Yevhen Bublyk
Department of Monetary Relations
State Organization "Institute of Economics and Forecasting
of the National Academy of Sciences of Ukraine", Kyiv, Ukraine
E-mail: bubl13@gmail.com
ORCID: https://orcid.org/0000-0002-6080-9341

Measures of financial regulators in the field of international capital flows control

Abstract

The article attempts to identify new trends in approaches to assessing the impact of uncontrolled international capital flows on the development of the national economy and the corresponding changes in regulatory policies. It is pointed out that uncontrolled capital flows pose a special threat to small open economies due to insufficient development of the institutional environment and low depth of financial markets. There has been constructed circle of typical for small open economies risks, conducted with uncontrolled capital flows movement, such as deepening structural imbalances in financial asset markets, undesirable excessive fluctuations in the national currency rate, the flight of national capital and the erosion of the tax base. Based on the analysis of recent research, international regulatory initiatives of EU countries, recommendations of international development institutions and IMF's Integrated Policy Framework, have been identified such trends as strengthening control over illegal capital flows, limiting of the negative speculative influence, panic and herd behaviour on exchange rate stability. Argued for a very important role which plays an uncontrolled dynamics of national currency rate on the transmission of global shocks to national economies. This necessitates a serious overhaul of exchange rate policy approaches. Central banks of small open economies should consider exchange rate stability as one of their goals. This does not mean inflation targeting abandon. The use of the instrument of currency interventions helps to influence the achievement of external targets, increasing the ability of interest rate policy instruments to achieve inflation targeting in the domestic market as well. As a conclusion and proposals for further development of policies in the financial sector to ensure the sustainable development of small open economies is systematized a list of possible regulatory measures. It is emphasized that the development of regulatory policies in the monetary and financial spheres in small open economies, which includes Ukraine, should be implemented comprehensively and include the development of macroprudential tools to limit systemic risk factors, suppress illicit capital flows and reduce the role of psychological factors of pro-cyclical behavior. The implementation of regulatory measures on transparent terms in such spheres will not make free-market self-regulatory mechanisms weaken, but rather helps to release them.

Keywords

International capital flows, financial openness, financial sector, exchange rate, macroprudential policy, foreign direct investments

JEL: E58, F31

DOI: https://doi.org/10.30525/2500-946X/2021-2-10

1 Introduction

A number of crisis events in the period 2008–2020 prompted a broad review of key approaches to monetary regulation and the implementation of financial policies. Among the key aspects of such changes are approaches and recommendations concerning the movement of international capital flows (ICF) and the appropriateness of influencing the exchange rate. Under the influence of the global recession, pandemic, consequences of unconventional monetary policy and more detailed assessment of the economic consequences of free international capital movements, the need to control them and limit undesirable fluctuations in the national currency in the interests of preserving monetary sovereignty.

The crisis events also confirmed the risks and strong negative potential of the uncontrolled movement of ICF. The negative impact of exogenous shocks from uncontrolled ICF may outweigh even the positive potential of financial integration and investment. Such an impact may result in pro-cyclical support for the accumulation of macroeconomic imbalances, the accumulation of systemic risk factors and the narrowing of funding for promising sources of economic development. In the most threatening situation, according to these circumstances, are open economies with relatively underdeveloped financial markets.

Awareness of these risks is already well visible in the world practice of both scientific research and policy documents of regulatory bodies and international development institutes. In particular, this concerns a more cautious attitude to the formation of financial openness and the updating of regulatory measures in the field of foreign trade and capital transactions aimed at strengthening the stability of national currencies. Based on this, the process of critical analysis of new trends and prospects for the development of ICF regulation in order to limit their negative impact is becoming important for small open economies, including Ukraine.

2 Characteristics of uncontrolled ICF movement for small open economies

Retrospectively assessing the process of financial liberalization during its active period during the 1970s and 2000s, it can be divided into two stages: intensive and extensive. From the late 1970s to the early 2000s, market linkages expanded. During this period, new countries developed in the international trade system, developing rapidly enough and increasing their financial openness to benefit from free trade and capital movements: South Korea, Malaysia, Singapore.

At the same time the results of research showing the contradictory consequences of financial openness were already published. In particular (Agénor, 2001), who showed that the practical impact of ICF on the diversification of financial risks in developing countries is minimal: they gain access to international capital markets only in "good times". Also (Gourinchas, Jeanne, 2006) concluded that in some cases the benefits of financial integration may be relatively small, even for countries that receive large amounts of foreign capital. According to the justification of catching-up development due to the free movement of international capital towards the most profitable industries, in the structure of capital inflows the greatest importance is the dynamics of FDI, which is positioned as the most productive type of external financing. practitioner.

At the same time, various studies have shown that FDI does not correlate well with job creation, poverty reduction and other development outcomes. Studies of the link between openness and economic growth through technology transfer have found that in countries with high levels of financial and trade openness, investment is concentrated in industrial production and trade, displacing investment in research and development (Grossman, Helpman, 2018). This does lead to equalization of wages and interest rates at the interstate level, and also leads to an increase in effective demand, which has a positive effect on GDP growth, but limits the innovative nature of economic development and creates conditions of economic instability. That is, in itself, the relationship between openness and economic growth can be derived from more fundamental economic processes and structural characteristics of the economy, and the monotonous manifestations of ICF indicate the feasibility of their differentiation and control.

It should be noted that most studies on the impact of ICF on the economic growth of feedback analysis have given limited attention. Whereas he finds more and more confirmation in practice. Currently, there are a number of studies that confirm the conclusion that the positive effect of capital inflows is achieved by economies that are in the process of active growth (Yomogidaa, 2006).

The fundamental basis for such a thesis may be the statement that the financial system is derived from the real sector of the economy. Namely, economic growth creates demand for financial services. Thus, the financial system does not generate economic growth, but only responds to the needs of the real sector (Robinson, 1952).

This thesis can be confirmed by the example of Ukraine. According to a recent study by the German Advisory Group, FDI accounts for only 4.6% of all Ukrainian companies. However, in the list of these companies are the largest and most profitable. In particular, they employ more than 20% of the working population of Ukraine, they account for 24% of the total capital of Ukraine and almost 35% of total gross value added (Saha, Kravchuk & Kirchner, 2018).

That is, mostly foreign investment is concentrated in already developed enterprises of profitable industries, rather than financing the development of new ones. FDI enterprises are not only much larger than enterprises with exclusively domestic investments, but also much more productive. Of course, it should be noted that a significant share of foreign investment in such enterprises is likely to be represented by reinvested Ukrainian capital.

Although the positive effect of financial openness can manifest itself over decades, a number of significant risks can also manifest themselves in the short run, so to speak, “short pain, long gain” (Schmukler, Kaminsky, 2003). It can be argued that this short-term period – "short pain" – came in 2008 and later became known as the "global financial crisis" (HFC). It has completed the current wave of globalization in the financial aspect as well.

Without delving into the role of deregulated ICFs in the escalation of the local crisis of the US mortgage market to the global level, we can only note that it will be difficult to deny. Taking into account the course of GFK, the risks of financial openness for the national economy were formalized as follows:

1) the impact of ICF on the structure of the financial sector and monetary indicators;
2) permanent outflow of national capital;
3) loss of monetary independence;
4) undesirable fluctuations in the national currency.

These risks are called the "four fears" of the monetary regulator. At the same time, World Bank reports show that ICFs tend to develop economies. In other words, the growing financial openness of developing countries did not lead to a redistribution of global ICF in their favor, even in the face of significant growth in total free capital, which began to circulate in international markets in the period 1990-2000.

This difference reflects the differences in the level of institutional development of different countries. With all-natural variability, the institutional capacity of Poland, the Czech Republic, Romania, Bulgaria, Slovakia and many other CEE countries remains higher than in Ukraine. This indicates that these states are able to lean on the dynamics of capital flows through regulatory measures.

Thus, given the weak institutional capacity of Ukraine’s state regulation, its ability to attract foreign investment is determined not so much by existing constraints as by the level of global conditions. As a result, at its proper level, the volume of foreign investment may increase even with the existing restrictions. On the other hand, in the event of the threat of inflows of significant amounts of speculative capital or capital flight from domestic markets, the existing rules of currency regulation are likely to be insufficient for their effective restrictions.

A characteristic problem of the uncontrolled movement of ICF for small open economies is the tendency to lose capital. As already mentioned, the desire of economic entities to the possibility of unimpeded withdrawal of capital from domestic markets is one of the important motives for moving towards financial openness of economies with underdeveloped institutional environment. Capital outflows from transition economies take the form of legal investments and illegal transfers abroad under specific lending schemes and settlements with counterparties.

Many years of experience in the development of transformational economies and emerging markets show

that the process of capital outflows is virtually impossible to ban on a permanent or long-term basis. It can be partially complicated, but in this case capital will continue to flow through existing gaps in legislation or through the creation of specific trade and economic schemes. It is also dangerous to impose sudden, unjustified restrictions with an indefinite term or conditions or too radical long-term restrictions on capital reversal, as this undermines the country's investment rating. At the same time, the "flight" of capital may be due to situational factors. The introduction of short-term restrictions on capital movements can significantly limit the effect of such factors.

After the financial and economic crisis of 2008, there was a noticeable shift in the scientific literature in the direction of research on the procyclical nature of ICF. After a number of works, the classification of capital flow factors was improved, where groups of cyclic and structural drivers were singled out (Koepke, 2015). Such factors include: the level of interest rates, economic growth, global risk perception. In general, the formal side of ICF's pro-cyclicality is not disputed: the positive correlation between capital flows and GDP dynamics over the last twenty years has been confirmed by the example of both emerging and developed markets. For developing countries, the work of Carla and Vincent Reinhardt is important, identifying cases of sudden inflows of large amounts of capital, which affected economic dynamics. Such sudden tides have been tentatively called "bonanza" (Reinhart, Reinhart, 2009). These researchers named cases of significant capital inflows (current account balance exceeds 20% of GDP), analyzed on the example of 181 countries during 1960–2007.

The findings of the study show that changes in factors such as stock prices, commodities, and interest rates and economic growth in developed countries have a systemic impact on TPC cycles in developing countries. The decline in world interest rates provokes cases of "bonanza" both through portfolio investment channels and through commodity prices. At the same time, in most cases, "bonuses" occur with countries that carry out financial liberalization. The course of such "bonanza" was purely speculative and lasted no more than 2-4 years, after which there was a sudden outflow of capital.

These consequences, in turn, are factors in the formation of significant components of the systemic risk of losing the country's financial stability through the accumulation and deepening of systemic imbalances in developing economies. To a large extent, the weight of these imbalances is exacerbated by the pro-cyclical nature of capital flows, and is realized in cases of their sudden stops or changes of direction.

3 The role of the exchange rate in the formation of systemic risk for small open economies

The systemic and pro-cyclical nature of capital flows in emerging markets at the global level became particularly pronounced on the eve of the 2008 crisis, against the background of slowing economic growth and declining return on capital in developed economies. Under these conditions, large amounts of capital, concentrated mainly in developed economies, in search of profitable directions began to emerge from those markets that slowed down and flowed into markets that showed business activity and profitability. Thus, there was a double negative impact of capital flows due to the spread and deepening of the economic recession in slowing economies and overheating of emerging markets. All this has offended at the global level.

This double effect of the pro-cyclical nature of ICF in financially open economies is manifested not only at the regional or global levels. Foreign capital also helps to fix and feed the current trend in domestic markets. Of particular note is the significant impact of capital flows on the dynamics of the exchange rate of the country – the recipient of capital. At the stage of rising activity of exporters in the country there is a strengthening of the national currency, which limits the further development of export activities. Under the influence of the revival of export activity and the corresponding growth of the economy, foreign capital flows into the country, which increases the revaluation pressure on the national currency and further inhibits the development of exports. In such circumstances, regulators should counteract the strengthening of the national currency through monetary and fiscal policies, as well as policies to regulate ICF, by stimulating capital exports.

Conversely, crisis trends in countries with weak national currencies cause the devaluation of these currencies, which in the first stage is accompanied by economic slowdown. Under such conditions, foreign capital "goes to the exit", which deepens the devaluation process, intensifies the economic downturn and, at the same time, leaves room for maneuver within the framework of monetary and fiscal policy.

ICF's significant sensitivity to the boom and bust stage also has a pro-cyclical impact on certain segments of financial markets, fueling credit booms and deepening creditors' bankruptcies through the cessation of their refinancing. The sudden outflow of capital and the cessation of refinancing provoke an increase in loan defaults, exacerbating the credit crunch, the devaluation of the national currency, the sudden sale of financial assets and real estate, and the bankruptcy of financial institutions. Such a combined blow has severe consequences for the entire financial sector and the country's economy.

Thus, the pro-cyclical impact is inherent in ICF in the context of unregulated financial liberalization. It is implemented through the channels of accumulation of external debt, strengthening the structural and functional deformation of the financial sector, supporting the growth of prices for financial assets, provoking a credit boom and fluctuations in the national currency. Procyclical influence of ICF through these channels determines the formation of factors of accumulation of systemic risk of financial instability.

For this reason, attempts to limit undesirable fluctuations in national exchange rates have recently intensified. This trend is shown by research (Aizenman, 2019). The fact is that the potential for exchange rate fluctuations in small open economies is much higher than in developed ones and it is more difficult to quell only by changing interest rates. That is why developing countries are more likely to reduce the level of monetary independence and financial openness, but increase the level of exchange rate stability.

Currently, the IMF recognizes that while a flexible exchange rate can mitigate the shock of a change in the nature of ICF, it does not provide sufficient protection for the economy from external shocks, especially in the face of disrupted access to global capital markets (Adrian, Gopinath & Pazarbasioglu, 2020), which is observed in a pandemic.

Therefore, given the risks of unregulated ICF and the need to address the problem of smoothing economic cycles

and prevent the accumulation of systemic risk of financial instability, it is logical to conclude about the significant regulatory potential of financial openness as an element of economic policy implemented by concerted measures. Implementing investment policy and economic development policy. An important institutional element of such a policy should be the transparency of its implementation conditions for institutional actors: external and internal investors and financial intermediaries. It is possible to ensure the transparency of the regulatory process by defining and publishing a system of macroprudential parameters on the basis of which market participants are expected to implement regulatory measures in relation to the level and structure of financial openness of the economy.

4 Directions of development of financial sector policies

The financial policies of various groups of countries are increasingly relying on numerous tools to combat instability in capital flows, including the stabilization of the exchange rate. These include monetary policy, macroprudential policy, foreign exchange interventions and capital flow management measures. An approach based on a combination of these policies should be considered quite reasonable. are most effective in mitigating the risks of sudden capital movements caused by global shocks and close to medium-term trade-offs of different policies is important and are part of the IMF's Integrated Policy Framework agenda. Accordingly, the IMF is actively working to develop a comprehensive approach to regulating capital flows. One of the consequences of this program should be a narrowing of the potential negative impact of ICF on undesirable fluctuations in the national currency.

The general characteristics of the implementation of measures to stabilize the exchange rate, including through control over capital flows, are based on purely market principles. The main one is that the risks are created by ICF, the movement of which is determined not by economic processes, but by behavioral and psychological factors. At the same time, such ICFs often violate not only market equilibrium, but also existing regulations. That is why the restrictions should primarily apply to illegal ICFs, or those whose movement is due to the effects of panic, herd behavior. In addition, ICFs need regulatory influence, which leads to the accumulation of systemic risk factors: overheating of credit markets, real estate markets, violation of the currency and term structure of loan portfolios, etc.

The current practice of developing regulatory policies in the financial sector fully confirms the following assumptions. Of particular note is the increased focus on combating capital flows that are semi-legal or aimed at eroding the tax base. This is clearly what BEPS and other anti-offshore initiatives are all about.

The large-scale reorganization of the current international taxation system, which is essentially BEPS, draws attention, among other things, to the strengthening of control over the IPC, which has resulted in the erosion of the tax base and tax evasion. In the case of Ukraine, the implementation of BEPS should be seen as a mandatory institutional precondition for ensuring financial stability and preventing the negative effects of uncontrolled ICF, which will further liberalize direct regulatory restrictions on currency transactions and ICF.

The expediency of introducing exchange rate regulation elements for small open economies at this stage is increasingly recognized by the IMF and other MFIs. In particular, it is noted that the central banks of small open economies should consider exchange rate stability as one of their goals. This does not mean that you should abandon inflation targeting. Challenges to the volatility of cross-border capital flows encourage central banks to use the instrument of foreign exchange interventions. This tool helps to influence the achievement of external targets, increasing the ability of interest rate policy instruments to achieve inflation targeting in the domestic market.

Regulatory practice regarding the differentiation of cross-border capital flows at the EU level manifests itself in the form of initiatives to monitor foreign investment, aimed at limiting the presence of capital of Chinese state-owned companies, combating illegal capital flows and eroding the tax base. In addition, although formally the EU authorities do not support the introduction of control over capital flows, both European legislation and regulatory practice in the EU provide for certain exceptions. In particular, there are a number of exceptions to the establishment of a regime of free movement of capital. For example: in the event that capital movements cause disturbances in the functioning of the capital market in any of the Member States, the European Commission, after consulting the Monetary Committee, will allow that country to resort to safeguards in the field of capital movements, the conditions and details of which it will determine.

The development of currency regulation policy at this stage in the EU is aimed primarily at preventing currency wars and using devaluation to strengthen competitiveness. Therefore, at the level of individual CEE countries, the actualization of the regulatory trend is noticeable among countries that have retained their own national currencies. Such attempts are made outside the monetary regulator in the form of tax regulation of the presence of foreign capital and the direction of foreign investment. Measures to manage the exchange rate in order to stabilize it, are implemented through the rhetoric of official institutions, which gives reason to expect a departure from the dominance of free exchange rates.

5 Conclusion

Based on the analysis of the post-crisis nature of ICF, their systemic-pro-cyclical influence in the conditions of financial openness of the national economy is revealed. Financial openness alone is not a sufficient condition for increasing factor productivity, accumulation of productive capital, technological re-equipment and overcoming the threshold value of the level of development of market institutions. Even FDI, which is positioned as the most reliable and productive tool for foreign capital inflows, actually predominantly reproduces speculative interests. Weak foreign exchange markets and financial institutions in general, which are characteristic of small open economies, are a factor in the permanently high risk of transmitting exogenous financial shocks.

At the same time, an important condition for realizing the potential of financial openness of the economy is the institutional capacity of the state to provide support for the level and structural parameters of real financial openness in the interests of economic development. This conclusion

confirms the nature of the development of regulatory initiatives in the financial sector, ICF movements and the exchange rate.

Existing and future measures to control the ICF and limit the negative impact of undesirable sharp fluctuations in the national currency should be focused on the following areas:

– development of macroprudential tools for controlling capital flows in order to prevent the accumulation of systemic risk factors of financial instability in the credit market segment;
– development of international tax legislation to combat illegal capital flight, investment monitoring;
– improvement of international exchange rate regulation mechanisms (such as ERMII, agreements to avoid currency manipulation, etc.);
– expansion of mechanisms of international financial assistance for stabilization of exchange rates.

In addition to transparent macroeconomic soundness, an important condition for a successful ICF control policy and limiting exchange rate fluctuations is its coherence at the international, at least regional, level. Currency regulation should not be a weapon in trade disputes, but serve only stabilizing purposes. Under this approach, currency regulation can be applied to developing economies without international tensions and criticism.

References

[1] Agenor, P-R. (2001). Benefits and Costs of International Financial Integration: Theory and Facts. Policy Research Working Paper, 2699.
[2] Gourinchas, P., & Jeanne, O. (2006). The elusive gains from international financial integration. The Review of Economic Studies, 73(3): 715–741.
[3] Grossman, G., & Helpman, E. (2018). Growth, Trade, and Inequality. Econometrica, 86(1): 37–83.
[4] Yomogidaa, M. (2006). International Capital Movements: Who Gains and Who Loses? Asia-Pacific Journal of Accounting & Economics, 13: 123–134.
[5] Robinson, J. (1952). The generalization of the general theory. The rate of interest and other essays. London: Macmillian.
[6] Saha, D., Kravchuk, V. & Kirchner, R. (2018). The economic impact of FDI on Ukraine Policy. Studies Series. German Advisory Group Institute for Economic Research and Policy Consulting, PS/01/2018.
[7] Schmukler, S., & Kaminsky, G. (2003). Short-Run Pain, Long-Run Gain: The Effects of Financial Liberalization. IMF Working Paper, 03/34.
[8] Koepke, R. (2015). What drives capital flows to emerging markets? A survey of the empirical literature. Institute of international finance, University of Wurzburg.
[9] Reinhart, C. & Reinhart, V. (2009) From capital flow bonanza to financial crash, in Felton, A. and Reinhart, C. M. (Eds.) The first global crisis of the 21st century, London: VoxEU.org
[10] Aizenman, J. (2019). A modern reincarnation of Mundell-Fleming's trilemma. Economic Modelling, 81: 444–454.
[11] Adrian T., Gopinath G., & Pazarbasioglu C. (2020). Navigating Capital Flows – An Integrated Approach. IMF blog. E-source: https://blogs.imf.org/2020/12/09/navigating-capital-flows-an-integrated-approach/