits of liberalization) [hereinafter Revisiting the 2005 IEO Evaluation].

[28] On the history of the Washington Consensus, see in particular John Williamson, 'A Short History of the Washington Consensus' (2009) 15 *Law and Business Review of the Americas* 7. See also Philip Arestis, 'Washington Consensus and Financial Liberalization' (2004) 27 *Journal of Post Keynesian Economics* 251.

1. **Fiscal Discipline.** This was in the context of a region where almost all countries had run large deficits that led to balance of payments crises and high inflation that hit mainly the poor because the rich could park their money abroad.
2. **Reordering Public Expenditure Priorities.** This suggested switching expenditure in a pro-growth and pro-poor way, from things like non-merit subsidies to basic health and education and infrastructure. It did not call for all the burden of achieving fiscal discipline to be placed on expenditure cuts; on the contrary, the intention was to be strictly neutral about the desirable size of the public sector, an issue on which even a hopeless consensus-seeker like me did not imagine that the battle had been resolved with the end of history that was being promulgated at the time.
3. **Tax Reform.** The aim was a tax system that would combine a broad tax base with moderate marginal tax rates.
4. **Liberalising Interest Rates.** In retrospect I wish I had formulated this in a broader way as financial liberalisation, stressed that views differed on how fast it should be achieved, and recognised the importance of accompanying financial liberalisation with prudential supervision.
5. **A Competitive Exchange Rate.** I fear I indulged in wishful thinking in asserting that there was a consensus in favor of ensuring that the exchange rate would be competitive, which pretty much implies an intermediate regime; in fact Washington was already beginning to edge towards the two-corner doctrine which holds that a country must either fix firmly or else it must float 'cleanly'.
6. **Trade Liberalisation.** I acknowledged that there was a difference of view about how fast trade should be liberalised, but everyone agreed that was the appropriate direction in which to move.
7. **Liberalisation of Inward Foreign Direct Investment.** I specifically did not include comprehensive capital account liberalisation, because I did not believe that did or should command a consensus in Washington.
8. **Privatisation.** As noted already, this was the one area in which what originated as a neoliberal idea had won broad acceptance. We have since been made very conscious that it matters a lot how privatisation is done: it can be a highly corrupt process that transfers assets to a privileged elite for a fraction of their true value, but the evidence is that it brings benefits (especially in terms of improved service coverage) when done properly, and the privatised enterprise either sells into a competitive market or is properly regulated.

9. **Deregulation.** This focused specifically on easing barriers to entry and exit, not on abolishing regulations designed for safety or environmental reasons, or to govern prices in a non-competitive industry.
10. **Property Rights.** This was primarily about providing the informal sector with the ability to gain property rights at acceptable cost (inspired by Hernando de Soto's analysis).[29]

The validity of the so-called Washington Consensus has been widely discussed, debated and questioned, both at the time and over time,[30] but the term has nonetheless become part of the vernacular. Indeed, and despite Williamson specifically stating that he did not include capital account liberalisation within the scope of the Washington Consensus, such policies became intertwined with the other aspects of the Consensus. Throughout the years, in fact, the Washington Consensus formed the basis of a paradigm shift whereby capital account liberalisation policies were increasingly adopted by developing economies wanting to signal their stability, openness and convertibility to foreign capital and overseas investors.[31] Progressively, the steady reduction of regulatory barriers led to an increase in financial inflows to both advanced economies and emerging markets,[32] and the Fund became involved in the process by requiring the removal of capital controls in its loan stabilisation and assistance programmes. To the IMF, the removal of financial regulatory barriers was a winning strategy. In fact, a 1997 IMF staff working paper even stated that 'countries have benefitted significantly from the global transfers of savings and technology associated with increased international capital flows [including through] inflows consisting of foreign direct investment and portfolio transactions'.[33] The working paper also noted that, when discussing capital account convertibility, the Executive Board 'underscored the beneficial effects on growth and investment of the expansion of private capital flows'[34] and that 'free capital movements facilitate a more efficient global allocation of savings

[29] Williamson (n 28).
[30] John Williamson, 'Democracy and the "Washington Consensus"' (1993) 21 *World Development* 1329, 1336; Moises Naim, 'Washington Consensus or Washington Confusion?' (2000) 118 *Foreign Policy* 87; Dani Rodrik, 'Goodbye Washington Consensus, Hello Washington Confusion? A Review of the World Bank's Economic Growth in the 1990s: Learning from a Decade of Reform' (2006) 44 *Journal of Economic Literature* 973.
[31] See for instance Joyce (n 10) 78. See Hart and Spero (n 12).
[32] IMF, 'The Fund's Role Regarding Cross-Border Capital Flows' (n 4) 1.
[33] IMF, 'Capital Account Convertibility and the Role of the Fund: Review of Experience and Consideration of a Possible Amendment of the Articles' (International Monetary Fund 1997) SM/97/32 7.
[34] Ibid. 8.