Making the most of international capital flows

by
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International capital flows have increased dramatically in the past decades. Gross cross-border capital flows rose from about 5% of world GDP in the mid-1990s to historical highs of about 20% in 2007. This growth was around three times stronger than growth in world trade flows. The contraction caused by the crisis affected mainly international banking flows among advanced economies and subsequently spread to other countries and assets. Capital flows have rebounded since the spring of 2009, driven by portfolio investment from advanced to emerging-market economies and increasingly among emerging-market economies themselves.

Financial globalisation, and the associated increase in the movement of capital across international borders, can be both a blessing and a challenge. As we argued in the 2011 OECD Economic Outlook, increasing international capital flows can support long-term income growth through a better international allocation of saving and investment, but they can also make macroeconomic management more difficult, because of the faster international transmission of shocks and the increased risks of overheating, credit and asset price boom-and-bust cycles and abrupt reversals in capital inflows. Volatility indeed is one of the hallmarks of capital flows.

Several countries, including in the OECD area, have dealt with the adverse effects of such volatility by taking measures to limit capital inflows. Others are considering doing so. At the same time, some emerging economies with restrictive regimes are opening up. These contrasting situations are a good enough reason in themselves to bring together experts and officials from the public and private sectors to exchange experiences, analyses and opinions.

But there’s another reason for today’s seminar too. In June this year, the OECD invited non-members to join our Codes of Liberalisation of Capital Movements and of Current Invisible Operations. These codes are an important tool to promote orderly liberalisation, learn from each other’s experience, and ensure mutual accountability. While the two OECD Codes constitute legally binding rules, implementation involves “peer pressure” and dialogue exercised through policy reviews and country examinations.
Countries that adhere to the Codes are expected to fulfil three core principles. First, non-discrimination, meaning they grant the benefits of their liberalisation measures to all other adherents and do not discriminate against other adherents when applying any remaining restrictions.

Transparency is the second principle. Adherents must report up-to-date information on barriers to capital movements and trade in services that might affect the Codes’ obligations and the interests of other adherents.

“Standstill” is the third principle. This means that adherents should avoid taking new restrictive measures or introducing more restrictive measures except in accordance with the Codes’ provisions or established understandings regarding their application.

By adhering to the Codes, a country receives international support and recognition for its openness, and joins a community of countries that refrain from a “beggar-thy-neighbour” approach to capital flows. In other words, countries that adhere to the Codes will not try to improve their own situation by harming others.

An adherent also enjoys the liberalisation measures of other participants, regardless of its own degree of openness. It is protected against eventual unfair and discriminatory treatment of its investors established in other participating countries.

A more subjective, but equally important benefit is that the country reassures market participants that it does not intend to maintain controls broader or longer than necessary. This is crucial in today’s economy where expectations and attitudes play such a significant role in financial markets and investment decisions.

There is obviously an issue of sovereignty in any discussion of openness (whether to capital flows or trade). I’d argue that the Codes help reinforce national influence because as an adherent, a country fully participates in shaping jurisprudence and improving the rules of the framework.
Moreover, the Codes recognise the right of countries to regulate markets and operations. The liberty to conduct transactions is subject to national regulations, as long as they do not introduce discriminatory treatment, in like circumstances, between residents and non-residents. Countries have the right to set prudential measures to protect users of financial services, ensure orderly markets, and maintain the integrity, safety and soundness of the financial system.

It’s also worth emphasizing that while economies are increasingly interdependent and interconnected, they are not identical, and the Codes recognise this.

Countries can pursue liberalisation progressively over time, in line with their level of economic development. Emerging economies such as Chile, Korea and Mexico have adhered to the Codes. Some OECD countries used a special dispensation from their obligations under the Codes for countries in the process of development, while still enjoying the same rights as other adhering countries.

Last the Codes also provide countries with flexibility to cope with situations of short-term capital volatility including the introduction of controls on short-term capital operations and the re-imposition of controls on other operations by invoking the Codes’ “derogation” clause in situations of severe balance-of-payments difficulties or financial disturbance. This clause has been used 30 times since 1961, most recently in 2008 when Iceland introduced exchange controls and measures restricting capital movements in response to a severe banking and balance of payments crisis.

Hence the Codes are the only multilaterally-backed instruments promoting the freedom of cross-border capital movements and financial services while providing flexibility to cope with situations of economic and financial instability. They were also the first instruments created by the OECD when it was founded in 1961. For 50 years adhering countries have used the Codes to support reform, to co-operate to reap the full benefit of open markets and to avoid unnecessary harm from restrictive measures.
The OECD Council decided in June 2014 to open the Codes to adherence by all interested countries outside the OECD membership with equal rights as OECD countries. This is an important step in expanding international co-operation, maintaining deep liquid global capital markets, and making the most of international capital flows as a tool to finance growth and development. Time has also come to think about how the Codes should be improved to ensure we can continue to maximise the benefits from open capital markets while avoiding their downside effects and adapt the Codes’ highly effective mixture of principle and pragmatism to the coming decades.

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