

# Capital Controls & FX Interventions in LatAm

Presentation to the European Central Bank Foreign Exchange Contact Group

5th October 2011

**Luis Martins**

**Head of Foreign Exchange in Latin America**

BBVA – Wholesale Banking

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A light blue map of Latin America is positioned behind the text. The map shows the outlines of the countries in the region, with a slightly darker blue color for the countries of Central and South America.

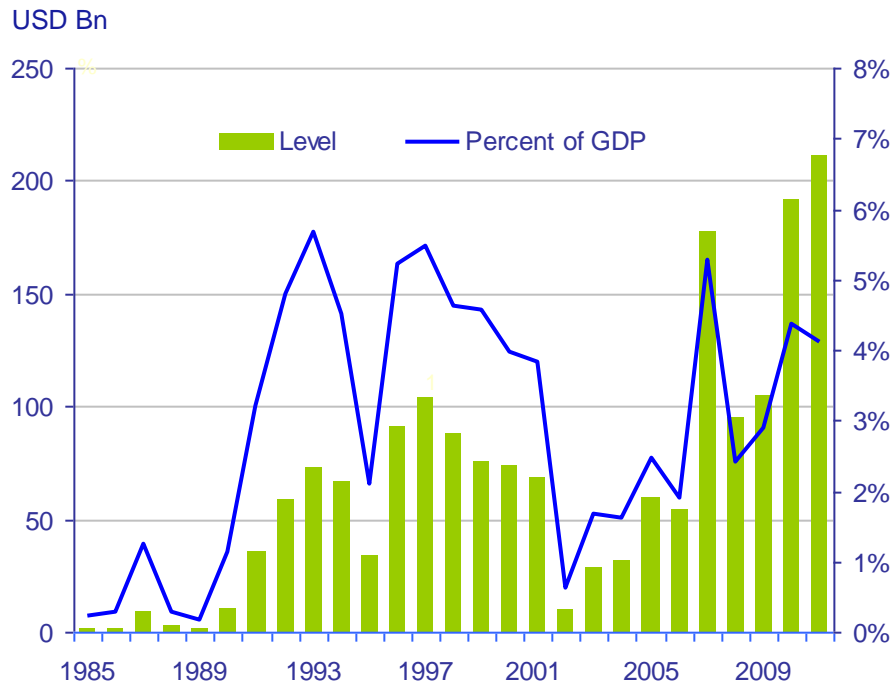
# Capital Flows in Historical Retrospective

# Capital inflows have been accelerating

- Substantial growth of the absolute level of private capital inflows into LatAm in recent years
- Nonetheless relative to the economy size they don't seem bigger than in previous episodes but the weight of Foreign Direct Investment (FDI) seems to be decreasing

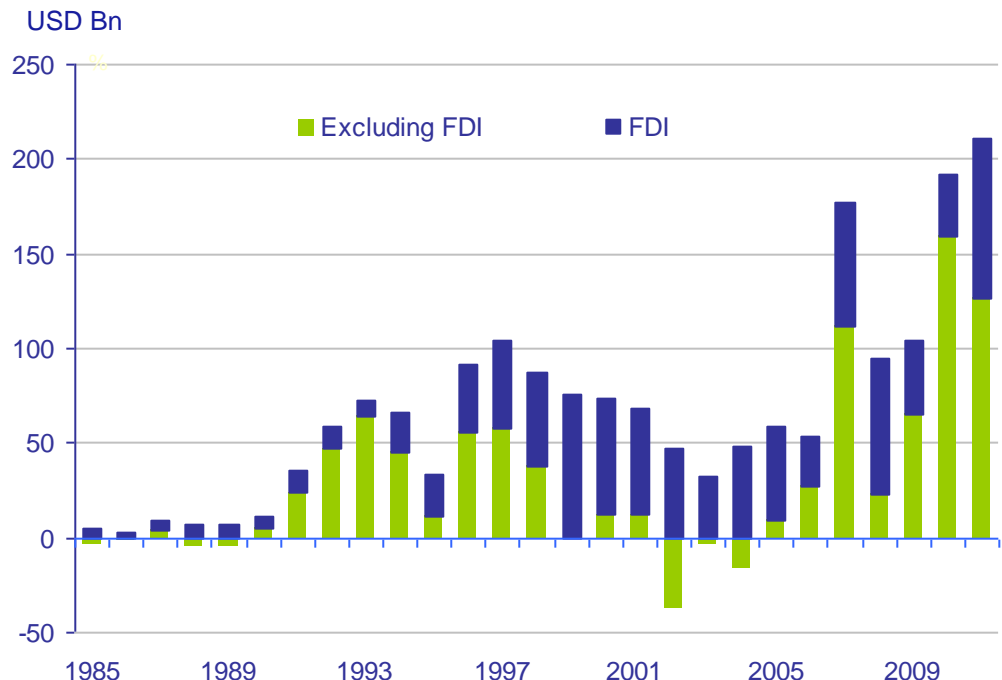
## LatAm Private Capital Inflows, Net

Source: IIF, own calculations \*\*LatAm: Arg, Bra, Chi, Col, Per and Ven.



## LatAm Private Capital Inflows, Net Breakdown FDI vs non-FDI

Source: IIF, own calculations

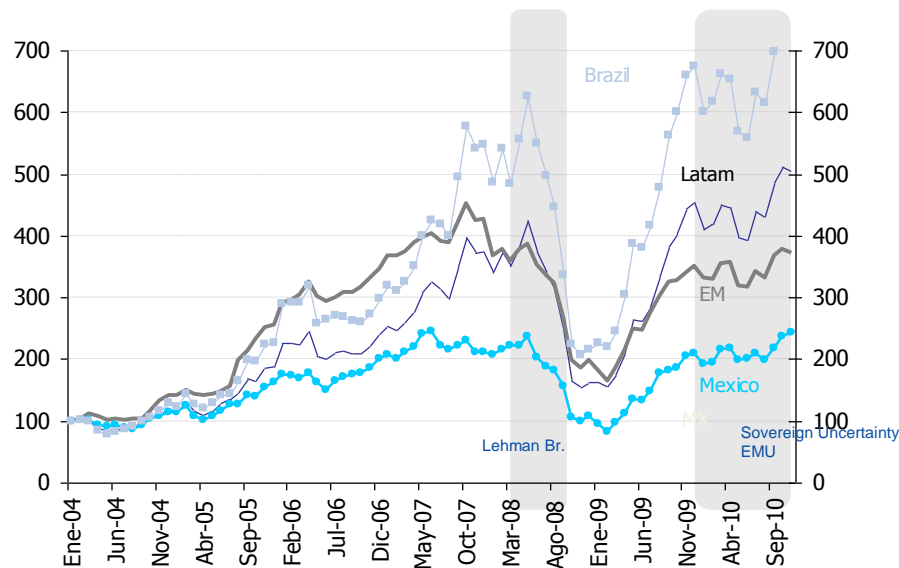


# With global liquidity drawn into LatAm

- Latam has shown increased ability to attract capital flows against the backdrop of greater international liquidity
  - Equity markets have rewarded Latam over other emerging markets (in particular the Brazilian rally stands out, driven by the economy's scale and the diversified nature of its listed companies)
  - Fixed income investment inflows have been higher in nations with deeper markets

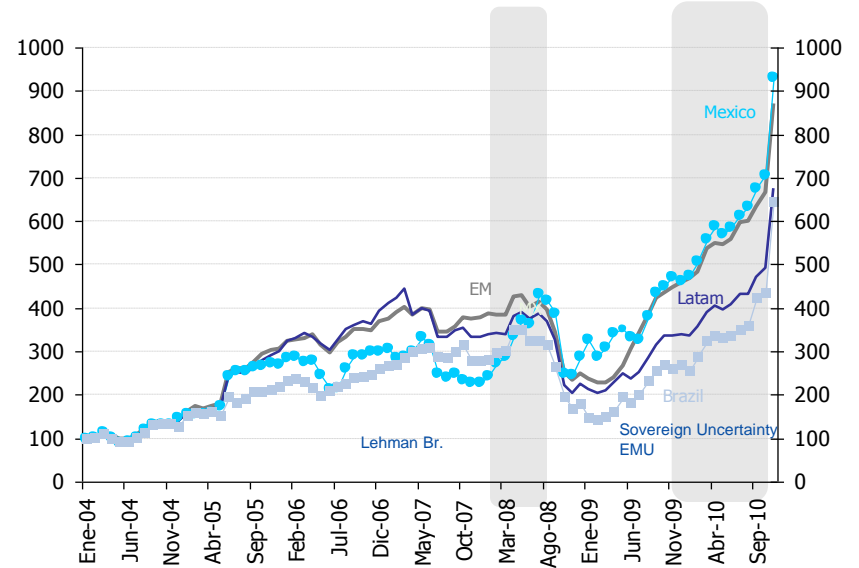
**International Equity Flows  
(Holdings, Indexed to Jan-04=100)**

Source: BBVA Research and EPFR



**International Bond Flows  
(Holdings, Indexed to Jan-04=100)**

Source: BBVA Research and EPFR

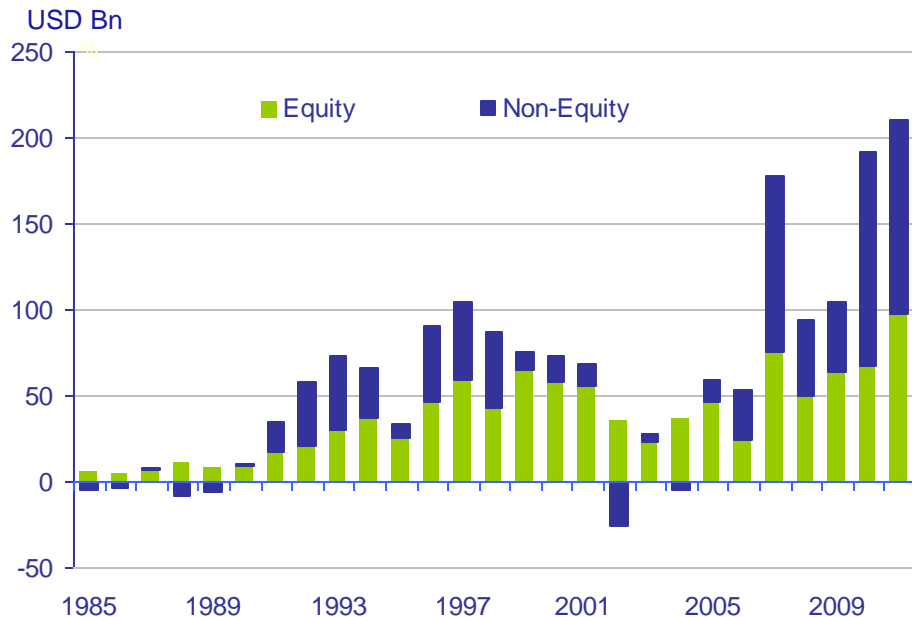


# Is it a flood of *hot money*?

- Although equity investment (FDI + portfolio investment) has been growing steadily **the bulk of the growth of private capital flows after 2008 is coming from non-equity investment components**
- The growth of debt from other private creditors seems to account for the bulk of the non-equity private capital inflows net growth

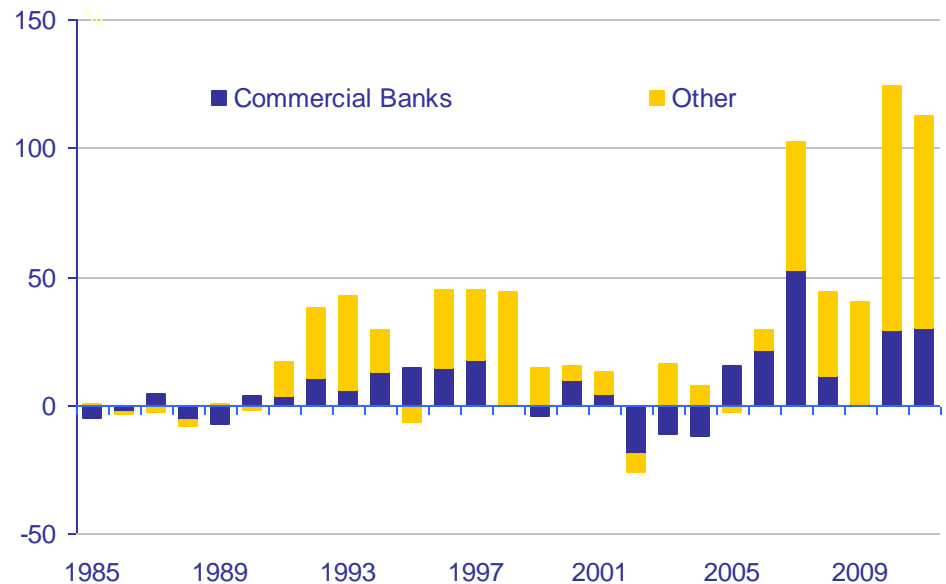
**LatAm Private Capital Inflows, Net Equity vs non-Equity Investment**

Source: IIF, own calculations



**LatAm Non-Equity Private Capital Inflows, Net Commercial Banks vs Other Private Creditors**

Source: IIF, own calculations

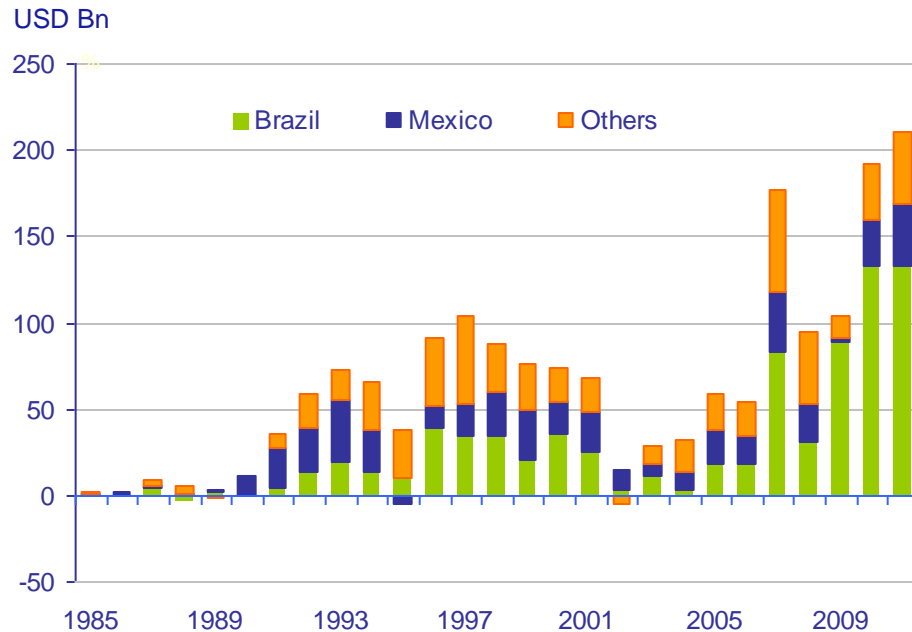


# Are there regional asymmetries?

- Brazil's contribution to the regional capital private inflows is overwhelming both on an absolute and relative basis
- On a relative basis to its economies' size Peru and Colombia also stand out in the last few years

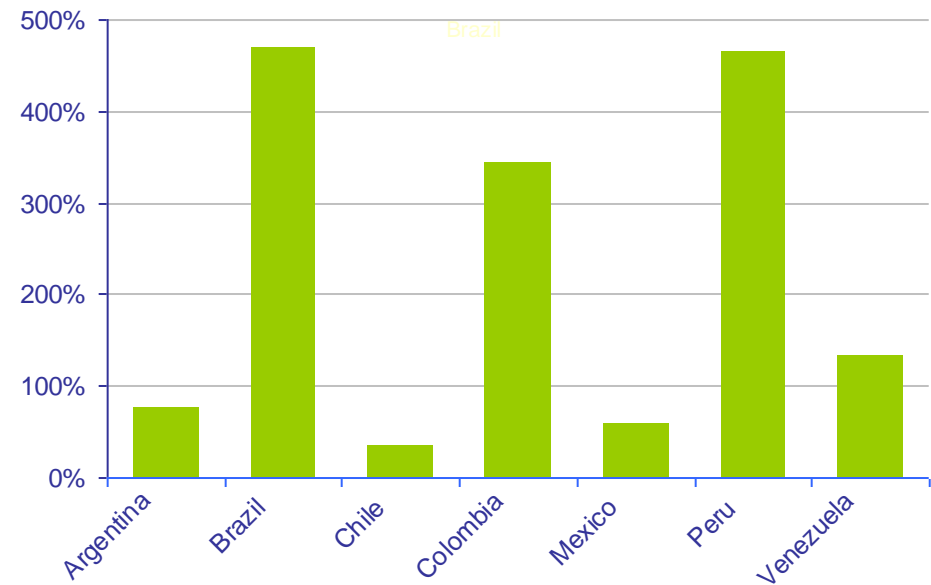
**LatAm Private Capital Inflows, Net  
Brazil vs Mexico vs Others**

Source: IIF, Own Calculations



**LatAm Private Capital Inflows, Net  
Growth Average 2007-2010 vs 2000-2006**

Source: IIF, Own Calculations



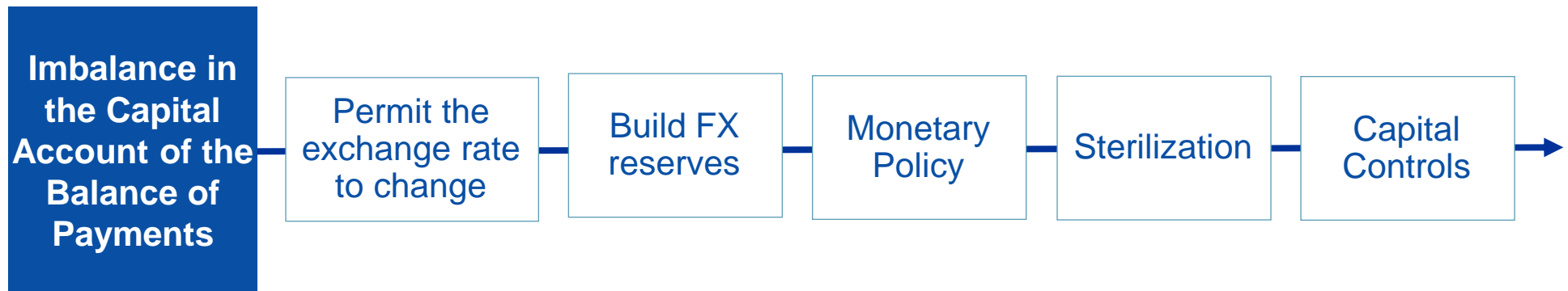
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# Rational for Policy Action & Toolkit Review



# Capital flows – rational for policy action

- The **IMF Articles of Agreement explicitly allow members to act upon its capital flows:**
  - *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 [...] Article IV – Section 3. Controls of capital transfers*
- Nonetheless the consensus over **capital controls use seems to be one of last resort**
- Its use seems justifiable to regain control over the other two elements of policy (exchange rate and price level) once they've achieved their *equilibrium* levels



- Note – we adopt a broad definition of capital controls as any policy action intended to act upon the capital account transactions



# Capital inflows – rational for policy action

## Macroeconomic Stability

- Pressure over the exchange rate
- Possibility of overshooting
- Loss of competitiveness by the tradable sector
- Inflation and economic overheating

## Financial Stability

- Asset price bubbles and fear of *hot money*
- Sectorial credit booms
- Foreign-exchange denominated credit growth (with no natural hedge)
- Intertemporal trade – trade consumption today for consumption in the future

## Policy Autonomy

- Regain control over monetary policy (if sterilization possibilities have been exhausted and it does not want to accumulate further reserves)
- Mundell's incompatible trinity (exchange rate and price level vs free capital movements)

# Capital inflows – policy toolkit review

## FX Intervention and Reserves Build-Up

- Spot and derivatives markets' intervention – discretionary and preannounced intervention programs
- FX options auctions
- Direct dealing with state owned companies
- Issuance of bonds denominated in local currency but paid in foreign currency

## Macro Prudential Measures

- Limits on banks' net foreign currency position (usually a proportion of their capital base)
- Limits on banks' net / gross foreign exchange derivatives positions (usually a proportion of their capital base)
- OTC derivatives regulatory registration
- Higher reserve requirements on banks' liabilities to nonresidents than on residents (e.g. nonresidents' local currency bank deposits vs residents' deposit)

## Capital Controls

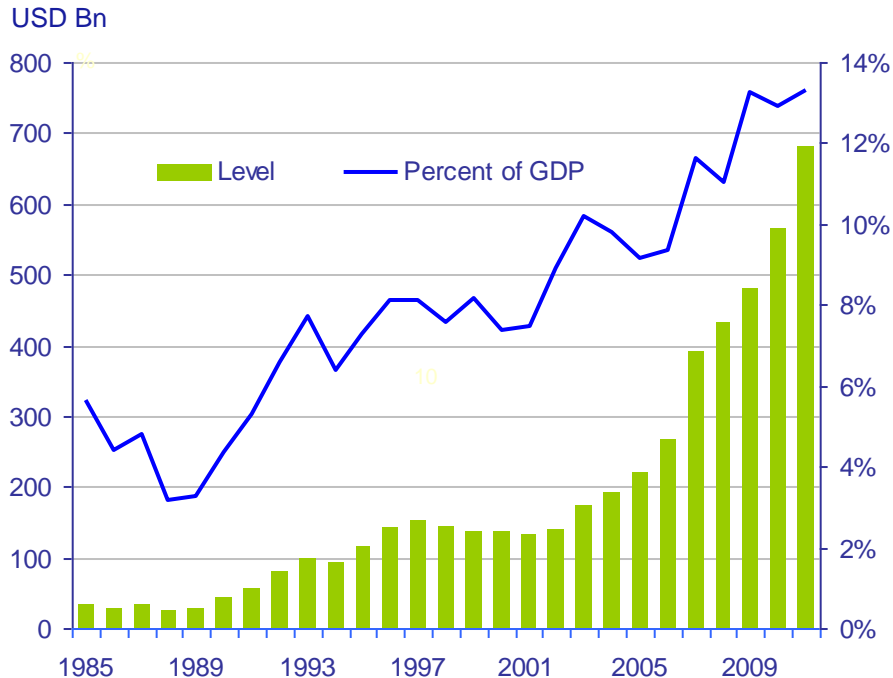
- Unremunerated mandatory reserve requirements
- Taxes on flows
- Minimum investment periods
- Compulsory conversion into local currency of exports proceeds

# FX interventions

- Their results seem to have been limited in terms of containing the currencies' appreciation (which in any case doesn't seem to be the CBs' intention – cf. BIS survey to CBs)
- Capital inflows along with high commodity prices are putting significant pressure on LATAM currencies, and these are expected to persist over the coming years

## LatAm Foreign Exchange Reserves

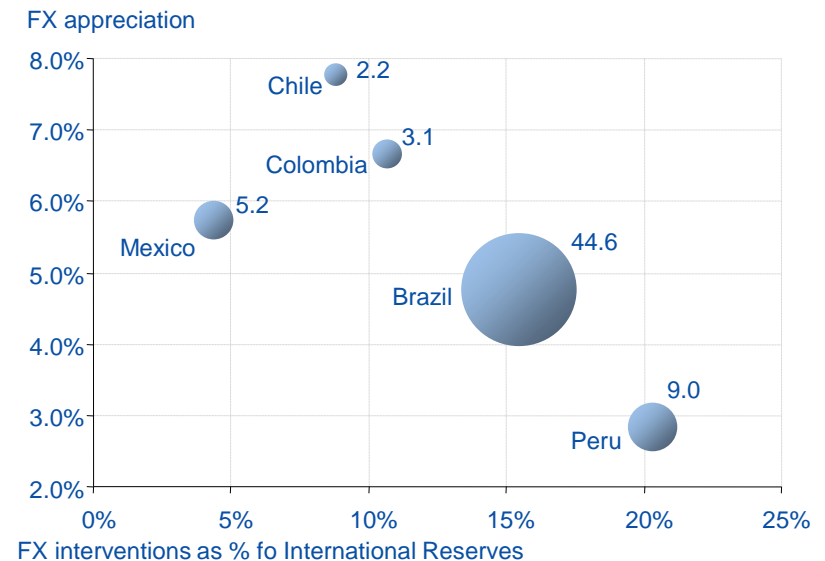
Source: Central Banks, Own Calculations









## Exchange rates: appreciation and FX purchasing activity

Source: BBVA Research. Exchange intervention: International reserve purchases between Jan10-Dec10 (% international reserves).

\*\*Exchange rate variation: Appreciation/Depreciation in Real Effective Exchange Rate between Jan10-Dec10



# FX interventions

Country	Daily Average Total Market Traded Volume (USD)	FX Intervention Mechanism
<b>Argentina (ARS)</b> 	Spot: 600 Mn Forwards & NDFs: 200Mn	<ul style="list-style-type: none"> <li>Spot and local exchange traded futures discretionary interbank market intervention</li> </ul>
<b>Brasil (BRL)</b> 	Spot: 4 Bn Forwards & NDFs: 17 Bn	<ul style="list-style-type: none"> <li>Spot and OTC FX swaps discretionary interbank market intervention</li> </ul>
<b>Chile (CLP)</b> 	Spot: 1.5 Bn Forwards & NDFs: 1 Bn	<ul style="list-style-type: none"> <li>USD 12Bn annual purchase program. Previous program had been in April 2008 and was suspended after Lehman</li> </ul>
<b>Colombia (COP)</b> 	Spot: 1 Bn Forwards & NDFs: 700 Mn	<ul style="list-style-type: none"> <li>USD 20Mn daily day purchase program</li> <li>Volatility control measures via USD spot auctions: buy or sell USD 200Mn when the central bank fix deviates at least 2% from the 10-day moving average.</li> </ul>
<b>México (MXN)</b> 	Spot: 15 Bn Forwards & NDFs: 1 Bn	<ul style="list-style-type: none"> <li>FX options monthly auctions of US 600 million. American USD put options with daily restrike and exercise contingent on 20-day moving average.</li> </ul>
<b>Perú (PEN)</b> 	Spot: 350 Mn Forwards & NDFs: 100 Mn	<ul style="list-style-type: none"> <li>Spot and OTC FX swaps discretionary interbank market intervention</li> </ul>

# Capital outflows – rational for policy action

- There's an adverse selection bias attached to capital outflows regulation
- Most policy-makers and academia have been focused on capital inflows. **Is there a room for capital controls on outflows?**

## Macroeconomic Stability

- Keep capital in the domestic economy facilitating taxation
- Permit credit allocation domestically without risking capital flight
- Preserve savings for domestic use
- Correct a balance of payments deficit

## Financial Stability

- Favor long-term vs short-term flows

## Policy Autonomy

- Regain control over monetary policy (if sterilization possibilities have been exhausted and it does not want to accumulate further reserves)

# Capital outflows – policy toolkit review

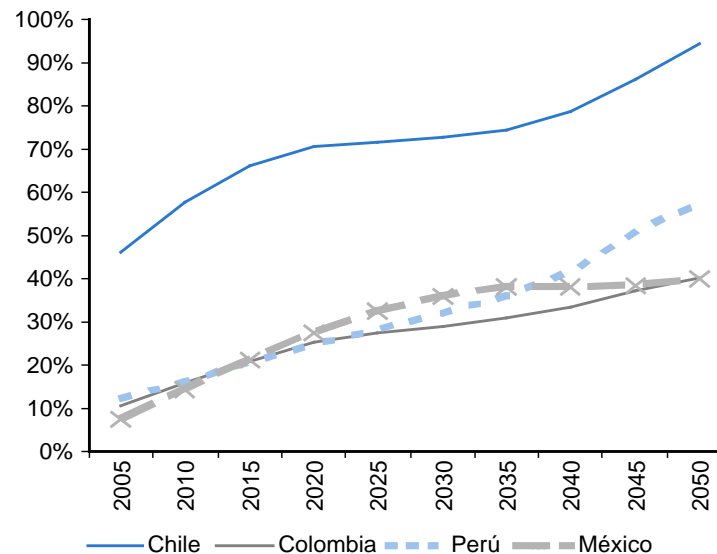
## Capital Controls

- Special requirements for repatriation of profits by foreign enterprises operating domestically
- Administrative limits on foreign currency purchase
- Domestic regulations on the portfolio choice of institutional investors

- The growth of savings in general and of pension funds in particular in LatAm will pose a growing pressure on portfolio investment outflows as these outgrow their local markets
- We already a taste of the potential impact of the portfolio investment abroad in 2009 in Chile and its impact in the USD liquidity locally

## Pension funds (% GDP)

Source: BBVA Research, OECD



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# A Roadtrip Over Past Episodes

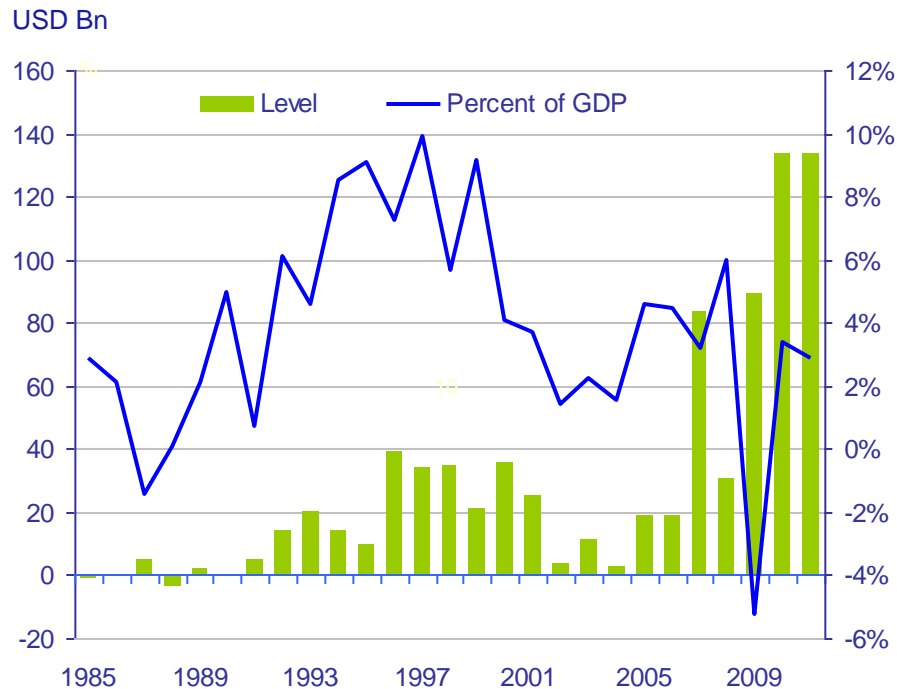


# A. Chile in the early 1990s

- Massive inflow of capital stemming from:
  - The consolidation of economic and political reforms in Chile
  - Strong differential between local and foreign interest rates

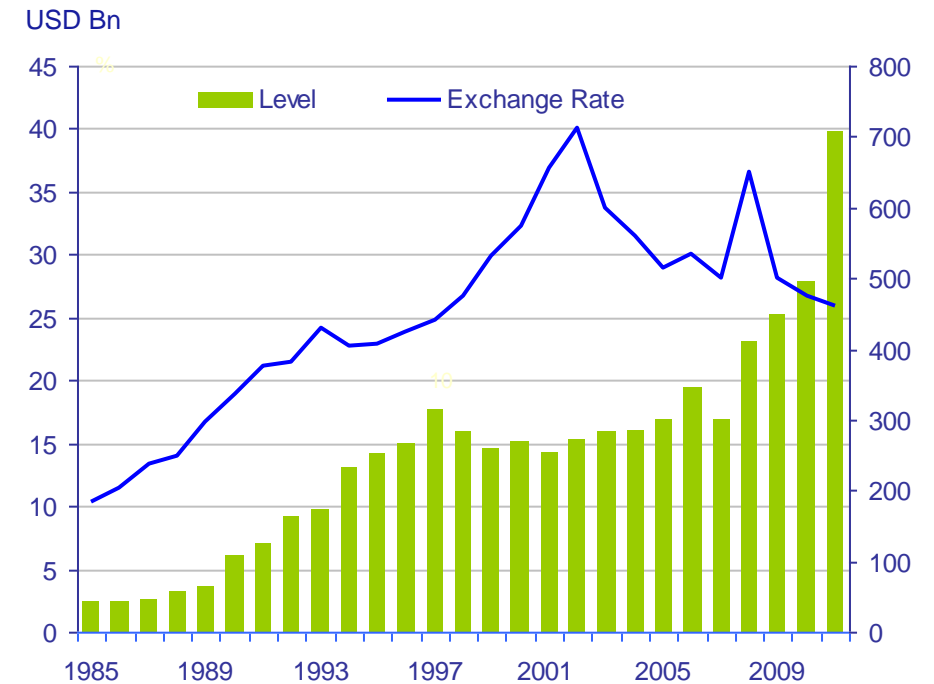
## Private Capital Inflows, Net

Source: Banco Central de Chile, IIF



## Foreign Exchange Reserves and Exchange Rate

Source: Banco Central de Chile, IIF



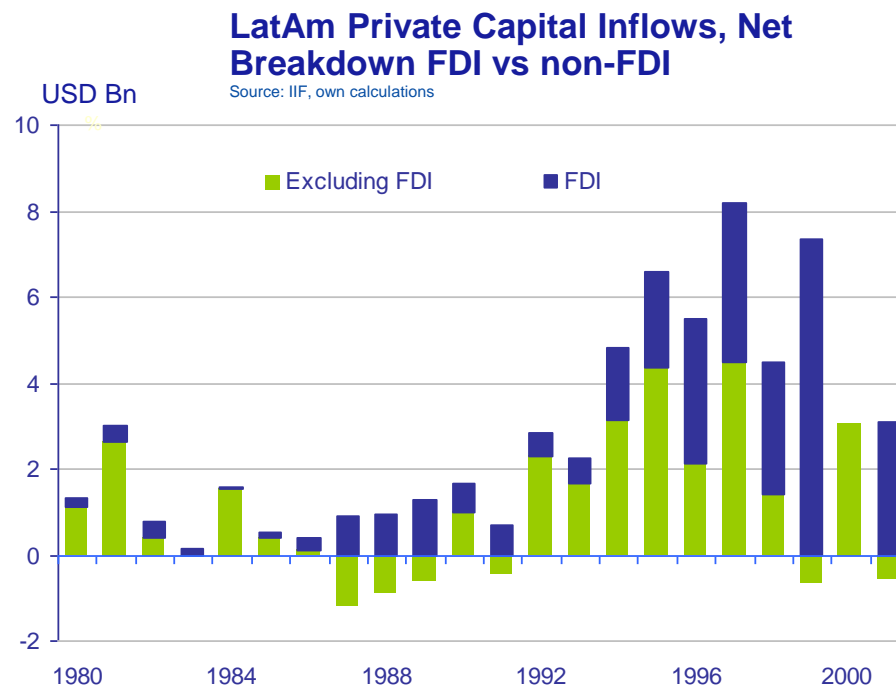


# A. Chile in the early 1990s (cont.)

- The **economic authorities' reaction**:
  - **Stage 1 (1989 – 1991)**: foreign exchange reserves accumulation and sterilization through bond emissions by the Central Bank
  - **Stage 2 (post March 1991)**
    - ✓ March 1991: Chilean commercial banks authorized to invest abroad up to 25% of their foreign exchange deposits
    - ✓ April 1991: exporters allowed to keep 5% of their export proceeds in foreign currency; capital repatriation on foreign investments allowed ahead of schedule (minimum of three years was in place) after payment of a fee to the Central Bank
    - ✓ June 1991: nonremunerated reserve requirement of 20% on all foreign currency denominated credits (except those granted to exporters) to be deposited at the Central Bank for a period of one year
    - ✓ October 1991: increase of liberalization of capital repatriation
    - ✓ March 1992: increase of the fraction exporters were allowed to keep in foreign proceeds from 5% to 10%
    - ✓ May 1992: further increase of liberalization of capital repatriation (minimum investment period lowered to one year); Pension funds (AFPs) became allowed to invest abroad up to 1.5% of their NAV
    - ✓ August 1992: increase of the reserve requirement on liabilities in foreign currency to 30%; increase of the AFPs foreign investment limit to 3% of their NAV

# A. Chile in the early 1990s (cont.)

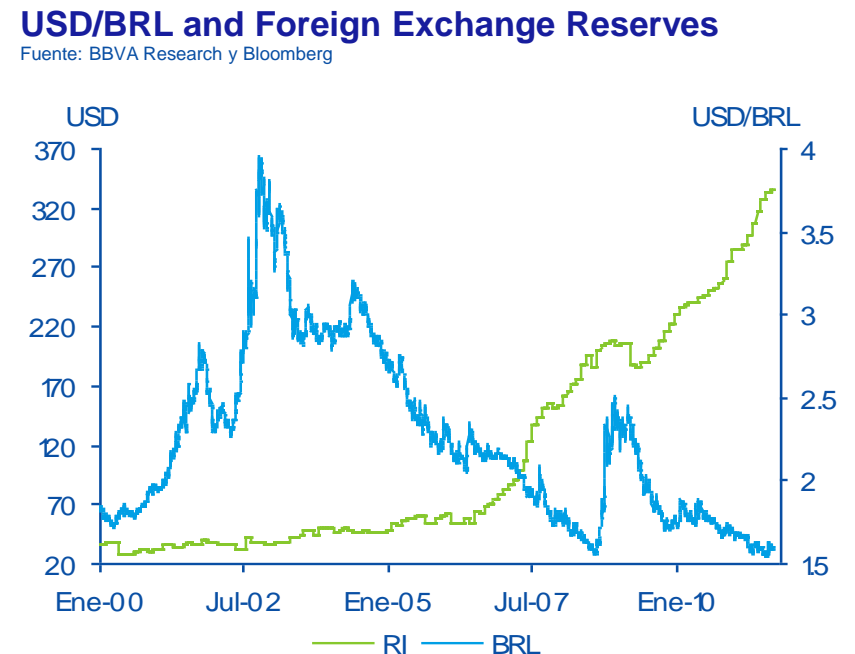
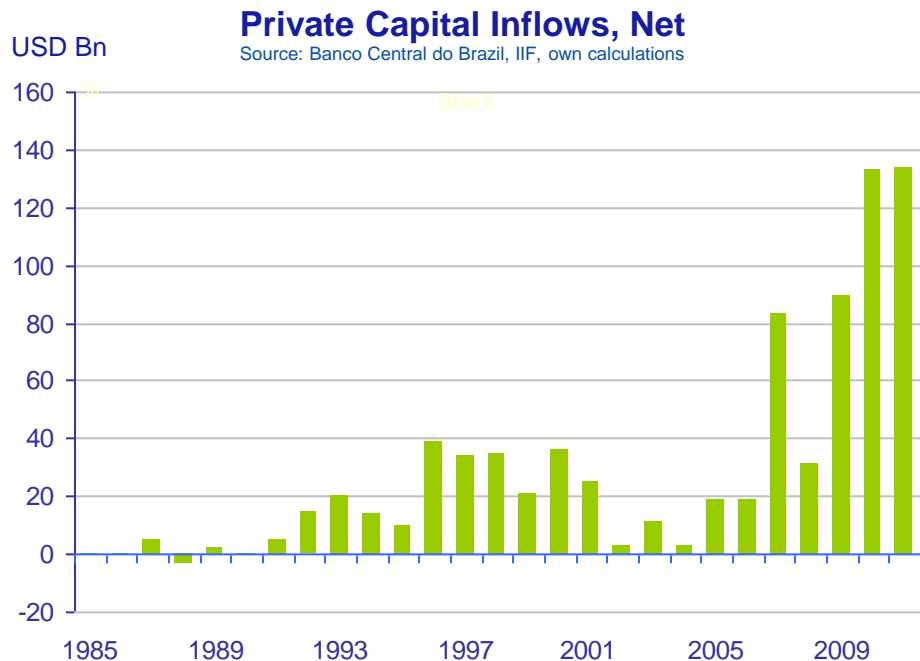
- The **authorities' goals**:
  - slow down the volume of capital flowing into the country
  - tilt its composition towards longer maturities
  - maintain the high differential between domestic and international interest rates in order to fight inflation
  - reduce or smooth the exchange rate appreciation
- **Conclusions** from Chile's experience are unanimous but a majority of the analysis would support:
  - The impact on the exchange rate was negligible
  - The impact on the total volume of inflows was small and in the short-term
  - The biggest impact was most likely in the composition of the inflows in favor of FDI



# B. The recent Brazilian experience

## Chilean Deja-Vu?

- From 2009 onwards the Central Bank rate of accumulation of foreign exchange reserves has been parabolic
- The authorities are determined not to see a 2008 redux with massive outflows on global risk-aversion.



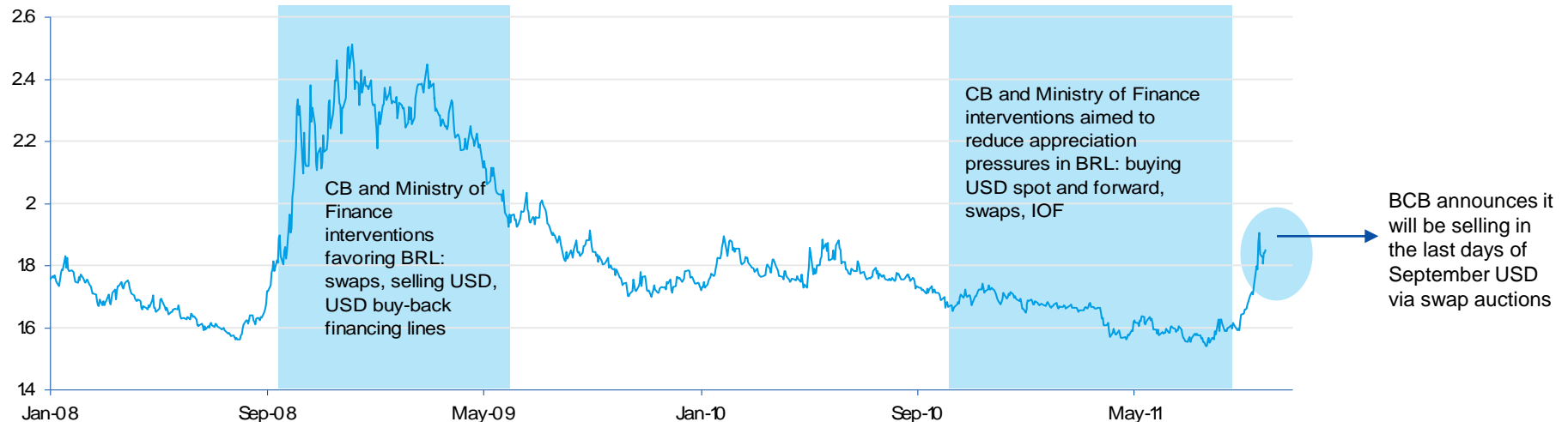
# B. The recent Brazilian experience

## Monetary Authorities Have Been Active in FX Interventions

- In order to stem BRL depreciation pressures in 2008 they began offering USD financing lines, auctioning swaps (selling USD), selling USD directly in the spot market, offered USD export financing lines
- In 2010 they reinstated the IOF in Oct 2009, raised it twice in the case of fixed income, imposed IOF in derivatives margins, raised reserve requirements to banks' short positions, bought USD via spot and forwards, authorized the SWF to buy USD

## FX Intervention Phases Since the Beginning of the Crisis in 2008

Fuente: BBVA Research y Bloomberg



## B. The recent Brazilian experience

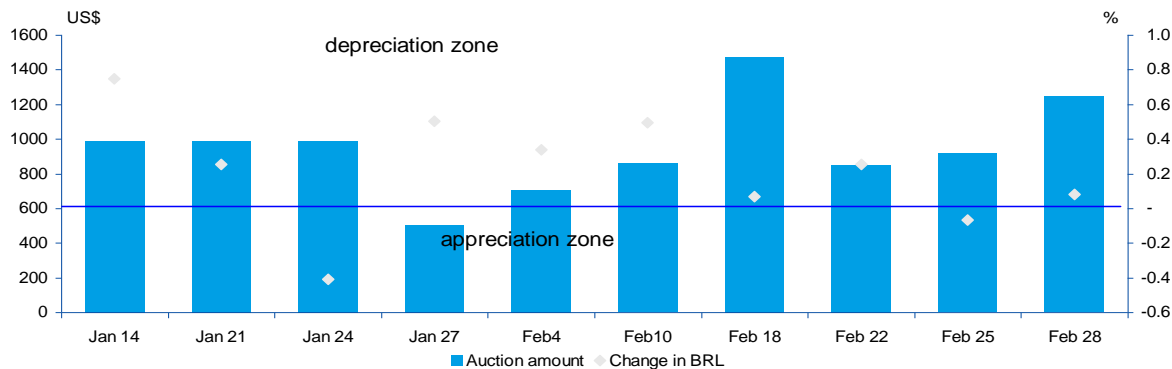
- The **economic authorities' reaction**:
  - **Stage 1 – Capital controls normalization**
    - ✓ February 2006: Income tax of 15% cut to 0% for foreign investors in the local fixed income market
  - **Stage 2 – Favouring USD depreciation**
    - ✓ March 2008: Imposed 1.5% IOF tax on foreign capital entering the country for investment in fixed-income
  - **Stage 3 – Favouring BRL appreciation**
    - ✓ September 2008: First FX swap auctions
    - ✓ October 2008: USD spot and futures market sales; March 2008 IOF tax eliminated;
    - ✓ December 2008: dollar financing to financial institutions, who on-lend to targeted Brazilian corporations with loan payments falling due over a pre-specified period
  - **Stage 4 – Favouring USD appreciation**
    - ✓ October 2009: Imposed 2% IOF tax on foreign capital entering the country for investment in equities and fixed-income instruments
    - ✓ October 2010: Tax rate on foreign investment in local bonds rises from 2% to 4% and then from 4% to 6%. IOF on derivatives margins increased from 0.38% to 6%
    - ✓ March 2011: Tax rate on foreign fund inflows related to loans or the issuance of bonds (with average maturity up to 360 days) by Brazilian companies is increased to 6%
    - ✓ April 2011: Tax rate on foreign fund inflows related to loans or the issuance of bonds (with average maturity up to 720 days) by Brazilian companies is increased to 6%

# B. The recent Brazilian experience

## Interventions Have Proved to be Effective Only Marginally and Temporary

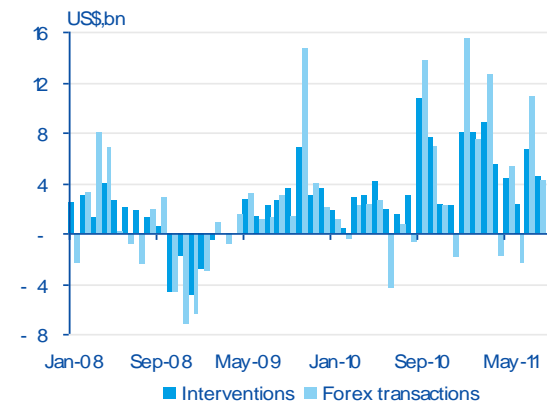
### Initial Reactions of BRL to Swap Auctions

Fuente: BBVA Research y Bloomberg



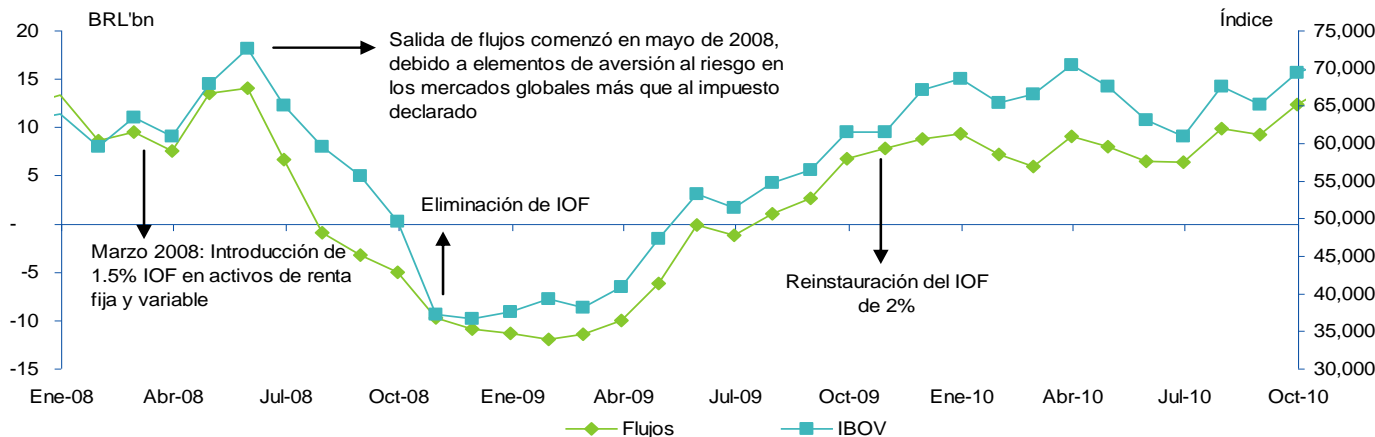
### Central Bank USD Transactions vs. Financial Flows

Fuente: BBVA Research y Bloomberg



### IOF More Effective in Equities than in Fixed Income

Fuente: BBVA Research y Bloomberg



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