

The politics of quantitative easing

A critical assesment of the harmful impact of European monetary policy on developing countries



Rodrigo Fernandez & Pablo Bortz & Nicolas Zeolla

June 2018

Colophon

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Authors: Rodrigo Fernandez & Pablo Bortz & Nicolas Zeolla

Layout: Frans Schupp

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Stichting Onderzoek Multinationale Ondernemingen
Centre for Research on Multinational Corporations

Sarphatistraat 30
1018 GL Amsterdam
The Netherlands
T: +31 (0)20 639 12 91
F: +31 (0)20 639 13 21
info@somo.nl
www.somo.nl

The Centre for Research on Multinational Corporations (SOMO) is an independent, not-for-profit research and network organisation working on social, ecological and economic issues related to sustainable development. Since 1973, the organisation has been investigating multinational corporations and the consequences of their activities for people and the environment around the world.



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Glossary

Bonds

Bonds represent debt obligations – and are therefore a form of borrowing. If a company issues a bond, the money they receive in return is a loan, and must be repaid over time, including interest to the investor that holds the bond.

Capital management techniques

Types of capital controls that aim to curb ingoing and outgoing capital flows.

Carry trade

A trade scheme that involves borrowing in a low-interest rate currency and converting the borrowed amount into another currency through deposits or buying assets.

Core countries

Dominant developed economies, such as the US, EU countries and Japan combined, that influence the global structures through their dominant political, economic cultural and financial authority.

Debt-to-income ratio

Indicates the percentage of debt in relation to income.

Euro crisis

This is the crisis that erupted within the Eurozone in 2010 triggered by the inability of Greece to service its debt. As a result, interest rates for most Mediterranean Eurozone countries' public debt increased dramatically. This led to austerity policies across the Eurozone.

Eurozone

The EU countries that are part of the European Monetary Union and share the euro as their common currency.

Exchange Traded Fund (ETF)

This is an investment fund that tries to track an index of a stock market. It is passively managed (copies the index) and does not try to do better than the stock market index.

Macroprudential regulations

This is the approach to financial regulation that aims to mitigate risk to the financial system as a whole (or "systemic risk") – as opposed to microprudential risk.

Money Market Fund (MMF)

An investment fund that invests in safe short-term assets and aims to maintain a stable asset value.

Mortgage Backed Securities (MBS)

These are debt certificates that are backed by the income stream that mortgages generate. These underlying mortgages are bundled into securitized assets.

Non-financial corporation

These are firms that produce goods and services and do not, as primary activity, trade in financial assets.

Portfolio rebalancing

A change in the composition of the assets in the balance sheet of investors.

Private Bonds

Bonds emitted by private, non-state entities (see also bonds).

Quantitative easing (QE)

A monetary policy that sees central banks buying sovereign bonds, other debt instruments (and in some countries like Japan and Switzerland also equity) with newly created money in order to lower interest rates and increase the money supply.

Repo Market

A repurchase agreement (repo) is a type of short-term borrowing. One side, usually on an overnight basis, sells high quality assets (like US sovereign bonds and buys them back the following day including a fee. This transaction allows banks to raise short term liquid funds and investors to make a small fee on their liquid assets (cash).

Sovereign bonds

Bonds emitted by (sovereign) states (see also Bonds).

Sovereign debt restructuring mechanism (SDRM)

An internationally accepted institutional arrangement to deal with the over-indebtedness of states.

Vulture fund

An investment fund that invests in debt considered to be very weak, known as "distressed securities". Investors make a profit by buying debt at a discounted price and then using aggressive methods to gain a higher amount than the purchasing price.

Zombie corporation

Zombie corporations (including banks) are indebted businesses that, although generating cash – after covering costs (wages, rent etc.) – only have enough funds to service the interest on their loans, but not the debt itself.

Acronyms

ADB	Asian Development Bank
AME	Africa and the Middle East
AP	Asia Pacific
BIS	Bank for International Settlements
BIT	Bilateral investment treaty
BOP	Balance of payment
CAC	Collective action clause
CMT	Capital management technique
DB	Development bank
DWI	Sovereign debt workout institution
ECB	European Central Bank
ECLAC	UN Economic Commission for Latin America and the Caribbean
EMEs	Emerging market economies
FDI	Foreign direct investment
FED	Federal Reserve System (central bank system of the US)
FTA	Free trade agreement
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
IMF	International Monetary Fund
IOF	<i>Imposto sobre Operações Financeiras</i> (Portuguese)
LAC	Latin America and the Caribbean
MMF	Money market funds
NFC	Non-financial corporation
NGO	Non-governmental organisation
OECD	Organisation for Economic Co-operation and Development
OTC	Over the counter
QE	Quantitative easing
QT	Quantitative tightening
SCDS	Sovereign Credit Default Swaps
SDR	Sovereign debt restructuring
SDRM	Sovereign debt restructuring mechanism
UNCTAD	United Nations Conference on Trade and Development
URR	Unremunerated reserve requirements
WTO	World Trade Organization

Introduction

Quantitative easing (QE) is a monetary policy that sees central banks buy bonds and other debt instruments with newly created money. Central banks buy government debt (sovereign bonds) – and, in the case of the European Central Bank (ECB), also corporate bonds – with money they have created electronically. This results in an exchange: investors sell their bonds to the central bank and receive money in return. In this way, central banks accumulate bonds and investors increase their cash holdings.

The current QE policies emerged in the US in the direct aftermath of the financial crisis of 2008 and have since expanded to other countries and regions including Japan, the Eurozone, Sweden, Switzerland and the UK. This follows an earlier QE experiment in Japan from 2001 to 2006. The overall expansion of central banks' balance sheets as a result of these monetary policies is in the range of US\$11 trillion between pre-crisis 2008 and 2018 (this includes figures for the US, Japan, the Eurozone).¹ The total size of the combined balance sheets is currently US\$15 trillion, or roughly 20 percent of global gross domestic product (GDP). Through this process, central banks have become key bond holders.

This report looks at the unintended consequences of these QE programmes, including growing inequality, fuelling asset bubbles and continuing the debt-led economic model that created the 2008 financial crisis.² These issues affect both developed and developing countries. However, developing countries are more vulnerable. The critical issue for developing countries is the effect of the massive increase in the inflow of capital in developed economies. The low interest rate that QE creates pushes investors towards economies with higher returns (or interest rates). This results in ever larger and more aggressive fluctuations of cross-border capital flows. These larger flows have resulted in the build-up of unsustainable debt, both sovereign and private, as will be highlighted in this paper.

This rising tide of capital flows, in particular the increase in the international bond issuance of emerging economies, could result in a new period of 'lost decades', provoked by debt crises. Since the 1970s we have seen the destructive force of the ebb and flow of capital from the core to developing countries and the long-term damage of dealing with the effects of cross-border debt without having a multilateral institutional framework in place to deal with the consequences.

1 Yardeni Research, "Global economic briefing: Central banks balance sheets," <<https://www.yardeni.com/pub/peacockfed-ecbassets.pdf>>, (14 March 2018), p. 1.

2 The effect QE programmes of developed economies have on developing countries involve central banks from the US, the Eurozone, Japan, the UK and Switzerland. The focus of the report will be on the monetary policies of the ECB. However, the ECB's QE cannot be fully separated from the overall purchasing programmes of other central banks from developed economies. Therefore, activities of the US Federal Reserve System (FED) will feature throughout the report.

The current increase in capital flows, propelled by QE, has led to an increase in foreign debt through international bonds. According to statistics from the Bank for International Settlements (BIS), the stock of international bonds from Latin America and the Caribbean region increased from US\$297 billion in 2009 to US\$ 757 billion in 2017.³ In the Asia and Pacific region, the stock of international bonds increased from US\$253 billion in 2009 to US\$637 billion in 2017.⁴ Once the period of QE ends, these capital flows may reverse, leaving behind a stock of unpayable debt.

This report argues that QE programmes are in danger of creating a new debt crisis in developing countries. Urgent action is needed to address this problem, including reversing the long-standing global trend and treaty commitments to liberalise capital controls and establishing an internationally accepted arrangement to deal with the over-indebtedness of states.⁵ Also non-financial corporations in developing countries have amassed problematic volumes of debt that will require solutions to prevent the socialisation of losses.

This report aims to inform non-governmental organisations (NGOs), academics and activists about the potentially harmful consequences of QE policies for developing countries. The authors argue for a renewal of long-standing efforts to establish defence mechanisms in the current global economy to prevent future debt crises. Much of the groundwork has already been laid by NGOs, academics and activists working on international debt issues over the past three decades. QE requires an acceleration of efforts to avoid past mistakes.

Central banks typically have a limited mandate. They lack a meaningful system of democratic control and accountability. They are also largely unable to address issues outside their direct constituency, including the harmful impacts of developed economies' QE policies for the global south. This means that protective measures need to be built into other parts of the global financial architecture as a matter of urgency.

The International Monetary Fund (IMF) played central role in the structural adjustment programmes in the past, but has gradually shifted its position about capital controls. Although it was an important agent in liberalising capital controls in the past, it has taken steps in the right direction by acknowledging the need for capital controls. This shift in position, however, is not there yet, as controls are only seen as an option of last resort.⁶ We have also seen improvements in the field of sovereign debt restructuring, for instance in the bond contracts. But there is a long way to go in this regard too. These shifts do point to potential possibilities to engage with the existing global policy framework in light of the new environment that was created by QE.

3 BIS, "Debt securities statistics", <<http://www.bis.org/statistics/secstats.htm>> (14 September 2017).

4 BIS, "Debt securities statistics", <<http://www.bis.org/statistics/secstats.htm>> (14 September 2017).

5 In the rest of the report we will refer to such international arrangements as a sovereign debt restructuring mechanism (SDRM), in line with proposals that originated in the UN Conference on Trade and Development (UNCTAD).

6 D. Gabor, "Managing Capital Accounts in Emerging Markets: Lessons from the Global Financial Crisis," *The Journal of Development Studies*, 48:6, 714-731, <DOI: 10.1080/00220388.2011.649257>, 2012.

This report is based on an extensive literature review, covering both primary and secondary sources. In addition, various datasets were used to explore and illustrate different aspects discussed in this report. The debt securities statistics of the Bank for International Settlements (BIS) were used to investigate the rise of bonds emitted across countries and sectors. The analysis of the development of different forms of capital control is based on an interpretation of the annual IMF report on exchange agreement and exchange restrictions. All sources are referred to in footnotes throughout the text.

This report is divided into four parts. First, we focus our attention on what QE is and where it comes from. Second, we outline the harmful consequences of QE. Third, we look at how QE affects global capital flows and why developing countries are particularly vulnerable. Fourth, we focus on how current institutional arrangements and trade and investment treaties, generate obstacles for solutions and what can we do about it. We conclude with some concrete recommendations for steps that need to be taken to urgently address the issues highlighted in the report.

1 How QE operates

1.1 What is QE and how does it work?

QE can be described as the purchase of bonds and other debt instruments by central banks with money that has been newly created. It is not only 'money printing' but an exchange between central banks and other financial intermediaries such as institutional investors. This policy is unconventional and unprecedented in most countries, except for Japan. The intended purpose of QE is to stimulate a country's economy by substituting assets held by financial institutions (for example, public debt, corporate bonds and mortgage-backed securities) with cash (created as part of the process).⁷ The result of this purchasing programme is that bonds that were previously held by financial institutions, mostly investors, move to the balance sheet of the central banks in exchange for money.

It is assumed by the advocates of QE that financial institutions such as banks and pension funds act as transmission channels of this supply of to-be-spent money (liquidity). This operates through the process of so-called 'portfolio rebalancing'. Financial institutions exchange bonds with central banks in return for cash, which then is used to buy other financial assets. This rebalancing of the portfolio leads to a shift towards higher risk assets, which in turn eventually leads to an increase in investments by companies and consumption by households, and hence stimulates the economy.

However, not all policy-makers are in favour of QE. The Bank for International Settlements (BIS) and the United Nations Conference on Trade and Development (UNCTAD) have both voiced concerns (albeit for different reasons), as have representatives of national central banks in the Netherlands and Germany. Policy-makers in developing countries such as Brazil have also voiced criticism. Concerns revolve around the question of the effectiveness and duration of QE; its long- and short-term side effects; and how this increase in liquidity may change the 'metabolism' of the global economy – increasing the risk of financial system volatility and crisis (e.g. asset bubbles) and amplifying the fragility of less developed economies.

One problem in assessing the effectiveness of QE and its wider consequences is that it came about in the extraordinary economic, political and financial environment created by the global financial crisis. In the Eurozone, QE policies emerged at a time of the euro crisis that was followed by a period of prolonged, severe austerity. A period of extraordinary governmental budget cuts (fiscal tightening, austerity) was combined with extremely loose monetary policies (QE). This means that demand was pulled in two opposing directions.⁸ These contradictory policies (one stimulating and one suffocating demand by consumers, governments and companies) create difficulties in assessing the impact of QE policies.

7 The ECB corporate bonds purchasing programme also exchanges debt securities directly held by non-financial corporations (primary market) by cash.

8 J.E. Stiglitz, *The Euro: How a common currency threatens the future of Europe* (New York and London: W.W. Norton and Company, 2016).

Where there is consensus, however, is that QE reduces the funding costs for banks, making it easier for them to provide loans or to trade in securities and derivative markets. But whether this increased liquidity remains in the financial sphere (being re-invested in financial assets) or reaches the 'real economy' (i.e. is used for productive means) remains to be seen. In a seminar, BIS researchers noted that "the theory of QE remains unclear". They quoted the former chair of the US Federal Reserve, Ben Bernanke:

*"The problem with QE is that it works in practice, but it doesn't work in theory."*⁹

In a separate report, the BIS states that monetary policies have not boosted economic activity as it did before the financial crisis and the period of QE.¹⁰ The lack of clarity on the effects of QE policies in terms of boosting demand (stimulating investments and creating jobs) in developed economies is matched by the lack of consensus on the harmful (unintended) consequences of QE for developing countries. This is the result of a limited number of studies and data constraints, and the absence of a clear understanding of how the changes in the metabolism of the global economy distress less developed economies as the effects of QE ripple through different channels (exchange rates, trade flows, interest rates, capital flows and debt levels) and different financial players.

1.2 Where does QE come from

QE policies originated in Japan in 2001 (well before the financial crisis of 2007-08) after 13 years of unsuccessfully trying to recover from a crisis that left a massive debt as real estate prices collapsed. Japan's \$300 billion QE programme was seen as a bold and experimental monetary policy at the time.

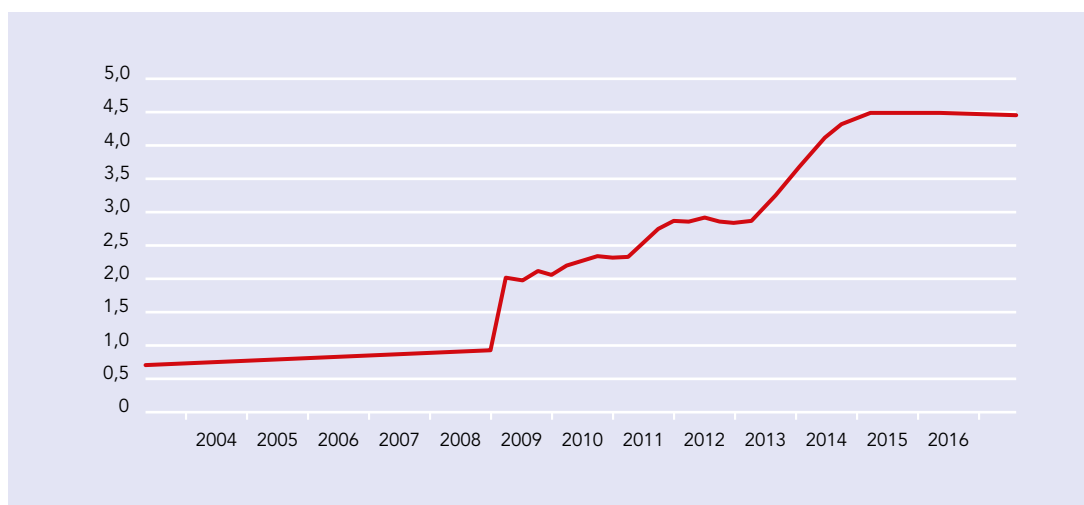
The new generation of QE programmes emerged in the US during the 2007-08 financial crisis. The context was a collapse of asset prices, bankruptcy of systemically risky banks such as Lehman Brothers and countless unknown interconnections between markets that fuelled overall uncertainty as investors did not know where the risks were. This dire setting led to interventions by central banks that included buying assets directly from banks and investors; in particular, asset-backed securities that triggered the crisis, in order to prevent a further collapse.

These desperate, crisis-focused activities transformed into more structured purchasing schemes (QE) in the US, as the fallout of the financial crisis proved to be more prolonged and structural in nature. Three QE programmes took place in the US between 2008 and 2015, raising the balance sheet of the US Federal Reserve from about US\$1 trillion to US\$4.5 trillion (see Figure 1). While the initial focus was on the purchase of mortgage-backed securities, the QE programmes broadened to include bonds issued by the US government (sovereign bonds). The Bank of England followed suit in 2009, buying sovereign bonds and high-quality corporate bonds worth over £200 billion, followed by other asset-purchasing programmes that together totalled £375 billion in 2012.

9 BIS, "QE experiences and some lessons for monetary policy: defending the important role central banks have played", TheEurofi High Level Seminar 2017, 5-7 April 2017, Malta, <<http://www.bis.org/speeches/sp170407.pdf>> (4 July 2017), p. 2.

10 BIS, "Market volatility, monetary policy and the term premium", BIS Working Papers No 606, January 2017, Basel, <<http://www.bis.org/publ/work606.pdf>> (4 July 2017), p. 16.

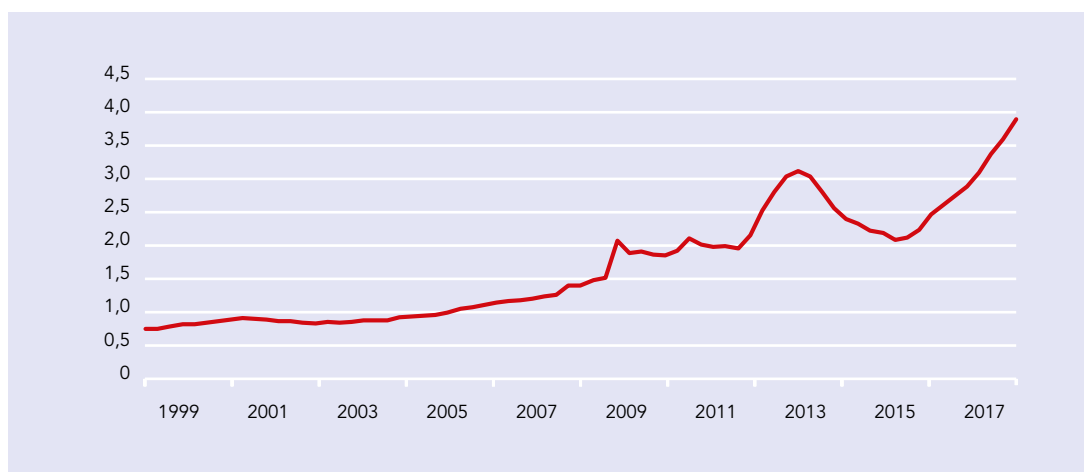
Figure 1 Total assets of US federal reserve in US\$ trillions



Source: Federal Reserve Bank of St. Louis¹¹

In Europe, the balance sheet of the European Central Bank (ECB) started rising well before its QE programmes started in 2015 (see Figure 2). These pre-2015 asset purchases were similar to the later QE programme but lacked the broader institutional framework of the QE period that signified the long-term and structural character. The ECB's QE programme was largely a continuation of the existing programmes and initially consisted of monthly purchases of financial assets in the range of €60 billion (increasing to €80 billion in mid-2016) in four separate purchasing programmes: covered bonds, asset-backed securities, sovereign bonds and corporate bonds (see Figure 2)

11 St. Louis Federal Reserve website, "Economic Research", <<https://fred.stlouisfed.org/graph/?g=iZry>> (15 March 2018).

Figure 2 Total assets of the ECB in trillions of Euros

Source: Federal Reserve Bank of St. Louis¹²

QE and interest rate

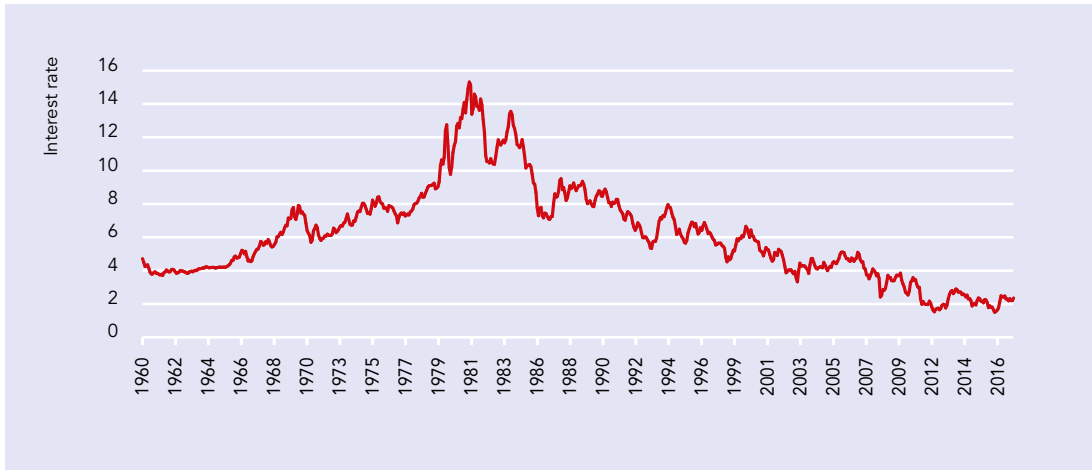
QE affected global financial behaviour and capital market developments by dampening effects on long-term interest rates. Although QE policies did lower interest rates – in some cases to unprecedented low levels – interest rates have been declining for more than 30 years.

Figure 3 portrays the long-term development of the interest rate over ten years in terms of US Treasury bills, the leading indicator of long-term interest rates in the US and worldwide. It shows that the trend towards lower interest rates has been part of advanced economies since the early 1980s. The structural dynamics that caused the decline of the interest rate will not be considered in depth in this report. Broadly speaking these dynamics include the policies of central banks known as the 'great moderation' that reduced economic and monetary volatility and rising demand for increasingly complex assets as a result of financial deregulation and innovation. This was driven in turn by the increase in corporate savings and assets managed by institutional investors. Developing countries also had an appetite for safe assets to build up reserves.

This report will restrict itself to the broadly accepted notion that QE did have an impact on interest rates. However, this was in the context of long-standing declining interest rates.

12 St. Louis Federal Reserve website, "Economic Research", <<https://fred.stlouisfed.org/graph/?g=iZry>> (15 March 2018).

Figure 3 Long-term government bond yields 10-year: main (including benchmark) for US



Source: Federal Reserve Bank of St. Louis¹³

13 St. Louis Federal Reserve website, "Economic Research", <<https://fred.stlouisfed.org/series/IRLTLT01USM156N>> (23 January 2018).

2 What are the negative effects of QE?

There are several interrelated, harmful effects resulting from QE policies. These effects have an impact on both developed and developing countries. In the following section, we will focus on the rise of capital flows and their effect on developing countries. First, however, we will take a look at the broader range of effects produced by QE. These include rising wealth inequality, the increase in systemic risks and the continuation of an unsustainable debt-led economic model.

2.1 QE fuels wealth inequality

Asset purchase programmes have not been an effective policy as far as stimulating demand is concerned, according to the BIS.¹⁴ However, these programmes have created winners and losers along the way, as a result of the build-up of wealth and interest income. Increasing demand by central banks for bonds has had mixed results. On the one hand, income from interest has declined, with a negative impact on savers and institutional investors (such as pension funds) investing in bonds and saving accounts. On the other hand, it has increased the value of outstanding financial assets such as shares and has fuelled real estate prices, with a knock-on positive effect on institutional investors.

Several studies have tried to map the outcomes of these contradictory developments. A comparison of different sectors in the Eurozone shows that the biggest winners were governments of core economies, whose borrowing costs declined sharply, sometimes due to negative interest rates.¹⁵ The German central bank estimated that the overall savings in interest payments for Eurozone governments (except Greece) as a result of the decline in interest rates amounted to €1 trillion from 2008 to 2017. Germany was the biggest winner on these terms with a saving of €240 billion.¹⁶ The second biggest group of winners in the Eurozone were non-financial firms, which also saw their borrowing costs fall due to lower interest rates. On the other side of the coin, banks were losers (as their interest income from loans declined sharply), as were households that were net savers. However, banks did gain from other activities (financial market operations) than the traditional deposit holding and lending functions, where income surged on the back of the rising value of financial assets. Banks thus made up for their lost income by changing their business model to become intermediaries for investors and to increase trading in securities and derivatives.

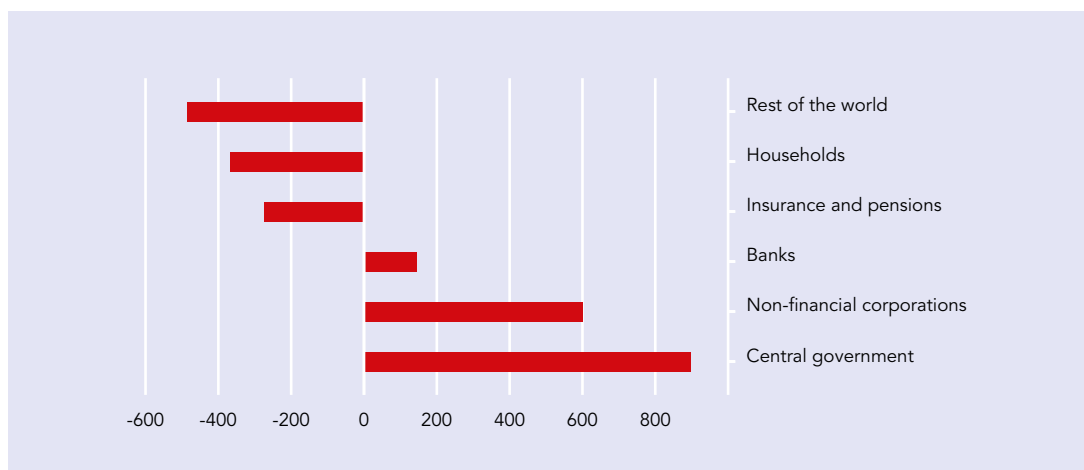
14 Claudio Borio and Anna Zabai, "Unconventional monetary policies: a re-appraisal", BIS Working Papers No 570, Monetary and Economic Department, July 2016.

15 See chart A: ECB, "Annual report 2016", April 2017 <https://www.ecb.europa.eu/pub/annual/html/ar2016.en.html#IDofChapter1_2_1_Box5> (4 August 2017), p. 48.

16 Deutsche Bundesbank, "The development of government interest expenditure in Germany and other euro-area countries", Deutsche Bundesbank Monthly Report July 2017 <https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2017/2017_07_development.pdf?__blob=publicationFile> (4 August 2017), p. 1.

An earlier report by McKinsey in 2012, measuring the distributional effects of QE in the US, found similar results (see Figure 4).

Figure 4 Estimated cumulative change in net interest income, 2007-2012 in US\$ billions



Source: McKinsey¹⁷

If we focus on the development of household wealth in the Eurozone since the start of its QE programmes, the largest beneficiaries (including losses due to lower interest income) were the wealthiest households.¹⁸ The increase in asset prices (shares and real estate) more than compensated for the decline in interest rate for these households. Data provided by the ECB is striking. It shows that, in the period between 2014 and 2016, the wealthiest 20 percent of households increased their net wealth as a share of net income by almost 30 percent. Households on the lowest 40 percent of the wealth distribution curve, on the other hand, saw their share of net wealth to income rise by no more than 4 percent.¹⁹

17 R. Dobbs, S. Lund, Tim Koller and A. Shwayder, "QE and ultra-low interest rates: Distributional effects and risks," McKinsey Global Institute, November 2013, <<http://www.mckinsey.com/global-themes/employment-and-growth/qe-and-ultra-low-interest-rates-distributional-effects-and-risks>> (23 January 2018).

18 C. Fontan and S. Jourdan, "How the ECB Boosts Inequality and What It Can Do About It", Social Europe, 10 May 2017, <<https://www.socialeurope.eu/2017/05/ecb-boosts-inequality-can/>> (12 July 2017).

19 See Box 5 on p. 48: ECB, "Annual report 2016", April 2017, <https://www.ecb.europa.eu/pub/annual/html/ar2016_en.html#DofChapter1_2_1_Box5> (4 August 2017), p. 48.

Overall there is a clear consensus between policy-makers – including those in central banks engaged with QE – that large-scale asset purchase programmes have distributional effects that favour the rich over the poor.²⁰ The broader long-term tendencies identified by economist Thomas Piketty – that returns to capital outpace economic growth – are magnified by these policies. This strong tendency for post-crisis monetary policies to create wealth inequality shows that the price of the crisis is being paid by the majority of the population that has had the least to do with creating the crisis in the first place.

Inequality is increasingly identified by institutions such as the International Monetary Fund (IMF) as a defining issue of our time that has a negative impact on economic growth and risks endangering democracy:

“Equality, like fairness, is an important value in most societies. Irrespective of ideology, culture, and religion, people care about inequality. Inequality can be a signal of lack of income mobility and opportunity – a reflection of persistent disadvantage for particular segments of the society. Widening inequality also has significant implications for growth and macroeconomic stability: it can concentrate political and decision-making power in the hands of a few, lead to a suboptimal use of human resources, cause investment-reducing political and economic instability, and raise crisis risk. The economic and social fallout from the global financial crisis and the resultant headwinds to global growth and employment have heightened the attention to rising income inequality.”²¹

2.2 QE promotes systemic risks

On a systemic level, QE has provided additional money in search of high yields to capital markets that are already saturated with high corporate savings (accumulated profits) and capital managed by institutional investors. This means that additional funds were pushed onto capital markets, looking for investments, lowering long-term interest rates and inflating asset prices (including residential real estate). This surplus liquidity means that high-quality assets (sovereign bonds from core economies and asset-backed securities) become relatively scarce as demand exceeds supply.^{22,23} In other words: there is an oversupply of liquidity and not enough high-quality assets to invest in. This is exacerbated by austerity policies, which reduce demand and therefore investment opportunities in the ‘real’ economy. This is an environment that fosters systemic risks.

The central banks in Germany and the Netherlands have focused their criticism on the narrower issue of ‘market distortion’ by QE. In their view, QE leads to the mispricing of risks of other financial assets as investors try to find alternatives to high-quality assets. This push towards more risky assets means

20 Bank of England, “The distributional effects of asset purchases”, Quarterly Bulletin 2012 Q3, <<http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/qb120306.pdf>> (4 August 2017).

21 IMF, “Causes and Consequences of Income Inequality: A Global Perspective”, 15 June 2015, Staff Discussion Notes No. 15/13, <<https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Causes-and-Consequences-of-Income-Inequality-A-Global-Perspective-42986>>, (4 August 2017), p. 5.

22 See: BIS, “Mind the gap? Sources and implications of supply demand imbalances in collateral asset markets”, BIS Quarterly Review, September 2013, <http://www.bis.org/publ/qtrpdf/r_qt1309h.pdf> (1 August 2017).

23 K. Martin, “Citi’s plea: ‘Please don’t buy so many bonds, Mr Central Banker’”, Financial Times, 5 September 2016, <www.ft.com/content/c955c445-b216-3843-99f8-e3780da4d7a8> (4 August 2017).

that systemic threats are enhanced, with all sorts of consequences.²⁴ Deutsche Bank notes that interest rates in Eurozone countries have been converging again, as they did before the euro crisis.

According to the Dutch central bank, this oversupply of liquidity threatens to create bubbles and keeps 'zombie banks' (see Glossary) alive, with a knock on negative impact on productivity:

*"The side-effects of this policy primarily undermine the operation of the financial markets. The large-scale purchase programmes and the flood of liquid assets have set the risk compass in financial markets spinning, with misallocations as a result. This is reflected in higher correlations between asset classes, diminishing market liquidity and inconsistent risk pricing. Current monetary policy creates an unhealthy search for yield. Partly as a result, prices on certain asset markets, such as real estate and bonds, may diverge from their fundamental values. Secondly, this fuels the risk that households, businesses and governments will be overindulged by the low interest rates. They will lose the incentive to clean up their balance sheets, push through structural reform and thus develop resilience to a higher interest rate environment. The continuing presence of zombie banks and businesses, or rather the lack of creative destruction, damages the European economy's growth potential."*²⁵

The problem with the mainstream critique of the misallocation of capital as a result of QE is that it assumes that 'normal' market prices are being distorted. In this view, based on the so-called "Efficient-market hypothesis", market prices reflect all available information, with little or no role for fashions, moods and bubbles. However, we believe that the structural imbalance – entailing an abundance of liquidity that exists irrespective of QE – and the related growth of debt, debt-led economic models and market-oriented policies, lie at the heart of systemic risks. In other words, the absence of QE also created a 'misallocation' of capital that fuelled the financialisation of non-financial corporations.²⁶

The harmful side effects of QE policies on financial market stability run through diverse and complex channels, affecting the behaviour and perception of corporations, investors and financial institutions as well as individuals, savers and households. However, we do not know the counterfactuals: what would have happened if central banks had not engaged in massive asset-purchasing programmes? The financial crisis of 2007-08 brought with it the collateral of QE policies to avoid further collapse. These crisis measures, however, seem to have strengthened the very structural deficiencies that led to the collapse of the financial system in the first place. This means that the contradictions leading to the financial crisis are being pushed to an even more dangerous level. At the heart of these contradictions lies a reliance on growing debt and an accommodating market-oriented policy framework.

24 BIS, "QE experiences and some lessons for monetary policy: defending the important role central banks have played", The Eurofi High Level Seminar 2017, 5-7 April 2017, Malta, <<http://www.bis.org/speeches/sp170407.pdf>> (4 July 2017), p. 5.

25 DNB, "2016 Annual report", De Nederlandsche Bank 2017, Amsterdam, <https://www.dnb.nl/en/binaries/Annual%20report%20DNB%202016_tcm47-356008.PDF> (2 July 2017), p. 15.

26 For an example of the financialisation of a non-financial corporation, see: R. Fernandez and R. Hendrikse, "Rich corporations, poor societies: The financialisation of Apple" (Amsterdam: SOMO, 2015) <https://www.google.com/url?sa=t&rct=j&q=&escr=s&source=web&cd=1&ved=0ahUKEwiYk6eC64TbAhWEzKQKHVKGA_oQFgggUAAA&url=https%3A%2F%2Fwww.somo.nl%2Fwp-content%2Fuploads%2F2015%2F10%2FRich-corporations-poor-societies.pdf&usg=AOvVaw115U5Y_qwO8MZkS-vpXnvDd>.

2.3 QE perpetuates an unsustainable debt-led economic model

The underlying problem, uncovered by the financial crisis, was the debt-led economic model that most developed economies had followed since the 1980s.²⁷ The rise of private debt by households counterweighed and substituted the decline of the wage share and the gradual erosion of the welfare state.²⁸ Economic growth became increasingly reliant on housing wealth financed by mortgages. This debt-led economic model is unsustainable and needs to be abandoned in favour of policies that return to a wage-led model and allow for the reduction of outstanding debt levels. In the absence of a rebalancing of debt levels and income levels, economies will remain crisis prone.

However, loose monetary policies pursued by central banks extend the life of this debt-led model – the explicit goal of QE is to lower the long-term interest rate and to increase private debt (of both households and corporations) to stimulate the economy. In the process, central banks have become essential actors in promoting debt-led economics and, as such, have become a structural destabilising force. Without any form of consultation or political debate, the continuation of debt-led economics is imposed on economies by central banks through QE policies.

The justification for increasing overall debt levels is that it allows households to consume and firms to invest, enlarge their productive capacity and increase productivity. Adair Turner, the former Chairman of the UK's Financial Services Authority, calls for a distinction between 'good' and 'bad' debt. The first is the use of debt to invest in productive activities that generate future income. The second is the use of debt to buy existing real estate or speculative financial activities. Bad debt does not create future income streams, only liabilities, while inflating asset prices. Therefore it is unsustainable.

In his assessment, the growth of private debt has been dominated by bad debt that creates bubbles, fosters systemic instability and fails to deliver economic activity and income streams to secure payments. Credit is used to finance already existing assets instead of investments that enlarge the productive capacity of an economy, which therefore leads to unsustainable debt.

"In advanced economies most credit is used to finance the purchase of existing assets, in particular, real estate. Such credit does not have a necessary and proportional impact on demand for the current goods and services that form national income. As a result it can grow to excessive levels that cause eventual crisis without that growth ever producing an increase in inflation and without it being necessary to economic growth."²⁹

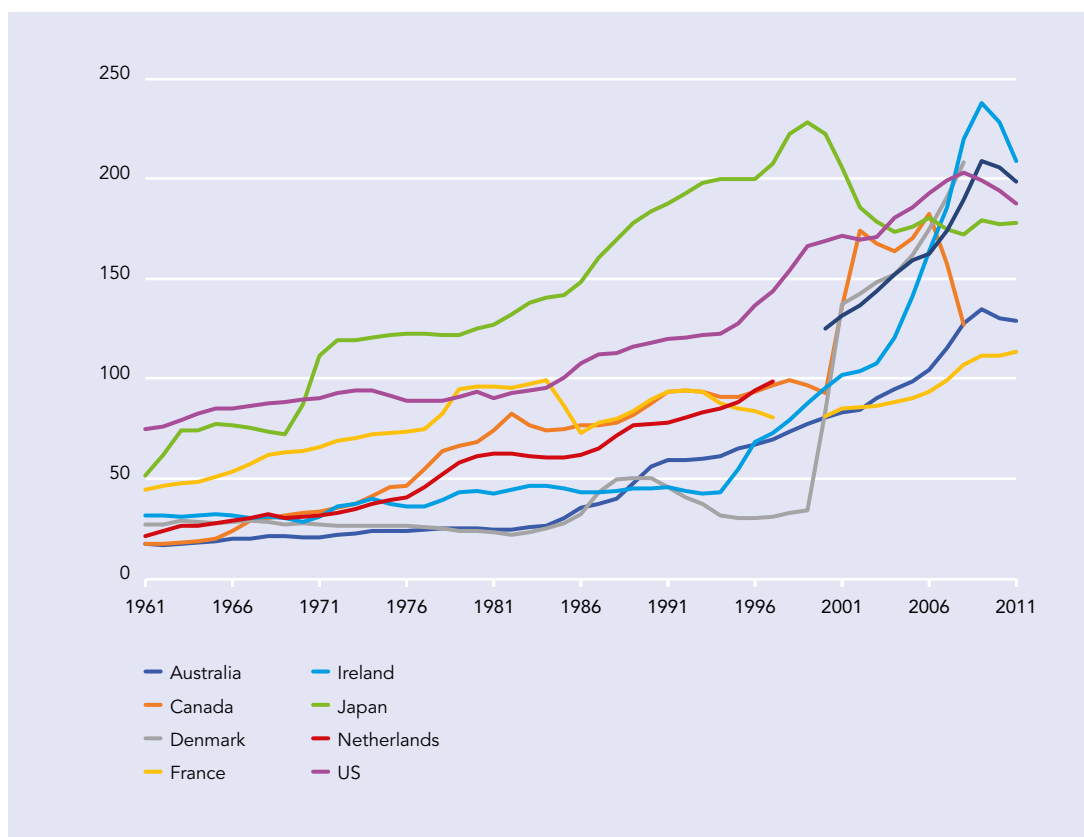
27 For an overview, see: W. Streeck, "Buying Time: The delayed crisis of democratic capitalism" (Verso Books, 2016).

28 E. Stockhammer and R. Wildauer, "Debt-driven growth? Wealth, distribution and demand in OECD countries", Cambridge Journal of Economics, Volume 40, Issue 6, 1 November 2016, p. 1609-1634, <<https://doi.org/10.1093/cje/bev070>> (2 July 2017).

29 A. Turner, "Between debt and the Devil: Money, credit and fixing global finance" (Princeton University Press, 2016), p. 116.

The level of private debt among households and non-financial corporations has been growing structurally as a share of GDP since the early 1960s across developed economies (see Figure 5).³⁰ This shows the magnitude of the mounting debt-led economic model. The ECB has become part of the problem, fostering the debt-led model instead of moving towards a sustainable economic model that relies on wages and investments and good debt into non-speculative activities.

Figure 5 Total private debt as share of GDP in selected developed economies



Source: BIS

³⁰ The statistical category 'private debt' includes non-financial corporations and households. The financial sector and banks, however, became even more indebted, but are excluded from this category.

A public debate is needed about how to move away from reliance on growing debt, and the role central banks should play in achieving this goal. This debate should not only focus on the *quantity* of debt, but crucially also on its *quality* ('good' versus 'bad') and the institutional mechanisms to organise the allocation of capital. If market forces are unable to move away from financing bad debt – while good debt for investment opportunities (for instance, investments in energy transition) are sidelined – we need to think of alternative forms of distributing capital. This includes rethinking the role of central banks in the overall financial architecture.

In an age where central banks have become 'self-governing' agents, exempt from political control, with a pivotal role in stimulating the debt-led economic model, we need to give serious thought to how these state institutions can be brought back into the realm of democratic control and accountability.³¹

31 Transparency International Europe, "Two sides of the same coin? Independence and accountability of the European Central Bank", 28 March 2017, <https://transparency.eu/wp-content/uploads/2017/03/TI-EU_ECB_Report_DIGITAL.pdf> (14 August 2017).

3 What are the critical QE issues for developing countries?

3.1 Emerging economies are fragile in the context of financial globalisation

The harmful consequences of QE discussed above have an impact on developing countries too. The QE policies directly feed the growing wealth inequality in developing countries, as wealthy individuals are able to profit from increasing asset prices at home and abroad. The misallocation of capital means that corporations in jurisdictions where QE policies exist have an advantage over companies from developing countries. Large corporations in the Eurozone that are eligible for the ECB's purchase programme are able to finance growing indebtedness at below market rates as the QE policies push down interest rates for these specific corporate bonds.

However, developing countries have to deal with additional issues when it comes to QE that do not have a such an impact on developed economies. First, emerging economies have smaller financial markets, with fewer diversified instruments and intermediaries.³² Secondly, the currencies of these economies are generally not accepted as a means of payment or collateral for international trade and international lending/borrowing.

The harmful consequences of QE policies arise due to the interaction of cross-border capital movements with these two distinctive characteristics of developing economies. By lowering returns (interest rates) in advanced economies, QE encourages financial inflows to emerging economies that lack the depth and varieties of outlets to absorb these inflows.

In addition, larger and more liquid financial markets allow for more diversification of actors, market activities, products and cross-border channels. A comprehensive study³³ by the IMF into a broad set of capital flows (including foreign portfolio equity investments (FPEI), bank loans, foreign direct investments (FDI)) into a large number of countries from 1980 to 2011 found important trends related to diversity. As developed economies have more diversified channels (types of investments and intermediaries) for cross-border capital flows, the study concluded that – whether in up- or down-swings – capital can switch from one channel to another more easily in developed economies than in emerging ones.

In addition, less mature financial markets in developing countries typically have higher interest rates for loans denominated in domestic currencies. With lower interest rates in international markets,

32 World Bank, "Financial Institutions and Markets across Countries and over Time Data and Analysis", Policy Research Working Paper 4943, May 2009, <<https://openknowledge.worldbank.org/bitstream/handle/10986/4154/WPS4943.pdf>> (4 August 2017).

33 IMF, "Capital Flows are Fickle: Anytime, Anywhere", IMF Working Paper, WP/13/183, August 2013, <<https://www.imf.org/external/pubs/ft/wp/2013/wp13183.pdf>> (4 August 2017).

firms from emerging economies have a natural incentive to borrow abroad in a foreign currency. This was also the main stimulus in Latin America in the run up to the debt crisis in the 1980s.

These capital flows provide abundant credit during the surge but have a tendency to leave behind unpayable debts when capital flows reverse. Corporations and public finances funded with bonds in a foreign currency face severe risks to capital flights. First, when there is a sudden slowdown in capital inflows, domestic financial markets freeze the refinancing of debt. Second, and most importantly, there is a currency mismatch. Unlike debt denominated in domestic currencies, emerging economies need to expand their exports to pay for debt in foreign a currency. This is what Keynes referred to as the “transfer problem”.³⁴

Adding to this, in times of stress, financial indicators from companies tend to deteriorate (because of their previously incurred debt), governments themselves face illiquid financial markets and are forced to cut back on other types of expenditures, and imports become more expensive, damaging production capacities and widening the gap when it comes income distribution. In summary, QE policies and the capital surges associated with them lead to mounting debts that are unsustainable, on multiple fronts.

3.2 Ebb and flow of capital movements create instability

The structural fragility of developing countries is heightened by the ebb and flow, or cyclical character, of global capital flows. The retreat of capital flows occurs relatively abruptly and can violently affect exchange rates, interest rates and inflation levels, and consequently the broader economic conditions. As capital flows in different directions, so the demand for local currency declines, thus creating downward pressure on the exchange rate. This increases the price of imported goods, which in turn causes inflation. A retreat of capital flows also increases the interest rate, as the credit rating declines, which has a negative impact on economic conditions. This negative spiral is often fuelled by central bank policies in developing countries that have adopted inflation targeting and therefore increase interest rates in these circumstances. Due to the fragility of developing countries, related to the relatively small and under-developed financial system, the volatility of capital flows has proved to be particularly destructive over the last four decades.³⁵

Since the 1970s, there have been three surges in cross-border capital flows from developed to developing countries that ended in crises, including the current one³⁶ – the first in 1982 (Latin America and Africa); the second in 1994 (Mexico), 1997 (South-East Asia) and 1999 (Russia).

34 “The Dawes Committee divided the problem of the payment of German Reparations into two parts-into the Budgetary Problem of extracting the necessary sums of money out of the pockets of the German people and paying them to the account of the Agent-General, and the Transfer Problem of converting the German money so received into foreign currency” Keynes, J. M. (1929). “The German transfer problem”. *The Economic Journal*, 39(153), p.1.

35 There are exceptions to this general rule of thumb. Larger emerging economies with large (relative to other developing economies) financial markets such as South Africa and Brazil also have extremely volatile exchange rates and capital flows.

36 Y. Akyüz, “Capital Flows to Developing Countries in a Historical Perspective: Will the Current Boom End With a Bust?”, Research paper 37, South Centre, March 2011 <https://www.southcentre.int/wp-content/uploads/2013/05/RP37_Capital-Flows-to-developing-countries_EN.pdf> (4 August 2017).

Currently we are living through the third surge. All these crises show the consequences of large, unmanageable cross-border capital flows that are moving into emerging economies. While the Latin American debt crisis of 1982 was predominantly shaped by commercial banks and the Asian crisis of 1997 was formed by portfolio investments and risky loans by foreign banks, the current inflow of capital is primarily through the international bond market by institutional investors and their asset managers. Although these inflows differ in nature, they have had the same impact on emerging economies that could not absorb such large inflows of credit: they reached a crisis point. These flows are generated by the difference in interest rate. As interest rates (reflecting higher risk) are higher outside developed economies they attract investors seeking higher returns.

In 1978, during the rapid build-up of foreign debt by Latin American countries, Alexander Lamfalussy (at that time economic advisor to the BIS and later one of the founders of the euro) stated that the cause of the mounting debt in Latin America was that the US was “pumping liquidity into the international financial system”.³⁷ Four years later, a continent-wide crisis that would last for more than a decade emerged once the Chair of the US Federal Reserve, Paul Volcker, raised the interest rate (“Volcker shock”) and the US stopped pumping liquidity into the international financial system.

3.3 What has been the effect of QE on developing countries?

Since QE policies in the US started, the world has experienced a third period of increased cross-border capital flows. The question we are faced with is whether we can avoid another crash due to unpayable bond debt once QE is terminated and capital invested in bonds in emerging economies returns to the core, making refinancing existing loans impossible. To answer this question, we need to look at the magnitude of the problem and how it resembles or differs from the previous surges in capital flows. How did QE affect the structural fragility of emerging economies?

“(…) the expansion of both the Fed and the ECB balance sheet since the crisis has been significant and it is likely to have encouraged capital outflow from their respective economies to other countries, especially emerging markets where interest rates remained significantly higher.”³⁸

The loose monetary policies in countries and regions such as the US, UK, EU, Japan, Switzerland and Sweden have injected roughly \$12 trillion into the global financial system since the collapse of Lehman Brothers. While the balance sheet of central banks increased as they exchanged bonds for cash, their counterparts – namely banks, financial institutions and non-financial corporations – reinvested this cash in other financial assets. The question is how much of this dislocation of investment, or ‘portfolio rebalancing’ in central bank jargon, moved to financial assets outside of core countries. In other words: how much of the increased liquidity flooded emerging economies, how much was invested in sovereign or corporate bonds, alongside shares from these countries, and what was the result of this?

37 P. Clement and I. Maes, “The BIS and the Latin American debt crisis”, Working Paper Research, No 247, 2013, National Bank of Belgium, <<https://www.nbb.be/doc/ts/publications/wp/wp247en.pdf>> (14 September 2017).

38 A. Apostolou and J. Beirne, “Volatility spillovers of Federal Reserve and ECB balance sheet expansions to emerging market economies”, Working Paper Series, 2017, No 2044, p. 3.

QE programmes have no restrictions or conditions on what the cash received by financial counterparts should be used for, including whether or not it can be spent on cross-border reinvestments. This means that any euro, pound or dollar received from central banks can be invested in any assets from any part of the world. This is remarkable if we consider that the aim of QE is to achieve an increase in spending within the jurisdiction of the respective central bank. The increase of cash in circulation caused by QE programmes also needs to be put in the context of liberalised capital controls throughout developed and developing countries.

This landscape of liberalised capital accounts has created an environment of highly mobile capital that can move in and out of countries with few restrictions. Investors can search for higher profits outside the countries QE originated from because there have been very few capital controls on outgoing capital nor on inflows into developing countries. Developing countries have often liberalised capital movements bilaterally, and have made commitments not to restrict capital flows, except in very special crisis situations, in trade and investment agreements. Many financial players have been able to expand internationally through liberalisation of financial services, unilaterally, bilaterally (Free Trade Agreements – FTAs) or multilaterally (General Agreements on Trade in Services – GATS), which has facilitated capital to move into developing countries.

In a report by the World Bank before the ECB's QE programme, the following was noted about reinvestments in emerging economies:

“Although QE was meant to be an expansionary monetary policy for the U.S. economy, the program had profound implications for developing countries. Faced with near zero-returns in the U.S. and other high-income countries – many of which were implementing unconventional monetary policies of their own – financial capital began to seek alternative sources of yield. Emerging economies, which had enjoyed heady growth rates and stable political-economic environments over the past decade, appeared to be an ideal investment alternative.”³⁹

The report, based on data covering 60 developing countries, estimates that the contribution of QE from the US amounted to at least a 13 percent increase of cross-border capital flows of a total 62 percent increase during 2009-2013.⁴⁰ Similar observations are made by economists from the Asian Development Bank (ADB)⁴¹ and the UN Economic Commission for Latin America and the Caribbean (ECLAC).⁴²

Another direct result of the financial crisis was a reduction in the indebtedness of banks in developed economies, and a retreat from foreign activities. This led to a visible process of 'de-globalisation' of

39 World Bank, “Tinker, Taper, QE, Bye? The effect of quantitative easing on financial flows to developing countries”, Policy Research Working Paper 6820, 2014, <<http://documents.worldbank.org/curated/en/570101468341335746/Tinker-taper-QE-bye-the-effect-of-quantitative-easing-on-financial-flows-to-developing-countries>> (4 August 2017), p. 2.

40 Idem, p. 1.

41 P.J. Morgan, “Impact of US Quantitative Easing Policy on Emerging Asia,” ADBI Working Paper Series, 2011 <<https://www.adb.org/sites/default/files/publication/156176/adb-wp321.pdf>> (14 August 2017).

42 E.P. Caldentey, “Quantitative Easing: Changes in global liquidity and financial instability,” Post Keynesian economics study group, working paper 1701, 2017 <<http://www.postkeynesian.net/downloads/working-papers/PKWP1701.pdf>> (14 August 2017).

banking.⁴³ In this context the main channel towards developing countries became the international bond market instead of bank loans.⁴⁴ This shift from bank loans and banks as primary actors in intermediating capital towards capital market based intermediation fits a broader pattern that has been observed by the IMF.⁴⁵ Part of this transformation is the rising importance of asset managers. Investors (such as pension funds and insurance companies) increasingly invest indirectly in bonds or shares through an asset manager. This has led to a concentration of market power in the hands of a small number of very large asset managers such as PIMCO, Blackrock, State Street and Wellington. In October 2017, PIMCO managed assets worth US\$2,060 billion, of which US\$1,011 billion were bonds.⁴⁶ Blackrock managed assets valued at US\$6,280 billion in December 2017.⁴⁷ These asset managers create investment funds that include developing country bonds and shares. Institutional investors, as well as individual investors, can invest in these funds.

Before addressing the capital flows observed in the last few years, we will provide a brief overview of the international bond market and how it is subdivided.

3.3.1 What are international bonds? A quick guide

Bonds are tradable debt certificates. The issuer (a company, bank or government) receives a loan for which it pays interest rates and repays the principle at the maturity date. The bond can be resold by the investor; hence it is a *tradable* debt security. The issuance of a bond is known as the primary market. On the secondary market, bonds can be traded on a stock market (publicly traded) or over-the-counter (OTC) in a private transaction. Bonds can also be used as collateral for transactions in other (shadow banking) markets, for instance in repo-market transactions or money market funds.

The market value of bonds differs according to the issuer and collateral. The valuation is manufactured by credit rating agencies. Bonds that typically receive high ratings are sovereign bonds from developed economies such as Germany and the US that can easily be traded for other assets (i.e. they are liquid). Corporate bonds from blue chip companies, such as Apple and mortgage backed securities, typically enjoy high ratings. These bonds with high ratings are also perceived as high-quality collateral, as opposed to other riskier asset classes. This difference in risk is also expressed in the interest rate variances. Bonds from developing countries therefore have higher interest rates than bonds from developed economies. As QE forces investors to seek more risk (portfolio rebalancing), capital starts to flow to bonds with higher risks and provides a better return.

43 BIS, "Financial deglobalisation in banking?", BIS Working Papers No 650, June 2017 <<http://www.bis.org/publ/work650.pdf>> (14 September 2017).

44 E.P. Caldentey, "Quantitative Easing: Changes in global liquidity and financial instability," Post Keynesian economics study group, working paper 1701, 2017, <<http://www.postkeynesian.net/downloads/working-papers/PKWP1701.pdf>> (14 August 2017).

45 IMF, "The asset management industry and financial stability", Chapter 3 of Global Financial Stability Report, April 2015.

46 Reuters Thompson data, accessed on 17 October 2017.

47 Investment Europe, "BlackRock breaks \$6trn AUM mark", <<http://www.investmenteurope.net/regions/north-america/black-rock-breaks-6trn-aum-cap/>>, accessed on 15 March 2018.

The global bond market consists of a domestic and an international market.⁴⁸ In a domestic bond market, national entities (both public and private) issue bonds in the local currency. For instance, a French corporation issues a bond in France, denominated in euros. In the international bond market, the issuer is non-domestic and issues the bond in a foreign currency. For instance, an Argentinean corporation issues a bond in France denominated in euros.

3.3.2 The international bond market and QE

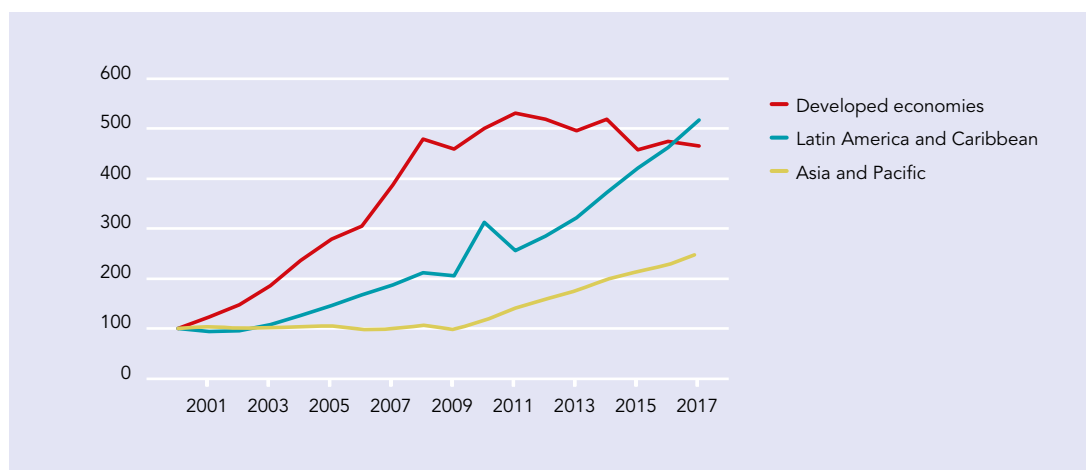
The international bond market has been in a state of continuous flux over the last two decades. However, it has remained completely dominated by debt (both public and private) issued by developed economies, which accounts for over 90 percent of the total stock. The total size of the international bond market – including public and private debt – rose from US\$33 trillion in 2000 to US\$87 trillion in 2015. The stock of debt from international bonds in developed economies rose rapidly before the financial crisis, but remained fairly stable afterwards (see Figure 6). This means that QE – although it involves central banks actively purchasing bonds – did not trigger an increase in the stock of bonds issued by sovereign states and corporations in developed economies and sold on international capital markets.

Developing countries, on the other hand, show a different picture altogether. Figure 7 shows the development of the outstanding stock of international bonds for three regions: developed economies; developing Asia and Pacific; and developing Latin America and Caribbean.⁴⁹ The figure shows how the outstanding debt developed in relative terms, compared to the year 2000. We can clearly see that, before the 2007-08 financial crises, the stock of international bonds increased rapidly in developed economies – by 500 percent from 2000 to 2008 – only to remain stable in the period from 2008 to 2017.

48 In order to simplify, other types of bonds, such as Eurobonds, are excluded from this overview.

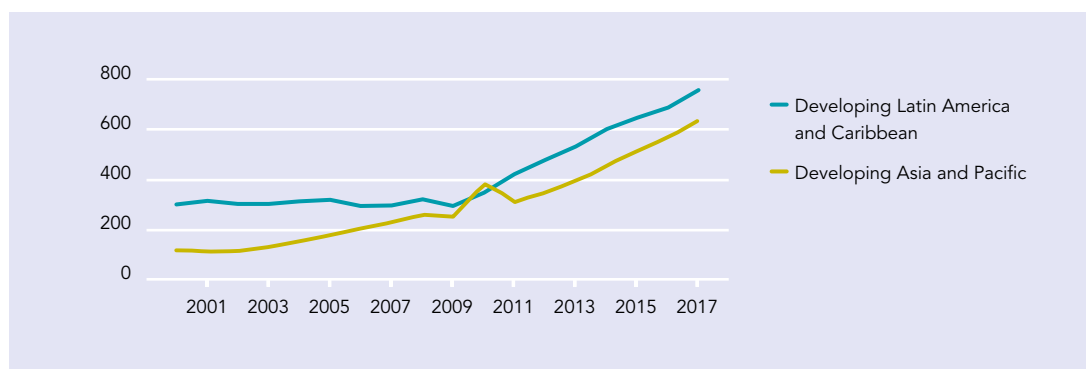
49 These regions are created by the BIS not by the authors.

Figure 6 Outstanding stock of international bonds, indexed 2000 = 100



Source: BIS⁵⁰

Figure 7 Outstanding stock of international bonds (public and private) in \$ billions



Source: BIS⁵¹

The Latin America and the Caribbean region shows a trend in the opposite direction. It was stable before the financial crisis and started to grow rapidly afterwards, in the period of QE. The category Asia and Pacific shows an on-going rise, briefly interrupted by the financial crisis. Figure 7 shows the nominal increase in the stock of international bonds. International bonds issued by Latin America and the Caribbean region (both public and private) increased from US\$297 billion in 2009 to US\$757 billion in 2017. In the Asia and Pacific region, the stock of international bonds increased from US\$253 billion in 2009 to US\$637 billion in 2017.

50 BIS, "Debt securities statistics", <<https://www.bis.org/statistics/secstats.htm?m=6%7C33%7C615>>, Table C3.

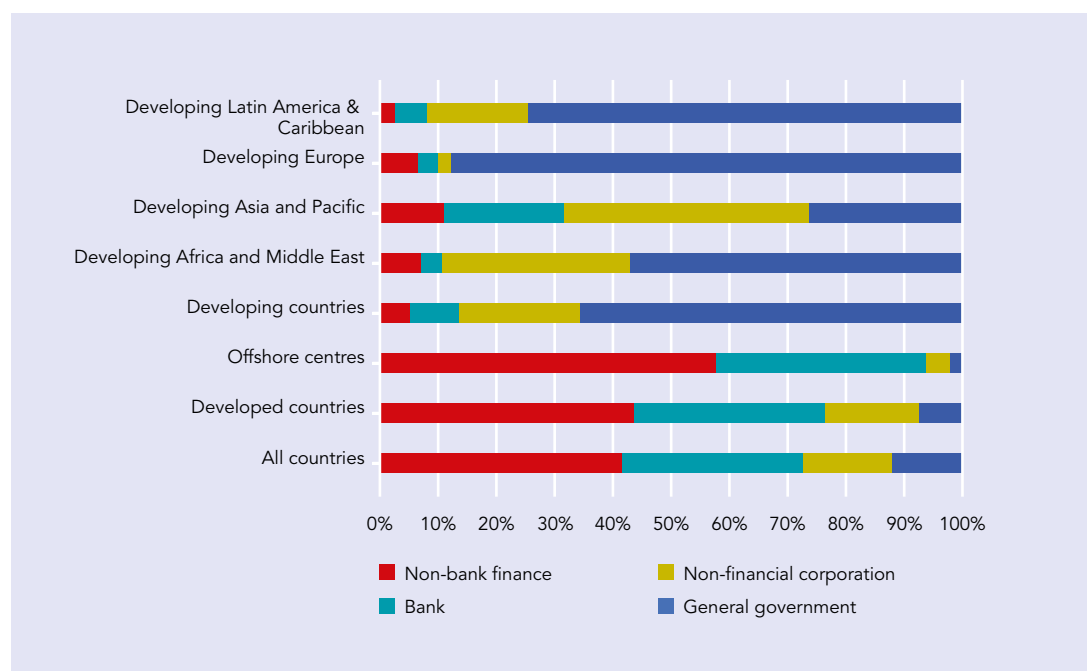
51 BIS, "Debt securities statistics", <<https://www.bis.org/statistics/secstats.htm?m=6%7C33%7C615>>, Table C3.

3.3.3 Which sectors caused the increase in international bonds in developing countries?

If we take a closer look at the underlying sectors that issued international bonds, we find an important shift from sovereign bonds to private bonds. Figures 8 and 9 provide an overview of the weight of the different sectors – namely public, corporate, banks and non-bank finance. This illustrates that international bond markets remain dominated by the composition of the international bond market of developed economies that mostly issue sovereign bonds domestically (in their local currency) and therefore sovereign bonds are a relative small part of the global picture of international bonds.

However, developing countries have smaller domestic markets and issue sovereign bonds internationally. If we compare Figures 8 (2002) and 9 (2017), we see that the difference for all countries is small but, once again, is produced by the weight of developed economies. But the shift for developing countries, specifically for Latin America and the Caribbean region, is dramatic. While sovereign bonds comprised more than 75 percent of all international bonds in 2002, they made up 47 percent in 2017. This shows a shift from public to private bonds.

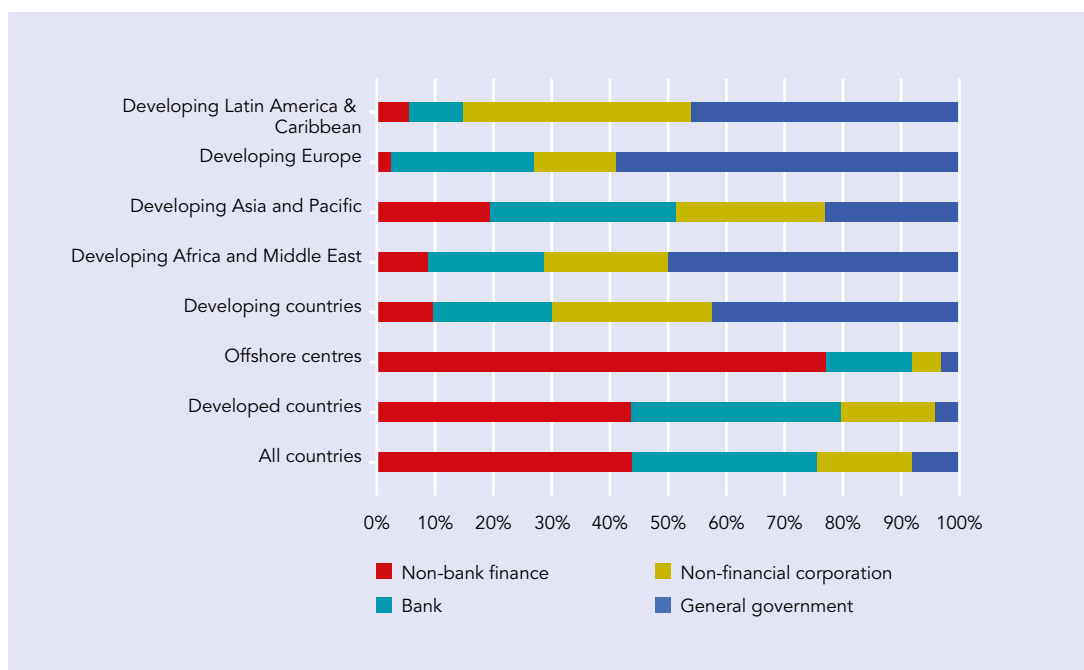
Figure 8 International bond market by sector, March 2002



Source: BIS⁵²

52 BIS, "Debt securities statistics, <<https://www.bis.org/statistics/secstats.htm?m=6%7C33%7C615>>, Table C3.

Figure 9 International bond market by sector, March 2017

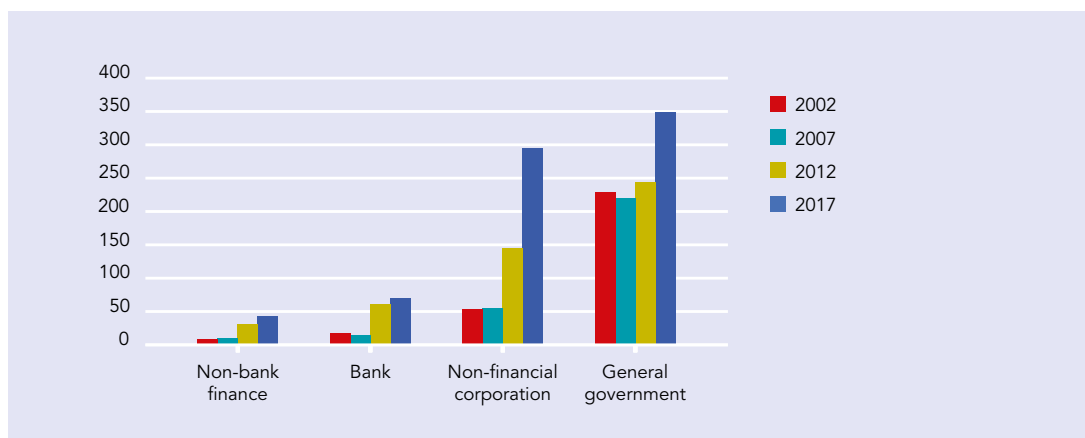


Source: BIS⁵³

If we dig deeper into the transformation of the international bonds issued by countries in Latin America and the Caribbean and the Asian region, we find that the move towards private bonds was mostly produced by non-financial corporate bonds. Figures 10 and 11 portray the nominal value of international bonds issued by sector in four different years from 2002 to 2017. In Figure 10 we can see how sovereign bonds issued internationally increased from US\$220 billion in 2007 to US\$349 billion in 2017 (up 37 percent). The bonds issued by the non-financial corporate sector, however, increased by 540 percent between 2007 and 2017, from US\$54 billion to US\$295 billion.

53 BIS, "Debt securities statistics," <<https://www.bis.org/statistics/secstats.htm?m=6%7C33%7C615>>, Table C3.

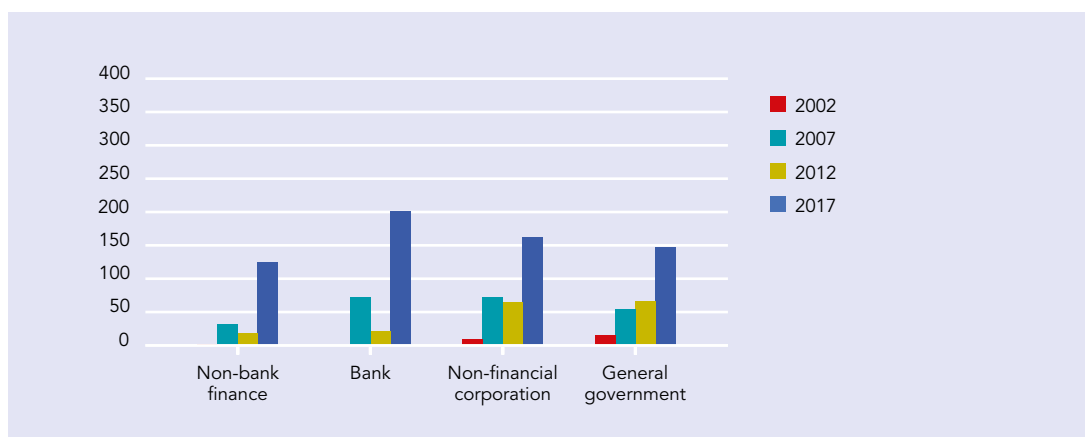
Figure 10 Sectoral overview of international bonds issued in developing Latin America & Caribbean in US\$ billions



Source: BIS⁵⁴

Figure 11 shows a different picture for developing Asia and Pacific, which is largely dominated by China. Between 2012 and 2017, sovereign bonds moved from the first to the third largest category. The largest increase is visible in the bonds issued by the banking sector, although increases in both non-bank finance and non-financial corporate are also large.

Figure 11 Sectoral overview of international bonds issued in developing Asia and Pacific in US\$ billions



Source: BIS⁵⁵

54 BIS, "Debt securities statistics," <<https://www.bis.org/statistics/secstats.htm?m=6%7C33%7C615>>, Table C3.

55 BIS, "Debt securities statistics," <<https://www.bis.org/statistics/secstats.htm?m=6%7C33%7C615>>, Table C3.

This shows that the increase in private international bonds is more diversified and complex across different regions. The overall tendency, however, is one of increasing debt and a shift of risks from public to private, particularly in the age of QE.

3.3.4 The ECB on the unintended consequences of QE for emerging economies

The ECB also conducted a noteworthy study on the potential impact of QE on emerging economies. The study covers the period before the ECB QE programme, and is therefore unable to quantify the full effects of the Eurozone. However, the conclusions – based on the US experience, the pre-QE expansion of the ECB balance sheet and a broad literature review – are significant. They state that the volatility experienced by Emerging Market Economies (EMEs) was caused by the expanding balance sheet of the ECB and the FED:

“Overall our results indicate that the volatility of the Fed and the ECB balance sheet can explain some of the volatility in emerging market economies (EME). We find that EME bond markets are most susceptible to positive volatility spillovers from both the FED and the ECB in terms of the magnitude of the effect.”⁵⁶

Moreover, the ECB study concludes that the effects of QE on the economic activity of China are significantly smaller due to its restrictions on cross-border capital flows. In other words, this ECB study shows that countries are affected by QE according to the liberalisation of their capital accounts:

“The policy implications of our paper are two-fold: First, EMEs need to pay particular attention to changes in the balance sheets of the FED and ECB given the extent to which there is an effect on domestic financial and real economy volatility. This is particularly the case with respect to EME bond markets, which have been subject to the most notable volatility spillovers in terms of magnitude. The most affected countries in general have been those with a more open capital account and greater financial linkages with the U.S. and euro area economies.”⁵⁷

The ECB study recommends a restriction on international borrowing by developing countries and suggests instead that they develop domestic bond markets, given the effects of QE:

“Given the susceptibility of EME bond markets to volatility spillovers, this would point in the direction of further efforts towards the development of local currency bond markets. Other measures to limit volatility spillover by EMEs may include, but are not limited to, altering monetary and fiscal policies where policy space is available, as well as exchange rate and foreign exchange reserves management.”⁵⁸

56 A. Apostolou and J.Beirne, “Volatility spillovers of federal reserve and ECB balance sheet expansions to emerging market economies”, Working Paper Series, 2017, No 2044, p. 2.

57 Idem, p. 20.

58 Idem.

Another set of measures proposed in this study is to have “targeted capital controls”:

“Moreover, where possible, macroprudential policies can be used to this end, as well as targeted capital controls, to help insulate economies from volatility spillovers from abroad.”⁵⁹

The study ends with a dramatic forecast on how a sudden end to loose monetary policies may have a negative impact on developing countries:

“Second, our results have implications for the impact of the exit from unconventional monetary policies, and how this is likely to affect the volatility of EMEs if it is not done gradually. Most EMEs remained resilient during the crisis and have been able to absorb the volatility originating from developed countries’ central banks. Given concerns regarding the economic outlook in EMEs, however, volatility spillovers from the end of accommodative monetary policies in the U.S. and of looser monetary policy in the euro area are likely to be large.”⁶⁰

3.3.5 Newer developments and vulnerabilities

The IMF has been promoting local currency bond markets as a potential alternative for international bond markets. This push for domestic bond markets is part of a general trend in which developing economies are encouraged to resort to bond markets, instead of banking financing, as the preferred source of financing for development purposes. Through QE, both international investors and borrowers in developing countries are persuaded to develop their capital markets via the liberalisation of financial markets and bond issuance in local currency in domestic markets, as the culprit of financial globalisation.⁶¹

With tightened banking regulations, and with low interest rates in advanced capital markets, investment funds are driven towards developing economies. But since these economies were traditionally centred on banking financing (and other directed credit sources), their capital markets were relatively underdeveloped, with few instruments and borrowers. There is thus a rhetoric and a policy agenda from international financial organisations that pushes authorities in developing countries towards the deregulation of bond markets, towards greater access for asset managers and to have more “liquidity”. Since indebtedness in foreign currency are recognised to pose a danger for financial stability, the development of local currency bond markets becomes the new paradigm for financial development in emerging economies.⁶²

Without omitting the fact that indebtedness in domestic currency is certainly safer for borrowers, these new trends still create new forms of vulnerability for developing countries. First, the predominant role of foreign asset managers coupled with the organizing mantra of “liquidity”

59 Idem.

60 Idem.

61 D. Gabor, “Goodbye (Chinese) shadow banking, hello market-based finance”, *Development and Change*, 2018, <<http://onlinelibrary.wiley.com/doi/10.1111/dech.12387/full>>.

62 Idem.

reinforces the influence of pro-cyclical international markets in developing countries. Low international interest rates and massive inflows into emerging economies (and their predictable impact on exchange rates) encourages “one-sided” bets, usually leveraged in a carry-trade fashion. This pro-cyclicality, also present in developed countries, counteracts the alleged “market-discipline”, by which borrowers would be deterred of pursuing leveraged and “unsound” expansionary strategies. Secondly, the change towards local currency financing does not fully prevent currency mismatch owed to the difference between the residence of lenders and borrowers, increasing pressures on domestic financial markets in times of large outflows of international investors. Thirdly, since most of these flows are intermediated by domestic banks, the stress is not limited to the specific markets involved, but rather to the whole financial system. During the financial downturn central banks usually tend to react to these outflows by raising the interest rate, but this also hurts “well-behaved” banks, damaging the credit to the real economy.

In a sense, the main danger for emerging economies relates to the unregulated integration to international financial markets, rather than the denomination of external liabilities, though the latter has an importance of its own. Capital control measures are intended to address these dangers, and are reviewed in the next section, together with other measures that can provide stable and safer flows of credit to the real economy.

4 Where do we go from here? Another world is possible

"This crisis started in the developed world. It will not be overcome ... through ... quantitative easing policies that have triggered ... a monetary tsunami, have led to a currency war and have introduced new and perverse forms of protectionism in the world."

Dilma Rousseff, former President of Brazil⁶³

4.1 Introduction

As discussed above, there have been other waves of inflows into emerging economies, which ended in severe crises and years of stagnation. In Latin America, the 1980s are known as the "lost decade" due to the persistent effects of the debt crisis, characterised by extensive external borrowing by the public and private sectors (lenders were mainly American banks). The 1997 East Asian crisis also featured massive foreign indebtedness by the private banking sector, which produced acute recessions and painful austerity policies, leaving their mark on economic policies for years to come. In the current wave of financial inflows to developing economies, there are a number of indicators that point towards worrying developments.

When analysing the need for the adoption of defensive structures vis à vis capital flows, the first point to consider is whether flows responded to conditions and necessities in the recipient economy or not. Several studies have concluded that capital flows to (and from) emerging economies are influenced predominantly by push factors or global conditions (particularly the monetary stance of major advanced economies, and global risk perceptions) to a much larger extent than the conditions in borrowing countries (and borrowing firms).⁶⁴ That is, the existence in EMEs of financial investment opportunities for foreign investors is a predominant factor in capital flows, relative to the real profitability opportunities in those markets.

Second, focusing on firm behaviour, there is also evidence that non-financial corporations from emerging countries have largely increased their borrowing in foreign currency in international capital markets.

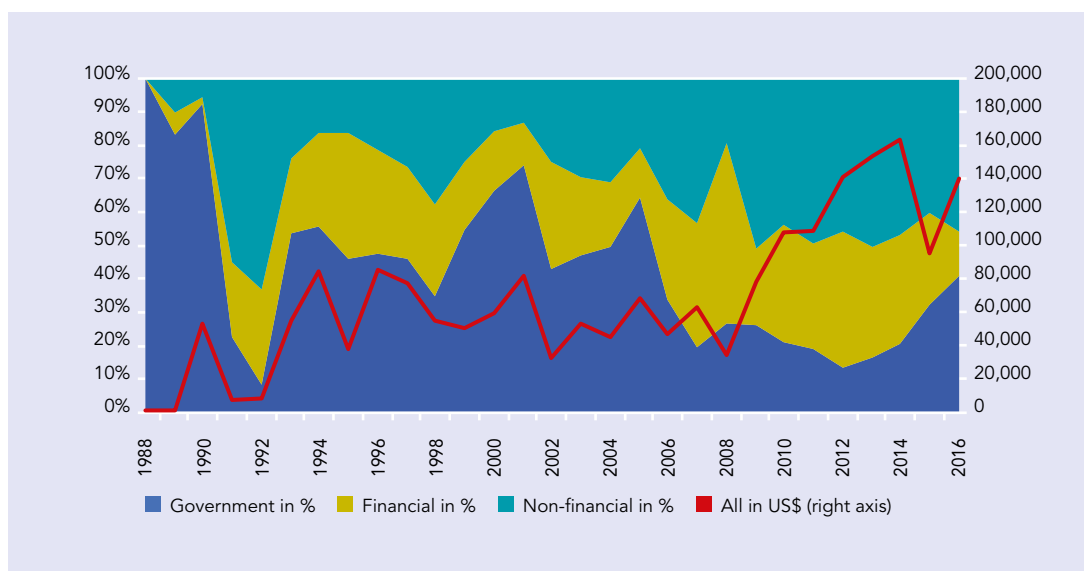
As is illustrated in Figure 12, since the 2000s, there has been an increasing participation of the non-financial private sector in international debt issuance, mainly at the relative expense of government

63 Quoted in: M. Fratzscher, M. Lo Luca and R. Straub, "A global monetary tsunami? On the spillovers of US Quantitative Easing", 2012, paper available at SRRN: <<http://dx.doi.org/10.2139/ssrn.2164261>> (14 September 2017).

64 H. Rey, "Dilemma not trilemma: The global financial cycle and monetary policy independence, Proceedings of the Economic Symposium of the Federal Reserve Bank of Kansas City", 2013. Available at <<https://www.kansascityfed.org/publicat/sympos/2013/gd5.pdf>>. See also E. Cerutti, S. Claessens and D. Puy, "Push factors and capital flows to emerging markets: Why knowing your lender matters more than fundamentals," Working Paper No. 15/127, 2015, International Monetary Fund, <<https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Push-Factors-and-Capital-Flows-to-Emerging-Markets-Why-Knowing-Your-Lender-Matters-More-Than-43015>>.

borrowing. Considering the gross issuances from emerging economies, in 2000 governments represented 66 percent of total issuance while non-financial corporations' debt issuance amounted to only 15 percent of the total. In 2016 the proportions reversed, with governments representing 13 percent of borrowing, and non-financial firms more than 45 percent of total bond issuance. Out of the US\$1.537 billion in new debt issuances, non-financial corporations (NFCs) explain almost 40 percent of the gross increment.

Figure 12 EME's gross debt issuances by economic sectors in millions of US dollars



Long-term gross issuance in international markets, in foreign currency, by economic sector (ultimate borrower criteria): Financial Corporations (FC); Non-Financial Corporations (NFC) and General Government (GG). Developing Economies. Total debt measured in right-hand side axis. Source: Authors' calculations based on BIS Debt Securities Statistics⁶⁵

In addition, there is evidence too that NFCs used their borrowed funds not only for investment purposes, but also for speculative purposes, profiting from interest rates differentials and favourable movements in the exchange rate.⁶⁶ This is particularly true for borrowing in US dollars by companies that already have large cash holdings. Non-financial corporations are adopting more financialised strategies, which in the case of emerging economies is reflected in higher and cheaper external borrowing.

⁶⁵ BIS, "Debt securities statistics," <<https://www.bis.org/statistics/secstats.htm?m=6%7C33%7C615>>.

⁶⁶ "Carry trade" refers to the practice of borrowing in a low-interest rate currency (notably, the US dollar or the Japanese Yen) and investing in an asset in a high-interest rate currency (usually in EMEs) in order to profit from the interest rate differential and the expectation of exchange rate appreciation. On the behaviour mentioned above, see V. Bruno & H.S. Shin, "Global dollar credit and carry trades: a firm-level analysis," *The Review of Financial Studies*, Vol. 30 (3), pp. 703-749, 2017.

A report by the IMF focuses precisely on the profile and performance of these firms that have borrowed in the international bond market since 2009.⁶⁷ Their analysis shows that bond issuing firms belong mainly to the construction, oil and gas, and retail sectors, which are traditionally pro-cyclical. Although the borrowed volumes have increased, this does not mean that the number of borrowing firms increased as well. On the contrary: there are fewer firms borrowing more abroad. These are large firms, responsible for a sizeable share of domestic investment, so that overall economic activity is very sensitive to the performance of these borrowers.

Borrowing non-financial corporations have increased their exposure to foreign exchange risks, while the profitability of their investments and their solvency indicators have deteriorated. The IMF states:

“Overall, the relative role of global factors as key drivers of emerging market corporate leverage dynamics has increased in recent years. The evidence shows some signs of elevated corporate exposure to a potential worsening in global financial conditions. The build-up in leverage in the construction sector and the related rise in net foreign exchange exposure as well as growing concentration of indebtedness in the weaker tail of the corporate sector provide particular reasons for concern.”⁶⁸

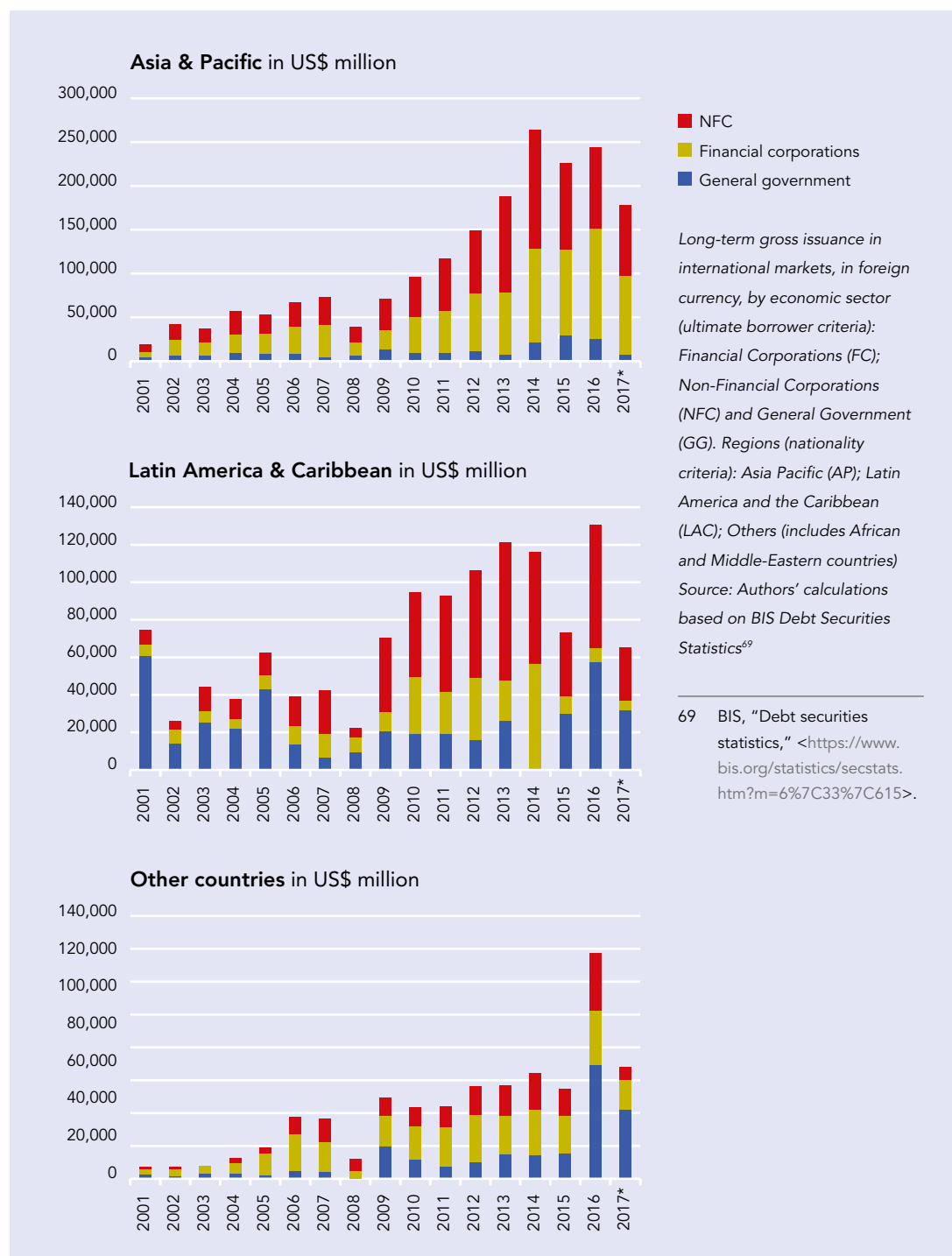
So far, the focus has been on non-financial corporations, since the literature concludes that it has been the most dynamic sector in terms of indebtedness. However, banks from emerging countries have also borrowed heavily abroad, and in recent years so have governments.

Figure 13 shows the gross issuance of debt securities denominated in foreign currency in international markets by the non-financial sector, relative to the financial sector and the government, in developing countries of selected regions (Asia and the Pacific; Latin America and the Caribbean; and other countries, particularly African and Middle Eastern economies). This draws on data from the BIS.

67 IMF, “Global Financial Stability Report”, October 2015, Chapter 3, <<http://www.imf.org/en/Publications/GFSR/Issues/2016/12/31/Vulnerabilities-Legacies-and-Policy-Challenges>>.

68 Idem, p. 94.

Figure 13 Relative debt issuance by sector



As shown in these figures, non-financial corporations have issued more bonds than financial firms or governments during most of the years shown, particularly in the AP and LAC developing economies (although not in AME countries, where banks were major borrowers). In recent years, however, Asian financial corporations have borrowed more in international markets, while in Latin America governments have increased their indebtedness (particularly in Argentina). Governments in Africa and the Middle East, issued nearly US\$70 billion in bonds in 2016, more than the borrowed sum by financial and non-financial corporations, a feature that is expected to be repeated in 2017 figures, though with high heterogeneity among these countries. In the first half of 2017, Latin American governments have issued more bonds than non-financial corporations.

Previous stress episodes have made clear the spillovers of private debt crises (including financial crises) into public finances. Falling investment and economic recessions, and declining commodity prices and exports, diminish fiscal revenues and demand higher public expenditure in the form of subsidies and welfare spending (unemployment insurance, fiscal transfers, etc.). Financial and balance of payments crises tend to compound this effect, because the severity of the crisis is aggravated further when firms are indebted in a foreign currency and have to face depreciations. On top of that, governments are usually called to bail out distressed financial institutions. Coupled with their own public debt denominated in external currency of some countries, their governments have a difficult task ahead of them in terms of facing the economic downturn while keeping up with their (rising) external obligations in times of reduced foreign lending (and usually capital flight from domestic residents as well).

Governments are aware of these dangers, and have implemented different measures and strategies to cope with these transformations. It is hard to say at this moment whether these efforts have been successful or not, because we are still on the upward part of the global financial cycle. What is certain, however, is that the monetary policy adopted by the US and the ECB poses dangers to developing countries related to the inherent instability of international financial markets, to which they are more exposed. And the burden is typically borne by the public sector and by the population at large when risks materialise in terms of mounting indebtedness and reduced fiscal space, falling output and growing unemployment. There is a clear need to erect defensive barriers in the face of global liquidity. However, what these barriers might look like, how to implement them and what to do when the gates cannot contain the floods are all open questions that we will turn to in the following sections.

4.2 Creating defensive structures: the role of capital controls

4.2.1 What are capital management techniques and why do governments use them?

The main outcome of QE in the US and Europe for EMEs has been the surge of capital inflows attracted by short-term interest rate differentials and opportunities in portfolio investments. This has led to unwanted exchange rate appreciation, asset bubbles and excessive credit growth, particularly directed towards the housing sector.

To cope with this, EMEs have implemented a broad range of capital control measures in order to moderate the macroeconomic impact of capital inflows and increase their policy autonomy. This re-regulation policy has mostly been driven by pragmatic reasons, not the will to fully transform the international financial system.

One example of this is the synchronicity of the growth and downsizing in regulation. Although EME countries have started to adopt a re-regulation strategy since 2006, it was only in the second half of 2008 until 2011 that most countries enlarged and intensified regulations in order to discourage the capital inflows in the aftermath of the global financial crises. An example of this is the tax on financial transactions implemented by Brazil in 2010: it was raised two times in less than two months and complemented with other restrictions on inflows as unremunerated reserves requirements. By 2013, however, most of the special requirements were eliminated. As we will describe below, the same has happened with Peru, Colombia and Turkey.

The effectiveness of these measures made the IMF reverse its opposition to the implementation of capital controls. In a series of official position note documents, the institution recognised the effectiveness of capital controls in changing the composition of inflows towards less volatile flows. This had the effect of discouraging speculative investment in activities such as currency derivative contracts or carry trade operations, and at the same time influencing, in the short-term, the total volume of inflows.⁷⁰

Technically, capital control measures are often termed *capital management techniques* (CMT), which include two varieties of controls (with some overlap between them): proper capital controls, and macroprudential regulation.⁷¹ The main difference between macroprudential regulation and capital controls refers to the residency status of the agents involved.

Capital controls are defined as a variety of instruments that tend to manage the volume, composition or allocation of international capital flows by explicitly taking into consideration whether the

70 IMF, "The liberalization and management of capital flows: an institutional view," Policy Survey Paper, 2012, International Monetary Fund, <<http://www.imf.org/external/np/pp/eng/2012/111412.pdf>>.

71 G. Epstein, I. Gabel, I. and K.S. Jomo, "Capital management techniques in developing countries: An assessment of experiences from the 1990s and lessons for the future. G-24 Discussion Paper Series No. 27, 2004, <<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.361.214&rep=rep1&type=pdf>>.

transaction was made by residents or non-residents. Therefore, capital controls are often linked with balance of payments registration techniques (for example, foreign currency purchase registration, a mandatory minimum time of permanence for certain types of capital inflows, etc.).

Macroprudential measures, on the other hand, consist of regulations on domestic financially risky positions, both for national or foreign firms (for example, caps on liabilities, limits on exchange rate exposures, etc.). Although it falls beyond the scope of this report, it is important to note that some macroprudential regulations operate regardless of the inflow or outflow of capital. A common macroprudential policy with this characteristic is the imposition of maximum loan to value ratios, for instance. We will describe this type of regulation later in more detail (see Table 2). Before continuing, however, it is relevant to mention that the type of capital flows regulation we will study here is one that is prone to macro stability, regarding all other relevant discussion on international regulation (as off-shore movements or tax evasion).

In this case, governments implement CMT with different policy objectives in mind, summed up in Table 1. The first justification for CMT is to increase domestic monetary autonomy. Capital controls allow central banks to set the domestic interest rate below international levels, to reduce the costs of borrowing for governments and firms.

Table 1 Capital management techniques (CMT)

Why regulate capital flows?
<ul style="list-style-type: none"> ■ To increase monetary policy autonomy (allow lower domestic interest rates) ■ To avoid currency overvaluations or excessive devaluations, and currency mismatches ■ To counteract the pro-cyclicality of capital flows and prevent asset bubbles: to discourage inflow surges in “booms” and reduce capital flights in “busts” ■ To attract favoured forms of foreign direct investment ■ To insulate countries from the contagion effects of financial crises abroad.

Source: Authors' analysis

These techniques are also useful to control movements in the exchange rate, to curb either appreciation or depreciation pressures. For example, regulation on inflows reduces the supply of foreign currency in the domestic market, lessening exchange rate appreciation. Exchange rate stability is also important for inflation concerns and income distribution. On the one hand, an overvalued exchange rate reduces the domestic perception of risk and provides incentives to borrow in foreign currency, increasing currency mismatch and the risks of external debt crises. On the other hand, on top of the loss in export competitiveness, an appreciated exchange rate reduces the price of imports of commodities and services (outward tourism), worsening the current account balance and increasing the risks of a balance of payment crisis.

A third reason for implementing capital controls is to smooth out the pro-cyclicality of international capital flows. During the boom, inflows swing towards financial investment, real estate and natural resources' companies, and help financing the current account deficit. However, when the international context changes, inflows suddenly reverse and the deficit can no longer be financed, leading to

balance of payment crises and large productive losses, with the adverse impact on employment and incomes. During a recession, domestic credit stalls as international capital leaves, reinforcing the contraction of the economy while hindering the recovery. In the case of larger and more volatile financial capital inflows, the pro-cyclicality risks are even higher. Investors buy assets and bonds in financial markets, making the space for financial bubbles to emerge. Discouraging inflows during the upswing can prevent large outflows during downturns.⁷²

As a fourth reason, capital controls can generate incentives to certain types of inflows through special fiscal exemptions to specific FDIs in order to promote capital allocation in priority sectors such as energy, green industries, etc. This final motive actually refers to the nature of international financial investment. As mentioned before, inflows to and outflows from EMEs are far larger and more disruptive than those that can be managed for by their economic conditions. This is due to the increasing relevance of money managers and institutional investors in driving international capital flows. These investors tend to consider different economies as equivalent in terms of risk, either because they are part of the same region or specialised in the same commodity production, alongside their real or commercial linkages. One example of this is the greater volume in newly financial investment vehicles as the exchange-traded funds (ETFs) that seeks to replicate specific index of EME exchange rates, sovereign bond ratings or stock markets. These financial trading practices increase EME gross financial flows correlation⁷³. To cope with these effects, governments might consider implementing extraordinary capital account regulation (as minimum time deposit, limits to profit remittances, special authorisation for foreign currency purchases for residents) in order to prevent contagion from international crises.

As will be shown later, the pattern and effectiveness of the regulation will largely depend on the velocity of the policy to act, the type and intensity of the risk, the commitments under international rules and the market pressure from analysts and financial products. In the post-2008 period, the main purpose of CMT was to discourage net capital inflows. And these types of measures were broadly effective.

Among other characteristics, CMTs differ by the degree of intervention. The less intrusive regulation is the requirement of providing statements on the type, volume, partner or destination of the operations, for instance. Then come price regulations, which mainly consist of taxes to diminish the profitability of the operation. And finally, the more intrusive type of regulation refers to quantity regulations, which limit or fully forbid certain types of operations. In Table 2, we present a variety of CMTs – distinguishing between capital controls or macroprudential measures.

72 An example of a financial boom-to-bust exchange rate cycle took place in Latin America during the 1980s. In the second half of the 1970s, countries experienced large financial inflows, mainly from international banks that had an excess of liquidity from “petrodollars”, that its counterparty was public and private sectors foreign currency nominated debt. This appreciated exchange rates, downsized private risk and allowed countries to finance large current account deficits. Events escalated in the 1980s with the so-called “Volcker shock” when the US Federal reserve tightened its monetary policy, triggering a series of financial crises and governments debts default.

73 Lettau, M., & Madhavan, A. (2018). “Exchange-Traded Funds 101 for Economists”. *Journal of Economic Perspectives*, 32(1), 135-54.

Capital controls can be regulations on price or quantity. Looking at regulations on *inflows*, price-based restrictions might consist of minimum time deposits (remunerated or not) that immobilise the non-resident deposit for a fixed period, or a tax on inflows that reduce interest rate and financial profit from abroad. The most common regulations are the unremunerated deposit known as unremunerated reserve requirements (URR), but taxes on financial inflows are also implemented. Regarding quantity regulations on inflows, countries might implement ceilings on foreign currency liabilities (volume or growth), special authorisation for FDI location, financial institution acquisitions or financial asset purchase (including derivatives contracts).

For *outflows*, there are also price and quantitative-based regulations. Price regulations on outflows can consist of special tax for foreign currency acquisition, (i.e. costlier financial or ordinary profit remittances to the home country for non-residents, or costly currency purchase for savings, imports or travel abroad by residents). Quantity regulations on outflows are similar to price regulations but tend to be more severe. Authorities might require special authorisation (discretionary or normative-established), maximum limit or total prohibition for the acquisition of foreign currency for a broad range of outcomes.

Table 2 Capital management techniques (CMT)

Capital controls	
Capital inflows	Capital Outflows
<p>Price</p> <ul style="list-style-type: none"> ■ Minimum time of deposit (remunerated or not) for non-residents. ■ Tax on capital inflows for non-residents. 	<p>Price</p> <ul style="list-style-type: none"> ■ Special tax on capital outflows (financial or ordinary profit remittances) for nonresidents ■ Special tax on capital financial transactions on foreign currency for residents.
<p>Quantity</p> <ul style="list-style-type: none"> ■ Ceilings on residents foreign currency liabilities (volume or growth). ■ Special authorization for FDI location and/or financial institutions acquisitions. ■ Special authorization or total prohibition for nonresident to specific financial asset purchase. 	<p>Quantity</p> <ul style="list-style-type: none"> ■ Special authorization, limits or total prohibition (formal or informal) for profit remittances to nonresidents. ■ Special authorization, limits or total prohibition (formal or informal) for the acquisition of foreign currency (including local deposits) for savings and other transactions by residents.
Macro-prudential instruments	
Single or Multiple, Broad-based or Targeted, Fixed or Time Varing, Rule or discretion	
<ul style="list-style-type: none"> ■ Ceilings on liabilities ratios (i.e. loan-to-value ratio, debt-to-income ratio) or/and credit growth, both domestic or currency nominated ■ Tax on capital inflows for non-residents. ■ Liquidity-related supervision, report or restrictions on foreign currency positions (i.e. limits on net open currency, foreign currency mortgages) ■ Special tax on capital financial transactions on foreign currency for residents. ■ Capital-related, special reserve requirements on asset and liabilities differentials (include the prohibition of “out of the balance” operations as derivatives contracts). ■ Others, quantitative limits on property of domestic companies, special reports or limits on domestic deposits or asset purchase for non-residents, taxes on foreign currency transactions. 	

Source: Authors’ analysis

In the case of non-residents, the most common regulation is again on profit remittances. For residents, it reaches every financial and commercial activity in foreign currency, such as the purchase of foreign currency for savings or travelling abroad. In extreme cases, quantitative outflow regulations might include special authorisations for currency purchases to pay commercial imports. These very severe money market regulations have been abandoned in most countries nowadays, but were widely adopted before the 1970s in highly regulated financial system in EMEs, including in Latin America.

Macroprudential measures have a wider range of actions. The first group refers to the supervision on asset ratios such as the loan-to-value ratio, debt-to-income ratio or others. This type of regulation applies not only to the level of the ratio, but also to its growth, whether denominated in domestic or foreign currency. The second macroprudential group of regulations are liquidity-related restrictions like limits on net exchange rate exposure to prevent currency mismatch. The third set of measures are the capital-related macroprudential measures that set special reserve requirements on asset and liability differentials. This often includes the prohibition of “off balance-sheet” operations such as derivative contracts, in order to prevent excessive leveraged positions. The last group of macroprudential measures are regulations that could include quantitative limits on the ownership of sensitive domestic companies (non-resident property of financial institutions or commercial bank ownership of a credit risk rating agency), special reports or limits on domestic deposits for non-residents or taxes on foreign currency transactions (for both residents and non-residents).⁷⁴

It is important to note that all of these variety of macroprudential regulations can also be distinguished within a wider implementation policy menu. First, risks can be tackled by using single or multiple instruments. For example, in order to discourage carry trade operations, central banks can establish both ceilings on “off balance sheet” operations on exchange rate derivatives and ceilings on residents’ short-term external currency liabilities. As a second alternative, the instrument might target a specific operation and/or sector, or it can be implemented in a broader way. As a third alternative, the instrument can be a fixed rule or a time varying rule, for instance a debt-to-income ratio that changes over the economic cycle. An example of a fixed rule is, setting the foreign debt-to-income ratio at 50 percent for an entire year, or perhaps raising it during specific seasons of the year, for example, to agricultural exporters during the harvest. Finally, the instrument might be rule-based or discretionary, giving the policy-maker ample room for its implementation. Rule-based instruments are usually preferred over discretionary rules, although the latter widens the field of action.

4.2.2 EME’s capital management techniques before and after the global financial crises: national experiences

In this section, we will record the different capital control measures implemented by looking at a set of representative EME’s market economies. The countries included in the analysis will be: Argentina, Brazil, Chile, China, Colombia, Egypt, India, Indonesia, Korea, Malaysia, Mexico, Peru, the Philippines, South Africa, Thailand and Turkey.

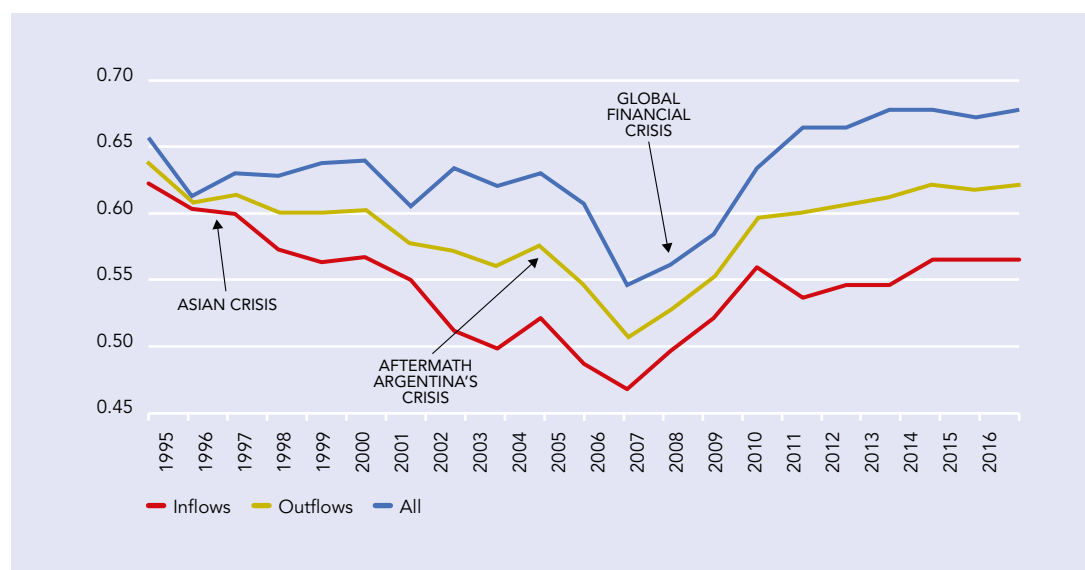
74 C.H. Lim et al. “Macroprudential policy: What instruments and how to use them? Lessons from country experiences,” IMF Working Paper No. 11/238, 2011, <<http://www.imf.org/external/pubs/ft/wp/2011/wp11238.pdf>>.

We will account for the changes in regulation using the dataset on changes in balance of payment regulations compiled by Fernandez et al (2015),⁷⁵ itself built on the IMF's Annual Report on Exchange Agreement and Exchange Restrictions (AREAER). Unlike other capital control datasets, this one has a granular distinction between every balance of payment position suitable to be regulated plus real estate and FDI restrictions, depending on whether they apply to inflows or outflows.

The dataset covers 32 different capital flow regulations for almost 100 countries. The index is synthetic and takes averages on the proportion of regulation measures existing in each country. Higher index values show a tightening in balance of payment regulations. It goes from zero to one, where one means that all markets suitable to be regulated have at least one regulation.

Looking at the last 20 years, EMEs have experienced two different periods of capital flow regulation. As can be seen in Figure 15, between the 1990s and mid-2000s, EMEs have witnessed a period of deregulation. This process was only briefly interrupted during the Asian crises in 1997, and in the aftermath of the Argentinean debt crises in 2001/2. This process was reversed in 2007, after the global financial crises, giving rise to a period of re-regulation with different characteristics.

Figure 14 Capital flows regulations on EME



Source: IMF-AREAER compiled by Fernandez et al (2015)⁷⁶

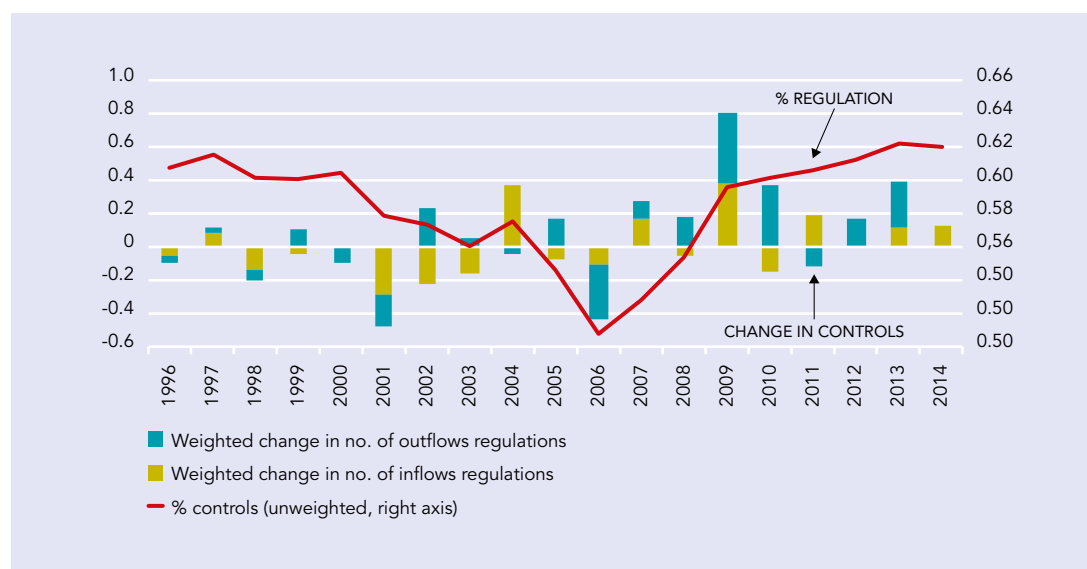
75 Fernández, A., Klein, M., Rebucci, A., Schindler, M., & Uribe, M. (2015). "Capital Control Measures: A New Dataset." IMF Working Paper: Capital Control Measures-A New Dataset, 15(80).

76 Idem.

It should also be noted that, similar to other datasets built on IMF-AREAR codification, the Fernandez et al (2015) database is not able to fully account for the intensity of the controls implemented. For instance, a country can forbid the operations on exchange rates derivatives for non-commercial purposes. But, this would not have the same impact on an economy that is facing large capital inflows (carry trade operations, for example) as in other countries that are adopting preventive regulatory measures. However, a simple transformation of the dataset allows us to assess the regulation intensity by year. A transformed dataset is presented in Figure 15. The bars inform the annual changes in the number of regulations weighted by its intensity in the country.⁷⁷ As a result, higher (lower) values imply higher (lower) regulation within higher intensity in capital flows movements. The dotted line is the original dataset outcome without transformation.

During the 1990s and early 2000s, there was a relatively low intensity of capital flow movements within a relatively large intensity in deregulation. However, after 2007, there was a rise in the capital inflows to emerging countries' economies, which give way to a period of intense re-regulation.

Figure 15 Regulation intensity



Source: Authors' analysis based on the IMF-AREAR database compiled by Fernandez et al (2015)⁷⁸ and gross capital flows IFS/IMF compiled by Araujo et al (2014)⁷⁹

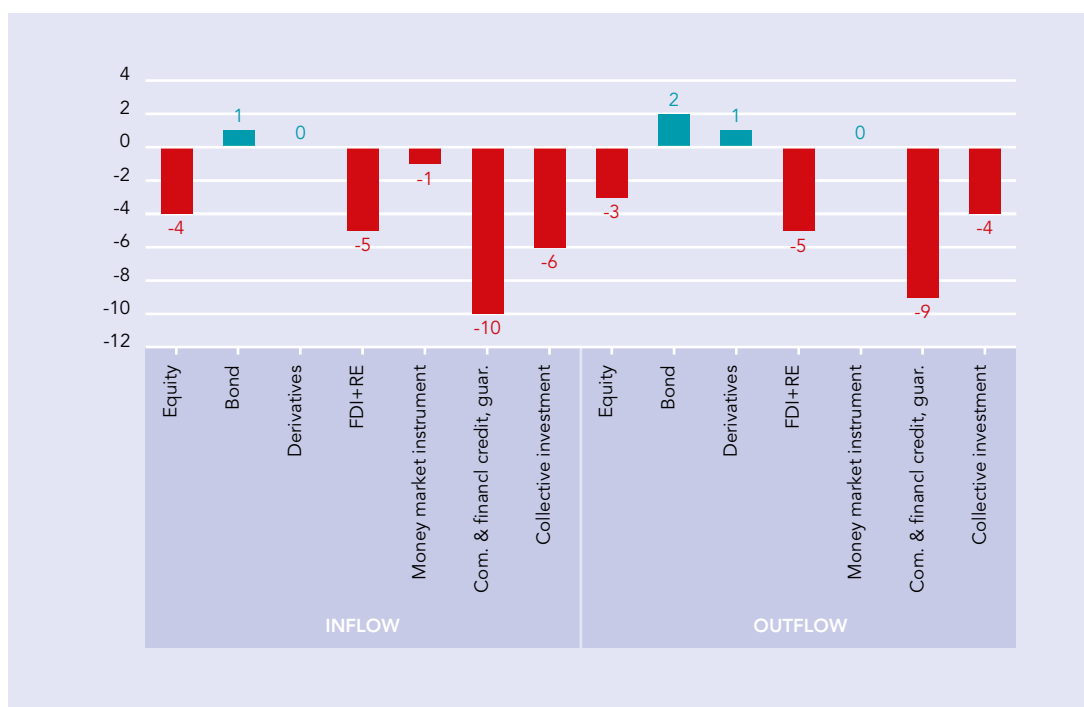
77 Specifically, we transformed the original Fernandez et al. (2015) dataset, multiplying the regulatory index by the ratio of each type of capital flow to GDP.

78 Source: IMF-AREAR compiled by Fernandez et al (2015), <<http://www.columbia.edu/~mu2166/fkrsu/>>.

79 Gross capital flows database compiled by Araujo, J. D., David, A. C., van Hombecck, C., and Papageorgiou, C. (2017). "Non-FDI Capital Inflows in Low-Income Countries: Catching the Wave?" IMF Economic Review, 65(2), p. 426-465.

Looking at this in more detail, it is important to study which type of market was more liberalised in comparison with others. As can be seen in Figure 16, between 1995 and 2006,⁸⁰ the main abolished regulation was on credit requirements for commercial or financial motives (for example, the use of credit statements or special authorisations). The second regulation erased was the restriction on real investment, FDI liquidation, real estate and investment funds (collective investment). In these sectors, there had been an equivalence between inflow and outflow deregulation.

Figure 16 Change in no. of year-on-year regulations 1995-2006



Source: Authors' analysis based on IMF-AREAER compiled by Fernandez et al (2015)⁸¹

In 2007, with the emergence of the global financial crisis, the process of international capital account deregulation was reversed. In response to the crisis, almost every EME has implemented a variety of capital management techniques in order to soften the impact of the large capital inflows from central economies. Between 2007 and 2015, EMEs increased overall regulation from 54 percent to 67 percent of all balance of payment (BOP) positions, with more intensity on outflows rather than inflows. As can be observed in the disaggregation of Figure 17, the most-affected outflow

80 It is important to note that, compared to other financial openness indexes (such as the Chinn-Ito index), 1995 is a low regulation starting point. But, as the dataset starts in 1995, this is our first year. See M.D. Chinn and H. Ito, "A new measure of financial openness," *Journal of Comparative Policy Analysis*, 10(3), p. 309-322, 2008.

81 Source: IMF-AREAR compiled by Fernandez et al (2015), <<http://www.columbia.edu/~mu2166/fkrsu/>>.

regulations were equities, bonds and derivatives (for instance, restrictions on foreign securities purchases by pension funds or others) followed by restrictions on money market instruments such as deposits, certificates of deposits (CDs), US treasury bills (or domestic equivalent) or repurchase agreements (REPO's) (during the peak of the crisis and to prevent capital flight, some countries implemented controls on dollar purchases).

Figure 17 Change in no. of regulations 2007-2015

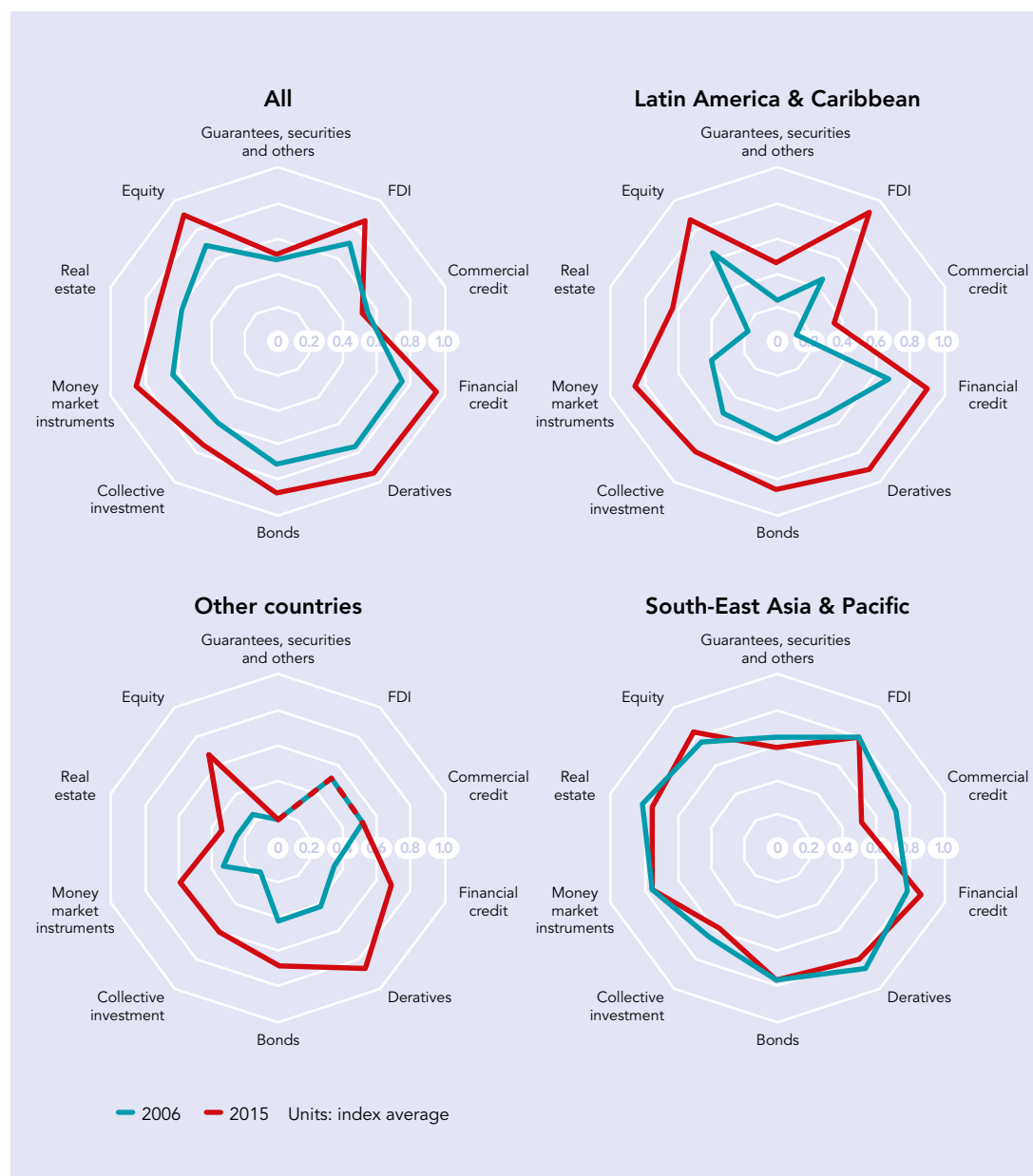


Source: IMF-AREAER compiled by Fernandez et al (2015)⁸²

Looking in more detail at the period after the crisis, the re-regulatory pattern has not been homogeneous across regions. Figure 18 reflects these differences.

82 Source: IMF-AREAR compiled by Fernandez et al (2015), <<http://www.columbia.edu/~mu2166/fkrsu/>>.

Figure 18 Regulation pattern changes by regions. Yearly average regulation



Source: Authors' analysis based on IMF-AREAER compiled by Fernandez et al (2015)⁸³

Note: Latin America and the Caribbean: Argentina, Brazil, Chile, Colombia, Mexico and Peru; South Asia and the Pacific: China, India, Indonesia, Korea, Malaysia, Philippines and Thailand; Other countries: South Africa, Egypt and Turkey.

83 IMF-AREAER compiled by Fernandez et al (2015), <<http://www.columbia.edu/~mu2166/fkrsu/>>.

In **Latin America**, capital account regulations have expanded, but the regulatory pattern remains the same. The country that implemented more overarching regulations was Argentina, including very strict government supervision on money markets such as taxes and quantity ceilings to currency purchase for both residents and non-residents. **Argentina** can therefore be treated as an outlier, especially after 2011. This is because of the vulture funds dispute and the existence of a negative interest rate differential (once taking into account country risk and depreciating expectations) that kept it apart from the large capital inflows coming into the region.⁸⁴

For the rest of Latin America, controls have been implemented in order to moderate the exchange rate appreciating pressure of capital inflows.⁸⁵ In aggregate terms, between 2006 and 2015 almost every country has increased the number of regulations. In the case of **Brazil**, between March and October 2008 the government implemented a tax on financial transactions (*Imposto sobre Operações Financeiras* or IOF in Portuguese) with a 1.5 percent rate on fixed income inflows to discourage “carry trade” operations.⁸⁶ The tax charges an extra cost on financial inflows from abroad, reducing the financial profit from the short-term deposit in the domestic market at the local interest rate. With the resumption of inflows after the crises, the government re-established the IOF with a higher 2 percent rate and extended to every portfolio inflow, equities and fixed income. For fixed income operations, it was subsequently augmented two times in October of 2010 up to 6 percent.

In the last incremental the tax was extended to apply as well on the issuance of depository receipts into local equities, short-term external borrowing (first for loans shorter than one year and then up to five years), and notional amount derivatives, including exchange rate futures. In 2011, the central bank implemented an unremunerated reserve requirement (URR) of 60 percent on short-term deposits in foreign currency above US\$3 billion. This means that large inflows should remain immobilised without interest rate compensation in special accounts by 60 percent of their total value. In practice, this heavy penalisation fully excludes short-term inflows larger than US \$3 billion. Both of these regulations were significant in terms of discouraging short-term capital movements, especially offshore bond issuances to execute carry trade operations. As the domestic interest rate fell (almost 10 percentage points in one year) and the global financial cycle pressures relaxed, in 2013 most of the controls implemented were eliminated.

84 In 2001 Argentina defaulted on its sovereign debt. This defaulted debt stock issues did not include the now widely used “collective action clause” by which countries guaranteed the acceptance of all holders in the case of restructuring processes (see section 4.3 for more details). Although Argentina carried on two successful sovereign debt restructuring processes (in 2005 and 2010) with more than 92% of holder agreement, the country faced a series of negative NY court rulings on its defaulted debt, in favour of “vulture funds”. Vulture funds are a type of speculative financial investor that acquires defaulted debt at a very low price with the only intention of litigating in courts in order to lobby for full debt repayment. In the Argentina case, the situation was aggravated after 2014 when Argentina lost the case after two adverse verdicts and a US Supreme Court rejection. The then Argentinean government (led by president Cristina Fernández de Kirchner) held its political position and promoted a fair sovereign debt restructuring process. Due to the ruling, Argentina was threatened with sanctions that included international sovereign asset confiscation. As a result, international capital markets remained closed for Argentina. This conflict ended in March 2016 when the newly-elected Argentinean government (led by Mauricio Macri) paid the amount determined by the US courts in full by issuing more than US\$ 12 billion in new debt.

85 J.D. Ostry et al. “Capital inflows: The role of controls. Policy Notes,” International Monetary Fund, 2010, <<https://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>>.

86 The IOF was originally established in 1993 and has been implemented intermittently since then.

In **Colombia**, the government imposed a 40 percent URR for most types of external borrowings and portfolio inflows in May 2007. In December 2007, the URR rose to 50 percent, and the government established a minimum two-year stay for newly established FDI. In addition, Colombia implemented other macroprudential measures on maturity mismatches, open positions of foreign exchange of banks and pension funds. In October 2008, the URR requirement was lifted.

Considering **Chile**, authorities implemented a number of restrictions on capital outflows, which were only focused on insurance companies and pension funds, limiting their purchase of money market instruments, equities, fixed income and other foreign securities abroad.⁸⁷

In the first quarter of 2008, **Peru** adopted a macroprudential liquidity regulation. For holders of foreign currency debt with a maturity of less than two years, a 30 percent reserve requirement was imposed. A few months later this requirement was increased to 50 percent. By the end of 2008, the reserve requirement was reduced to 30 percent, and by 2011 it returned to pre-crisis level. In 2010, the government set a 30 percent tax for corporations and 5 percent for individuals on derivative earnings with a maturity of less than 60 days in the domestic market. **Mexico** has not adopted any significant measure except Basel II and III banking regulatory agreements. Note that some EMEs might have relaxed their capital flow restrictions after their economies were negatively affected by the end of the commodity boom.

In the case of the **South Asia, East Asia and the Pacific**, the regulatory landscape has not changed significantly between 2006 and 2015. After the 2008 financial crisis, most of the regulations were applied to credit markets (investment funds, commercial credits, financial credits and guarantees) and coverage instruments (derivatives). However, after the inflow boom, the majority of these regulations were eliminated.⁸⁸

In 2009, **Indonesia** imposed a one-month minimum holding period on central bank bonds for all investors. These regulations were lifted in 2012. In terms of macroprudential regulations, in March 2011 the government set a limit on the daily balance of banks' short-term foreign borrowing to 30 percent of their capital.

In the case of **Korea**, in 2010 authorities implemented a macroprudential regulation that forbade domestic banks from holding more than 50 percent of their capital in foreign exchange derivative contracts (the percentage for foreign bank branches was 250 percent).

In terms of capital controls regulations, in late 2006, **Thailand** implemented (before the crisis) a 30 percent one-year URR for inflows. Early withdrawals were subject to approval by the monetary

87 The government did not implement more severe capital account regulations because, in the words of Jose de Gregorio, Governor of the Chilean Central Bank, "they had not been needed in the current macro-economic framework". The justification is that the relative appreciation of the exchange rate in Chile was not as large as in Brazil. See M. Garcia, "Capital Controls and implications for surveillance and coordination: Brazil and Latin America," CIGI, 2015, <https://www.cigionline.org/sites/default/files/new_thinking_paper_11_0.pdf>, p. 4.

88 E. Cerutti, S. Claessens and L. Laeven, "The use and effectiveness of macroprudential policies: new evidence," Journal of Financial Stability, 2015.

authorities and were penalised with a 10 percent tax on the original transaction value. This produced a 15 percent devaluation in the Baht, hitting a nine-year low against the dollar. Later, debt flows with full coverage became exempt from the URR. In March 2008, the URR was eliminated for all types of flows. In 2010, a 15 percent tax was restored on non-residents' interest earnings and capital gains on new purchases of sovereign bonds, equalising the tax with individual residents.

Neither **China**, **India** or **Malaysia** implemented any significant additional regulation on inflows or outflows in the post-crisis periods. They had already restrictions on capital movements and operations of foreign banks. However, China and Malaysia have experienced some regulatory easing. In the case of **China**, since 2013 regulations on commercial credits and guarantees have been removed.

Finally, for others we can observe that have experienced additional imposition of regulations with a change in their regulation pattern, increasing the regulations on equity flows. However, the national experience is very heterogeneous. On one hand, **South Africa** has been liberalising outflows by residents: since 2010 the ceiling on outflows and offshore asset purchases by residents has risen.⁸⁹ South Africa also issued important amount of sovereign bonds (and faces seriously challenges of debt repayment).⁹⁰ On the other hand, Egypt and Turkey expanded the number of regulations.

In the case of **Egypt**, since 2009 pension funds have not been allowed to invest abroad. Moreover, in the context of political instability, in 2011 the government implemented ceilings on currency purchases for residents as an effort to limit capital flight, including money market instruments, fixed income, equities and collective investment instruments.

In the case of **Turkey**, after the financial pressures and reserve losses experienced between the last quarter of 2009 and the first quarter of 2010, the government implemented a series of capital controls on residents to purchase foreign currency and other foreign currency denominated assets in order to moderate capital flight. However, as these pressures were reduced, the government removed the ban on onshore foreign lending to unhedged Turkish corporations, encouraging a shift in foreign credit from offshore banks to the domestic market.

The diverse range of measures implemented by different countries at different times reinforces the following conclusion:

*“There is no single type of capital management technique that works best for all developing countries. Indeed our cases, demonstrate a rather large array of effective techniques”.*⁹¹

89 IMF, “Recent Experiences in Managing Capital Inflows – Cross-Cutting Themes and Possible Policy Framework, Policy paper, Strategy, Policy, and Review Department”, 2011, <<https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Recent-Experiences-in-Managing-Capital-Inflows-Cross-Cutting-Themes-and-Possible-Policy-PP4543>>.

90 See <<https://mg.co.za/article/2017-11-25-global-credit-ratings-agency-has-downgraded-south-africa-to-junk-status>>.

91 G. Epstein, I. Grabel and K.S. Jomo, “Capital management techniques in developing countries: An assessment of experiences from the 1990s and lessons for the future”, PERI Working Paper No. 56, 2003, University of Massachusetts Amherst, <http://scholarworks.umass.edu/cgi/viewcontent.cgi?article=1043&context=peri_workingpapers>.

4.2.3 Implementing capital controls: legal and practical barriers

Beyond these recent experiences, the scope for adopting more severe capital management techniques (i.e. to gain larger monetary autonomy) is limited. There is no central regulation or agreement governing capital controls (as it were during second world war). The more general norms are the IMF Articles of Agreements that reach over 189 country members, were sanctions to capital transfers controls could lead to a cessation of IMF financing and, in extreme cases, generate an IMF member suspension.⁹² Besides this, there are other implicit rules based on the current international monetary order, with large idiosyncratic costs for policy deviations. In Table 3, we summarise most of the legal agreements on capital movements.

Table 3 International legal restrictions to capital controls

Normative	Scope	Enforcement instrument	Flexibility	No. of countries
EU members	EU members only. Prohibition to impose restriction on cross-border movements of capital	EU Council	Low. Safeguards can only be determined by EU Council. Dispute resolution EU-State	28
Agreement on World Trade Organization- General Agreements on Trade in Services (WTO/GATS) – service sector agreements	Countries that subscribe the agreement. Allowing companies of the financial sectors listed in GATS annexes to establish in other GATS members or supply financial services from abroad, or allow presence of individual financial services persons.	WTO dispute panel and retaliation	Low. Periodic rounds of negotiation. Safeguard clause allows controls on special circumstances. Dispute resolution State-to-State	164
Subscribers on Bilateral Investment Treaties (BITs) and Free Trade Agreements (FTAs)	Provide legal protection to international investors in domestic economy by imposing special international courts to deal with demands. There are more than 2.300 BITs and other special and regional agreements	BITs court suits	Low. Agreements that the US is party to do not allow for capital flow restrictions. Others may provide temporary safeguards but under many conditions. Dispute resolution Investor-State.	58 (US agreements) 69 (others agreements)
OECD code of liberalisation on capital movements	OECD members only. Agreements on capital account liberalisation.	OECD sanction	Medium. Code allows for controls on capital flows based on “serious economic disturbances”	35
IMF articles of agreements	IMF members	IMF supervision	Medium. Special allowance on IMF board authorisation. But, if no authorisation get low commitment enforcement (no IMF founding). Finally, dispute resolution IMF-State	189
Domestic law	National legislation	National justice courts	Medium. Congress can abrogate existing legislation	-

Source: Authors’ analysis⁹³

92 IMF articles agreement, art. VI. 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.” <<https://www.imf.org/external/pubs/ft/aa/>>.

93 See J.D. Ostry, “Managing capital flows: What Tools to use?” Asian Development Review, 29(1), 82, 2012; D.H. Pabian, “Capital Controls in International Law: Clarity through a Central Regulatory System,” Minnesota Journal of International Law, 24 (1), 2015. p. 1-32, <<http://minnjl.org/wp-content/uploads/2015/05/Capital-Controls-in-International-Law.pdf>>.

In the case of the WTO, all member countries committing to free access to financial services (residents taking a derivative position on an external market) or cross-border trade in financial services (residents taking a commercial loan from a non-resident) must liberalise their capital account to fulfill these agreements. According to Gallagher (2011) “developed economies see this agreement as a cornerstone to the new WTO agreement under the Doha Round”.⁹⁴ Most Bilateral Investment Treaties (BIT) and Free Trade Agreements (FTA) (but not all)⁹⁵ include restrictions on the ability to implement capital controls. When a dispute arises, the controversy has to be carried through dispute settlement systems set up by the FTAs or by the BITS, in the latter case always between investor and the State.

For the rest of the international normative, members of the Organisation for Economic Co-operation and Development (OECD) and countries under IMF supervision, legal restrictions to implement capital controls are more flexible. The enforcement to maintain a free capital account is very low. In the case of the OECD, it implies losing the members’ privilege (special OECD credit lines and immigration agreements, etc.). In the case of IMF is even lower. The most flexible of all are the domestic legislations. In most cases, a norm with a lower juridical value than a law is enough to apply capital controls. It is for this that the international legal framework is not so tight on capital controls as one tends to think. Under the WTO/GATS, for instance, monitoring or the application of the rule is only done by a Committee on Balance of Payments, or complaint must be made by a WTO member before the WTO dispute settlement system before perhaps a sanction can be taken.

On the other hand, there are implicit pressures within the international financial system to prevent the implementation of capital controls. In the first place, there is the issue of how global productions are structured. The growing importance of multinational corporations on commercial activities creates an incompatibility between restrictions on financial flows and the many types of current account transactions (such as currency purchase regulations to promote import substitution).⁹⁶ In this sense, multinationals are more able to avoid controls through transfer pricing or intra-company loans. Tight regulation to prevent these transactions might be too difficult to implement given the variety of existing financial instruments. For this, in the current international division of labour system, restrictions on financial flows have implications for global production. In second place, the deviation from “desirable” policy practices carries a penalty through higher cost for debt issuances on international credit markets. In some cases, the idiosyncratic surcharge for implementing larger regulations on capital flows could cause more damage by stopping external financing for investment projects and by isolating the government from organised credit markets, making it more difficult to finance current account deficits and to promote sustained growth.

94 K.P. Gallagher, “Losing Control: Policy Space for Capital Controls in Trade and Investment Agreements”, *Development Policy Review*, 29(4): p. 387-413, 2011.

95 “Most BITs and FTAs conducted by Japan, the European Union, and Canada either have a safeguard measure whereby a nation is able to pursue its domestic regulations related to capital account regulations, or a safeguard measure to prevent and mitigate financial crises. For instance, the EU-Chile and Canada-Chile agreements have annexes that allow Chile to deploy its infamous unremunerated reserve requirements (URRs), whereas the U.S.-Chile agreement does not” in K. Gallagher, S. Griffith-Jones, S. and J.A. Ocampo, “Regulating global capital flows for long-run development,” Pardee Center Task Force Report, 2012, Boston University, p.127.

96 M.A.R. Ghosh, “What’s in a Name? That Which We Call Capital Controls”, International Monetary Fund, 2016.

4.3 Sovereign debt restructuring mechanism

4.3.1 The need for a global sovereign debt restructuring mechanism

As mentioned above, external public debt crises are not always prompted by lack of fiscal prudence, particularly in the case of developing countries. Financial crises triggered by excessive private borrowing (by banks and non-financial corporations) also weigh heavily on public finances and foreign exchange reserves, leading in many cases to countries stopping their debt payments. The impact on economic activity and living conditions are prolonged and severe.⁹⁷ The last decades have shown, however, that restructuring public debt and setting the conditions for sustained growth is a contentious process, riddled with costly and lengthy legal fights between states and their creditors. The result of these disputes may actually derail, to some extent, the reduction in debt obligations necessary to reignite economic activity. Or they may unfairly reward rogue investors (known as “vulture funds” – see Glossary), whose only intention was to derail the restructuring process to gain many times their investments, without regard to the multiple other factors at stake.

Although each country has legislation to address private bankruptcy, the fact that states cannot go bankrupt and disappear leads to a different approach to sovereign default. One problem is that contracts that govern the international bonds by developing countries are often under the law of the US or UK or other countries (to guarantee legal certainty). However, the fact remains that there is no agreed global mechanism to deal with cessation in the payment of sovereign bonds.

There are plenty of reasons to change the current “non-system” of sovereign debt restructuring (SDR) processes. The United Nations Conference on Trade and Development (UNCTAD) characterises the current situation regarding SDRs as fragmented, unfair and inefficient.⁹⁸ Unlike the times when creditors were mainly other governments or banks, nowadays there are many different bondholders, including funds that specialise in buying defaulted bonds, traded at very low values, particularly from countries with low legal capabilities, such as heavily indebted poor countries. Work by UNCTAD shows that the debt litigation offers sometimes nullify the reduction achieved in debt volumes.⁹⁹ And courts have endorsed the claims of holdouts (i.e. creditors unwilling to come to an agreement such as ‘vulture funds’), at the expense not only of debtor governments but also other, more willing creditors. The IMF admitted that creditor litigation has become a major obstacle for SDR.¹⁰⁰

97 M. Hutchinson and I. Noy, “Output costs of currency and balance of payments crises in emerging markets, *Comparative Economic Studies*,” Vol. 44 (2), 2002, pp. 27-44.

98 UNCTAD, “Sovereign Debt Workouts: Going Forward. Roadmap and Guide”, (Geneva: United Nations, 2015), <http://unctad.org/en/PublicationsLibrary/gdsddf2015misc1_en.pdf>.

99 UNCTAD, “*Trade and Development Report 2015*,” Chapter 5, (Geneva: United Nations, 2015), <http://unctad.org/en/PublicationChapters/tdr2015ch5_en.pdf>. See also J. Schumacher, C. Trebesch and H. Enderlein, “What explains sovereign debt litigation?” CESIFO Working Paper No. 5319, 2015, <https://www.econstor.eu/bitstream/10419/110830/1/cesifo_wp5319.pdf>.

100 IMF, “Sovereign Debt Restructuring. Recent Developments and Implications for the Fund’s Legal and Policy Framework”, (Washington D.C.: IMF, 2013).

Creditors have also created more damage than the size of their claims might imply. A study of legal disputes surrounding sovereign default processes stated:

"We find that the number and intensity of lawsuits has greatly increased and that more and more countries are affected (25 in total). In recent years, almost 50% of debt crises involved litigation, compared to less than 10% in the 1980s and early 1990s. The claims under dispute have grown from close to nil to an average of 4% of restructured debt, or 1.5% of debtor country GDP. Distressed debt funds now account for 75% of cases and they often use legal tactics that disrupt a country's trade and capital flows, with the aim of forcing the sovereign into an out-of-court settlement. 'Vulture funds' tend to initiate at least one attempt to attach and seize government property abroad, such as oil tankers, export revenues, presidential airplanes, social security funds in overseas accounts, and interest payments to other creditors. Our case studies show that the externalities caused by such creditor action can be much larger than the value of the litigated claims themselves, e.g. in the Republic of Congo, where litigious creditors blocked the country's oil exports for years."¹⁰¹

Finally, the results of SDR processes are usually inefficient. They are adopted too late, due to incentives for governments and creditors alike. Governments are afraid that declaring a default may trigger (or deepen) economic crises, while declaring default too early may be seen as a strategy to lower debt servicing. On the creditors' side, it suits them better to admit that debtors have a "liquidity problem" than a solvency crisis, where they cannot expect to recover their lending in full.¹⁰² These incentives to delay debt restructuring tend to aggravate and lengthen the duration of the crises.¹⁰³ On top of that, success by certain vulture funds – such as in the case of Argentinean debt – has prompted governments to offer low debt reductions or "haircuts", with the consequence that the debt trajectory has not returned to a sustainable path.

This behaviour is all the more paradoxical because SDR is more efficient when implemented pre-emptively than after the default itself. A study on the topic found that "pre-emptive restructurings are associated with significantly lower haircuts compared to post-default cases (18% vs. 48% for post-default cases), a much shorter duration of debt renegotiation (1 year vs. 5 years), and significantly lower output losses (post-default cases see a protracted decline in GDP after crisis start, while pre-emptive cases do not). Furthermore, we show that pre-emptive restructurings see a quicker re-access to international capital markets, as measured by the placement of bonds or syndicated loans with external creditors."¹⁰⁴ So it seems that there are gains to be made when conducting orderly, speedy and timely debt restructuring, in terms of output costs, debt sustainability and creditor confidence.

101 J. Schumacher, C. Trebesch and H. Enderlein, "Sovereign Defaults in Court" (6 May 2014), pp. 1-2. Available at SRN: <<https://ssrn.com/abstract=2189997>> or <<http://dx.doi.org/10.2139/ssrn.2189997>>.

102 UNCTAD, "Trade and Development Report 2015", p. 137.

103 Over the last decade there has been a rapid growth of Sovereign Credit Default Swaps (SCDS), which in principle protect creditors from default. This gives the holder of an SCDS the incentive to *trigger* a default, and less incentive to cooperate in the restructuring.

104 T. Asonuma and C. Trebesch, "Sovereign debt restructurings: Pre-emptive or post-default," Munich Discussion Paper no. 2015-18 (Department of Economics, University of Munich, 2015, <<https://epub.ub.uni-muenchen.de/26563/>>).

4.3.2 Global initiatives for SDR mechanisms

While official credit (i.e. lending from government to government) is dealt by the Club of Paris, debt with private creditors has no supranational body to oversee it. The London Club is an informal group of private banks that deals with lending (loans) to emerging economies. The IMF introduced a proposal in 2003 that was rejected by developing countries for infringing on domestic legislation. It was also rejected by the US, together with private creditors who rejected SDRs. Since then, there have been renewed talks at the UN level to move forward in the direction of international guidelines and/or international bodies to address SDR processes. However, progress has been very slow.

There are broadly three approaches to SDRs.¹⁰⁵ First, the prevalent “non-system” is a *market-based approach* based on the clauses included in the contracts plus the legislation of the jurisdiction established to rule the debt. A step forward within this approach has been the inclusion of *Collective Action Clauses (CACs)* at the bequest of the IMF 2003 proposal. These clauses (which have been present in the debate since the days of the League of Nations in the 1930s) were adopted after the disputes surrounding the Argentinean default in 2001. The restructuring offered by the Argentinean government enjoyed over 90 percent of acceptance among bondholders (between 2005 and 2010), but a few remaining holdouts obtained legal victories in New York courts. These trials forced the country to make good on their bonds, which were acquired at very low values in secondary markets after the default was announced.

CACs are designed to avoid blocking minorities, and they work better when applied on an aggregate basis, i.e. on the whole of the debt under restructuring, and not on each separate bond series issuance. Their design has been improved to accommodate different developments.¹⁰⁶ These improvements within the market-based approach still allow for a high degree of voluntary and consensual participation (though not requiring 100 percent acceptance). However, they have nothing to say regarding crisis prevention, financing during default, debt sustainability, and they also pose several problems regarding inter-creditor treatment. For instance, it is not the same holding a short-term as a long-term bond; it is not the same to be a domestic creditor or a foreign creditor, in terms of political and economic implications.¹⁰⁷

In 2015, the UN adopted a set of basic principles for SDR processes, a series of internationally accepted guidelines based on international law.¹⁰⁸ This second approach, known as a “*soft law*” *approach*, defines guidelines to coordinate SDR mechanisms regarding the behaviour of participants, accepted by domestic legislation and applicable within the existing body of international law.

105 This section follows UNCTAD (2015b), pp. 141-146.

106 See A. Gelper, B. Heller and B. Setser, “Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Debt Contracts”, in M. Guzmán, J.A. Ocampo & J. Stiglitz (eds), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises*, (New York: Columbia University Press, 2016), <<http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=2807&context=facpub>>.

107 S. Brooks, M. Guzmán, D. Lombardi and J. Stiglitz, “Identifying and resolving inter-creditor and debtor-creditor equity issues in sovereign debt restructuring,” Policy Brief No. 53, Centre for International Governance Innovation, 2015, <<https://www.cigionline.org/publications/identifying-and-resolving-inter-creditor-and-debtor-creditor-equity-issues-sovereign>>.

108 United Nations, “Basic Principles on Sovereign Debt Restructuring Principles, A/RES/69/319”, approved on 10 September 2015 <<http://www.un.org/en/ga/69/resolutions.shtml>>.

The basic principles adopted by the UN are:

- ❑ **Sovereignty**: states have a right to determine their own domestic policy, including debt restructuring, although this should be a last resort measure. Good faith by debtors and creditors during the SDR workout negotiations. This includes fairness, trustworthiness and honesty.
- ❑ **Transparency**, including the timely sharing of data and processes.
- ❑ **Impartiality**, so that institutions and participants involved do not influence other stakeholders, preventing conflict of interest and/or corruption.
- ❑ **Equitable treatment**, so that debtors do not unduly discriminate among creditors, unless it is justifiable by law.
- ❑ **Sovereign immunity** from jurisdiction and execution of public assets.
- ❑ **Legitimacy**, respecting requirements of inclusiveness and rule of law.
- ❑ **Debt sustainability**, promoting inclusive growth, minimising economic and social costs, preserving the stability of the international financial system and respecting human rights.

Decisions by a qualified majority of creditors is not affected by other sovereign states or a minority of creditors.¹⁰⁹

The major limitation of the soft-law approach is its non-binding nature. There are no guarantees that participants will commit to these principles. Keeping this in mind, UNCTAD has moved forward with the design of a *mandatory global framework* for an SDR mechanism, under the umbrella of a UN resolution calling for a multilateral legal framework for SDR processes.¹¹⁰ This is the third and last type of approach to improve SDRs.

It is necessary to describe in some detail UNCTAD's proposal, because it is the most comprehensive, integrated and complete attempt to establish a global SDR mechanism with the aim of isolating as much as possible the population from the economic and social turmoil that defaults entail, while assuring that the workout succeeds in bringing debt dynamics into a sustainable path and setting the conditions for long-lasting growth.

The mechanism designed by UNCTAD comprises the establishment of a Sovereign Debt Workout Institution (DWI) that coordinates between debtor states and its creditors. Reaching out to the DWI would only occur after states conduct debt sustainability analyses, and conclude that liquidity support (i.e. IMF programmes, for instance) are not enough to honour debt commitments. This analysis should take into account broad early warning indicators such as currency risks and mismatch by different sectors, the history of fiscal performance, the possibility of banking bail-outs by the government, and other relevant variables.

109 It should be mentioned that Belgium and the United Kingdom implemented legislation, adapted to these principles, to prevent vulture funds from unduly profiting at the expense of sovereign countries, particularly in the case of poor countries (in the United Kingdom legislation). See UNCTAD 2015b, p. 144.

110 United Nations General Assembly Resolution 68/304, adopted on 9 September 2014. Available at <http://unctad.org/meetings/en/SessionalDocuments/ares68d304_en.pdf>. UNCTAD (2015a) describes the SDR workout mechanism presented in this section.

However, delays in debt restructuring should be avoided. If the debtor concludes that restructuring is necessary, it can invoke a pause on debt service, notify the DWI and all other stakeholders, and call for immediate SDR workout negotiations. Debtor countries should procure interim finance for the duration of negotiations, particularly aimed at financing needed imports and current account transactions. They can also implement exchange controls and other types of capital controls, as deemed necessary.

An impartial institution agreed by debtors and creditors would evaluate debt sustainability. Together with the restructuring proposal during negotiations, the debtor government should announce an economic and social recovery programme. Agreement can be achieved directly with a qualified majority of creditors, or at the instance of a mediator (the DWI). It can also be determined by an arbitration panel, if negotiations are unsuccessful.

If the guiding principles have been observed during the workout, the agreement should be validated by the courts. Claims by uncooperative creditors should not be recognised by courts or tribunals, because they violate good faith.

As can be seen, this holistic and supranational approach avoids many of the pitfalls that plague the narrow market-based approach to SDRs, while preserving some of its improving developments (such as aggregate and well-designed CACs). It could speed up SDRs, avoiding unnecessary and damaging delays; it could spread burdens fairly across stakeholders; and it could ensure the success of the SDRs.

However, at the same time, this approach has the obvious limitation that it would require a multi-lateral treaty with ratification by major jurisdictions, all of which would imply a lengthy process. As well as the legal obstacles, it is expected that private creditors would oppose the implementation of this sort of proposal, particularly vulture funds with well-established political connections. The design of an economic and social plan that cares for sustained, equitable and inclusive economic growth may not be easy to reconcile with the adjustment programmes fostered by the IMF, which – among other measures – usually include austerity policies, labour market flexibilisation and pension system reforms, leading to widening inequality and exclusion.

4.4 Alternative policy tools

Different countries have implemented several capital control measures with varied degree of success, though they have been recently recognised by the IMF as a feasible policy in the face of volatile capital flows. These barriers have been effective in terms of affecting the composition of inflows and discouraging short-term speculative investments.¹¹¹ However, as we have already seen in section 4.2 above, there are some practical obstacles for the implementation of capital control measures. On the one hand, we see institutional and legal restrictions imposed by the patchwork of bilateral treaties. On the other hand, financial markets complicate unilateral interventions by creating means for arbitrage. Financial markets are developing increasingly complex instruments to avoid these

111 P.G. Bortz and A. Kaltenbrunner, "The international dimension of financialization in developing and emerging economies", *Development and Change*, 2017, <<http://onlinelibrary.wiley.com/doi/10.1111/dech.12371/abstract>>.

controls (regulatory arbitrage), which raises questions about their efficiency. The fact that financial markets penalise these protective measures with a surcharge in their borrowing costs raises the question of what alternative policy tools emerging countries actually have to defend themselves from the effects of the QE policies in developed economies.

As mentioned in section 4.2, there are macroprudential policies applied to domestic financial markets that can help to counteract the spillovers of financial inflows, in terms of the exposure of the banking sector to exchange rate movements and capital flights, for instance. They can also prevent excessive credit growth and asset bubbles, particularly in the real estate sector (but not limited to this sector). In short, what these measures are trying to do is prevent the build-up of unsustainable indebtedness and take care of the balance sheets of different sectors, financial and non-financial. When the crisis hits, and when it affects banks' balance sheets, a speedy clean-up of their assets is extremely important to restore the conditions for future sustained growth, as the experience of the Nordic countries in the early 1990s shows.¹¹² This may involve incurring additional public costs, but this does not need to be the case. The persecution of fraudulent practices can also have positive spillovers.¹¹³ And last but not least, in order to prevent financial fragility, it is important that incomes increase together with debts, and that they do so in an equitable manner, i.e. with reduced income and wealth inequality, so that leverage does not raise for the different sectors.

The second important thing to do is to offer an array of financing means that represent an alternative to international markets. Implementing capital controls may have the unintended effect of increasing the costs of foreign finance for investment projects. To cope with this side effect, it is important to offer domestic finance, which is generally best assured through public banks and specialised banks (industrial banks, agricultural banks, etc.). Development banks (DB) are suitable also to complement this task. During and after the 2008 crisis, development banks played a critical role, by adopting a counter-cyclical lending policy that fostered lending to small and medium firms, building programmes and even major companies.

Development banks – typically, the largest financial institutions in developing countries – are key to providing finance in terms and quantities that are not offered by commercial banks. Furthermore, development banks constitute a policy instrument used by many countries around the world. In a survey of development banks, the World Bank says:

“In emerging market economies, for instance, DB’s usually constitute the main source of long term credit, loan guarantees, and other financial services in the infrastructure, housing and agriculture sectors. Even in some advanced economies [German, Japan and Canada], where private financial institutions and capital markets satisfy the financial needs of firms and individuals, several DBs continue to play an active role in providing financial services to so-called strategic sectors of the economy.”¹¹⁴

112 C. Borio, B. Vale and G. von Peter, “Resolving the financial crisis: Are we heeding the lessons from the Nordics?”, BIS Working Papers, No 311, July 2010, <<https://www.bis.org/publ/work311.htm>>.

113 W. Black, “The best way to rob a bank is to own one,” University of Texas, Austin, 2005.

114 J. Luna-Martínez y C. Vicente, “Global Survey of Development Banks,” Policy Research Working Paper No. 5969, World Bank, 2012, <<http://documents.worldbank.org/curated/en/313731468154461012/pdf/WPS5969.pdf>>.

As well as national development banks, there are also regional banks that were designed to play the same role. The European Investment Bank is one such case. The most recent experience in that regard is the establishment of the Asian Infrastructure Investment Bank, which has developed countries as members, but derives most of its capital from emerging economies.¹¹⁵ Generally speaking, development banks can play a key role in fostering sustainable development, clean energy, and strategic investment projects, while specialised banks can provide the finance needed for specific sectors, reducing the need to borrow in international markets. Central banks can play a role in this regard too.¹¹⁶

This does not imply that external public debt is bad per se. Borrowing abroad for infrastructure projects that are paramount to the economy is sensitive. However, the most important concept to keep in mind is that, just as commitments to future outflows in foreign currency rise (with increasing debt), so too must the income in foreign currency to pay for those outflows. That is why public external debt must be used for financing projects that help set the conditions for its future repayment, in terms of greater export capacity, or fewer imports demand. A proper domestic financial policy can help to minimise the detrimental impacts of financial inflows.

115 On the Asian Infrastructure Investment Bank, see S. Griffith-Jones, L. Xiaoyun and S. Pratt, "The Asian Infrastructure Investment Bank: What can It learn from, and perhaps teach to, the multilateral development banks?", Evidence Report No. 179, Institute of Development Studies, 2016, <<http://www.stephanygj.net/papers/TheAsianInfrastructureInvestmentBank-WhatCanItLearnFromandPerhapsTeachTotheMultilateralDevelopmentBanks2016.pdf>>. On the role of development banks, see S. Griffith-Jones, "Development Banks and their key roles," Discussion Paper No. 59, Bread for the World, 2016, <http://www.stephanygj.net/papers/Development_banks_and_their_key_roles_2016.pdf>.

116 See G. Epstein, "Development central banking; a review of issues and experiences," Employment Working Paper No. 182, International Labour Organization, 2015, <http://www.ilo.org/employment/Whatwedo/Publications/working-papers/WCMS_377808/lang--en/index.htm>.

5 Conclusions

Given the history of debt crises in developing countries, with profound and long-lasting socio-economic and political consequences, we must be alert to signs of another debt crisis. QE in developed economies and low interest rates has had many unintended side effects, one of which is the rise in capital flows to developing countries. The IMF already gave a warning about very high debt levels for low income countries¹¹⁷. This brings with it risks of recreating the type of environment that has led to debt crises in the past. However, due to increase of the developing country government and corporate bonds, the nature of the creditor landscape has changed with more dependence from bond holders in developed countries, including institutional investors such as private pension funds, in contrast with previous debt problems from over-borrowing from private or government-backed banks.

QE policies lie at the very heart of post-crisis stabilisation attempts by central banks in core countries. And given the (constitutional) mandate and undemocratic character of these central banks, we cannot expect them to be guided by the impact their policies have on the global south, except where they backfire on developed country financial systems and economies.

The severe effect of post-crisis monetary policies in developed economies on developing countries calls for defensive structures to be created elsewhere at the global level, and perhaps at the regional level too, outside the developed world.

Moreover, concerns about unpayable corporate bonds call for mechanisms to divide the financial risks for the parties on both side of the contracts. One of the key development in the period of QE was the growing debt of the non-financial corporate sector. There is a need to move away from the dominant narrow market-based approach to resolve problems arising from over indebtedness of corporations. Large corporate bankruptcies can equally result in a downward economic process that may not be easy to reconcile with an economic and social model that cares for sustained, equitable and inclusive economic growth.

The global financial architecture needs to be transformed to accommodate restrictions on capital movements and arrange for the bankruptcy of national states, or sovereign debt restructuring mechanisms (SDRM). The absence of an SDRM has led to an unacceptable breach of the democratic processes over the last four decades. Developments in Greece since 2010 serve as reminder of the infringement of international bodies in the absence of clear guidelines and obligations of respect of human rights and democracy, even in conditions of debt stress.

117 IMF, Macroeconomic developments and prospects in low-income developing countries—2018 , 15 February 2018, <http://www.imf.org/en/Publications/Policy-Papers/Issues/2018/03/22/pp021518macroeconomic-developments-and-prospects-in-lidcs> (viewed 17 March 2018).

History has shown that sovereign debt crises are a mechanism for generating private gains and public losses on a large scale. These crises have been exploited for market-oriented social and economic adjustment programmes since the 1980s. Given the increasing concentration in the market power of large multinational corporations, banks and financial institutions since the 1980s and in the face of growing global wealth inequality, this mechanism that feeds on crises must be addressed by an SDRM.

Discussions about both capital controls and SDRM as policy tools have been around for more than 40 years. It is high time to take a serious look at these ideas in the light of growing global liquidity propelled by QE policies. As the world enters into a post-QE period between 2018 and 2019, or central banks start with policies of quantitative tightening (QT), we may start to see a reversal of capital flows from the global south to the core, with potentially devastating consequences. The global financial context seems to have become more destructive for developing countries than ever, highlighting that it's now time for a new push towards establishing SDRM principles and for re-regulating capital movements.

This report invites NGOs, activists and academics to cooperate in pushing forward an alternative agenda for our international financial architecture. The period of QT and increasing interest rates will create a dangerous environment for developing countries and increase the risks of another global financial crisis. This requires us to rethink old ideas and explore new ones. How can we best shape a system of regulated and restricted cross-border capital flows? Where do we start to concretise and implement the SDRM that has been discussed by UNCTAD? How do we translate principles of responsible lending in a fluid market based environment?

Below we offer some concrete suggestions to help address the urgent concerns highlighted in this report.

Recommendations

- **Central banks** need to be governed by a decision-making process that adheres to democratic principles and is accountable for the wider implications of monetary policy. The swelling balance sheets of central banks in developed economies, signifying the larger power over financial and economic processes, should be accompanied by a process of accountability.
 - The institutionalisation of the doctrine of independent central banking must be reversed. Monetary policy is too important to be left to unrestrained technocrats with influence from, and potential ties to, corporate finance interests.
 - The narrow mandate central banks have, the sole focus on price stability by the ECB, should be replaced by a broader mandate that guarantees inclusive and sustainable environmental, economic and social goals.

- If QE is applied, there should be mechanisms to stop undue outflow to other economies (capital controls on *outflowing* money). The price for the unintended external effects should be paid by the country that employs the QE instrument.
 - Such mechanisms could be: third country cross-border transaction taxes, increased risk assessment methodologies before buying debt from developing countries, debt restructuring clauses in corporate bond contracts, supervisory intervention and caps on high exposure through asset managers to over-indebted countries.
 - QE should come with conditions for banks, financial institutions, and corporations whose assets are being bought by central banks. Such conditions could include lending or investing in the real economy in a socially and environmentally sustainable way and a ban or cap on speculative trading with the extra cash.
 - If corporate bonds are part of the purchasing program there needs to be an independent oversight mechanisms. The QE buying program has to be consistent with the raising supervisory practice and obligations whereby banks or investors, and their supervisors, take into account social, environmental and governance risks.
 - More information is still needed about the nature, the terms, amounts, and conditions of debt.
- The dogma that the cross-border **mobility of capital** should be guaranteed above all else, and which has been institutionalised in the EU constitution and international agreements, must be replaced by a more realistic approach to the free movement of capital. Such approach takes account of the effects of post-crisis monetary policies, the increase in market based financing, the speculative and herd-like behaviour of financial markets, and the structural weakness of less developed economies in the face of the contemporary financialised system of capitalism.
- The IMF should not view managed capital controls as measures of last resort, but as standard practice.
 - The establishment of local bond markets should not be considered as a solution for the problems that QE creates when foreign investors can buy local bonds. The main danger for emerging economies relates to the unregulated integration to international financial markets, rather than the denomination of external liabilities. Therefore, re-regulation of financial markets should be on the table as measure to erect defensive measures. For instance, openness to foreign financial intermediaries in developing countries should be limited and be preceded by adequate regulation, supervisory cooperation with home supervisors, and limitations of vulnerabilities to external shocks (e.g. adequate capital reserves and limits on capital inflows and outflows by a give foreign financial player, etc.)
 - As well as sovereign bonds, corporate bonds need to be part of a multilateral framework to intervene in times of debt stress, unsustainable debt and defaulting debts beyond the narrow market based processes that are currently available. Corporate debt restructuring clauses should be harmonised and be based on equitable burden sharing. Beneficiaries

of bond related assets (funds etc.) should be able to hold asset managers responsible for too risky selling and manufacturing of debt related products or investment strategies. The duty of all investors should be to take the long term social, environmental and governance risks and impacts into account.

- Principles for responsible lending need to be translated into regulation and broadened to include institutional investors, investment funds and any other type of bank and non-bank financial intermediary.
- We will need to break through the existing patchwork of bilateral and multilateral **trade and investment treaties** that have a one-dimensional focus on enforcing the free movement of capital with too little exceptions and possibilities for (at least) preventive capital control measures. We should separate the following three steps:
 - First, the limited scope for interventions that exist within the scope of investment and trade treaties (both macro-prudential and capital controls) must be used by national authorities. Any new trade and investment agreement should include the right to a flexible use of capital controls adapted to the country and circumstance, with mechanisms to avoid corruption-related or otherwise outright abusive use of controls. Partner countries of existing trade and investment agreements that have strict rules on restricting capital controls could sign among themselves a memorandum of understanding that capital controls can be used as preventive measures to avoid destructive and abusive impacts on the financial system, the economy and society of a country, while at the same time establishing supervisory cooperation for oversight and dialogue.
 - Second, in the longer term, international organisations such as the IMF must change their conditions and crisis management approach in order to facilitate the wider unilateral use of capital controls. The IMF should officially review its 2012 position on the use of capital controls, in favour of more flexible, preventive and adapted use of capital controls.
 - Third, developed economies must use their influence in international organisations such as the UN, the OECD and the IMF to advance a programme that incorporates the full array of defensive mechanisms, including capital controls and debt restructuring mechanisms, as well as limits to market based finance that create unsustainable debt.
 - Finally, this should lead to a multilateral process that hinders the mobility of capital and ensures that the right type of 'patient capital', with a long-term commitment to sustainable growth, is able to reach developing countries on the right terms.
 - More information and research is to be made available how unsustainable debt creation will impact on investors and citizens in developing countries as well as developed countries (e.g. pensioners, clients of insurance companies who invest in bonds).

- Fundamentally, a **debt-led economic model** is unsustainable and need to be abandoned in favour of policies that return to a wage-led model, that allow for the reduction of outstanding debt levels and better management and obligations of private funding towards sustainable activities.
 - A public debate is needed about how to move away from reliance on growing debt, and the role central banks should play in achieving this goal. This debate should not only focus on the *quantity* of debt, but crucially also on its *quality* ('good' versus 'bad') and the institutional mechanisms to organise the allocation of capital.
 - If market forces are unable to move away from financing bad debt – while good debt for investment opportunities (for instance, investments in energy transition) are side-lined – we need to think of alternative forms of distributing capital. This includes rethinking the role of central banks and public banks in the overall financial architecture, as well as government regulation of the financial sector and all private funding mechanisms.

