# The Review of the OECD Code of Liberalisation of Capital Movements

## The Revised Code and User's Guide

## OECD Report to G20 Finance Ministers and Central Bank Governors

June 2019

OECD

**This report responds to a request by the G20 Finance Ministers and Central Bank Governors for the OECD to present the outcomes of the review of the OECD's Capital Movements Code, launched in 2016.**

## THE CAPITAL MOVEMENTS CODE AND ITS REVIEW

Since its inception in 1961, the Code of Liberalisation of Capital Movements (hereafter referred to as "Capital Movements Code") remains to date the sole multilateral agreement among State parties dedicated to openness and transparency in cross-border capital flow policies.

The Capital Movements Code has served as a platform to get international recognition for reform efforts, compare progress, and exchange good practices among Adherents in their path toward open and orderly capital account movements. It has served as an anchor for countries' policies in times of financial turmoil, by providing a due process - transparency and accountability – to observe when Adherents reintroduce capital flow restrictions while wishing to signal their continued commitment to openness.

The global financial and economic crisis of 2008 left the international monetary system with vulnerabilities caused by volatile capital flows and the spill-over effects from diverging national policies. The policy environment around capital flows thus moved multilateral co-operation, openness and transparency to the top of the policy agenda, and important momentum built up for a review of the Code to verify and ensure its continued relevance.

Recent experience with the use of capital flow management measures, in particular the increased use of currency-based measures, has prompted renewed debate on their effectiveness to address financial sector vulnerabilities and their implications for longer-term prosperity. Recognising the need to advance consensus on the desirable features of a multilateral regime for cross-border capital movements, the G20 welcomed the review of the Capital Movements Code in its 2017 Hamburg Action Plan.

The review was conducted over the last three years (2016-19), with the support of the Advisory Task Force on the Codes (ATFC), an OECD platform that includes OECD and non-OECD countries. In line with the G20 call for non-adhering G20 countries to participate in the review (G20 Hamburg Action Plan), almost all the G20 countries contributed to the ATFC work on the Code Review, and the G20 was regularly de-briefed on the state of the review discussion. The results of the review, as briefly described below and in more detail in the Annex, are reflected in changes to the Code itself (in the governance area) as well as in modifications to the User's Guide that serves as an important complement to the Code.

The thirty-six OECD Members have adhered to the Capital Movements Code. Since 2012, the Capital Movements Code (as well as the Code of Liberalisation of Current Invisible Operations) is also open to adherence by non-OECD countries. Following the G20 call for non-

adhering countries to consider adhering to the Code, taking into consideration country-specific circumstances, several non-OECD G20 members have started their adherence processes.

## KEY OUTCOMES OF THE REVIEW

The review amends the Code and/or User's Guide in the following key areas[1]:

### I) Treatment of measures taken with a macro-prudential intent

Following the 2008 financial crisis, many countries have introduced policies designed to reduce systemic risks, often referred to as macro-prudential policies. For the most part, such policies have no bearing on the Capital Movements Code as they are not discriminatory, either by the residency of the parties to the transaction or by the currency in which the transaction is conducted. Some of the measures taken by countries do however discriminate by currency. Typically, such currency-based measures treat transactions in foreign currency less favourably than transactions in local currency. In such cases, they may have a bearing on the Capital Movements Code. A substantial part of the discussions of the review served to clarify or develop new understandings on the treatment under the Capital Movements Code of these different types of measures.

The main outcomes in this area include the following:

- New introduction to the treatment of macro-prudential measures under the Code.
- New understanding on the treatment of measures on foreign currency liabilities.
- New understanding on the treatment of liquidity ratios that are differentiated by currency (Basel III).
- Clarification of the existing understanding on limits to the net foreign exchange positions of financial institutions.
- Clarification of the treatment of measures taken by a country in the context of a reciprocation agreement with another country for macro-prudential tools.
- Flexibility provided by the Code in an environment of capital inflows surges: further guidance on the invocation of derogations in the context of capital inflow surges.

[1] More detailed explanations can be found in the Annex to this report. Where this report refers to Codes (plural), the descriptions refer to both the Code of Liberalisation of Capital Movements (Capital Movements Code) and the Code of Liberalisation of Current Invisibles Operations (Current Invisibles Code).

### II) Improvement of the assessment process

The terms of reference for the review stated that improved effectiveness of the instrument could be achieved along two lines: (i) by improving the effectiveness of the assessment of measures; and (ii) by improving transparency and review mechanisms. Delegates voiced a strong interest in the process and governance of the Codes, in particular to develop a clear structure for the assessment of measures under the Codes and to improve transparency and review mechanisms under the Codes. The main outcomes of the review include the following:

- Clarification of the criteria and process for the conformity assessment of measures,
- Strengthening of OECD Secretariat's monitoring role of country measures,
- Reaffirmation and strengthening of the notification procedure for new measures through clearer deadlines, and
- Prompt declassification of the reports on assessment of measures, subject to safeguards.

### III) Closer co-operation with other International Organisations (IOs)

Third, the review considered the possibility of leveraging the expertise of other relevant IOs by formalising their role and allowing the bodies in charge of the Codes to consult with them at any moment or in the course of reviews of specific measures. The main outcomes in this area are an explicit provision for the possible consultation of other IOs by the ATFC and/or the Investment Committee (the two bodies in charge of the Codes), and the possibility to request the International Monetary Fund (IMF) to give its views on issues related to balance of payments and the state of the international reserves of an Adherent.

### IV) More effective decision making

Finally, the decision-making rules for certain decisions were strengthened, so that in certain specific cases of assessments of country-specific measures, the country whose measures are being assessed, may not block the Investment Committee from reaching a conclusion on whether a country's measure is conforming or not.

## BEYOND THE REVIEW

Following the successful review, the updated Capital Movements Code provides a unique platform to get international recognition for reform efforts, compare progress, and exchange good practices, on the move towards open and orderly capital movements. It will be more effective as a "conflict avoidance" device and as an anchor for countries' policies in times of financial turmoil, by providing strengthened due process – transparency and peer review –

to observe when countries reintroduce capital flow restrictions while wishing to signal their continued commitment to openness.

To chart the way forward, the OECD, together with Japan's G20 Presidency, will host a high-level seminar on "Integration or Fragmentation? International Capital Flows in the Post-Crisis World", to be held on 11 September 2019 at the OECD headquarters in Paris. The seminar will focus on issues such as challenges to integration, including market fragmentation, financial fragilities stemming from capital flows and spill-overs, the path towards capital account openness for emerging market economies and policy challenges such as the migration of risks to unregulated areas of the financial system. An invitation has been issued to all G20 members.

# ANNEX: SUMMARY OF CHANGES TO THE CAPITAL MOVEMENTS CODE AND USER'S GUIDE

## A CODE MORE IN LINE WITH CURRENT CHALLENGES

### The treatment of measures with stated prudential intent under the Capital Movements Code

In recent years, many countries have introduced macro-prudential policies. Whereas such policies rarely have a bearing on the Capital Movements Code, there can be cases where such measure discriminate by residency and/or by currency and thus may have a bearing on the Code. A substantial part of the discussions of the review served to clarify or develop new understandings on the treatment under the Capital Movements Code of these different types of measures.

The main outcomes of these discussions include the following:

i) New introduction to the treatment of macro-prudential measures under the Code.

ii) New understanding on the treatment of measures on foreign currency liabilities.

iii) New understanding on the treatment of liquidity ratios that are differentiated by currency (Basel III).

iv) Clarification of the existing understanding on limits to the net foreign exchange positions of financial institutions.

v) Clarification of the treatment of measures taken by a country in the context of a reciprocation agreement with another country for macro-prudential tools.

#### *i) New introduction to the treatment of macro-prudential measures under the Code*

In line with the terms of reference of the review, a large part of the discussions was dedicated to possible financial stability risks arising from free capital flows, and the financial stability toolkit available to address such risks. Therefore, several meetings of the Advisory Task Force on the OECD Codes (ATFC) focused on the treatment of different types of macro-prudential measures.

Considering the importance of this issue following the global financial crisis, as well as in the current macroeconomic environment, the delegations agreed on a general introduction that helps to clarify the treatment of macro-prudential tools under the Capital Movements Code and is included in the revised User's Guide.

#### *ii) New understanding on the treatment of measures on foreign currency liabilities*

An excessive dependence of certain financial institutions, especially banks, on short-term foreign currency liabilities has been a recurrent problem for many countries, in particular for emerging markets, and countries have taken a variety of measures to address this issue.

The ATFC discussed a number of these measures (e.g. reserve requirements, liquidity ratios, levies) and their treatment under the Capital Movements Code, notably in cases where the measures differentiate by currency. In light of the prudential importance of such measures, as well as their potential negative impact on capital flows, delegations agreed that non-residency based restrictions on financial institutions' foreign currency liabilities be assessed on a case-by-case basis. Such restrictions include measures based on the remaining maturity of bonds or other debt securities, as well as reserve requirements.

- *Minimum reserve requirements and reserve requirements differentiated by residency*

While traditional minimum reserve requirements imposed on financial institutions by central banks are covered by a 1992 understanding not giving rise to any reservations under the Capital Movements Code, reserve requirements that are higher for non-resident liabilities than liabilities to residents have been treated as restrictions under the Capital Movements Code. On several occasions, it was concluded that for such measures, appropriate reservations under the Capital Movements Code need to be lodged, or the derogation clause invoked in case the reserve requirements impact operations subject to standstill ("List A"). Accordingly, residency-based reserve requirements continue being covered by the Capital Movements Code.

- *Reserve requirements differentiated by currency*

The ATFC developed further analysis on the current use, motivations, and criteria for analysis of currency-differentiated reserve requirements. Reserve requirements differentiated by currency were typically introduced with a prudential intent, aimed at discouraging the use of foreign currencies in the economy, fighting dollarisation, or reducing currency risk in bank balance sheets.

Differentiation by currency may, however, act as a disincentive to conduct an operation covered by the Capital Movements Code insofar as cross border capital movements are usually denominated in foreign currency.

In light of these discussions, delegations agreed that these measures should be analysed on a case-by-case basis.

- *Non-residency based measures targeting the remaining vs. original maturity of the operation*

The ATFC also discussed the relevance for financial stability of remaining maturity, as opposed to original maturity, as a potential target of prudential measures and the treatment of such measures under the Capital Movements Code.

Delegations agreed that a case-by-case analysis is also warranted for non-residency based measures targeting the remaining maturity of bonds or other debt securities.

***iii) New understanding on the treatment of liquidity ratios that are differentiated by currency (Basel III)***

The ATFC recognised that large gross foreign exchange positions could expose banks to risks, even if netted or hedged, in particular where these positions are short term or there is a difference in maturity between foreign currency assets and liabilities. Such liquidity risks can be addressed with adequate tools, specifically targeted at foreign exchange operations.

The international regulatory standard in this area ("Basel III") outlines a Liquidity Coverage Ratio (LCR) and a Net Stable Funding Ratio (NSFR), as the recognised tools to address liquidity risk. An increasing number of countries subsequently adopted national adaptations of these ratios, including adaptations that discriminate between foreign and local currency. This has raised the question of the treatment of such measures under the Capital Movements Code.

Delegations agreed that the various national applications by currency of the LCR and NSFR, even where they go beyond the Basel III minimum standard, should not be considered capital flow restrictions, and should not give rise to reservations.

As with other Understandings, the Understanding that such liquidity ratios should not be considered restrictions under the Capital Movements Code does not prevent these measures from being reviewed, e.g. in case of excessive calibration, as per the provisions of the revised Article 16.

***iv) Clarification of the existing understanding on limits to the net foreign exchange positions of financial institutions***

Under the Capital Movements Code, Adherents may regulate the net external positions of domestic financial institutions dealing in foreign exchange. On several occasions in the past, the ATFC interpreted this provision as exempting limits on the overall net open foreign exchange positions of banks from the Capital Movements Code, since such limits were widespread among Adherents and were endorsed at the global level by the Basel Committee on Banking Supervision.

To avoid any future interpretation problems, delegates agreed to clarify the wording in light of past interpretations i.e. explicitly exempting from the scope of the Code limits on the "overall net foreign exchange position", as defined by the Basel Committee.

***v) Clarification of the treatment of measures taken by a country in the context of a reciprocation agreement with another country for macro-prudential tools***

Certain macro-prudential measures, notably those directed at the prevention of over-lending and the development of asset price bubbles, may only apply to domestic financial institutions. Such measures may, however, become ineffective, if they can be avoided by borrowing cross-border from banks in other countries, or from branches of foreign banks in the country.

Countries have started to address this problem through agreements with the home countries of such foreign lenders, where the home country agrees to apply the same macro-prudential measure set by the host country to its own institutions (for lending to host country borrowers).

While these measures may concern operations covered by the Capital Movements Code, there was broad agreement that reciprocation arrangements for macro-prudential measures are agreements among countries that fall outside the scope of the Capital Movements Code.

As with other Understandings, the Understanding that such arrangements should not be considered restrictions under the Capital Movements Code does not prevent these measures from being brought to the Committee for review in case of a potential impact on third countries, as per the provisions of the revised Article 16.

## The flexibility provided by the Code in cases of capital inflows surges

In the context of examining the flexibility mechanisms of the Code, the ATFC also reviewed the use of the derogation clauses in Article 7. The derogation clauses allow a country, in exceptional situations, to temporarily re-impose restrictions it had already abolished. In recent times, derogations were invoked most frequently in connection with a "serious economic and financial disturbance" (Article 7b of the Code).

The ATFC noted that while the derogation clause had mainly been used in cases of crises associated with capital outflows, there have also been past cases (the most recent one in 1992) where the derogation clause of Article 7b was invoked in an environment of capital inflows. As strong capital inflows became a renewed concern for a number of countries following the 2008 financial crisis, the discussion focused on the use of the derogation in the context of capital inflow surges.

### *Further guidance on the invocation of derogations in the context of capital inflow surges*

The ATFC discussed a note outlining possible quantitative measures of the occurrence of capital inflow surges.

Without prejudice to the use of other measures by the Committee, the ATFC suggested that quantitative measures could serve as part of the evidence presented to the Committee when a derogation is invoked. A quantitative framework to provide evidence of a capital inflows surge can increase clarity and transparency surrounding the invocation of Article 7b.

At the same time, the ATFC considered that the quantitative framework to measure capital inflows and identify surges should be seen in connection with the ability of the economy to absorb these surges, and in the context of viable alternative policies. It also noted that at no point in the history of the Code has evidence of a capital inflow surge alone been a reason for invoking a derogation.

## MORE EFFICIENT AND TRANSPARENT CODES

In order to make the Codes more efficient and transparent, the review focused on improving the effectiveness of the assessment of measures and on improving transparency and review mechanisms. A significant part of the review discussions was dedicated to the process and governance of the Codes, including the development of a clear structure for the assessment of measures under the Codes

The main outcomes of these discussions include the following:

i) Clarification of the criteria and process for the conformity assessment of measures.

ii) Strengthening of the possibility to refer measures to the Organisation.

iii) Reaffirmation and strengthening of the notification procedure for new measures through clearer deadlines.

iv) Prompt declassification of the reports on assessment of measures, subject to safeguards.

### *i) Clarification of the criteria and process for the conformity assessment of measures*

Article 11 of the Codes details the general notification requirement by Adherents of newly introduced measures that may have a bearing under the Codes. The Committee then undertakes an examination of the measure in view of determining whether the measure constitutes a restriction in the meaning of the Codes.

Delegations agreed that a clarification on the various tests and criteria used to determine the conformity of a measure under the Codes would be beneficial. Therefore, a list of clear-cut questions, describing the examination procedure in case of newly introduced measures, is now included in the User's Guide under Article 12, Section B. In addition, a flow chart in Appendix 3 to the User's Guide now illustrates the process for the assessment of measures under the Codes.

### *ii) Strengthening of the possibility to refer measures to the Organisation*

The ATFC further discussed the mechanism embedded in Article 16 whereby an Adherent can bring to the attention of the Committee non-discriminatory domestic-regulation measures ("internal arrangements") introduced by another Adherent, where such internal arrangements are likely to restrict the possibility of effecting transactions or transfers, and if the Adherent considers itself prejudiced by such arrangements.

Delegations recognised that in practice Adherents might be reluctant to use this possibility, as this process may create bilateral issues. Therefore, the delegations considered that granting to the Secretariat a similar possibility to bring measures to the attention of the Committee would reinforce and complement this mechanism. In practice, the Secretariat has been doing this for many years and Adherents have appreciated this approach.

Delegations pointed to the usefulness of such strengthened mechanisms particularly in the context of the discussion on the treatment of macro-prudential measures. It was recognised that internal arrangements, e.g. extreme calibration of certain macro-prudential measures, may still lead to disincentives to operations covered by the Codes, and that therefore, even if an understanding exists that particular measures should not be considered restrictions, it was important to have a well-functioning mechanism for bringing such measures to the Committee for review where necessary.

***iii) Reaffirmation and strengthening of the notification procedure for new measures through clearer deadlines***

In order for the Investment Committee to fulfil its monitoring role, it is essential that relevant measures, whether newly implemented or modified, are notified to the Organisation in a timely manner. The ATFC thus reiterated the importance for Adherents to follow the existing procedure of notification of measures.

Delegations proposed to maintain the rule currently stated in explanations to Article 12 of the User's Guide, according to which "*Members are required to notify the Organisation within 60 days of all measures having a bearing on the Codes, as well as of any modification to such measures.*"

Additionally, delegations stressed the need to enforce this rule, and therefore proposed to clarify that notification of measures must be made within 60 days of their implementation.

***iv) Prompt declassification of the reports on assessment of measures, subject to safeguards***

Another tool for strengthening the assessment process that found broad support was a gradual move toward more transparency, whereby final reports by the Committee and recommendations on Adherents' positions under the Codes would, as a rule, be made promptly available to the public, unless the Member explicitly objects and in duly justified cases.

In order to increase transparency, instead of awaiting three years after publication for automatic declassification of official documents, delegates decided to promptly declassify all Committee decisions and final reports on Adherents' obligations under the Codes, therefore making them publicly available.

This declassification would be automatic, unless the Adherent explicitly objects in duly justified cases. The Adherent should explicitly state the reasons for the objections (e.g., confidentiality requirements and/or market sensitivity issues). In such cases, selected extracts, sections of the document or, as a minimum, an agreed summary statement should be declassified.

## CLOSER CO-OPERATION WITH OTHER INTERNATIONAL ORGANISATIONS

The ATFC also discussed the involvement of other International Organisations (IOs) in the assessment of measures under the Codes.

Many ATFC delegates suggested a more formalised involvement of other IOs in economic discussions of specific measures, in particular in discussions of the macroeconomic and financial stability context, or on international standards or practices in the areas within the relevant IO's competence, specific expertise and mandate.

The main outcomes of these discussions include the following:

i) Explicit provision for the consultation of other IOs by the ATFC and/or the Committee, and

ii) Possibility to request the IMF to give its views on issues related to balance of payments and the state of the international reserves of an Adherent.

### *i) Explicit provision for the consultation of other IOs by the ATFC and/or the Committee*

The ATFC discussed the possibility of leveraging the expertise of other relevant IOs by formalising their role and allowing the ATFC and the Committee to consult with them at any moment or in the course of reviews of specific measures. Under existing practice, other IOs are often invited to provide inputs on their areas of expertise that can shed light on the discussion of particular measures under the Codes, discussions regarding international standards or practices, or country-specific assessments. This participation by IOs in the process was, however, not explicitly provided for in the text of the Codes.

Delegations agreed to formalise this *ad hoc* participation of other relevant IOs, whose participation, on a case-by-case basis, could be requested at any moment by the ATFC or the Investment Committee. Adherents can consider this additional information as complementary to the Secretariat's assessment of consistency with the Codes.

### *ii) Possibility to request the IMF to give its views on issues related to balance of payments and the state of the international reserves of an Adherent*

In addition, the ATFC considered it important to involve specifically the IMF in relation to problems with the overall balance of payments of an Adherent invoking the derogation clause of Article 7c) of the Codes.

Again, the consultation of the IMF on issues related to balance of payments and the state of an Adherent's international reserves has so far been informal, there will now be a formal basis for such consultations.

To note is that previously the Codes referred to the term "monetary reserves" instead of "international reserves". Since this formula is now in disuse, delegates decided to update to the more precise and commonly referred term of "international reserves". A corresponding drafting adjustment was approved under Article 7c) of the Codes.

## MORE EFFECTIVE DECISION MAKING

Finally, the ATFC considered whether to suggest a modification of the Committee's decision-making rules for certain decisions relating to the Codes. The reason was that over the last few years there have been long-running cases where the Committee has encountered difficulties in reaching consensus on country-specific assessments and recommendations, since the Adherent under review can block the Committee from reaching a conclusion.

Whereas delegations did not favour an overall move to a decision-making mechanism different from consensus for all decisions under the Codes, they supported a consensus-minus-one mechanism in certain specific cases, notably as a last resort option where it is not possible to reach consensus on whether a country's measure is conforming or not.

Find the OECD Code of Liberalisation of Capital Movements online at
**www.oecd.org/investment/codes.htm**

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