THE OECD'S APPROACH TO CAPITAL FLOW MANAGEMENT MEASURES USED WITH A MACRO-PRUDENTIAL INTENT

REPORT TO G20 FINANCE MINISTERS
16-17 April 2015, Washington D.C.

OECD

The OECD Investment Committee is mandated by the OECD Council to consider all questions concerning the interpretation and implementation of the provisions of the OECD Code of Liberalisation of Capital Movement or other Acts of the Council relating to the liberalisation of capital movements. This report has been developed by the Secretariat on the basis of the text of the Code and the Users' Guide, which is an authoritative interpretation of the Code's obligations approved by the Investment Committee, as well as Committee reports setting understandings among Adherents regarding the scope of Code's obligations. It is intended to foster a better understanding of the treatment under the Code of capital flow measures used with a macro-prudential intent; it does not in any way alter or modify rights and obligations of Code's Adherents, the interpretation and implementation of which remain the sole responsibility of the Investment Committee.

SUMMARY

G20 Finance Ministers and Central Bank Governors at their meeting in Istanbul on 9-10 February 2015 asked "the IMF and OECD, with input from the BIS and FSB, to assess whether further work is needed on their respective approaches to measures which are both macro-prudential and capital flow measures, taking into account their individual mandates, by our meeting in April".

This report addresses this request from the perspective of the OECD Code of Liberalisation of Capital Movements, a legally binding agreement open to adherence to non-OECD countries. The OECD, as the IMF, holds the view that there is no presumption that full liberalisation is an appropriate goal for all countries at all times. Adherents to the Code are countries that have agreed to mutually commit to progressive liberalisation of a list of operations between residents and non-residents, subject to the ability to lodge reservations and invoke derogation clauses at times of balance-of-payments or financial stress. A process of notification of measures and peer review is used to ensure observance of the Code. Macro-prudential measures generally fall outside the scope of the Code. Adherents can introduce capital flow restrictions with a macro-prudential intent through due process that serves the collective interest in transparency and accountability and guarantees acceptance of the measures by their peers.

The IMF uses its Institutional View on capital flow liberalisation and management for providing advice and assessments when required for surveillance, but the Institutional View does not alter Fund members' rights and obligations under the IMF Articles of Agreement or other international agreements. The OECD Code is an international agreement among governments on rules of conduct for capital flow measures. While the roles and purposes of the IMF's Institutional View and the OECD Code are distinct, the IMF and OECD approaches are largely complementary. Continued co-operation between the two institutions will help inform the assessments of measures that are both macro-prudential and capital flow measures, under our respective approaches. The Code's approach is consistent with and a contribution to implementing the G20 Coherent Conclusions for the Management of Capital Flows.

The report identifies pending issues that may be calling for an update of the Code. The Background Note provides detailed information, in particular on Code's treatment of certain currency-based capital flow measures with a declared macro-prudential intent.

THE CONTEXT

Open regimes for international capital flows serve long-term global growth better than closed capital accounts. At the same time, capital flow volatility can pose risks to financial stability. In their communiqué, G20 Finance Ministers and Central Bank Governors meeting in Istanbul on 9-10 February 2015 recognise "the role of sound macroeconomic policies, structural reforms and strong prudential frameworks to help address potential volatility of financial flows." The OECD shares this view.

The G20 Finance Ministers and Central Bank Governors at their meeting on 9-10 February 2015 asked "the IMF and OECD, with input from the BIS and FSB, to assess whether further work is needed on their respective approaches to measures which are both macro-prudential and capital flow measures, taking into account their individual mandates, by our meeting in April". A perception could arise that countries receive seemingly conflicting signals from different international institutions regarding the appropriateness of such measures. While some tension is inevitable because mandates and obligations differ across legal frameworks and institutions, a question is whether institutions can do more within their existing mandates to address the perceived need for more harmonious signals regarding such measures.

The OECD has jurisdiction over capital flow measures by countries which adhere to the Code of Liberalisation of Capital Movements, as it has responsibility for implementation of this international agreement establishing rules of conduct for its Adherents based on a distinctive peer-review approach (see Background Note). Open to adherence by non-OECD countries, the Code is the only multilateral agreement among state parties dedicated to co-operation on capital flow measure management and progressive liberalisation. It is from the perspective of this agreement that this report addresses the G20 request. [1]

The G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences (2011) recognise the overlap between capital flow management measures (CFMs) and macro-prudential policies and call for CFMs to be *"transparent, properly communicated, and be targeted to specific risks identified. In order to respond properly to the specific risks identified, capital flow management measures should be regularly reviewed by national or regional authorities as appropriate*". The G20 Coherent Conclusions include CFMs among the category of policies that "*should be the object of regular, credible and even-handed multilateral surveillance to assess both their individual impact and aggregate spillover effects*."

The Code's monitoring and peer review process has contributed to collective surveillance of CFMs for over 50 years by making measures transparent and subject to peer review. Notification requirements ensure information on barriers to capital movements in adhering countries is complete, up-to-date, comprehensible and accessible. The OECD Investment Committee is tasked with the examination of countries' measures and the assessment of their conformity under the Code. These requirements are the backbone of the Code's dialogue process; they serve to support an exchange of views among Adherents on whether a measure is justified and proportional to its stated objectives, on whether less restrictive means are available to attain legitimate policy objectives, with a view towards contributing to the development of best practices and to better understanding of the systemic consequences of individual country measures. This process of dialogue supports multilateral co-operation in a sensitive and key

[1] This report has benefitted from an exchange of views between the OECD and IMF staff. Inputs have been provided by the BIS and FSB that have been taken into account in the final version of the report. The IMF has prepared a separate note on their approach to the assessment of such measures.

policy area and ultimately supports financial stability at a global level. As all OECD legal instruments, the Code is open to adherence by non-OECD countries.

THE CODE'S APPROACH TO CFMs AND MPMs

Major reviews of financial regulation have been under way in the aftermath of the 2008 global financial crisis. There has also been greater resort to the use of CFMs, for example to address macro-prudential concerns. Among CFMs the greater resort to currency-based measures (discriminating on the basis of the currency of an operation, rather than residency of the parties to the operation) may help address banks' balance sheet vulnerabilities arising from operations denominated in foreign currencies. As is the case for all CFMs, currency-based measures can equally support the attainment of a country's exchange-rate or other external balance objectives.

Table 1 provides some illustrative examples of measures which the IMF and the OECD consider to be both CFMs and Macro-Prudential Measures (MPMs) and their assessment under the IMF and OECD frameworks[2].

In this setting, the IMF and OECD, each within the scope of their respective institutional mandates, play a positive role to support countries' quest for sound strategies to address vulnerabilities created by volatile capital flows. It is well recognised that each organisation follows its respective approach, reflecting distinct mandates and membership. However, these should not be seen as inconsistent but rather largely complementary, and the binding nature of the Code does not prevent countries from adopting appropriate regulatory measures, including those that may be recommended by the IMF's Staff pursuant the guidance set in the IMF's Institutional View or in its paper on "Key Aspects of Macroprudential Policy".

The OECD shares the IMF Institutional View that there is no presumption that full liberalisation is an appropriate goal for all countries at all times. The Code offers countries a mechanism to signal their readiness and willingness to commit to progressive liberalisation and openness, within a framework of mutual accountability, dialogue and transparency. Countries at different levels of development have adhered to the Code[3]. The experience with implementation of the Code for over 50 years does not reveal a conflict with the need to regulate financial markets and institutions. This section looks at how the Code's provisions protect financial regulators policy space, while supporting liberalisation commitments.

Key features

In assessing whether a specific measure falls within the scope of the Code, what matters is the bearing on the obligations set out in the Code's Articles and in the Code's liberalisation lists of operations, not the intent with which an Adherent declares to have introduced the measure.[4] The Code's Articles establish principles that Adherents

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2 See Background Note, section 5, for further discussion and analysis under the approach of the Code of two of the illustrative examples provided in Table 1.

3 Adherents to the Code include advanced and emerging countries, several of which were developing countries when they joined the Code. The Code was opened to adherence by non-OECD countries in 2011, reflecting its global vocation. Currently four new applications for adherence (Colombia, Costa Rica, Latvia and Lithuania) are being processed.

4 In this regard, the scope of measures having a bearing on the Code includes measures which are designed to limit capital flows (i.e. falling within the standard definition of a CFM), as well as measures which may be intended for other purposes, but do restrict operations covered by the Code. Furthermore, it should be noted that not all CFMs have a bearing on Code's obligations, as explained below.

agree to uphold in any circumstances. These include procedural obligations, i.e. the notification and examination obligations that are the backbone supporting the Code's dialogue process, and a set of substantive obligations. In addition, the Code sets specific liberalisation obligations, subject to safeguards and flexibility mechanisms, for operations under liberalisation lists A and B (see Background Note, Box 3). The Code covers residency-based measures, as well as other non-residency measures, as does the G20 Coherent Conclusion's definition of CFMs.[5] The Code also calls for:

- Non-discrimination of non-residents as a key criterion for operations in the country concerned.
- Freedom of residents to conclude operations taking place while abroad under the rules of the foreign jurisdiction.
- Freedom to use foreign currency in denomination and settlement of listed operations, while protecting countries' right to regulate the use of currencies in their territory (Background Note, section 4).

Based on the Code's text and jurisprudence, four cases can be envisaged regarding the treatment of CFMs under the Code. In particular, they can:

a. be in contradiction with the Code's Articles such as the need to treat equally non-residents across adhering countries (MFN principle); or

b. be outside the scope of the Code, as is the case of measures which regulate operations among residents and the vast majority of macro-prudential measures, including Basle minimum capital requirements, which do not target the specific operations covered by the Code by prohibitions or disincentives to their conclusion, but rather set regulatory requirements to manage the risk of operations for the bank's capital; or

c. have a bearing on the Code, but conform with liberalisation obligations, to the extent that they do create impediments or disincentives for the conclusion of listed operations, but they are covered by a specific carve-out of the liberalisation obligations as agreed among Adherents (e.g. rules for the net foreign exchange exposure of banks are carved-out by such an understanding among Adherents);[6] or

d. have a bearing on the Code and constitute a restriction, to the extent that they do create impediments or disincentives for the conclusion of listed operations.

Flexibility mechanisms

With respect to measures that constitute restrictions (case d. in the above paragraph), Adherents may limit the scope of their Code's obligations by lodging of reservations or by invoking derogation (Background Note, section 3) as follows:

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5 G20 Coherent Conclusions: "*For the purposes of these conclusions, capital flow management measures are those designed to influence capital flows and comprise residency-based capital flow management measures, often referred to as capital controls, and other capital flow management measures that do not discriminate on the basis of residency but are nonetheless designed to influence flows. The latter category would typically include (a) measures that differentiate transactions on the basis of currency, including a subset of prudential measures, and (b) other measures (e.g. taxes on certain investments) that are typically applied in the non-financial sector*".

6 See Background Note, Box 2, for further examples of how the Code's provisions protect countries' policy space.

- Reservations protecting the right of Adherents to reintroduce and maintain measures limiting liberalisation obligations with respect to operations which they are not in the position to liberalise may be lodged when obligations are added, expanded, or begin to apply − typically at the time of adherence.
- Further flexibility exists for measures restricting short-term operations, which can be introduced at any time when needed, even if no reservation had been initially lodged, as these operations are covered by Liberalisation List B for which there is no standstill commitment.
- For measures for which standstill applies (bearing on List A operations), current Adherents may still limit the scope of their Code obligations, in order to justify imposing new restrictions, by invoking the Code's derogation clauses under Article 7.

The status regarding flexibility provided by the Code to regulate for financial stability purposes is as follows: i) the vast majority of MPMs are in the category of measures that fall outside the scope of obligations, while many CFMs that are MPMs are conforming measures; ii) for restrictive measures, while future Adherents enjoy full flexibility to lodge reservations, current Adherents may do so only for List B operations and must resort to derogation for List A operations.

The residual issue of flexibility under the Code is the resort to derogation by current Adherents to deal with: i) the introduction of restrictions on a temporary basis to respond to capital surges in a preventive manner; and ii) the introduction of restrictions on a permanent basis to respond to financial stability concerns. The issue is not immaterial, as standstill applies to certain operations that can support short-term or volatile capital flows, in particular for certain inflow operations.[7] However, there is no established precedent for resort to derogation in such cases (Background Note, section 3).

There is a further element of flexibility in the approach of the Code in the form of further understandings reached among Adherents that help shape the scope and application of obligations. This element is relevant for new measures restricting List A operations that have been designed to become a permanent feature of an existing Adherent's financial regulatory regime or for measures that have become part of agreed international regulatory standards. The OECD Investment Committee is tasked with all questions of interpretation and implementation of the Code and such further understandings are formalised in Decisions made by consensus among Adherents taking into account the collective interest, the availability of less restrictive means and other considerations.

Ongoing work among Adherents, benefiting from the views of non-Adherents, including all G20 countries, has looked into the issue of the level of flexibility provided by the Code to adopt measures in the context of ongoing use of currency-based CMFs. Results of a survey circulated in the second quarter of 2014 show that respondents except one country expressed the view that the Code has sufficient flexibility regarding the introduction of such measures.

SUPPORT FOR COUNTRIES' POLICIES AND THE COLLECTIVE INTEREST

The Code's process is an opportunity for the country concerned to secure international acceptance of its measures. Lodging a reservation or invoking the derogation clauses under Article 7 does not constitute a violation of the Code and, on the basis of past experience, there is no stigma attached to their use. It is rather an opportunity for the country concerned to explain to its peers the policy challenges faced.

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7 Examples of such List A operations are bank deposits by non-residents and operations in stocks and bonds with an original maturity of one year or more.

The ongoing dialogue on CMFs with a macro-prudential intent is particularly relevant in a context of multilateral co-operation since the measures have potential spillovers and implications on other Adherents and on the international financial system. For example:

- Which would be the consequences on the overall system if several Adherents, including large economies, were to introduce restrictions on cross-border lending or borrowing/lending in foreign currency?
- How cross border capital flows will be intermediated if banks can only borrow and lend in their local currency?
- What would happen to liquidity in FX trading in global markets if several Adherents, including large economies, were to introduce CFMs which restrict the use of FX derivatives by banks?

While measures introduced as a result of unilateral moves by individual countries can lead to undesirable collective outcomes, measures based on prescribed global standards reflect an international consensus among financial regulators and the Code's approach allows for Adherents to reach understandings on the conformity of internationally agreed standards with the Code's obligations, as was the case for instance for Basel rules on bank's net foreign exchange positions.

As an international agreement of co-operation, the Code seeks to find the right balance between a country's individual interest and the collective interest in an open and functioning global financial system. In the past, most changes in capital flow measures by OECD members were in the direction of progressive liberalisation, and the national interest and collective interest were seen to naturally coincide. Today, this reconciliation between the two is made more difficult by financial innovations which may pose greater systemic risks, renewed international tensions on exchange rates, shifts in wealth between advanced and emerging economies with varying degrees of openness, and a proliferation of individual financial regulatory initiatives in response to the 2008 global crisis.

FURTHER WORK

The Code is a living agreement which is updated by Adherents in light of evolving global conditions to ensure its continued relevance and effectiveness as an instrument of co-operation. Ongoing work serves to confirm its role in the current financial environment. Adherents to the Codes are currently reflecting on possible terms of reference for an update of the Code. Reflections are already active among Adherents in relation to the interpretation of some existing understandings. Building on existing discussions, the Secretariat considers that such terms of reference could include the following elements: clarify the scope of the Code regarding some specific "grey" areas and new financial market instruments; examine the asymmetry regarding standstill for inflow and outflow operations in some specific areas; and, improve implementation and review mechanisms (Background Note, section 7).

The IMF and OECD have a long standing co-operation on the relationship between CFMs and macro-prudential measures and other relevant matters. Having said that, co-operation among international organisations can be further developed. The IMF's Staff country advice based on the Institutional View can help inform economic justifications for measures being assessed by state parties to international agreements, including the OECD Code. Discussions at the OECD can help inform IMF's Staff country advice on specific measures, so that authorities are mindful of the need to introduce such measures in a manner consistent with their country's rights and obligations under international agreements covering capital flows such as the OECD Code.

TABLE 1. SELECTION OF CAPITAL FLOW MANAGEMENT MEASURES (CFMS) THAT ARE ALSO MACROPRUDENTIAL MEASURES (MPMS)[1]

	I. Type of Measure	II. Description and Purpose of Measure	III. IMF Assessment[2]	IV. OECD Assessment[3]
1	Limit	Limit on banks' foreign exchange derivative contracts set as a percentage of bank capital. The measure increases the cost of derivative transactions, thereby limiting banks' reliance on short-term external funding. Measure introduced in the context of capital flow volatility and limits the systemic impact of large movements in capital flows. The measure mitigates systemic liquidity risks associated with banks' reliance on FX funding and volatile capital inflows.	The measure is an MPM because it limits banks' reliance on short-term external funding and the exposure of the financial sector to systemic liquidity risks associated with a sudden stop in capital flows. Although the measure does not discriminate on the basis of residency, given the circumstances, including the announced objective, it is nonetheless designed to limit capital flows. Therefore, it is also considered a CFM. Assessment is based on Annex II, page 40 and Box 2, page 21 of the institutional view; and the section on liquidity tools, para 135 of the detailed staff guidance note on macroprudential policy instruments.	The measure has a bearing on Code obligations only to the extent that it extends to operations carried-out abroad by resident banks, in which case it has a bearing on obligations established under Liberalisation List B, item XII. Operations in foreign exchange. B. Abroad by residents. Adherents may limit the scope of their Code obligations under List B at any time by lodging a reservation. See OECD's Background Note, section 5: "Illustrative examples", for further details on this measure.

Notes

1. This table is an illustrative list of possible measures that can be considered as both CFMs and MPMs, and is not a recommended or exhaustive list. The description and purpose of the measures provided under column II focuses on their use as CFMs/MPMs.

2. The IMF approach for assessing whether a particular measure is a CFM and an MPM is based on "The Liberalization and Management of Capital Flows: An Institutional View" and "Key Aspects of Macroprudential Policy" and the associated staff guidance notes, including the "Staff Guidance Note on Macroprudential Policy—Detailed Guidance on Instruments." A measure is considered as both a CFM and an MPM when it is designed to limit capital flows in order to reduce systemic financial risk stemming from such flows. In practice, the IMF assessment of such measures has been guided by the provisions noted in the table, and also depends on country-specific circumstances, including the overall context in which the measure was implemented. Such measures can have a role in supporting macroeconomic policy adjustment and safeguarding financial system stability in certain circumstances, such as in response to capital inflows: (i) when the room for adjusting macroeconomic policies is limited; (ii) when the needed policy steps require time, or when the macroeconomic adjustments require time to take effect; (iii) when an inflow surge raises risk of financial system instability; or (iv) when there is heightened uncertainty about the underlying economic stance due to the surge.

3. The assessment of a specific country measure is guided by its bearing on the operations covered by the Code. Specifically, measures are to be assessed in a meeting of the Investment Committee on the basis of adherents' obligations under the Code, notably under Article 2 of the Code of Liberalisation of Capital Movements to grant any authorisation required for the conclusion and execution of transactions and for transfers set out in liberalisation lists A and B. The further understanding among members on measures equivalent to restrictions extends liberalisation commitments to include measures which constitute disincentives for the conclusion of operations covered by the Code (see Users' Guide: Measures constituting restrictions).

	I. Type of Measure	II. Description and Purpose of Measure	III. IMF Assessment[2]	IV. OECD Assessment[3]
2	Limit	Limit on the daily balance of banks' short-term (up to one year) liabilities to nonresidents set as a percentage of bank capital. The measure increases the cost of banks' use of short-term funding from non-residents beyond a set limit. The measure contains systemic liquidity risk by reducing banks' reliance on short-term external funding and indirectly dampens excessive credit growth funded by capital inflows.	The measure is an MPM because it increases the cost of banks' reliance on short-term external funding, thereby limiting excessive credit growth and the exposure of the financial sector to systemic liquidity risks associated with a sudden stop in capital flows. Since the measure discriminates between resident and nonresident lenders, it is also considered a CFM. Assessment is based on Annex II, page 40 and Box 2, page 21 of the institutional view; and the section on liquidity tools, para 135 of the detailed staff guidance note on macroprudential policy instruments.	The measure has a bearing on Code obligations under: • Liberalisation List A - item XI. Operation of deposit accounts. A. Operation by non-residents of accounts with resident institutions. Adherents may limit the scope of their Code obligations under List A by lodging a reservation only when obligations are added, extended or begin to apply. Adherents may invoke a derogation to suspend their obligations, subject to additional review and reporting requirements (see OECD's Background Note). • Liberalisation List B - item V. Operations on money markets. D. Operations abroad by residents. - item VI. Other operations in negotiable instruments and non-securitised claims. D. Operations abroad by residents. - item IX. Financial credits and loans. A. Credits and loans granted by non-residents to residents. Adherents may introduce such measures, covered by List B, at any time by lodging a reservation.
3	Tax	Additional buyer's stamp duty on purchases of certain categories of residential property levied at a higher rate for nonresidents than residents. The measure mitigates the build-up of systemic risk stemming from capital flows to an overheating property market. By increasing the costs of purchase of residential property particularly for nonresidents, the measure reduces non-residents' housing demand.	The measure is an MPM because by limiting the inflow of foreign capital into the domestic property market, it reduces the systemic risk associated with property price corrections when these inflows recede. Since the measure discriminates between residents and nonresidents, it is also considered a CFM. Assessment is based on Annex II, page 40 and Box 2, page 21 of the institutional view; and the sections on household sector tools (para 71) and corporate sector tools (para 90) of the detailed staff guidance note on macroprudential policy instruments.	The measure affects non-residents' purchase of real estate in the country introducing the measure and as such has a bearing on Code obligations under List B, item III. Operations in real estate. A. Operations in the country concerned by non-residents. 1. Building of purchase. Adherents may introduce such measures, covered by List B, at any time by lodging a reservation.

	I. Type of Measure	II. Description and Purpose of Measure	III. IMF Assessment[2]	IV. OECD Assessment[3]
4	Tax	Bank levy on non-deposit FX liabilities with maturities shorter than one year. The measure increases the cost of short-term non-core FX funding. Measure was introduced in the context of capital flow volatility and limits the systemic impact of large movements in capital flows. The measure mitigates systemic liquidity risk associated with banks' excessive reliance on short-term non-core FX funding and volatile capital flows.	The measure is an MPM because it limits banks' reliance on short-term external funding and the exposure of the financial sector to systemic liquidity risk associated with a sudden stop in capital flows. Although the measure does not discriminate on the basis of residency, given the circumstances, including the announced objective, it is nonetheless designed to limit capital flows. Therefore, it is also considered a CFM. Assessment is based on Annex II, page 40 and Box 2, page 21 of the institutional view; and the section on liquidity tools, para 135 of the detailed staff guidance note on macroprudential policy instruments.	To the extent that the measure limits the freedom for residents to freely decide on the use of currency for denomination and settlement of operations with non-residents, the measure has a bearing on Code obligations under: • Liberalisation List B - item V. Operations on money markets. D. Operations abroad by residents. - item VI. Other operations in negotiable instruments and non-securitised claims. D. Operations abroad by residents. - item IX. Financial credits and loans. A. Credits and loans granted by non-residents to residents. Adherents may introduce such measures, covered by List B, at any time by lodging a reservation. Specific measures may also have a bearing on operations covered by Item X, Sureties, guarantees and financial back-up facilities of the General List, with items falling under both liberalisation lists.
5	Reserve requirement	A reserve requirement on domestic banks' foreign currency swap and forward transactions with nonresidents. The measure increases the cost to domestic banks of foreign currency swap and forward transactions with nonresidents. The reserve requirement mitigates systemic liquidity risk related to increasing currency and maturity mismatches on banks' balance sheets driven by short-term capital inflows.	The measure is an MPM because it limits systemic liquidity risks related to increasing currency and maturity mismatches on banks' balance sheets caused by short term capital inflows. Since the measure discriminates between residents and nonresidents, it is also considered a CFM. Assessment is based on Annex II, page 40 and Box 2, page 21 of the institutional view; and the section on liquidity tools, para 135 of the detailed staff guidance note on macroprudential policy instruments.	The measure has a bearing on Code obligations only to the extent that it extends to operations carried-out abroad by resident banks, in which case it has a bearing on obligations established under: • Liberalisation List B - item XII. Operations in foreign exchange. B. Abroad by residents. - item VI. Other operations in negotiable instruments and non-securitised claims D. Operations abroad by residents. To the extent that swaps contain also an interest rate element. - item VI. Other operations in negotiable instruments and non-securitised claims C. Operations in the country concerned by non-residents. To the extent that swaps contain also an interest rate element and that residents are allowed to carry-out such operations. Adherents may limit the scope of their Code obligations under List B at any time by lodging a reservation.

	I. Type of Measure	II. Description and Purpose of Measure	III. IMF Assessment[2]	IV. OECD Assessment[3]
6	Reserve requirement	A reserve requirement on banks' credit lines and other external obligations with nonresidents of three years or less in maturities. The measure increases the cost of banks' reliance on external funding. The reserve requirement prevents the build-up of systemic risk associated with FX lending in the context of a highly dollarized economy and strong capital inflows.	The measure is an MPM because it increases the cost of banks' reliance on external funding and the exposure of the financial sector to systemic risks associated with currency mismatches on banks' balance sheets and a sudden stop in capital flows. Since the measure discriminates between resident and nonresident lenders, it is also considered a CFM. Assessment is based on Annex II, page 40 and Box 2, page 21 of the institutional view; and the sections on tools that target foreign exchange loans (para 109) and liquidity tools (para 135) of the detailed staff guidance note on macroprudential policy instruments.	The measure has a bearing on Code obligations under: • Liberalisation List A - item IV. Operations in securities on capital markets. D. Operations abroad by residents. - item XI. Operation of deposit accounts. A. Operation by non-residents of accounts with resident institutions. Adherents may limit the scope of their Code obligations under List A by lodging a reservation only when obligations are added, extended or begin to apply. Adherents may invoke a derogation to suspend their obligations, subject to additional review and reporting requirements (see OECD's Background Note). • Liberalisation List B - item V. Operations on money markets. D. Operations abroad by residents. - item VI. Other operations in negotiable instruments and non-securitised claims. D. Operations abroad by residents. - item IX. Financial credits and loans. A. Credits and loans granted by non-residents to residents. Adherents may introduce such measures, covered by List B, at any time by lodging a reservation. Specific measures may also have a bearing on operations covered by Item X, Sureties, guarantees and financial back-up facilities of the General List, with items falling under both liberalisation lists.

BACKGROUND NOTE

THIS BACKGROUND NOTE PROVIDES INFORMATION SUPPORTING THE REPORT

1. AN OVERVIEW OF THE CODE'S FRAMEWORK

1. The OECD Code of Liberalisation of Capital Movements was established in 1961 at a time when many OECD countries were in the process of economic recovery and development and when the international movement of capital faced many barriers. It is binding for the 34 OECD members, including twelve G20 countries. Since 2012, the Code is also open to non-OECD countries. All Adherents have an equal say in the governance of the agreement.[1]

2. When the Code was first established, its coverage was rather limited. Since then, national economies have become more integrated, financial market regulation more harmonised and financing techniques more sophisticated. Over time the Code has been revised to reflect both these changing economic realities and new aspirations of adhering countries. The Code is based on several premises validated by evidence and experience:

- An open multilateral regime for international capital flows serves the global economy better than closed capital accounts. This is all the more true today as financial markets need to play their full role in allocating cross-border saving and investment efficiently in support of a sustainable global recovery.
- Reintroducing capital flow restrictions can play a role in specific circumstances. On these circumstances, transparency and international co-operation are important. While restrictions can be justified from an individual country's viewpoint, a "beggar-thy-neighbour" approach to restrictions can lead to negative collective outcomes.

1.1 A forum for international dialogue and co-operation

3. The Code has provided an established and tested process of international dialogue and co-operation. The process is managed and controlled by Adherents through a dedicated forum at the OECD in which each country can explain its policies and raise questions about the policies of others. The IMF and other relevant international organisations are invited to this forum.

4. The process is peer driven. Over time, Adherents have developed a well-established jurisprudence regarding implementation of the Code's rights and obligations and the conformity of individual country measures. Notification and examination of country measures enhance transparency and mutual understanding.

1.2 An agreement adapted to different levels of development

5. A country wishing to adhere to the Code is reviewed and assessed on its merits, in light of the specific circumstances of the country, including its level of economic and financial development and taking into account the provisions of the Code.

6. Countries can pursue liberalisation progressively over time, in line with their level of economic development. Emerging economies such as Chile, Korea and Mexico have adhered to the Code. Other countries, specifically Spain until 1962, Greece until 1977, and Turkey until 1986, availed themselves of a special dispensation

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1 The Code is a decision legally binding for its Adherents. Under general international law it is therefore equivalent to an international agreement legally binding for its Adherents.

from their obligations under the Code for countries in the process of development while still enjoying the same rights as other adhering countries.

Box 1. Experience with sequencing liberalisation

Many but not all Adherents have followed a gradual approach to lifting capital controls. The process typically begins with less volatile transactions and those more directly necessary to normal business activities. Hence, direct investment is usually authorised earlier than portfolio investment and commercial credits are liberalised before financial loans. Equity operations are liberalised before those in debt securities–and when these have been liberalised, Adherents begin with long-term bonds, thus keeping control over money-market instruments for a longer period.

As financial market integration accelerated in the 1980s, countries found limits to the merits of further fine-tuning sequencing of liberalisation.

- In Turkey, outward direct investment and portfolio investment were liberalised at the same time.
- Sweden liberalised operations in Treasury bills and longer-term government bonds together, in 1989; Italy and Ireland liberalised operations in equities and bonds in tandem rather than in sequence.
- Several countries, such as France and Norway, maintained restrictions on lending to non-residents in local currency until the latest stage of liberalisation, for fear of facilitating speculation against the currency.
- In general, the last operations to be liberalised were those concerning deposit accounts with non-resident institutions abroad; and this mainly for tax control reasons.

Overall, today OECD countries have reached high-levels of financial openness, compared with non-OECD economies including large G20 countries such as China and India. These countries are embarked in gradual capital movement liberalisation very much for the same reasons that prompted OECD countries adhering to the Code to start opening their capital accounts many years ago and can benefit from country experiences under the Code.

1.3 The contribution made by the Code over time

7. Article 2(d) of the OECD Convention of December 1960 enjoined members to "*pursue their efforts to reduce or abolish obstacles to the exchange of goods and services and current payments and to maintain and extend the liberalisation of capital movements*". In this spirit, the Code was designed to reflect members' search for a balanced and orderly process where liberalisation could be pursued in a safe manner, taking into account individual countries' specific needs and preferred pace of liberalisation.

8. Over time the Code has contributed to:

- entrenching the capital account opening process as undertakings by Adherents;
- pushing the opening process forward and consolidate it on a broad multilateral and non-discriminatory basis;
- guiding sequencing of liberalisation, thanks to the structure and tenets of the Code's obligations;
- providing a benchmark for regulation in this area, which has then served a reference for other treaties such as the Treaty on the Functioning of the European Union, whose provisions on capital movements have been inspired by the Code;

- providing a forum for discussion and exchange of information on country measures;
- establishing a peer-review mechanism in the context of a multilateral agreement, which has provided incentives for policy makers to undertake reforms and policy adjustments.

2. A ROBUST STANDARD OF LIBERALISATION

9. Under Article 1, members (Adherents to the Codes) "*shall progressively abolish between one another, in accordance with the provisions of Article 2, restrictions on movements of capital to the extent necessary for effective economic co-operation. Measures designed to eliminate such restrictions are hereinafter called measures of liberalisation*".

10. Article 2 establishes that: "*Members shall grant any authorisation required for the conclusion or execution of transactions and for transfers specified in an item set out in List A or List B of Annex A to this Code*" (see Background Note, Box 3).

2.1 Measures equivalent to restrictions

11. In the context of the 1992 review of the Codes which expanded the scope of the obligations substantially, members agreed that "*equivalent measures*" were to be covered. Thus, measures which create disincentives for operations covered by liberalisation lists A and B are considered as restrictions. Members also agreed that the Committee would be responsible for making the determination of whether a specific measure is to be considered an "*equivalent measures*" and thus deemed to be a restriction.

2.2 Internal arrangements

12. The liberalisation obligations under the Code apply to operations between residents and non-residents, internal arrangements do not normally have a bearing on Code's obligations. Such internal arrangements include for example domestic regulations concerning only residents or local licensing requirements applying to residents and non-residents in a non-discriminatory manner,

13. However, under Article 16 "*If a Member considers that the measures of liberalisation taken or maintained by another Member, in accordance with Article 2(a), are frustrated by internal arrangements likely to restrict the possibility of effecting transactions or transfers, and if it considers itself prejudiced by such arrangements, for instance because of their discriminatory effect, it may refer to the Organisation*".

3. A FLEXIBLE FRAMEWORK FOR COPING WITH CAPITAL FLOW VOLATILITY

3.1 Safeguards and policy space

14. Capital flows are an integral component of international finance. They allow for savings to be channelled from surplus countries to deficit countries, where returns to investment are typically higher. However, these flows can also pose important challenges to open economies. The Code contains flexibility mechanisms to cope with situations of economic and financial instability:

- Reservations and derogation allow countries to limit the scope of their liberalisation obligations and so maintain restrictions on operations which they are not in a position to liberalise at the time of adherence to the Code or they need to reintroduce after adherence.
- Certain operations are not covered in the liberalisation lists A and B of the Code: operations among residents are not covered, nor are financial credits and loans by non-residents to residents other than enterprises.
- Furthermore, Adherents have agreed to exclude certain types of measures from the scope of their Code obligations. Such understandings are formalised as decisions of the Investment Committee. For example, Adherents have agreed that rules on the net foreign exchange positions of banks are exempted from Code obligations.
- Other ways in which the Code's provisions protect countries' policy space are discussed in Box 2.

Box 2. The protection of countries' policy space

Besides the Code's provisions allowing for the reintroduction of restrictions on capital flows, the protection of countries' policy space in a range of other aspects is granted, for example, by:

- Article 3: it contains safeguard provisions relating in particular to public order and essential security interests deemed to address exceptional situations.
- Article 5: it affirms Adherents' rights to prevent fraud connected to transactions and transfers, to act against evasion of their laws and regulations.
- Liberalisation obligations under the liberalisation lists provide scope for prudential measures, for example for operations in securities (items IV, V, VI and VII of the Code). Adherents "*may require that transactions and transfers be carried out through authorised resident agents*;" and that "*residents may hold funds only through the intermediary of such agents*"; and that members may "*take measures for the protection of investors, including the regulation of promotional activities*".
- Regarding financial credits and loans, "*Members may regulate the net external positons of domestic financial institutions dealing in foreign exchange*".
- According to understandings reached among Adherents, Adherents "*would be free to regulate for prudential purposes the foreign exchange exposure of certain key institutions, such as banks, pension funds and life assurance companies*".

15. At present, putting aside reservations to reflect restrictions on FDI and portfolio investment abroad by pension funds and insurance companies which many Adherents have, four Adherents maintain reservations for some forms of CFMs, another is being invited by its peers to lodge a reservation, and one Adherent is under the derogation regime.

16. In the event of recourse to new restrictions on capital movements, countries have agreed under the Code to well-tested guiding principles such as transparency, non-discrimination, proportionality and accountability:

- Capital flow restrictions are measures that could best be considered when alternative policy responses are insufficient to effectively achieve the objective pursued.
- Their implementation needs to be transparent. Measures should be subject to accountability, including open for international discussion.

- Measures should not discriminate among investors from different countries, and avoid unnecessary damage, especially when they have a bearing on the interests of another country.
- The severity of restrictions should be proportional to the problem at hand, with measures disrupting business as little as possible and in particular minimising adverse impacts on operations such as FDI and commercial credits.
- Restrictions and corresponding reservations may be maintained for as long as needed, but should be removed once non-restrictive means become available to address legitimate policy concerns.
- Countries should be mindful of their rights and obligations under international agreements, including IMF's Articles of Agreement.

3.2 The Code's reservation system

17. Article 2 of the Codes protects the right of Adherents to reintroduce and maintain measures which limit liberalisation obligations. The way to do so is to lodge reservations with respect to operations which they are not in the position to liberalise, at the time of adherence, when obligations are added or expanded, and at any time when needed for List B operations.

18. When the Codes were amended in 1992 and during past adherences, countries lodged reservations for restrictions on capital movements which today would likely to be considered as CFMs taken with a macro-prudential intent.

19. By lodging reservations, adherents can maintain measures in force while still placing them under the disciplines of the Codes' provisions, both procedural (transparency and peer review) and substantive (granting of equal treatment to all adherent countries and commitment to standstill).

20. Reservations are to be reviewed with an aim "*making suitable proposal designed to assist Members to withdraw their reservations*". Restrictions and corresponding reservations may be maintained for as long as needed, but are expected to be removed once non-restrictive means become available to address legitimate policy concerns.

21. Restrictions on most short-term capital operations fall under Liberalisation List B (Box 3) and can be introduced at any time, even if no reservation had been initially lodged (the usual "standstill" rule does not apply). Restrictions can be re-imposed on other operations (List A) by invoking the Code's "derogation" clauses.

3.3 The derogation of Code's obligations

22. For measures with a bearing on List A operations, for which standstill applies, restrictions can be imposed by invoking the Code's derogation clause under Article 7, which is allowed:

- if an adherent's "*economic and financial situation justifies such a course*", as per Article 7(a); or
- in case of "*serious economic and financial disturbance*", as per Article 7(b); or
- if the "*overall balance of payments of a Member develops adversely at a rate and in circumstances, including the state of its monetary reserves, which it considers serious*", as per Article 7(c).

23. Derogations for balance-of-payments reasons (Article 7(c)) have time limits, but not for "*serious economic and financial disturbance*" (Article 7(b)), nor if an Adherents' "*economic and financial situation justifies*" (Article 7(a)).

Box 3. Operations covered by liberalisation lists A and B of the Code

LIST A "Standstill" applies to these operations (i.e. derogation needed to reintroduce restrictions)	LIST B No "standstill" applies to these operations
I. Direct investment	
II. Liquidation of direct investment	
III. Real estate – Sale	**III. Real estate – Purchase**
IV. Operations in securities on capital markets	**V. Operations on money markets**
VII. Collective investment securities	**VI. Negotiable instruments and non-securitised claims**
VIII. Credits directly linked with international commercial transactions or rendering of international services In cases where a resident participates in the underlying commercial or service transaction	**VIII. Credits directly linked with international commercial transactions or rendering of international services** In cases where no resident participates in the underlying commercial or service transaction
	IX. Financial credits and loans
X. Sureties, guarantees and financial back-up facilities (see List B)	**X. Financial back-up facilities** in cases not directly related to international trade, international current invisible operations or international capital movement operations, or where no resident participates in the underlying international operation concerned
XI. Operation of deposit accounts by non-residents of accounts with resident institutions	**XI. Operation of deposit accounts** by residents of accounts with non-resident institutions
XIII. Life assurance	**XII. Operations in foreign exchange**
XIV. Personal capital movements Except Gaming	**XIV. Personal capital movements** Gaming
XV. Physical movement of capital assets	
XVI. Disposal of non-resident-owned blocked funds	

24. The resort to derogation for balance of payments (Article 7(c)) and for economic and financial disturbance (Article 7(b)) is well tested for cases of temporary departures from standstill obligations[9], and there is precedent for long-lasting derogations justified under the "*economic and financial situation*" clause (Article 7(a)) for countries in process of development. However, the use of Article 7 to introduce preventive measures to deal with capital inflow surges that may threaten stability, or to cover a measure introduced for an indeterminate time period and intended as a permanent feature of the financial regulatory regime, are not tested practices that are supported by precedent.

3.4 Macro-prudential measures generally fall outside the scope of the Code

25. The vast majority of macro-prudential measures *(*MPMs) simply fall outside the scope of the Code, even those that may have an incidence on capital flows. For a measure to have a bearing on the Code's obligations, it does not suffice that it have an impact on capital flows or capital mobility; measures which do not target the specific operations covered by the Code –by either prohibiting such operations or creating disincentives for their conclusion- fall outside of the scope of the agreement. MPMs such as Basle minimum capital requirements for internationally active banks impinge on all bank operations, do not create impediments or specific disincentives for operations listed under the Code, are typically not capital flow measures and have no bearing on Code obligations of Adherents. They are rather set regulatory requirements to manage the risk of operations for the bank's capital.

26. Operations among residents also fall outside the scope of the Code, as they are not covered by liberalisation obligations under lists A and B. Thus a CFMs targeting such operations, e.g. a prohibition for established banks to lend in foreign currency, falls outside the scope of the Code. Such internal measures can have an impact on capital flows but have no bearing on Code obligations.[10] In contrast, the IMF's approach may cover such measures, as they may be tools used to manage capital flows or to minimize banking sector fragilities. This is an example of the distinct and complementary approaches of the IMF and OECD, pursuant to their respective mandates.

27. Some MPMs, including in particular some which are CFMs, would be considered conforming measures from the viewpoint of the Code. These are measures which limit, create impediments or disincentives for the conclusion of a listed operation but that are not covered by liberalisation obligations under lists A and B. These measures are conforming due to carve-outs in text of the Code, or as a result of explicit understandings reached among Adherents, notably measures commonly used by Adherents to address prudential issues. An example such a carve-out in the text of the Code is to allow for resident agent rules for transactions and transfers under various Code items. Rules for the net foreign exchange position of banks are carved-out by an understanding among Adherents.

28. Finally, some CFMs do fall in the category of restrictive measures which impede or create disincentives for the conclusion of operations covered by liberalisation lists A or B. Such measures may be maintained by members which have limited the scope of their commitments under the agreement by lodging of reservations or by invocation of derogation. An Adherent may still be in conformity with the Code, provided that the Adherent in question respects the procedural requirements.

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9 These clauses have been used 30 times since 1961.

10 Except to the extent that such internal measures can be shown to frustrate liberalisation commitments, see section 2.2.

29. In sum, the vast majority of MPMs fall outside the scope of obligations, while many CFMs that are MPMs are conforming measures. Even for those which are not, Adherents which maintain measures constituting restrictions can always avail themselves of the reservation and derogation facilities. While reservations and derogations cannot be made with respect to the basic principles of the Code, as set out in its Articles, this is unlikely to impose any constraint on the introduction of prudential regulations.[11]

Furthermore, there is scope for narrowing the scope of the Code to accommodate the need to regulate: this has been done by explicit specific carve-outs in the text of the Code, or by limiting the scope of further understandings reached among Adherents that are formalised in decisions of the Investment Committee. This practice has been used for internationally agreed regulatory standards and provides a mechanism to avoid creating conflicting requirements for countries that have obligations under the Codes and are also committed to internationally agreed minimum standards for financial regulation.

4. OBLIGATIONS FOR OPERATIONS IN FOREIGN CURRENCY AND USE OF FOREIGN CURRENCY

30. The Code covers only operations between residents and non-residents. A key test is non-discrimination, but the Code also includes other specific liberalisation commitments.

31. Under Article 2 "*[W]henever existing regulation or international agreements permit loans between different Members […] the repayment obligation may be expressed or guaranteed in the currency of either of the two Members concerned*".

32. Furthermore, under item XII of Liberalisation List B, members –subject to reservation (see section 3.1) which they may have lodged– commit to permit their residents to freely buy and sell domestic currency for foreign currency and to exchange currencies, by means of spot or derivative transaction, when the operation takes place abroad.

33. The 1992 review of the Codes obligations led to enlarged obligations on use of foreign currency in denomination and settlement. At that time, members agreed on the following, as reported in Council document C(92)4:

> "*{3. Use of foreign currency in denomination and settlement}*
>
> *35. One of the innovations of the Revised Code is to provide that all the operations are to be liberalised regardless of the currency in which they are denominated or settled. This includes currency composite units of account such as the ECU and the SDR.*

11 For example, a measure is not conforming under the Code if it violates the MFN principle under Article 9 of the Code; this discipline of the Code is unlikely to be an impediment to the implementation of needed financial regulations. The obligation under Art 2(d) to allow loans between residents of two adhering countries to be "*expressed or guaranteed*" in the currency of either country, where such loans are allowed, can be seen to be in the nature of a commitment to avoid conflicting requirements that would frustrate a liberalisation measures, rather than a commitment to liberalisation in itself.

36. In the sense of the Codes, the Committee took this to imply that non-residents in dealing with residents on the territory of residents should have access to the same facilities and can use the same foreign currencies that residents are permitted to use for domestic operations.

37. Similarly, residents should be permitted to use, in respect of operations abroad in another OECD Member country, any currency that may be used in the Member country concerned for the transactions in question.

38. Where operations have no natural domestic counterpart (e.g. Sections VIII to XII of the Revised Code), Members should be able to use any foreign currency for the denomination or settlement of those operations".

5. SOME ILLUSTRATIVE EXAMPLES OF CFMs USED WITH MACRO-PRUDENTIAL INTENT AND THEIR TREATMENT UNDER THE CODE

34. This section analyses two illustrative examples of CFMs discriminating on the basis of currency that have been used by national authorities to mitigate capital flow volatility with a declared macro-prudential intent:

- Price-based charges, such as a levy applied to banks' FX non-core liabilities with a maturity of less than one year.
- Quantity-based limits, such as a leverage cap on banks' FX derivatives positions.

35. The resort to use of CFMs discriminating on the basis of currency has been more frequent in the post-crisis period. These measures may help address balance sheet exposures that operations in foreign exchange (FX) may create for banks, leading to greater systemic risk. As is the case for all CFMs, currency-based measures can equally support the attainment of exchange rate or other external balance objectives of the country.

5.1 Levy on FX non-core liabilities: the functioning of the measure

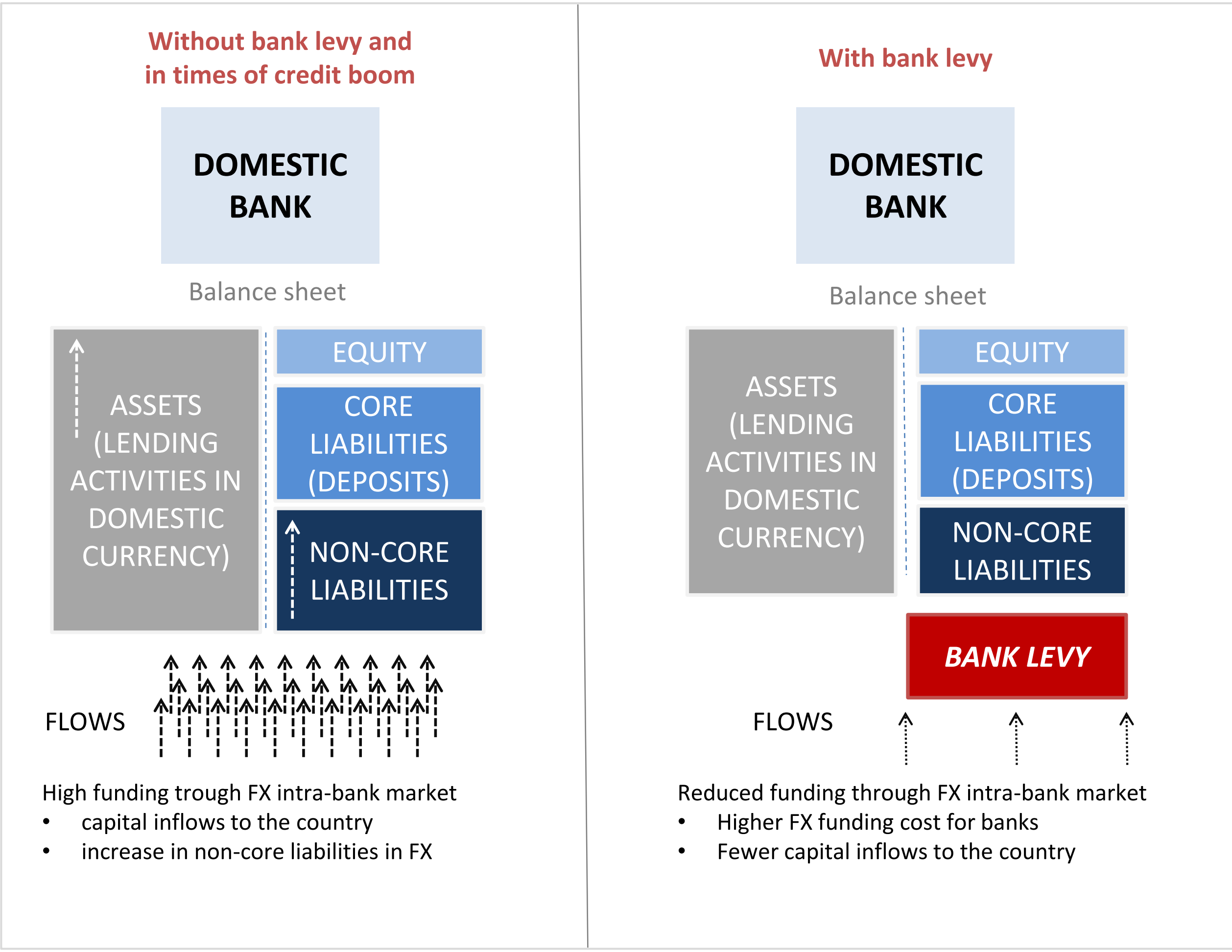
36. A levy on banks' FX non-core liabilities introduces a disincentive for banks to use sources of funding that are seen as unstable and create greater systemic risk, as the central bank is unable to act as lender of last resort in foreign currency. More stable core liabilities, such as deposit funding from residents, are not taxed. Non-core liabilities include wholesale funding such as i) inter-bank liabilities (mostly vis-a-vis international banks), or ii) bond funding by issuance on international markets. A higher levy on shorter maturities can induce a shift in the maturity composition of banks' FX funding.

37. The levy, or tax, can mitigate banks' balance sheet vulnerabilities during capital inflows surges as banks would use less non-core funding to support an increase in their lending activities (Figure 1) and the banking system would be less exposed to a reversal in capital flows that could otherwise put pressure simultaneously on the exchange rate and on banks' balance sheets.

38. In countries where banks face limitations to borrow in their domestic currency on international markets - as there is no ready market for operations in the domestic currency outside of the country concerned, a levy on banks' FX liabilities has a similar effect as a tax on foreign liabilities and could be used to attain external balance objectives.

39. To summarise, the bank levy can limit the role of domestic banks in the intermediation of external financing therefore constitutes a CFM. As the measure is also intended to reduce systemic vulnerabilities in banks' balance sheet, it is a CFM that can be used with a macro-prudential intent.

Figure 1. The functioning of the bank levy on non-core liabilities



5.2 Leverage cap on banks' FX derivatives positions: the functioning of the measure

40. A leverage cap on banks' FX derivative positions as a percentage of a bank's equity limits the extent to which banks may sell FX hedges to customers, typically domestic corporates.[12] Once the cap is reached, there is an additional cost for banks of entering in additional FX derivative contracts, as an increase in the FX derivative positions would require additional capital. As banks are also subject to limits on their net FX positions, banks must square their overall borrowing and lending in FX with their FX position in derivatives. As long as the cap is not binding, the net long position in FX derivatives can be used to balance net FX borrowing and square the overall FX position of the bank. However, once the leverage cap is reached, it in effect restrains FX borrowing by banks.[13]

12 A banks' FX derivative position may include FX forward contracts, FX swaps, cross-currency interest rate swaps, etc.

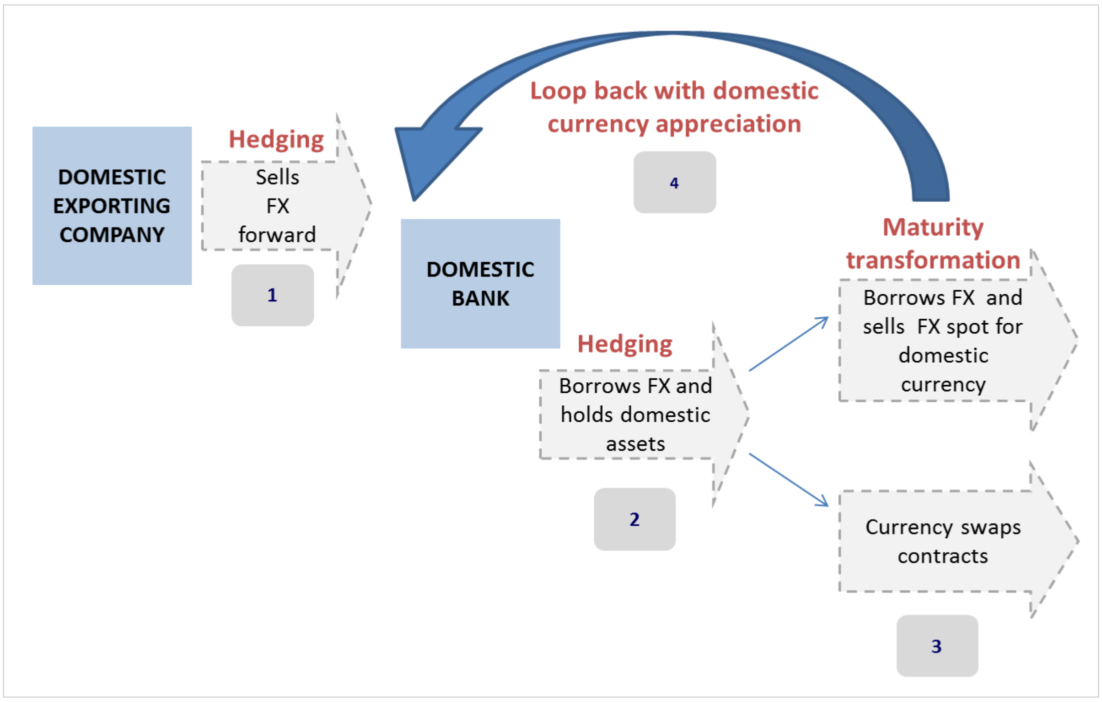
13 Leverage caps can be used as a measure to close loop-holes; for example to ensure enforcement of primary measures limiting FX lending by domestic banks to resident corporations. Corporates may wish to borrow in FX to hedge export earnings. Where such lending is permitted, domestic banks have an alternative way by which they can offer FX hedges for export receipts to their customers.

41. Leverage caps on banks derivative positions can be useful to limit the potential maturity mismatch of FX assets and liabilities that banks may face as a result of the following chain of transactions: corporate domestic non-financial exporting corporates (e.g. manufacturers, shipbuilders, construction companies), seek to sell FX forward to banks in the expectation of exchange rate appreciation in order to hedge against receivables in FX from future sales; banks seek to hedge the currency risk arising from the resulting long forward position in FX by borrowing short-term in FX. As a result of these transactions, banks face a maturity mismatch to the extent that they borrow short-term in FX in the international inter-bank market, while their currency derivative contracts for delivery of FX to domestic corporates are longer term.

42. In times of stress banks' access to short-term FX funding in international markets may be curtailed, generating simultaneous pressure for exchange rate depreciation and on banks' balance sheet positions.

43. The short-term FX borrowing in international markets conducted by the banks, to square the FX derivatives offered to corporates, creates pressures for the appreciation of the domestic currency as banks sell USD to purchase domestic currency in the spot market. As the measure limits the extent to which banks may engage in this chain of transactions, they limit the market pressure on the spot rate to appreciate (Figures 2 and 3).

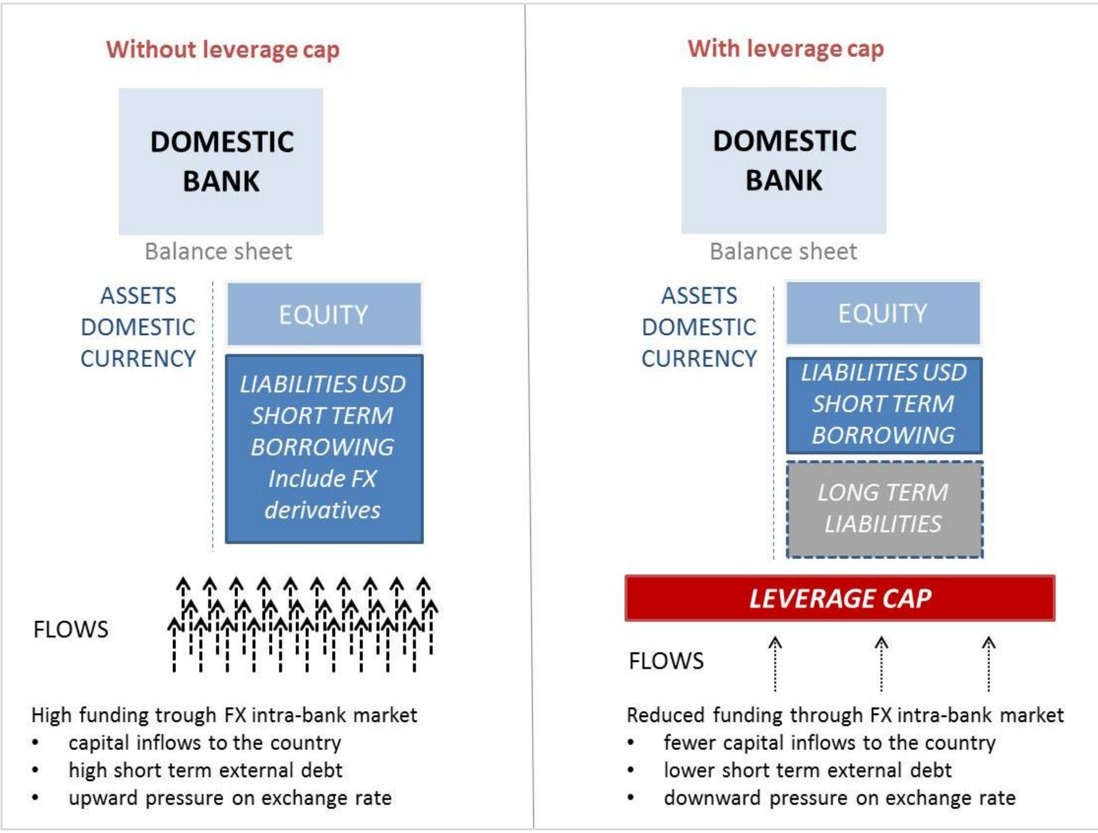
Figure 2. The build-up of short term liabilities in foreign currency by banks



44. To summarise, the leverage cap manages capital flows, and in particular cross-border flows to banks, with also the macro prudential intent of mitigating banks' FX funding risk associated with the build-up of FX short term liabilities and affecting banks' use of external debt.

45. The leverage cap, by influencing FX borrowing by banks, can also be used to attain exchange rate or other external balance objectives.

Figure 3. The functioning of the leverage cap on banks' FX derivatives positions



5.3 The Code's approach on the assessment of these two illustrative examples

46. The levy on FX non-core liabilities has a bearing on Code's obligations to the extent that it interferes with the freedom to use foreign currency in denomination and settlement of listed operations between residents and non-residents.

47. The levy on non-core liabilities with a maturity of less than one year has a bearing on items V "Operations on Money Markets", VI "Other Operations in Negotiable Instruments and Non-Securitised Claims", IX "Financial Credits and Loans", X "Sureties, Guarantees and Financial Back-up Facilities" which are List B operations. The country concerned could lodge a reservation.

48. If the levy was to apply on liabilities with a maturity of more than one year, it would have a bearing on items IV "Operations in Securities on Capital Markets" and potentially on X "Sureties, Guarantees and Financial Back-up Facilities" which are List A operations and for which "standstill" applies. The country concerned could invoke a derogation clause under Article 7.

49. The leverage cap, to the extent that it applies to operations by residents abroad, has a bearing on liberalisation commitments under item XII/B of the Code, calling for freedom by residents to buy and sell FX (spot and forward) when abroad. To the extent that the leverage cap would target only operations among residents, it would constitute an internal measure and thus fall outside of the scope of the Code, except to the extent that such an internal measure would be seen as frustrating liberalisation commitments (Annex 2).

50. The leverage cap on FX derivative positions has a bearing on item XII "Operations in Foreign Exchange", which is a List B operation, and the country concerned could lodge a reservation.

51. The examples show that the Code's approach would not prevent countries from taking measures that they feel necessary for financial stability and indeed may be fully justified from a national standpoint, but rather would encourage them to follow due process when they introduce these measures, in the collective interest for transparency and accountability.

6. DIALOGUE AND CONSIDERATION OF THE CONSEQUENCES FOR THE INTERNATIONAL FINANCIAL SYSTEM

52. The ongoing dialogue on CMFs with a macro-prudential intent is particularly relevant in a context of multilateral co-operation since these measures can have unintended spillover effects and implications on other Adherents and on the international financial system. For example:

- Which would be the consequences on the overall system if many or very large economies were to all introduce restrictions on banks' FX liabilities and FX derivative trading?
- What would happen to liquidity in FX trading in global markets if many or very large economies were to introduce the restrictions on banks' FX derivative trading?
- What consequences of the restrictions if generalised for the role of banks in international borrowing and lending?
- Who will intermediate FX flows over borders if local banks can only borrow and lend in local currency?

53. As an agreement of co-operation, the Code is about finding the right balance between an Adherent's individual interest and the collective interest in an open, functioning global financial system. In the past, most capital flow measures by OECD members were in the direction of progressive liberalisation, and national interest and collective interest naturally coincided. Today, this reconciliation between the two is made more difficult by financial innovations, new international tensions on exchange rates, shifts in wealth between advanced and emerging economies, and a proliferation of individual financial regulatory initiatives in response to the 2008 global crisis.

7. FURTHER WORK

54. There are also areas of improvement calling for an update of the Code to confirm its role as a living agreement for international co-operation in the current financial environment. Adherents to the Codes are currently reflecting on the possible terms of reference for an update of the Code. Reflections are already active among Adherents in relation to the interpretation of some existing understandings. Building on existing discussions, the Secretariat considers that such terms of reference could include *inter alia* the following elements:

7.1 Clarify the scope of the Code regarding some specific "grey" areas and new financial market instruments

55. The illustrative examples presented in this Background Note fall under the Code. Nevertheless there are a number of "grey" measures[14]. Second, some financial innovations such as Credit Default Swaps (CDSs) did not exist when the Code was extended to cover all financial operations in 1992 and need also to be looked at from the perspective of ascertaining the scope of the Code. Third, more generic criteria could be provided to support Adherents' assessment of whether a specific measure is to be considered a measure "equivalent" to restrictions and thus deemed to be a restriction falling under the Code (Annex 3); for instance impact assessments conducted by the Secretariat for recent measures having a bearing on the Code could become a more systematic practice.

7.2 Examine the asymmetry regarding standstill for inflow and outflow operations in some specific areas

56. The Code's List B covers capital inflows and capital outflows generally in a symmetrical manner. However, this is not the case for commercial credits granted by non-residents to residents and the operation by non-residents of deposit accounts with resident financial institutions which are in List A operations subject to standstill while their capital outflow counterparts are in List B. This asymmetry between List A and List B is in part the legacy of past times when less developed countries were mainly concerned with protecting scare domestic saving from threat of capital flight, and could be examined and, if needed, reconsidered[15].

57. Also, avoiding reservations that are unduly constraining by locking-in specific coefficients used at a given point in time for a CFM with a macro-prudential intent has been an *ad hoc* practice and can be made a conventional practice, subject to safeguards to be devised.

7.3 Improve implementation and review mechanisms

58. The Code process relies on peer pressure for enforcement. For the process to be effective, its governing bodies need to have effective mechanisms for review and for decision making that best fit present day needs. To improve transparency of decision making and strengthen implementation, publication of Investment Committee reports and recommendations on Adherents' positions under the Code could be made the rule. So far publication has been on a case by case basis.

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[14] Measure 6 in Table 1 of the OECD Report may be in that category. While banks' reserve requirements generally speaking fall outside the scope of the Code, the Investment Committee is currently considering interpretations on reserve requirements that specifically target banks' operations with non-residents or in foreign exchange.

[15] The symmetry could be re-established by moving non-residents' deposit accounts to List B, while reclassifying commercial credits by residents in the List A category which would subject these operations to "standstill".

www.oecd.org/investment/codes.htm