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"Smoke but do not inhale": Capital Inflows, Financial Markets and Institutions, a Tale from Three Emerging Giants

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Executive Summary

The recent international financial crisis has, among other consequences, raised a new interest on Keynes and Minsky and their vigilant stance towards unregulated short-term capital flows. As large amounts of capital are flowing back to emerging markets, even the IMF recognizes that some form of regulation may be convenient. Brazil comes as a useful example. In 2009 authorities reintroduced a 2 per cent tax on foreign loans, subsequently raised to 6%. But in spite of those increases and of other prudential measures introduced by the government, foreign capital keeps flowing in. At 12 per cent the interest rate in Brazil ranks among the highest on the world, consequently attracting speculative investors from everywhere and leading to further appreciation of the Real. The appreciation trend experienced by the local currency, however, won´t stop with taxes to capital inflows. A more substantial approach may be helpful. The experience of both China and India might prove exemplary. In the case of India, authorities persisted in their cautious and multi-faceted approach with regard to capital flows and financial integration. Certainly, India has always maintained important controls on their capital account during the whole process. It is also maintained that the presence of strong capital control mechanisms, on both inflows and outflows, isolated China from financial market volatility. There is now a consensus among policy makers and academics on China´s gradualist route towards development along on the relevance of tight capital restrictions.

In other emerging economies financial deregulation gained momentum, capital flows transformed into bank liabilities almost instantly, increasing the feasibility of currency and maturity mismatch problems. Henceforth, regulating cross-border transactions can be seen as imperative. A series of options are available, including the introduction of reserve requirements or the prohibition of certain financial transactions. Brazil moved in that direction since 2008 but more radical options are also available. Both China and India have maintained a certain degree of financial repression, blocking the entrance of foreign banks or banning them from financing local private agents.

Despite the progress at the macro front, capital controls and prudential measures in financial markets could certainly be institutionally contested as recent RTAs, including BITs and FTAs,

expressly banned them. While most developing countries and transition economies actively introduced or passively acquiesced neoliberal packages offered to them, the larger emerging economies (China, India, Brazil) reworked their national development strategies to define a more complementary role for foreign investment and actively sought to limit or reduce the risks associated with FDI, or those related to portfolio investment. In other words, this group of countries were very cautious on the institutional front, reducing their legal risks and Brazil directly rejected any sort of legal constraint from bilateral treaties. China and India also profited all the legal loopholes of the WTO/GATS system. In particular, the right given to member countries by GATS to maintain sovereignty over prudential and related regulations of all financial firms resident in the countries.

1. **Introduction**

In the past, foreign shocks spread to national economies mainly through trade channels, and transmission of such shocks took time. After globalization and increasing capital account liberalization, most cross-border transactions become delinked from trade, financial related instead. Henceforth, shocks arrive at domestic financial markets almost immediately. When coupled with financial deregulation, freeing completely the capital flows might certainly increase the probability of a crisis particularly among poorly developed domestic financial systems. The problem aggravates as emerging countries´ interest and inflations rate continued to remain higher than in major advanced economies. But conventional monetary policy responses might not work under this macro scenario, as exchange rate movements are more likely to be linked to changes in capital than trade flows. Henceforth, Central Bank´s responses might now address the issue when moving its interest rate. The effects of exchange rate movements are not just confined to price stability. Under a regime of capital account openness exchange rate dynamics might enhance financial system fragility. Henceforth, policy – makers might carefully control misalignments at both, interest rate and exchange rate, in order to maintain the economy performing.

To some extent, the actual situation began its trend after the collapse of the *Bretton Woods* system in the earliest 1970s, implying the irruption of a new flexible exchange rate system and the dismantling of former controls on capital flows worldwide extended. The shift towards free markets was accelerated with the coming to power of Margaret Thatcher and Ronald Reagan in 1979 and 1980 respectively. The predominant neoliberal vision perceived increased financial activity as beneficial for development and, Keynesian-Myskian caveats were set aside. By the same token, the efficient market hypothesis substituted Keynes´ *beauty contest* parabola of how financial market actually behaves. That was the central message arriving from the developed world, and being vociferated by the International Financial Institutions (IFIs), throughout a collective of instructions enclosed under the Washington Consensus. Henceforth, rescue packages originated at the International Monetary Fund (IMF) or World Bank (WB) lending practices, introduced new clauses of financial deregulation and capital account fully convertibility. Under this new framework, developing countries were urged to liberalize their capital account and deregulate their financial sector. In other words, a micro-macro initiative was under operation. Sooner than later Wall Street and the US government began to move forwards the institutionalization of this scenario, both at the bilateral and multilateral foray.

International investment agreement (IIAs)[1] would swiftly become the centre of a new legal framework supporting the liberalization task[2]. Financial liberalization was also integrated at the Uruguay round, and numerous new instruments were soon launched at the newly created WTO, including those introduced by the General Agreement on Trade in Services (GATS)[3]. Henceforth, either on a bilateral or multilateral basis, developing and emerging economies passed through a [legal or institutional] process of financial deregulation and capital account liberalization.

Following the failure of Lehman Brothers there was a substantial reversal in portfolio capital inflows affecting emerging economies. But, as emerging economies proved resilient to the contest, portfolio investors swiftly returned. Many emerging countries have received capital flows much than their financial requirements, as the Brazil case might be illustrating. As a consequence a more nuanced opinion on the beneficial role of short-term capital inflows emerge, recognizing that excess funds may give rise to asset bubbles and macro instability.

The paper analyses the liberalization wave, at both macro and micro levels, and its legal consequences among three emerging giants: China, India and Brazil. In a first section, it considers the financial, monetary and exchange rate policy options adopted by those countries attempting to reflect how they confronted the Impossible Trinity (commonly referred as the Trilemma[4]). Certainly, the deepening of domestic and international financial markets has also influenced the responses posed by the previous mentioned trilemma. The point is referred in the second section that briefly analyse banking regulation and market structure. In a third section, the paper looks at institutional transformation launched at both, multilateral and bilateral level which might be preventing the regulation of capital flows or affecting market entry conditions. Finally, some conclusions are drawn, scrutinizing the sequencing options adopted by these countries and how analysed countries responded to the new institutional scheme.

The analysed countries, particularly China and India, have resisted short-term capital flows, intervening in the foreign exchange markets, introducing controls and maintaining a highly

[1] Among others, IIAs include the following: Bilateral Investment Treaties (BITs), Free Trade Agreements (FTAs), Regional Trade Agreements (RTAs), and Economic Partnership Agreements (EPAs).

[2] Initially built-in a bilateral format, investment liberalization will spread later under a free trade scheme. Particularly, following the signal of the North American Free Trade Agreement (NAFTA).

[3] It might be also consider the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), and the Trade-Related Investment Measures Agreements (TRIMs)

[4] As an expression, the trilemma has been introduced by logicians at the 17th century, in order a describe a situation in which someone faces a choice among three options, each of which comes with some inevitable problems (Mankiw, 2010).

repressed financial system. Rephrasing FT´s columnist Martin Wolf, they "*smoke but do not inhale*".

2. At the macro level: the capital account and the impossible trinity

The incompatible trinity is a term used in discussing the problems associated with creating a stable international financial system. It refers to the impossibility to achieve simultaneously the triple contradicting, but desirable goals of fixing its exchange rate (to foster stabilization of trade and growth), of running an independent monetary policy (to achieve domestic monetary policy goals) and of freeing completely its capital flows (for an optimal allocation of resources). According to the Mundell-Fleming model, a small, open economy cannot achieve all three of these policy goals at the same time: in pursuing any two of these goals, a nation must forgo the third.

Under the golden standard, the *trilemma* was fully operative. Capital flows were almost unfettered and currencies tied to gold. External shocks were passing through the national economy without further restrictions, and the economy enthused alongside capital inflows movements. Monetary policy was absent from the policy discussion, and authorities incapable to manipulate interest rates. The financial architecture settled down at the *Bretton Woods* Conference radically altered the previous scheme, introducing a more stable regime although a more closed one. National currencies become pegged to the US dollar, which in turn, was tied to gold. Nearby all countries maintained capital controls on both inflows and outflows[5], consequently, international financial markets were tiny and highly regulated. But, at the beginning of the seventies the previous consensus collapsed. The new global scenario was one of high liquidity affecting agents' perceptions over the costs and benefits of regulate the capital account. The world observed an unprecedented growth in financial products, and private capital flows began to return to the South. The system of fixed exchange rates broke down, and a new market-friendly era began. Unfortunately, such an abrupt change came deprived of provisions. Developing countries were clearly less protected, henceforth more exposed to further macro instability and deprived of accurate regulatory tools. Uncontrolled capital movements affected the real exchange rate with significant costs on the real side[6] although their financial effects are

[5] Capital controls could take a quantitative or qualitative character, affecting inflows and / or outflows. Among the regulations affecting capital inflows could be mentioned those introducing minimum stay requirement or limiting local agents (domestic firms and residents) from borrowing in foreign currencies, or the introduction of unremunerated reserve requirement (URR). Exchange controls or taxes / restrictions on outflows could be cited as an example of management techniques affecting outflows. Price-based techniques include the Tobin tax or the URR, whereas quantitative – based measures include quantitative limits on foreign ownership of domestic companies stock or reporting requirement and quantitative limits on borrowing from abroad.

[6] Uncontrolled capital flows could alternative be mitigated by encouraging local firms to invest abroad (outward FDI) or by maintaining a permissive policy towards capital controls, thus helping investors to invest abroad (i.e.: capital flights).

certainly critical. Under an open economy environment monetary policies have both monetary and exchange rate consequences. Henceforth, policy – makers confronts a new problem when dealing with inflation, as usual interest rate tools cannot solve since raising short-term rates induce speculators from everywhere to enter into the market (the so-called "*carry-trade*" subject)[7]. The quantitative easing policy practised by the US and other advanced economies added more pressure to the picture: with interest rates close to zero, cross-arbitrage remains prevalent. But not only interest rates are far from equilibrium, exchange rate efficiency has also become increasingly questioned. Exchange rate influence, on the other hand, is not only limited on trade related effects, but additionally its impact spawned to net capital gains obtained by private agents external holdings, the so –called "*valuation effect*" (Lane and Shambaugh, 2009).

Nevertheless, and despite this sort of problems a true *crusade* against financial regulation and capital controls unleashed, and monetary authorities at developing countries become a territory to conquest. Liberalization and deregulation have also transformed the banking industry, transforming financial institutions into powerful actors. The financial boom began to transform into a burst, however, someone in between 2004 to 2008. Risk seeking by voracious investors reached unprecedented levels, and capital inflows began to flood into emerging markets profiting from high yields and *calm waters*. And then, the Lehman Brothers collapse, and the "*perfect storm*" began. But the accumulation of international reserves, among other factors, gave more leeway to policy makers at emerging economies (Frenkel, 2007; Aizenman et.al., 2008)[8]. Nonetheless, and above all, those countries playing at the vertexes of the triangle became more exposed whereas cautious countries performing at the interior made relatively well. Certainly, and considering the policy options adopted by the analysed countries, China and India avoided the hard corners more fervently than Brazil.

The following paragraphs introduce the experiences of Brazil, China and India, including the main policy response introduced by authorities in these countries in the aftermath of the crises. Policy options were certainly more extreme at Brazil, although less radical when compared

[7] In a carry trade, an investor holds a high-yielding ("target") currency assets financed with a low-yielding ("funding") currency liability. In the present context, Brazilian Real or Chinese Yuan qualifies are considered target currency, whereas US dollar or Japanese yen could be considered as funding currencies.

[8] *Frenkel* introduces a thought-provoking idea: the trilemma should be considered false as a general theorem. According to the author, in a context signed by an excess supply of international currency, the central bank can simultaneously control the exchange rate and the interest rate (Frenkel, 2007; page 30). *Aizenman*, by contrast, sustain a less radical idea, claiming that the trilemma remains latent but international reserves reduce the constraints faced by the (open) economy. In particular, international reserves can reduce both the probability of a sudden stop and the deep of the resulting output collapse when the sudden stop occurs (Aizenman et.al., 2008; page 2).

against their Latin American pairs. Policy makers at both China and India were more precautious, interested in preserve policy space and macro autonomy. Nevertheless, the recent crisis reinforced authorities in the three countries to maintain away from the vertexes, particularly in managing the capital account openness.

Brazil – Macro

Until the early nineties, Brazil followed a policy of industrialization by substitution of imports (ISI), with strong involvement of multinational (market seeking) companies (particularly, directing towards the manufacturing sector)[9] attracted by the promise of the internal market rather than any legal protection available, and in spite of the existence of some sectorial restrictions consistent with the ISI model[10]. At the banking industry, in particular, authorizations for entry were only conceded on a reciprocal basis and, once entered, foreign banks were also subject to special capital requirements (Freitas, 2009). Thoughout all this period, the Brazilian economy experienced a outstanding evolution, particularly during the 1970s ("*os anos do miraclo*") when growth rates averaged a 8,63 percent of annual increasse. But, Brazil become more nor less dependent on foreign inputs during this period, pushing the economy to recurrent balance of payments crisis.

Table 1: Brazilian growth in historical perspective, average rate (%)

Period / Decade	GDP	Population	Per capita GDP
The 60s (1961-70)	6,17	2,89	3,19
The 70s (1971-80)	8,63	2,44	6,04
The 80s (1981-90)	1,57	2,14	-0,56
The 90s (1991-00)	2,54	1,57	0,95
The new milennium (2000-10)	3,58	1,21	2,33

Source: Fundación Getulio Vargas and IBGE

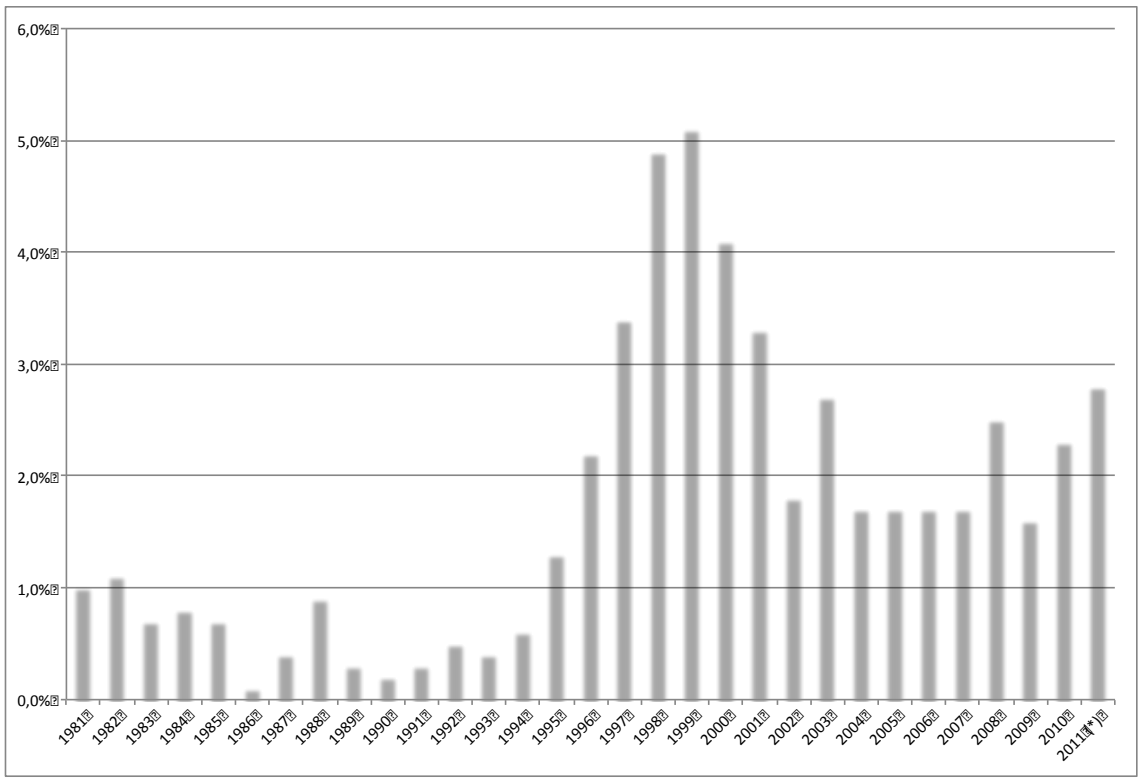
The rise in global interest rise coupled with a sharp rise in oil prices exposed Brazilian structural weakness. The external debt crisis aggravated the pre-existent fiscal and financial gaps and the collapse of the internal market put a damper on business prospects and FDI halted. New tensions became apparent in the Brazilian treatment of FDI, thereafter. Decree-Law Nº 1986/82 introduced a series of restrictions for foreigners to operate at the local capital market. A 1988 constitutional amendment introduced further restrictions, including a formal ban to operate in

[9] The arrival become stimulated by various types of incentives, as the government felt that they were needed in order to accelerate the country´s industrial development (Baer, 2008)

[10] For instance, foreign investors were obliged to register in the Central Bank in keeping with existing foreign exchange and tax controls. But, on the other hand, the government were guaranteeing MNCs the "right of return" and of profit remittances (Carvalho and Souza, 2010).

the banking industry. But, despite these legal attempts, authorities become confidently in moving into a new macro approach. Deregulatory initiatives and liberalization measures were undertaken under both Collor de Melo and Itamar Franco governments, including the opening of the securities market to foreign investors and the permission to transfer financial resources abroad without proof of previous internment (through the so-called CC5 results) (Carvalho and Souza, 2010). However, and despite the efforts the inflationary burden continued.

Graph 1: Brazil, FDI as a percentage of GDP (1981-2011)



Source: *Banco Central do Brasil*

On July, 1994, the government launched a new programme (Real Plan) aimed to curb inflation by commiting to maintain an exchange rate ceiling of one-to-one parity with the dollar[11]. A few months before Brazil normalized the financial front by achieving an agreement with the international banking sector (i.e.: Brady Plan). Hereafter, Brazilian authorities adopted a more liberal and market-friendly approach toward national development. The plan was fully successful in settling the inflation down, putting an end to contract indexation and chronic high inflation. From a political perspective, the success of the plan granted the Ministry of Economy

[11] In contrast to the Convertibility Plan in Argentina, the monetary authorities at Brazil did not explicitly state the relationship between changes in the monetary base and foreign reserves movements, henceforth, allowing for some discretionary leeway.

(Fernando Henrique Cardoso - FHC), the possibility to run for the presidential race. Attracted by the privatization programme and the new macro environment, FDI inflows significantly increased thereafter (see previous graph). The success generated some complications, however, including an important bias towards exchange rate appreciation (depressing manufactured exports) and demand expansion (pulling for imports). The plan stemmed powerless to knot the fiscal front and, henceforward, induced a rapidly – accumulating external debt. External imbalances, in turn, leave the economy at the mercy of financial speculators[12].

Graph 2: Brazil, interest rates (January 2003 – July 2011)

Politics put more stress on the picture, as markets permanently questioned Lula involvement in the 1998 Presidential race. In order to keep the exchange rate, the government profited from an IMF syndicate loan that proved unsuccesful to revert market expectations. Under this circumstances, the re-elected president (FHC) decided the Real to float, in January 1999, convinced that the currency would be less vulnerable to future speculative attacks. The new approach included an inflation targeting regime along more pressure on achieving primary fiscal surplus (Fiscal Responsibility Law). During this period Brazil attracted an important number of foreign investors (Mortimore and Stanley, 2010), including the massive entrance of portfolio investments which put more pressure on the exchange rate[13]. The economy growth at very low

[12] In might be important to emphasize the low interest rate level observed among industrialize countries in the nineties. Henceforth, pushing capital towards emerging economies as investors look after better returns. During the Asian crisis the country lost U$ 11 billion in reserves in three months, forcing the Central Bank to raise interest rates from 19% annual average to 46% at November 1997. Few months' later, high interest rates pulled foreign investors back, although "temporarily": the Russian crisis pulls them out again (Carvalho and Souza, 2010).

[13] Capital inflows increased spectacularly in the nineties, in both FDI and financial flows: whereas at 1990 capital flows represented 0,9% of Brazilian GDP, ten years later they totalized 3,8%. Considering

rates, however, as the government opted for a contractive fiscal policy and mantained very high real interest rates[14]. But volatility remained. The occurrence of new external shocks (Russia, Argentina, dot.com bubble at the US) aggravated the external front. Confronted to a new crisis, economic authorities acted similarly to the previous one: raising interest rates and causing the economy to contract (Cardim de Carvalho e Pires de Souza, 2010). Nevertheless, and despite all the undertakings made by the government towards the market, the Brazilian economy could not take off.

In order to reduce volatility, and despite the liberalization path already launched[15], economic authorities decided to advance throughout the regulation of capital inflows. The legal framework still contained elements dated from the Vargas administration (Carvalho and Garcia, 2006)[16]. Price-based schemes including explicit taxs on capital flows, foreign loans and certain exchange transactions[17]. The government also maintained different administrative controls as outright prohibitions against (or minimun maturirty requirement for) certain type of inflows ("*sand in the wheel*" provisions). But, the effectiveness of capital controls remained questioned (Cardoso and Golpin (1998), Sohiet (2002), Paula, Oreiro and Silva (2003), Carvalho and Garcia (2006), basically after the ineffectiveness of the fiscal policy[18]. A different and more

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the 1990-2000 period, mid and long term inflows totalized U$ 95,8 billions – mostly commercial notes (71,0%), followed by inter-firm credits (17,1%), bonds (5,9%) and commercial papers (4,3%). Short – term flows, in turn, were important till 1995, thereafter-monetary authorities began to bet hard against speculative capitals (Terra and Sohiet, 2006).

[14] Between 1995 and 2007, the average GDP growth was 2,9%. Average nominal interest rates between 1995 and 2007 were around 22,9% per year, although slightly lower for the 2000-2007 sub-period: 17,5% (nominal) and 9,8% (real). A high interest rate certainly reflected a policy choice made by the monetary authority in order to maintain the inflation at low levels. Contractive fiscal policy, in turn, become entrenched in the inflation targeting scheme, pushing the country to push for high target goals for primary surplus – between 3,75% and 4,25 of GDP during the 2000-2007 period. But, although the primary fiscal surplus might have contributed to lowering the debt burden, the external vulnerability led it to an increase in the short and medium term debt (Ferrari-Filho and Spanakos, 2009).

[15] As an example, Terra and Sohiet (2006) mentioned the approval of two resolutions (Nº 1832/91 and Nº 1482/92) reducing the short-term capital stance, along the CBB Resolution Nº 2388 constituting the foreign capital fixed-rent fund. Since 1997, the FHC government introduced a series of rules and measures, resuming the opening of the capital account. But the path was further discontinued following the Asian crisis, as the Brazilian authorities re-introduced different policies to curb the increase in capital outflows.

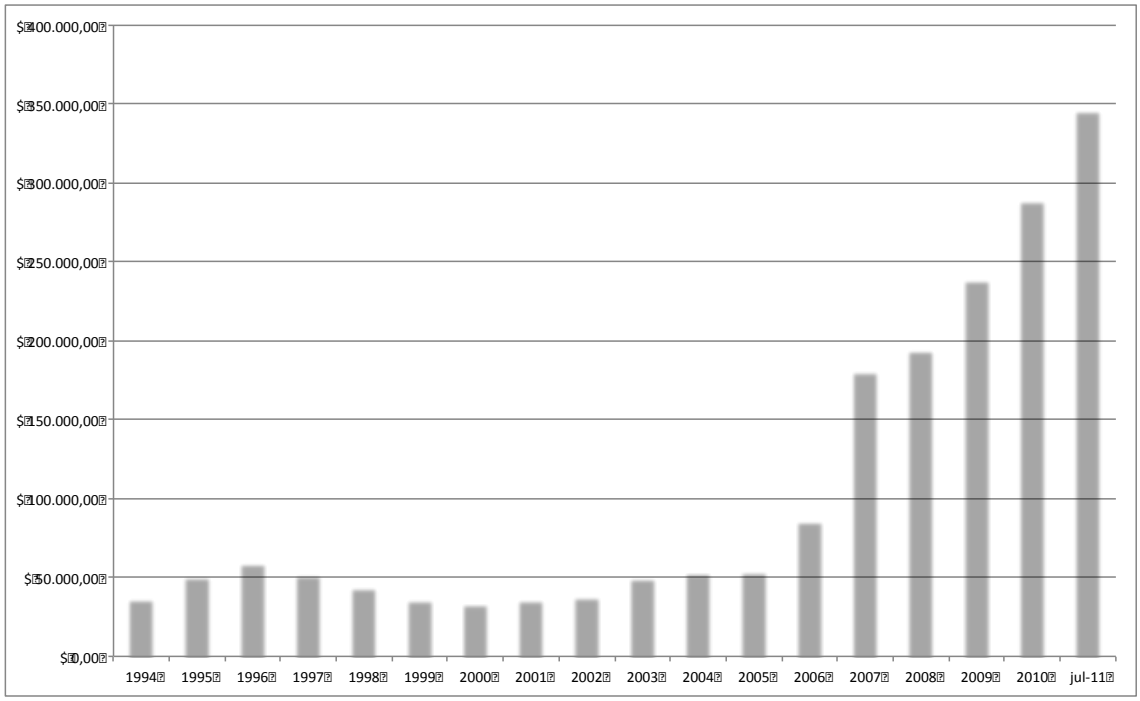
[16] Brazilian legal framework included [at 2006] the following requirements: foreign exchange must be converted into the national currency; export revenues and resources secured offshore must be brought back into the country; and private exchange rate transactions are prohibited (Carvalho and Garcia, 2006).

[17] The so-called tax on financial operations (or *Imposto sobre Operações Financeiras* – IOF) was introduced at June, 1994 by Law Nº 8.894. Inflows were mostly charged at 2% - although some operations were exempted, as those involving the State (local, regional or national) and their related companies and payments accruing to import and exports operations.

[18] Cardoso and Golpin (1998) introduce an index of capital controls describing all legal transformation affecting the capital inflows, including all the normative introduced by the Central Bank of Brazil.

optimistic opinion become sustained by another group of scholars, for whom ineffectiveness (of capital controls) resulted from the absence of more more restrictive measures (Costa da Silva and Cunha Resende, 2010)[19].

Graph 3: Brazil, foreign exchange reserves

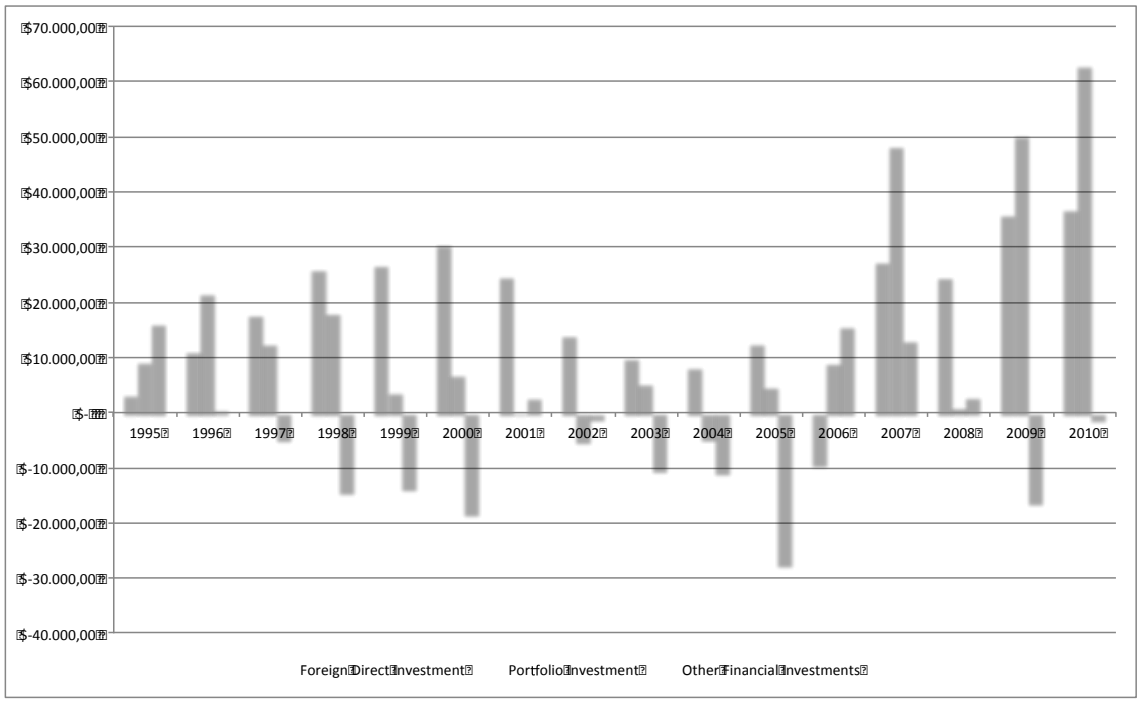


Since 2003 macro tended more favorable as commodity prices began to improve and exports continued to raise, moving the current account quickly from deficit to surplus[20]. The always problematic fiscal front become less traumatic as the economy recovered and government´s revenues raised – certainly helped by the impressive amount of exports proceeds. Favored by the new external scenario, the country also began to increase its gross international surpassing U$ 300 billions at July 2011, and relaxed the the always annoying debt constraint along. Last, but not least, interest rates began to coming down, albeit at very slowly rates and remaining settled at two-digit levels. All this set the Brazilian economy into a more relaxed site, but instable.

[19] In particular, Costa da Silva and Cunha Resende (2010) emphasize the importance of quantitative methods over price-type controls, particularly to deal with exchange rate crisis.

[20] Considering a five-year period, Brazilian exports multiplied by a factor of 3,5, surppassing U$ 200 billions in 2010.

Graph 4: Brazil, Net Financial Flows (1995-2010) (U$ Millions)



When the international financial crisis exploded, however, affected both the real and the financial side. Foreign investors´ aforementioned enthusiasm suddenly reversed, leading to a sharp decline in portfolio flows and other financial investments. MNCs subsidiaries established at Brazil also experiencing a sudden change of mood, increasing their remittances and payments abroad. These attitudes augmented the pressure on the real exchange rate, forcing the government to lead the initiative (Tabak et. al., 2010). Among the measures undertaken by the government, the economic team impulsed the expansion of banking loans throughout monetary instruments[21] and by the enactment of new credit lines at the Brazilian Development Bank (BNDES) (Sobreira & de Paula, 2010). At the monetary front, authorities rushed to shield the system from a systematic crisis, introducing new rediscount lines and liquidity provisions (auctions of loans reserves and currency swaps agreeements) (Tabak, et. al., 2010)[22] and enacting new regulatory and prudential measures. At the fiscal front, policy actions were oriented to induce private agents consumption and investment expenses, introducing a more adaptable position over it previous more ortodox approach. A high level of international

[21] In order to push financial institutions towards credits, the government introduce penalties in the reserve requirement of time deposits. Another important set of measures was related to development of the discount windows procedures and of the Credit Guarantee Fund (CGF). The creation of a special type of time deposit (6 months, backed by the FGC) becomes another valuable instrument introduced by monetary authorities (Mesquita Toro, 2010).

[22] The swap agreement obtained with the US FED might have also helped at mantaining investors calm, and relaxing the exchange rate market

reserves also helped to insulate the Brazilian economy from the crisis. But, more importantly, the crisis persuaded Brazilian authorities to a more active response towards the international community, with Guido Mantega, the Ministry of Finance, its principal spokeman.

Graph 5: US dollar versus Brazilian Real exchange rate (January 1995 – June 2011)

Notwithstanding the progress, matched against international benchmarks, local interest rates continues to be elevated, around 12,25 percent according to latest figures[23]. On the other hand, when observing latest years figures it also become evident the important transformation at the Balance of Payments´ financial account. Portfolio related operations has become the main source of capital inflows arriving to Brazil (see graph 2), totalizing U$ 67.794,86 in 2010. But FDI inflows are also surpassing previous records, as the bouyant economy continues to attract investors from all over the world [24]– including an important mass of Japanesse households[25]. Capital inflows coupled with high commodity prices, in turn, are pushing the Real to appreciate (*Brazil Fears economic fallout as real soars*" FT, July 1, 2011) [26] and, henceforward,

[23] The SELIC identifies the basic interest rate. One of the main explanations behind the high level exhibit by this rate relates to the Brazilian public debt, and the fact that an important portion of the debt remains indexed to the SELIC (World Bank, 2006). This fact reduces monetary authorities' degrees of freedom, and the effectiveness of the regulatory policies affecting capital movements.

[24] According to the 2011 World Investment Report (WIR) elaborated by the United Nations Conference on Trade and Development (UNCTAD), Brazil jumped to the fifth place among the major destinations of Foreign Direct Investment (FDI) (U$ 48,4 billion) from a previous 15th position (U$ 25,9 billion). The US continued to lead the ranking with U$ 228,2 billion received, followed by China (U$ 105,7 billion), Hong Kong (U$ 68,9 billion) and Belgium (U$ 61,7 billion).

[25] Between January and April 2011, Brazil receipt about U$ 42,3 billions, more tan 5 times as much as the same period last year. From this total, Japanese investors explained about U$ 4 billions (FT, July 1st 2011), after reaching U$ 30 billion last year ("*Yen influx into Brazil set to grow*" FT, June 28, 2011).

[26] At July 1st the real traded at 1,5523, its strongest level since just after it was first floated in 1999 (FT, July 1, 2011).

introducing the local economy into a vast political discussion ("*Currency wars not over, says Brazil*" FT, July 5, 2011)[27]. To summarize, high interest rates matched local currency appreciation trend induced investors´ enthusiasm to carry trade. High real rates have failed to cool the economy but also to bring down inflation as many from developed world continues to flow into the country.

Table 2: Brazil, capital flow management related measures (from October 2009 to January 2011)

Year	Measures
2006	BCB limit on banks´foreign exchange exposure (FEEs) fixed at 60% in July, but reduced back to 30% in December
2007	BCB introduced counter cyclical time-varying capital requirements
2008	On March 17, the IOF tax was raised to 1,5% on the entry of foreign funds in the settlement of investments in the financial and capital markets and extended in May to similar transactions made by means of simultaneous operations Exemptions were applied to funds related to equities, equities derivatives, public offerings, and subscriptions of shares The 1,50 tax was eliminated in October
2009	IOF tax reintroduced on portfolio equity and debt inflows, with a 2% tax.
2010	IOF tax rate increased to 4 percent for fixed income investments and equity funds IOF increased to 6 percent for fixed income investment and extended (at the 6% rate) to margin requirements on derivatives transactions. Some loopholes for IOF on margin requirement closed Raised bank capital requirement for most consumer credit operations with maturities of over 24 months, which apply primarily to car loans Raised the unremunerated reserve requirements on time deposits form 15% to 20%. The additional (remunerated) reserve requirement for banks´sight and time deposits were also increased from 8% to 12%.
2011	Imposed reserve requirement for banks´ short dollar positions in the cash market Imposed 2 percent tax on local corporate offshore borrowing or debt issuance of less than 1-year maturity

Source: IMF (2011a, b and c).

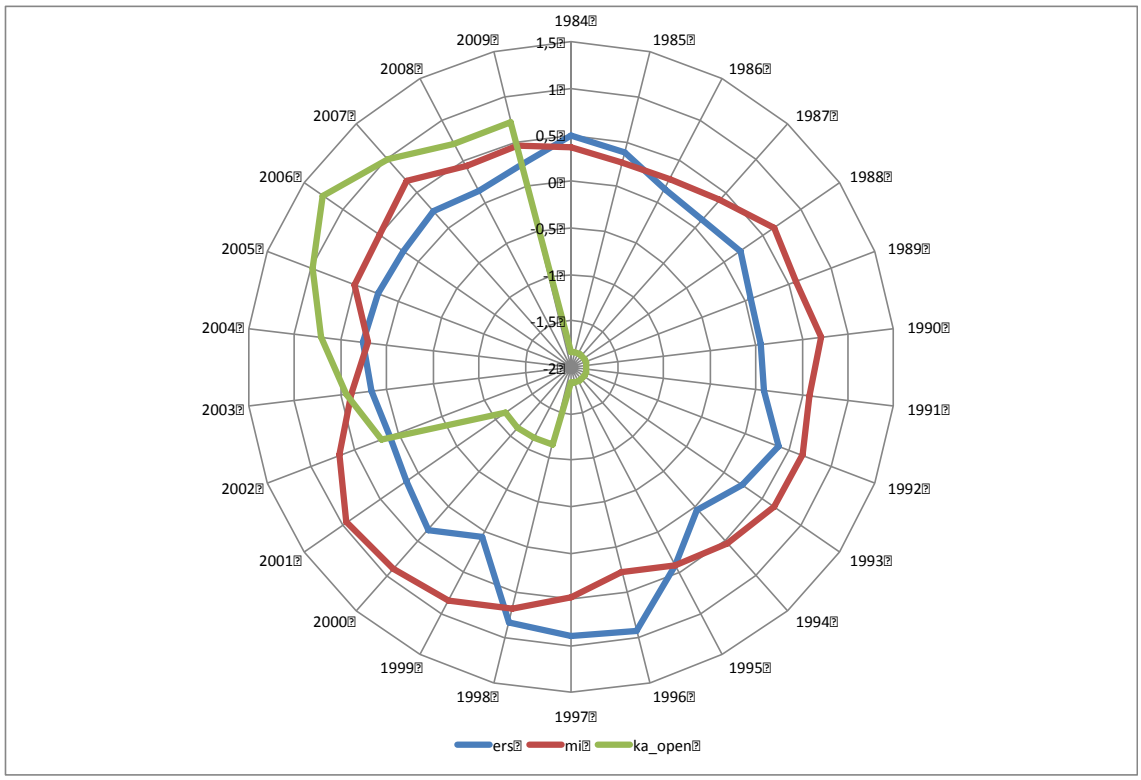
Henceforth, and despite the battery of macro measures being introduced since 2008 and the actual level of international reserves, the government announced the reintroduction of a 2% year tax on foreign loans (i.e. capital controls) later expanded to 6% (see previous table)[28]. Likewise, the government began to intervene in the currency swap markets ("*Rousseff to tackle sharp rise in the real*", T, Janauary 4, 2011) and taxing bond´s portfolio inflows (Financial Times, July 5, 2011). Theoretically, Brazil shows a low degree of capital openess as playing in the middle field of the triangle. In practice its capital account is decidedly open, and authorities forced to play macro prudential policies. Policies, however, might prove useless when funds massively arrives

[27] Since the end of 2008 the real appreciated 39% (Bloomberg, "*Mantega Threatens More Capital Controls to Prevent Brazil Currency Wars*"). Siemens, German industrial group and Brazil´s biggest electronic conglomerate, has entered into the debate, warning of the danger of deindustrialisation ("*Siemens warns on Brazil´s strong real*" FT, May 4, 2011)

[28] In her inaugural speech on January 1st., Brazilian President *Dilma Rousseff* stated that Brazil would protect "*the country from unfair competition and from the indiscriminate flow of speculative capital"*.

overheating the national economy and introducing alarming symptoms of being traped by the "dutch disease".

Graph 6: Brazil, playing the Trilemma (1984-2009)



Source: Aizenmman, Chinn and Ito

According to Mesquita and Torós (2010), the main lesson to be extracted from the recent experience is that a country characterized by inflation – targeting, prudential monetary policy, conservative banking rules and practices enter into the crisis later and exit sooner, all along with lower price volatility. Hermann (2010), on the other hand, signalls macro stability (i.e.: as balanced fiscal and monetary aggregates) as a necessary but insufficient condition to impulse financial broadening and, henceforth, economic development. The current situation sounds close to the latest, is not time to play at the vertexes. The appreciation trend experienced by the local currency, however, cannot be merely confronted by taxing capital inflows. According to prominent local authors as Jose Luis Oreiro (from the Brazilian Keynessian Association)[29] and

[29] "*Economista da UnB defende reduçâo da Selic para segurar alta do real*" (http://jlcoreiro.wordpress.com/2011/07/29/economista-da-unb-defende-reducao-da-selic-para-segurar-alta-do-real-portal-sul-21/).

Antonio Delfim Netto (emeritus proffesor at FEA-USP and former Ministry of Economy)[30], a more substantial approach might be helpful including a reform into the monetary policy envisioned to curb the interest rate ceilings. In this sense, the India case could become exemplary.

India - Macro

After a brief period of FDI promotion upon independence, India established a relatively closed economy with considerable state intervention in industrial policy and multiple controls over private investment. The government implemented a national development strategy characterized as a highly interventionist industrialization model popularly known as the "Licence Raj", affecting both local and foreign investors. The legal scheme introduced by the Foreign Exchange and Regulation Act (FERA) imposed a 40% ceiling on foreign investors participation in industrial projects, sometimes even preventing TNCs using their own brands in India. Despite these restrictive rules and institutional arrangements, benefits were considerable for those lucky foreign investors that managed to enter - typically market-seeking TNCs (Kumar, 1995). Obviously, capital movements were highly restricted; development was mainly financed from domestically mobilized resources. From a macro perspective, the model become characterised by a pegged exchange rate system and fiscal dominance whereas repression categorised financial markets (Mohan and Kapur, 2009).

But, and despite the inner orientation of the economy policy, the country not kept immune from a foreign exchange crisis. India´s economic performance could also be considered unsuccessful under this period, observing a per capita growth rate of 1,7 per cent between 1950 and 1980 (defiantly termed "*Hindu rate of growth*"). Consequently, the government began to phase out the model in the early 1980s, to place the per capita rate of growth on a 3,8 per cent during the subsequent two decades (Rodrik and Subramanian, 2004).

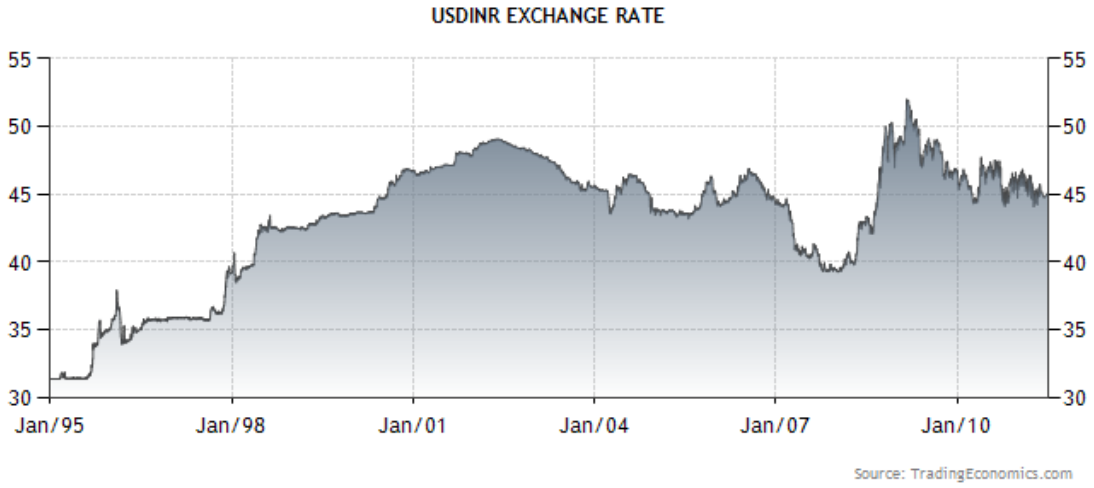
During this decade the government opted for a more flexible exchange rate regime moving, firstly, to a basket of currencies and later to [a theoretical] market-determined floating exchange rate scheme since March 1993 although, in practice highly administrated (or "de facto" pegged)[31] system as the Reserve Bank of India (RBI) actively participated at the market to avoid

[30] "*O Trilema*" at Valor Económico, 05/04/2011. Available at https://conteudoclippingmp.planejamento.gov.br/cadastros/noticias/2011/4/5/o-trilema

[31] In practice the rupee has been pegged to the U$ in the period 1993-2008 (Patnaik, 2010).

extreme volatility and influencing rupee parity[32]. India exchange rate policy, on the whole, become guided "*by the need to reduce excess volatility, prevent the emergence of destabilising speculative attacks, help maintain an adequate level of reserves, and develop and orderly foreign exchange market*" (Mohan and Kapur, 2009). Extensive management practices, on the other hand, were possible thanks to the presence of voluminous capital controls and the limited integration to international financial markets reported by India (Khurana, 2007).

Graph 7: US dollar versus Indian rupee exchange rate (January 1995 – June 2011)



The government also began to reshape its industrial policy, by introducing a price liberalization scheme, an important reduction in tariffs and the partially progressive dismantling of the Licence Raj system. India gradually opened up its markets through economic reforms reducing former controls on foreign trade and investment (including portfolio) (Panagariya, 2004; Ahluwalia, 2002), although maintaining restrictions over debt flows (Shah and Patnaik, 2004, Mohan and Kapur, 2009). Important liberalization measures were also adopted at India´s stock market, benefiting the arrival of foreign institutional investors (FIIs), including pension funds[33].

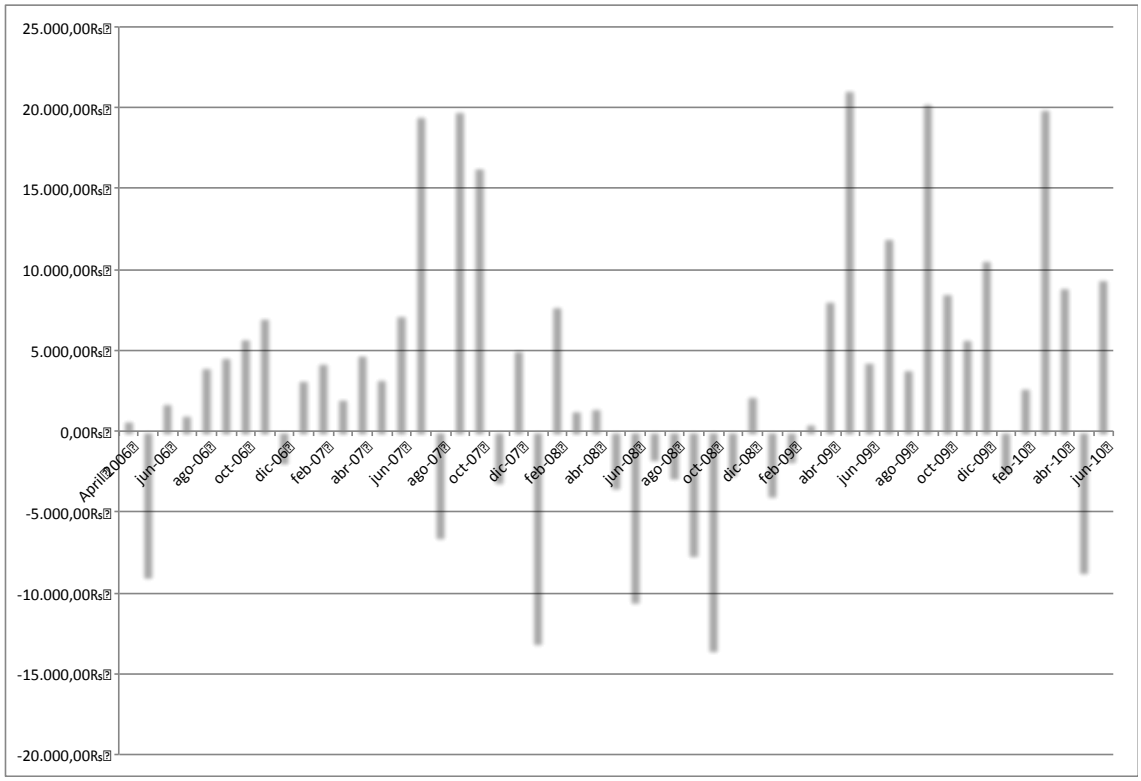
Nevertheless, and as previously commented, the Asian crisis interrupted the route towards rupee fully convertibility along other liberalization measures suggested by the committee chaired by S. S. Tarapore. Advances were ultimately following a step-by-step strategy (Chandrasekhar,

[32] Several authors have tested the "dirty-floating" scheme introduced by the government, most of whose results indicate that the Rupee continued to be pegged to the U$ dollar.

[33] Permission to enter was granted on both, primary and secondary market for securities. Ceilings on shares of domestic companies that can be held by foreigners were maintained, however, been initially settled at 5% for a particular entity and 24% for all FIIs participating in the market (later expanded to 30%).

2008)[34]. As for example, whereas FIIs were just allowed to invest in government bonds in April 1998, by January 2003 all previous limitations were removed. Likewise FIIs share (at local firms) enlarged up to 49% at 2001 from a previous ceiling of 30%. Institutional investors would become powerful in the new millennium. Between 2004 and 2007, IFIs related inflows totalized U$ 45,07 billions, but the ascending trend would become reversed during the financial crisis (Arora, et. al., 2010). During the first semester of the 2008-year foreign investors pulled $ 57 billions out of the market, a movement basically originated at foreign Banks and financial entities. Funds returned after April 2009 as observed in the next graph.

Graph 8: Net Investment by FIIs in the Indian Capital Market (April 2006 – June 2010)



Source: RBI

Historically, India´s stock markets were tiny and listed companies were actively traded (Chandrasekhar, 2008), all of which generated a high degree of volatility. As a consequence of all of this, India´s financial sector is primarily bank based. Market importance began to rise in recent years, however, as denoted by the rocketing increase experienced by SENSEX, the daily

[34] Among others measures, the new economic team become more permissive with remittances or maintaining portfolios abroad. All inflows by non-residents are freely repatriable, whereas some restrictions are maintained on resident non-financial companies. Indian citizens could also invest abroad, although important restrictions are still binding for borrowing abroad (Mohan and Kapur, 2009). A complete list of liberalization measures benefiting capital account convertibility is listed at Chandrasekhar (2008).

stock price index of Bombay Stock Exchange[35]. Certainly, FIIs has played an important role in this surge. A set of actions launched by the government also helped[36], including the launching of several IPOs by state-owned firms[37].

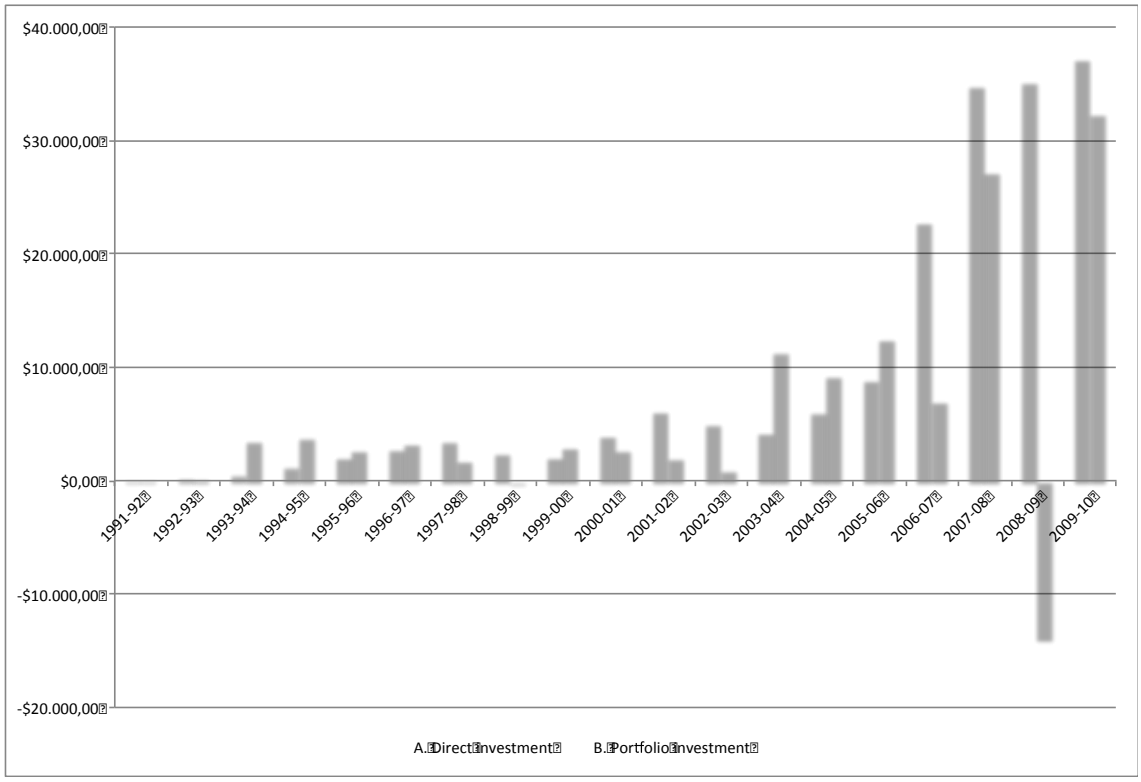
As for domestic companies, they are entitled to issue American Deposit Receipts (ADRs) and Global Depository Receipts (GDRs). In the case domestic mutual funds, the government authorized them to invest in foreign securities, whereas some qualified mutual funds are permitted to invest cumulative up to U$ 1 billion in overseas exchange traded funds (Reddy, 2009). But, in contrast to what happened in other emerging markets, India´s experience with ADRs and GDRs become short-lived, particularly thanks to the sophistication of the domestic stock market (Shah and Patnaik, 2010). On the other hand, restrictions were maintained for foreigners at the market for government securities (Shah and Patnaik, 2004), a decision basically adopted to maintain autonomy over its decision – making process (Chandrasekhar, 2008; Economist, 2009). Analogously, the RBI conserved several constraints on foreign currency borrowing by firms, by fixing both the maturity and the interest rate of the loan, and banning short-term borrowing (Economist, 2009; Patnaik, 2010).

[35] At July 25, 1990, SENSEX Index was fixed at 1.000 points, reaching 6.000 points ten years later and 17.000 points by September 2007.

[36] As for example, in his Budget speech at the Congress the government compromised to "abolished the tax on long-term capital gains from securities transactions altogether", a fiscal concession that [might] triggered the speculative surge in stock markets.

[37] At mid-October, 2010 the state-owned Coal India launched an IPO expecting to rise up to $ 3 billion. Previously, Power Grid Corporation and Steel Authority of India have adopted a similar path ("*Rupee off highs as capital controls talks weigh*" The Economics Time, 11 October, 2010).

Graph 9: India, foreign investments inflows (1991-92 to 2009-2010) (Million of U$ dollars)

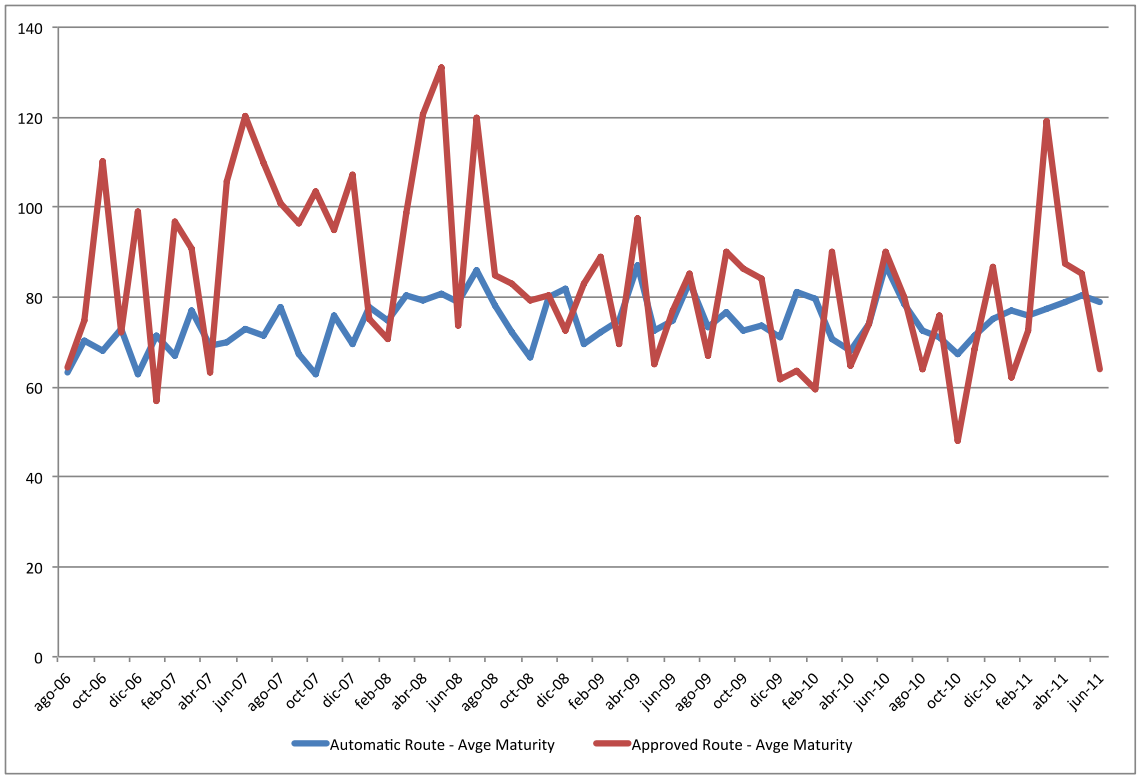


Source: Figures from RBI database
Notes: Portfolio investments include GDRs/ADRs, FIIs and Offshore funds and others.

As observed in the previous figure portfolio investments are adding in importance, although not all inflows qualify as non-stable funds. Debt flows, on the other hand, are subject to prudential controls through a system of overall ceilings on the amount that can be borrowed, maturity prescriptions and ceilings on interest rate spreads (Mohan and Kapur, 2009). However, in order to support productive investments, the government allowed for some exceptions in external commercial borrowing (ECBs). ECB are commercial loans raised by Indian borrowers from non-resident lenders with a minimum average maturity of three years (36 months) (see RBI Guidelines at http://www.welcome-nri.com/info/project/ECB_Guidelines.htm) [38].

Graph 10: India, ECBs average maturity (in months) (August 2006 – June 2011)

[38] Eligible borrowers under the scheme are all corporate entities (except financial intermediaries), units in special economic zones and non-governmental organizations (NGOs) engaged in micro-financed activities. ECB guidelines explicitly address those ventures that could be founded by external funds, including investments in the real sector. Funds can only be raised among a limited number of lenders, including international banks, international capital markets, multilateral financial institutions, export – credit agencies, suppliers of equipment, foreign collaborators and foreign equity holders. Finally, it might also be remarked that ECBs costs are limited by a ceiling (*Libor* plus 300 bps for a 3 to 5 years maturity loan).



A buoyant economy induced ECBs related inflows to increase since mid - 2002 (Mohan and Kapur, 2009; Arora et. al., 2010). Inflows increased from a quarterly average of U$ 1,2 billion during June 2002 – September 2004 to U$ 4,1 billion during September 2005 – December 2006. During 2007 ECB related inflows were at their maximum, totalizing U$ 33, 31 billions, to decrease thereafter (more data at the appendix) (ECBs data available at RBI webpage http://www.rbi.org.in/scripts/statistics.aspx). As capital inflows continued to jump into the country, and the economy to show some overheating signs, the government tightened the regime, particularly aiming to discourage real estate loans. These measures were somewhat relaxed following the collapse of Lehman Brothers, but resumed once capital inflows made their reappearance. Thereafter, the RBI modified the ECB guidelines several times, either liberalizing or restricting the scheme. Anyway, ECB access continues (partially) subject to prior approval, external funds are mostly used to finance the import of capital goods, observing a balancing maturity profile (Mohan and Kapur, 2009). Foreign currency convertible bonds (FCCBs) become a funding alternative for Indian firms certainly less demanded than ECBs, observing a dwindling trend since 2007-08.

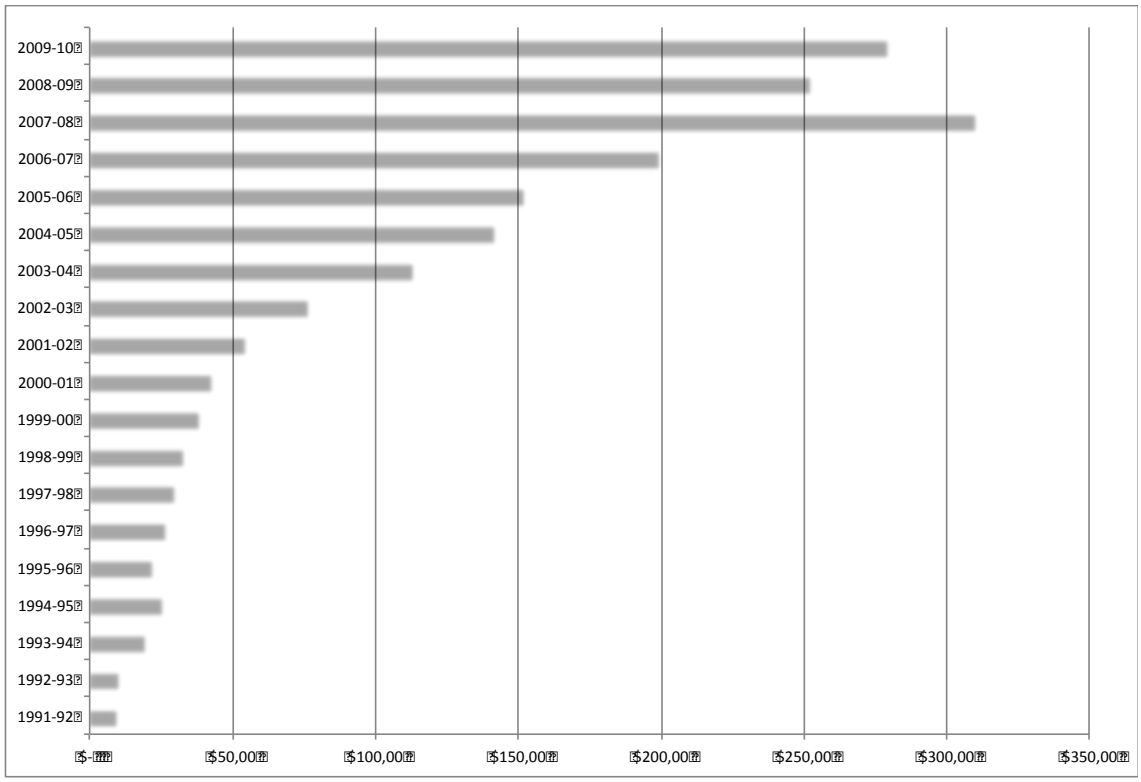
Table 3: India, ECBs and FCCBs registered with the Reserve Bank (in U$ millions)

Instrument	2007-08	2008-09	2009-10	2010-2011
ECBs	22,224	15,462	17,363	24,481
FCCBs	6,103	463	3,362	1,270
Total	28,327	15,925	20,725	25,751

Source: RBI (2011, b)

India's economic performance in the post-reform period shows many positive features. The average growth rate that put India among the fastest growing developing countries at that time. As the economy keep on growing, helped the domestic demand to flourish, whereas the country maintained high rates of gross capital formation. Simultaneously, the government advanced at the fiscal front, reducing their financing needs. Inflation rates were significantly reduced, but still higher than in most advanced and (some) emerging economies. Remittances from abroad keep entering, increasing the availability of external funds for the public and private sectors. Meanwhile, the services sector continued their expansion, becoming an important source of foreign exchange – the merchandise trade continued experiencing recurrent deficits, however. India also transformed into one of the FDI top destinations, ranking just besides China and the US, and certainly a leading country among MNCs (UNCTAD, 2005)[39].

Graph 11: India, Foreign exchange reserves (U$ billions)



The RBI began to build-up an important amount of foreign reserves short after the liberalization process began (RBI, 2010b), surpassing the U$ 300 billions barrier during 2007-2008 period and totalizing at September 30, 2010, U$ 292,9 billions. The accumulation process, in turn,

[39] With a total of U$ 98 billion, India resulted the largest recipient of net capital flows among BRICs countries in 2007, ahead of Russia (U$ 96 billion), Brazil (U$ 88 billion) and China (U$ 70 billion).

becomes explained by the massive entry of foreign capitals, mainly FDI but also by FIIs intermediate resources, as explained. The excess of FX assets obviously forces the RBI to expand the system liquidity; at least on a partial basis with the remaining maintained as government securities to be sell at the market. Henceforth, and since April 2004, India launched the Market Stabilization Scheme (MSS), which allows the government to issue Government Treasury bills or bonds to offset the expansionary impact of capital inflows[40]. The scheme operates on a symmetrical basis, injecting capital during a reversal in capital flows and purchasing foreign currencies to prevent excess liquidity in the national economy. In order to neutralise the expansionary impact of foreign exchange purchases on the domestic monetary and liquidity conditions, authorities were not constrained to one instrument (Mohan and Kapur, 2009). The RBI is also entitled to alter bank´s cash reserve requirements (CRRs), to launch open market (repo / reverse) operations via the Liquidity Adjustment Facility (LAF)[41] scheme or to introduce a liquidity adjustment facility. As in the case of MSS, all these instruments are prepared to work on symmetrical basis[42].

Table 4: India, movements in Foreign Exchange Reserves (U$ millions)

Date	FCA	SDR	Gold	RTP	Total FOREX Reserves
30-Sept-07	239.954	2	7.367	438	247.761
31-Mar-08	299.230	18	10.039	436	309.723
30-Sep-08	277.300	4	8.565	467	286.336
31-Mar-09	241.426	1	9.577	981	251.985
30-Sep-09	264.373	5.224	10.316	1.365	281.278
31-Mar-10	254.685	5.006	17.986	1.380	279.057
30-Sep-10	265.231	5.130	20.516	1.993	292.870

Notes: 1) FCA as for Foreign Currency Assets, maintained as a multi-currency portfolio comprising major currencies, and valued in terms of US dollars, 2) SDR as for Special Drawing Rights, 3) Gold includes U$ 6,699 million reflecting the purchase of 200 metric tonnes of gold from IMF in October 2009, totalizing a physical stock of gold of 557,75 tonnes, 4) RTP as for Reserve Tranche Position in the IMF

Source: RBI (2010b)

[40] Legally, the government is prevented to finance its expenditures through the sale of these securities (Chandrasekhar, 2008). Government Treasury bills or bonds, on the other hand, are specific limited (Mohan and Kapur, 2009).

[41] In contrast to other instruments being mentioned, like CRR or MSS, LAF is basically aimed to manage transitory liquidity shortfalls / surpluses in the money market.

[42] As capital inflows were massively entering into the country, the RB raised the CRR from 4,5 per cent (March 2004) to 9.0 per cent (July 2008), although most of the increase was launched by the end of 2007. As flows suddenly reversed, authorities rolled back the requirement to previous levels. From August 2008 to January 2009, CRR was reduced by 400 basis points, whereas REPO rate decreased by 425 points (from 9 % in August 2008 to 4,75 in May 2009) and Reverse REPO rate by 275 basis points (from 6 % in November 2008 to 3,25% in April 2009) (Arora et.al., 2010).

When the sub-prime crisis exploded, macroeconomic fundamentals proved resilient. The government announced several stimulus packages in order to maintain the level of economic activity unperturbed. Fiscal measures included a reduction in indirect taxes and sector specific measures, increasing government´s expenditure by 36% in the third quarter of 2008-09 (Arora et. al., 2010). The package augmented the government fiscal deficit, however. Monetary response was also rapid and ample, including a series of conventional and exceptional instruments to lead liquidity into the economy, including: open market operations, CRR reduction, MSS unwinding / buyback, term REPO facilities (14 days), increase in Export credit refinance, special refinance and liquidity facilities for banks (more details at Arora et.al., 2010, page 817). Finally, and in order to reverse the adverse trend in capital inflows, the government has also unwind former regulations. The crisis, however, affected the Indian economy and trade imbalances grew significantly, particularly the trade account as imports remained high pulled by a firmly domestic demand. The stock market was also severely hit as the foreign investors lost confidence in the local economy [43] (Chandrasekhar, 2008; Arora et.al., 2010). Consequently, the Indian rupee depreciated against the US dollar, although the RBI contained the falling throughout open market operations and selling dollars to the market (diminishing FX reserves) (FOREX data on RBI webpage). But sooner than later, foreign investors were back in India, resuming the former pressures on rupee appreciation and macroeconomic overheating.

When the Lehman Brother crisis started, challenged authorities at the Reserve opted to preserve the economy from contagion and maintained its key policy rate at 4,75% despite important inflationary pressures (Economist, 2009). Once capital inflows resumed, RBI decided for a tight monetary policy, increasing their referential rate – actually set at 6, 5% (see next graph). Monetary authorities also announced a series of measures in order to discourage housing loans – including an increase in the Loan to value ratio (RBI, 2011b) RBI authorities also revised commercial banks´ CRR figures along modifying their reserve requirements (RBI, 2010).

Graph 12: India, interest rate (January 2002 – July 2011)

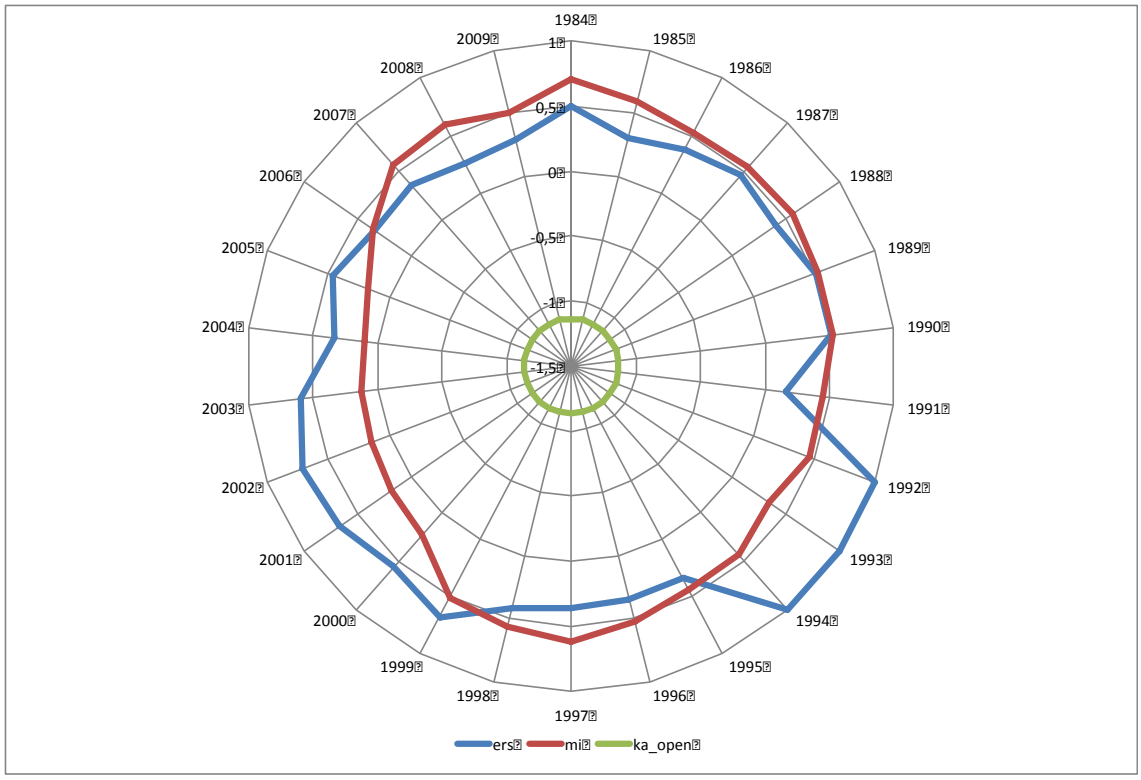
[43] IIFs retracting caused a 23,43% drop at the Bombay Stock Exchange (BSE), in just 26 trading days beginning at January 8, 2008. But local factors have also influenced investor´s pessimism. Afterwards, the Satyam episode, concerning irregular practices among Indian companies, started another phase of capital outflows, and generating a 16,1% loss in just 13 trading days starting at January 6, 2009.

The monetary policy also included important sterilization measures in order to reduce pressure on the rupee, particularly by the launching of open market sales of government securities from its portfolio and reintroducing the MSS. In addition, authorities used the liquidity adjustment facility (LAF) scheme to extract liquidity from the local financial system.

Alternatively the government could either introduce more controls or stimulate capital outflows, either by encouraging local firms to go global or inducing local private agents to invest abroad. As portfolio flows continued to flood the country[44], authorities began to consider the reintroduction of more stringent capital controls (Chandrasekhar, 2009).

Graph 13: India, playing the Trilemma (1984-2009)

[44] Between April and December 2009 inflows nearly equalled the total from 2000 to 2005, strengthen the local currency and destabilizing the Indian macro ("*India considers capital controls*" gulfnews.com, May 3, 2010).



Source: Aizenmman, Chinn and Ito

On the whole, and despite the liberalization trend launched at the beginning of the 1990s, India has always maintained important controls on their capital account during the whole process. The prudential attitude adopted towards banks access to external commercial borrowing has also helped (Mohan and Kugar, 2009).

China - Macro

The Popular Republic of China (PRC) initiated a large walking towards a more balanced and successful model that entailed breaking with some traditional communist practices, including a closer association with the international economy in the form of international trade and foreign investment beginning as of 1978 (Mortimore and Stanley, 2010). Two decades of exceptionally high growth in the order of 10% a year transformed the economy, converted the PRC into the world's principal exporter, pulled more than 500 million Chinese out of poverty and consolidated a huge domestic market (World Bank, Database). The PRC adopted an open policy towards FDI, but a gradualist approach, transforming the country in one of the principal developing country recipients of FDI (UNCTAD, 2008b)[45]. FDI, in turn, become massively

[45] By 2005, the PRC was receiving annual FDI inflows of US$ 70 billions. It might be important to notice that the bulk of the FDI originated in Asia, particularly from Hong Kong, Japan, Korea, Taiwan and Singapore.

involved in transforming China in the world leading export platform[46]. Both, FDI attraction and export promotion become the drivers of China´s exceptional growth, a path characterized by the simultaneous presence of commercial and capital account surplus.

Table 5: China financial account (1997-2010) (U$ dollars, 100 MM)

Year	FDI Inflows	Portfolio Inflows	Others - Inflows	FDI Outflows	Portfolio Outflows	Others - Outflows	Total
1997	$45,44	$9,23	$37,97	$-3,77	$-2,29	$-65,55	**$21,04**
1998	$45,64	$1,90	$41,78	$-4,53	$-5,63	$-85,44	**$-6,27**
1999	$41,01	$1,81	$48,93	$-4,04	$-13,04	$-69,47	**$5,21**
2000	$42,10	$7,81	$42,08	$-4,61	$-11,81	$-73,61	**$1,96**
2001	$47,05	$2,40	$50,07	$-9,70	$-21,81	$-33,20	**$34,83**
2002	$53,07	$2,29	$72,96	$-6,28	$-12,63	$-77,07	**$32,34**
2003	$55,51	$12,31	$151,82	$-8,28	$-0,88	$-157,70	**$52,77**
2004	$60,91	$20,26	$262,18	$-7,77	$-0,57	$-224,27	**$110,73**
2005	$1.242,00	$220,00	$3.067,00	$-183,00	$-269,00	$-3.108,00	**$969,00**
2006	$1.333,00	$456,00	$5.163,00	$-304,00	$-1.132,00	$-5.030,00	**$486,00**
2007	$1.732,00	$640,00	$7.031,00	$-301,00	$-453,00	$-7.728,00	**$921,00**
2008	$1.904,00	$677,00	$5.238,00	$-687,00	$-250,00	$-6.569,00	**$313,00**
2009	$1.502,00	$981,00	$5.299,00	$-799,00	$-594,00	$-4.620,00	**$1.769,00**
2010	$2.144,00	$636,00	$8.253,00	$-894,00	$-395,00	$-7.528,00	**$2.216,00**

Source: Data from the State Administration of Foreign Exchange - SAFE webpage

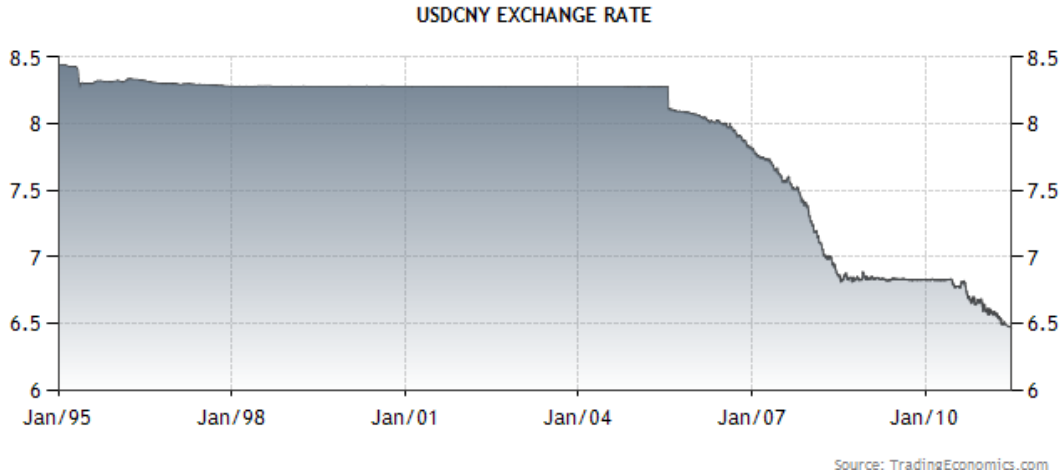
But, although the government highly incentivised the FDI arrival some capital inflows were certainly less, and portfolio and foreign debt flows were definitely unimportant[47]. China´s capital account followed a "selective opening" strategy (Prasad and Wei, 2004; Glick and Hutchinson, 2008; Yu, 2010). Inflation remained at low levels for most of the transitional phase, mainly thanks to the flexible monetary policy implemented by the Popular Bank of China (PBC). During this phase the government always retained critical limitations on the national

[46] China's cautious FDI policy originally focused on restricting FDI to the cheap labour export assembly activities in the Special Economic Zones, for the most part reserving the domestic market to domestic companies or limited to joint ventures of foreign companies with local partners. For foreign investors, activities in the PRC were defined as prohibited, restricted, permitted and encouraged. MNCs companies were originally prevented to commercialize its production in the countryside. In terms of country of origin, most funds were coming from the region, particularly, from Hong Kong. On the other hand, FDI was subject to approval, and later registered with both the planning and foreign trade department of the government. After entry into the WTO in 2001, China's FDI rules became more liberal in the sense that they encouraged more activities and fewer restricted activities were maintained and eventually 75% of all foreign companies were wholly-owned foreign companies.

[47] The policy might be enunciated as "welcome to FDI, but no thank to foreign debt and portfolio flows" (Prasad and Wei, 2004 pp 453).

currency convertibility, along high restrictions on their purchase by domestic importers[48]. Fiscal policy has complemented monetary policy, in particular, in allowing the government to maintain policymaking autonomy and limit external vulnerabilities[49]. On the whole, and considering the last 30 years, China maintained an annual average growth rate of nearly 10% to become the second biggest economy of the world after the US[50]. Certainly, "*China´s gradual approach to financial liberalization and capital account openness [could be understood as] a key element contributing to its rapid and highly stable growth*" (Yu, 2009)[51].

Graph 14: US dollar versus Chinese Yuan exchange rate (January 1995 – July 2011)



Until 1994 China maintained a differentiated exchange rate regime, an expanded strategy adopted by several developing countries, in order to protect local production from foreign competition. Thereafter, a managed floating exchange rate regime replaced a centralized and fixed one, although the new one could be better described as a *de facto* fixed. As for example, consider the 1994-1998 period where the exchange rate appreciated from 8.7 Yuan per dollar to 8.3, as observed by Robert E. Rubin (US Treasury secretary at the time of the Asian crisis), a truly "*island of stability*" in a turbulent world. Starting in 2005 monetary authorities allowed the Yuan to revaluate, and the exchange rate become determined by a basket of currencies

[48] To qualify for FX, domestic buyers had first to be eligible to import. For licensed imports, enterprises had to obtain the license in the first place, whereas for non-licensed imports, SAFE approval was based on a "priority list".

[49] The government has also limited its external debt to low levels, although shortening its maturity in recent years because the increasing importance of trade credits. Enterprises were particularly discouraged from taking external debt (Prasad and Wei, 2004).

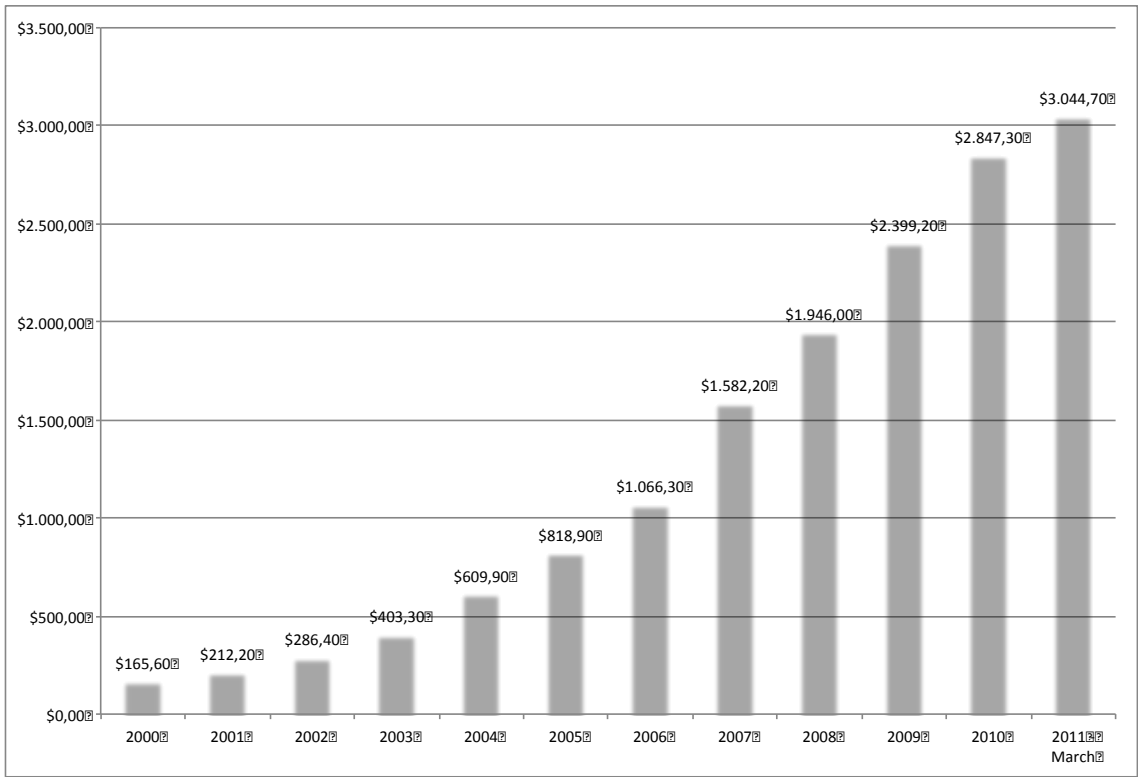
[50] The latest figure reveals a nominal GDP of $U 1.337 trillion ("*China: Second in line*", Economist, August 16th, 2010)

[51] An important point made by Yu (2010) is the coincidence between the launching of the reform at China and the Latin America debt crisis, which prevented the giant Asia on the importance of sequencing.

thereafter but the dollar maintained its relevance. Floating range becomes narrowed since 2008 as the global financial crisis emerged. Two years later, at June 21 2010 China ended de facto peg to the dollar and the renminbi began to appreciate (FT, August 11, 2010) [52].

To limit local currency appreciation, authorities intervened in the foreign exchange market, accumulating massive amounts of foreign reserve. Henceforth, with a stable exchange rate, increasing trade surplus and large FDI inflows international reserves grew steadily. As the model persisted and growth rates sustained their trend, China continue to amass reserves, passing from U$ 186,3 billions in 2000 to U$ 3,04 trillion at March 2011 reflecting an strong capital account surplus (FDI inflows) along a formidable surplus in their current account (export boom).

Graph 15: China´s foreign exchange reserves minus gold (Billion of U$ dollars)



The Asian crisis convinced Chinese authorities the relevance of maintaining restrictions on capital flows but, fundamentally, on the importance of an accurate sequencing policy. Thereafter the government began to relax constraints on capital flows. Initially, due the financial commitments made by China towards its enter at the World Trade Organization (WTO) in 2002. FDI flows become fully liberalized thereafter, including the abolishment of former

[52] Since July 2005 to June 2010 RMB appreciated 21,88% against the US dollar and 21,07% against the Euro (PBC, 2010).

requirements encompassing foreign investors on FX balance. But controls on short-term capital flows remained strong. A year later the government adopted a policy of "*difficult in and easy out*" directly distressing speculative capital movements but indirectly benefiting the newly adopted "*going global*" strategy. The crusade also reflected a mounting apprehension of inflationary pressures among policy authorities at both SAFE and PBC[53], as the economy began to show some overheating signs[54]. In parallel, the control on cross-border capital inflows become more tenuous, as domestic agents obtained access to new external sources of credit, including the surge of equity inflows (Yu, 2010)[55].

As time passed and the economy keep on growing, the government began to rise some former controls, benefiting both households and enterprises (Yu, 2010). Residents are now allowed to buy foreign equities, although via qualified domestic institutional investors (QII)[56], and permitted to convert RMB to foreign currency up to U$ 50.000 per annum. Non-residents, on the other hand, are now entitled to open RMB accounts and also allowed to buy *A shares* in the stock market through the QII scheme. Restrictions on Chinese enterprises´ overseas investments are minimum. Similarly, controls over domestic institutions´ issuance of bonds abroad have been loosened. Controls were also lifted on exporter´s foreign – currency earnings[57], a move made by the government to maintain hard currency abroad and to control inflationary expectancies at home, but also reinforcing Chinese firm's global expansion. Financial openness resulted less spectacular concerning cross - border debt flows, a differentiating trend also observed at India. To sum up, liberalization covers now most of the transactions included at the capital account. But, and a great but, some important controls on the capital account are still

[53] The authority in charge of fixing the exchange rate policy is the State Administration of Foreign Exchange (SAFE), in cooperation with the People´s Bank of China (PBC). SAFE is the successor of the State General Administration of Foreign Exchange (SGAFE), an agency created in 1979 within the Bank of China to supervise all inflows and outflows of foreign exchange.

[54] Excess demand could be, in partly, attributed to an important career for fixed assets investments among Chinese provinces. However, easy mortgage loans have also precipitated an increasing demand for housing. Overseas "hot money" keeps consumer prices on the trend, observing a monthly inflation rate of 4% at October 2010 ("*China´s stocks decline on inflation, capital controls concerns*" Bloomsberg Businessweek, Monday February 14, 2011).

[55] This relates to the issuance of IPOs by local enterprises in overseas stock markets, but particularly at Hong Kong Stock Exchange.

[56] QII could be further differentiated into the Qualified Foreign Institutional Investor (QFII) scheme and the Qualified Domestic Institutional Investor (QDII) scheme. QFII scheme allows qualified domestic Banks to conduct overseas wealth management to their clients and qualified securities brokers to make overseas portfolio investments. QDII scheme involves private agents operations.

[57] SAFE started the trial programme at October 1st, allowing 60 exporters in four cities and provinces to keep their hard currencies abroad ("*China Expands Its Easing of Capital Control son Exporters*" WantChinaTimes.com. 2011-01-03).

binding, a trend reinforced after the irruption of the latest crisis and the launching of the QE policy by the US administration.

To begin with, the government reversed its former policy (difficult in, easy out) as it proved ineffective to prevent an increase in macroeconomic volatility. In the same direction, and basically thanks to the effects of capital inflows on the real estate sector, Chinese authorities become eager to combat illegal inflows. The SAFE has also begun to think on tightening the management of banks´ foreign – debt quotas and introducing new rules on their currency provisions (Bloomberg Businessweek, November 10, 2010), although short before the same regulatory agency has advanced in easing some controls obstructing the debt market ("Easing China´s Capital Control". Milken Institute, September 29, 2010)[58]. Last, but not least, and in order to reduce FX uncertainty, the government has also signed an important number of currency swaps agreements (Zhang and Li, 2010).

In order to prevent economic disruption Chinese authorities introduced an ambitious proactive fiscal policy, including an industrial restructuring programme (crucially funded by the banking industry) aimed to reduce obsolete capacity and to boost investments in energy – saving technologies. On the monetary side, liquidity is mainly managed throughout the use of both open market sterilization measures and bank´s reserve requirements ratios.

Sterilization operations become an important instrument since 2005. Open market operations (OMO) are channelized through the selling of central bank bills (CBBs) to commercial banks (Yongzhong, 2009; Yu, 2010)[59]. For Yu (2010) sterilization operations were truly successful as the broad monetary base (M2) has been on line with the needs of economic growth. Yongshong (2009) put sustainability under doubt, however, as the scheme tend to increase the share of low-yield assets in hands of commercial banks. In order to keep the monetary base under control, authorities imposed more stringent lending conditions (Glick and Hutchinson, 2009; Wolfe et.al., 2011) and, more recently, began to raise reserve requirements (Kawai and Lamberte, 2010; BOFIT, 2011; FT "*Chinese repo rate hits 3-year high*" June, 22, 2011). Inflationary

[58] In this direction, in August 2010 the SAFE allowed offshore banks and foreign central Banks to invest in the RMB interbank bond market.

[59] Open market operations channelled throughout CBBs operations since 2002. Previously, the PBOC used treasury bonds and securities in order to sterilize capital inflows.

pressures also lead the People´s Bank of China to increase the short-term interest rate close to 6,56 per cent whereas the 7-day repurchase or REPO rate augmented to 8,90 per cent[60].

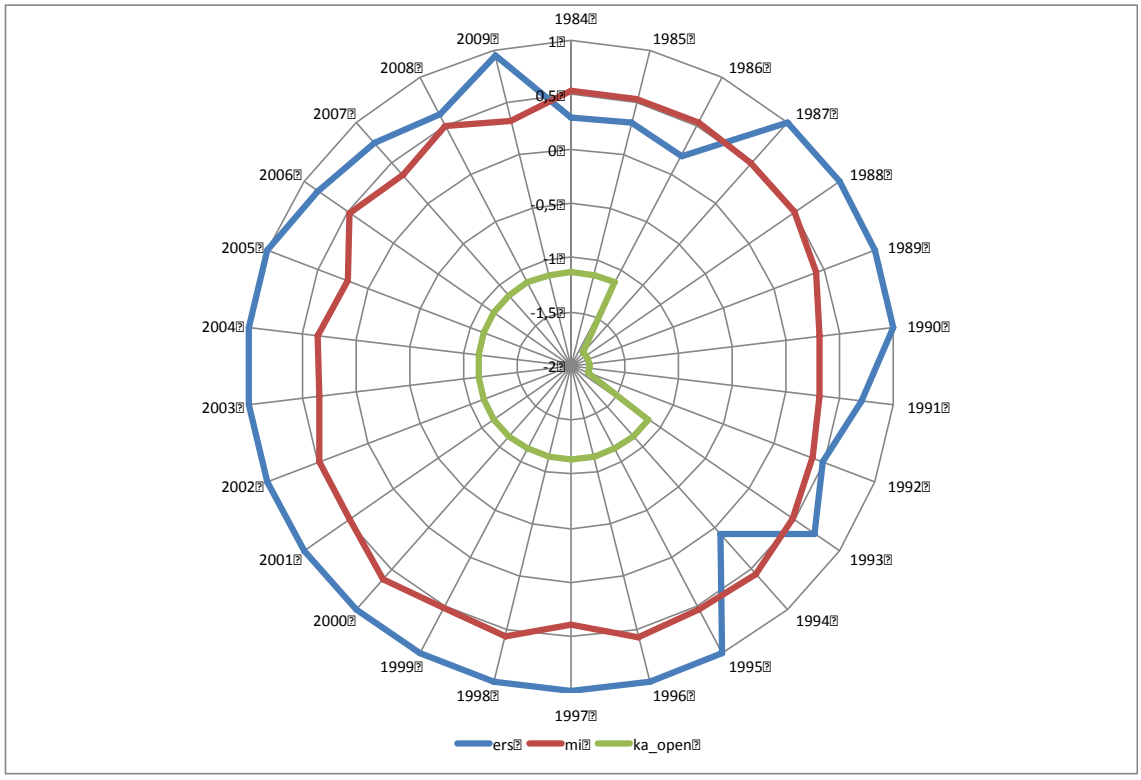
On the whole, the policy choice of a fixed exchange rate and a fairly closed capital account appears to be effective, permitting China to maintain an independent monetary policy: i.e. maintaining the local interest rate delinked from international rates (Ma and McCauley, 2007; Cheung et.al., 2007).

Graph 16: China, interest rate (January 2002 – July 2011)

Chinese officials become extremely cautious on preventing the interest rate gap between the Yuan and the US dollar to rise. Expectations of Yuan appreciate, however, remained among economic agents inducing a rampant dollar carry trade ("*Hot money inflows put govt in a quandary*", China Daily 2010-07-09). The government treated to circumvent the problem by tightening controls and introducing several macro - prudential measures (Yu, 2010), although achievements might have been limited (Wolfe et. al. 2011). Hereafter, an important number of specialists have begun to advice on the effectiveness of capital controls.

[60] China projected 4 per cent inflation for the current year, but authorities recently conceded that this goal was out of reach. Local pundits estimate an inflation rate of almost 5 per cent (FT, June, 2011)

Graph 17: China, playing the Trilemma



Source: Aizenman, Chinn and Ito

There is now a consensus among policy makers and academics on China´s gradualist route towards development along on the relevance of tight capital restrictions. The process of capital account liberalization started in mid-1980, become suspended after the arrival of the financial crisis to the region in 1997-98. As China accessed to the WTO, authorities re-launched the process although with enthusiasm but not exempted from suspicion (as referred at the institutional section), and quite limited progress (Chinn and Ito, 2011). The raising prominence of China in the world economy is beginning to push the RMB towards its internationalisation and, henceforth, introducing more pressure over the maintenance of capital controls. Such a trend also spawns new challenges on the trilemma, in particular, "*the conflict between monetary and exchange rate objectives will become harder to resolve*" (Glick and Hutchinson, 2008). Authorities are aware of the problems posed by this type of actions and, again, have opted to preserve a gradualist approach: full RMB convertibility would be on place by 2020 China, the time needed to develop Shanghai into an international financial centre (Zhang and Li, 2010). But the current situation could undermine the previous analysis, as authorities perceives greater

risks in accumulating US dollars along the creditworthiness of the US government ("*Renmini´s rise fuels talk of China policy shift*" FT - August 11, 2010)[61].

[61] FT article highlights the influential opinions of *Xia Bin* (member of the monetary policy committee of the PBoC) and *Yu Yongding* (former member of PBoC´s monetary policy committee), on the increasing risk posed by the high dependency on the U$ dollar. Zhang Xioqiang (vice head of the National Development and Reform Commission), however, point out that as exports remains important renminbi appreciation should not be overly fast.

3. At the micro level: financial markets

The provision of financial services has undergone a transformative expansion in the last decades, moving away from a largely domestic market to an increasingly internationalized space. Under the new scenario that emerged after the collapse of the Bretton Woods system characterized by floating exchange rates, low interest rates and abundant liquidity, international banks were striving to place their credits. Henceforth, financial globalization has also transformed the way foreign shocks diffused among emerging market economies (EMEs).

As capital flows could be transformed into bank liabilities almost instantly, generating important currency and maturity mismatch problems. Currency mismatch might be observed when balance sheets are heavily tilted towards foreign-currency-denominated debt and local-currency-denominated assets and/or earnings. Maturity mismatch, in turn, arises when long-term loans are hedged on short-term liabilities. Even if firms do not default, depreciations may have substantial welfare effects through the balance sheet effect (i.e.: a wealth redistribution effect) [62]. Henceforth, regulating cross-border transactions becomes imperative. A series of options are available, including the introduction of reserve requirements on cross-border inflows or the prohibition of certain financial transactions as, for example, those associated with lending in foreign currencies. A more radical option is to maintain a certain degree of financial repression, blocking the entrance of foreign banks or impeding them to finance local private agents.

At the micro level, financial deregulation gained momentum after the collapse of the Bretton Woods system. As observed among most emerging economies, financial repression was witnessed among the three analysed countries, and well preserved at both China and India.

Brazil – Micro

Until the mid-eighties, Brazilian financial system characterized as a represed model, with the state fixing prices (interest rates) and rationing quantities (allocating credit). The presence of foreign banks was scarcely limited, however whereas state owned banks (SOBs) were warmly disseminated. Under the inflationary regime, banks directed most of their lending capacity to buy governmental bonds. The financial system went into profound changes after the

[62] The effects generated by a movement in the real exchange rate (RER) are greater, however. A modification in the RER affects the trade balance, basically, by pushing exports (pulling imports), as the new rate turns under (over) valued. Structuralist, in turn, also highlights their effect on income distribution RER changes affects the balance of payments and output and employment levels (Frenkel and Rapetti, 2010).

introduction of the Plan Real, particularly by the government´s decision to discontinue the "*floating*" scheme[63]. The new scenario faced financial players into a hard dilemma: either to sell their share at the market (to either new entrants or competitors) or intent to maintain their stance by gaining competitiveness. But the new financial scenario turned more unpredictable, adding more pressure to the system and particularly affecting small and medium size banks and public entities (Hermann, 2010)[64].

Henceforth, and in order to solve the dilemma, the government launched a series of measures aimed to attract the leading players[65]. Bankers from Europe or the States were seen as more solid, both in terms of capital and liquidity provisions, but also more efficient and technologically in the frontline. Foreign banks began to massively arrive at Brazil, initiating an important trend towards banking concentration and (partial) denationalisation[66]. There were also several modifications at the institutional front, starting after the Tequila crisis[67], particularly attacking the weak regulatory and prudential architecture[68]. The government, however, went further, removing former legal restrictions placed on foreign participation including those introduced at the Brazilian Constitution[69]. In the same direction, during 1993 the government

[63] Although non optimal, the adoption of indexation of contracts become a decisive step for the survival and strengthening of the domestic banking system. In particular, by creating a domestic reserve asset competing with massive dollarization of private agents portfolios (Carvalho and Souza, 2010).

[64] Only three big national Banks were affected by the crisis (*Banco Nacional, Banco Económico and Bamerindas*). BANERJE and BANESPA were the two biggest public – regional Banks distressed by the mid-90s crisis. Nevertheless, as the fiscal front presented conflictive the government advanced into the privatization process and sold 12 regional SOBs.

[65] Two measures were particularly important. One is the creation of the PROER (Program of Incentives to the Restructuring and Strengthening of the National Financial System), whose objective was to assure the liquidity and solvency of the national financial system. In order to achieve this, the program introduced a merger and acquisition policy, including important tax incentives and credit facilities to those interested in participate. The second one relates to the implementation of the PROES (the Program of Incentives for the Reduction of the State´s Participation in Banking Activities), whose primarily goal was to reduce the number of public sector participants in the financial system.

[66] Foreign Banks entrance was mainly made throughout acquisition of both public entities and (local) private banks. The purchases of *Banco Meridional*, *Banco Bozano - Simonsen* and *Banco do Estado de Sâo Paulo* by Spanish *Banco Santander* transformed it in one of the most relevant entrants. Other European banks were also entering in the Brazilian market in the late nineties, as the Dutch ABN AMRO or the French *Societe Generale*. The participation of foreign-controlled banks among the fifteen largest banks increased from 6,5% to 34,0% between 1994 and 1998 (Carvalho, 2002).

[67] Introduced basically throught CBB Resolutions.

[68] At this stance the Brazilian government move away from the Glass/Steagal type organizational model introduced in the mid-1960s. Since 1988 authorities recognize universal or multiple banks (Resolution 1524).

[69] The issue was certainly unclear under the 1998 Federal Constitution. Foreigners with interest to operate at the Brazilian market were obliged to ask for a special authorization from Congress authorities.

decided to open the fixed-rent market to foreign capitals (Annex VI, Resolution 1289)[70]. It might be stressed the expanding relevance that equity markets began to have in the financial matrix, which in part reflected the rising presence of foreign investors[71]. Additionaly, the retreat of inflation permitted Brazil to recreate the debt market[72].

Changes were also relevant at the regulatory front. At 1994 the authority in charge of bank regulation and supervision (National Monetary Council- NMC)[73] adopted the 1988 Basle Accord (NMC Resolution 2099), and encouraging financial institutions to adopt the new capital requirement ratio of 8%. Prudential regulations were expanded under the FHC government, increasing the capital requirement ratio up to 11% and introducing a new deposit assurance scheme (*Fundo Garantidor de Créditos* - FGC). But, although the new rules were aimed to shield brazilian banks from liquidity shortages, the system´s fragility increased as profits began to disminish and holding extra capital became a "*luxury that struggling institutions could not afford*" (de Paula and Sobreira, 2010). In other words, the "*rules of the game*" introduced via the privatization programme (PROER and PROES) and the FGC merely permmited foreign banks to increase their share in the local market (Arienti, 22007; Cardim de Carvalho e Pires de Souza, 2010).

Thereafter, the bank industry reembarked into a process of market concentration and denationalisation. Foreign bank performance has not matched expectations, however, and their attitude towards credit lending and risk management not dissimilar to what observed among local private ones. Two facts are important to mention, however. Firstly, and despite the arrival of new banks from abroad, an important number of brazilian private banks (including Bradesco, Itaú and Unibanco) decided to play an active role at the privatization process (Arienti, 2007). Secondly, foreign bank entry also become limitated throughout bureocratic measures, including BCB policy of permissions on a case-by-case basis (Paula and Sobreira, 2010).

[70] The first steps towards attract foreign investors were undertaken in the late eighties, by introducing a special vehicle to participate in the market. In 1991 foreigners were allowed to operate without intermediaries.

[71] By 2005 foreign investors were explaining most of the operations. Primary and secondary purchases made by this group of investors reached 71,2% of total primary and secondary markets (Carvhalo and Souza, 2010, page 27).

[72] A market that virtually exploded in the late 2000s, as interest rate continued to fall.

[73] CNM´s resolution 2099 defined 4 risk "buckets", with weights 0%, 20%, 50% and 100%. Brazil also adopted Basel II rules in 2004. It is important to note that, whereas financial regulation and supervision is conducted by the CMN, the BCB is in charge of the monetary policy.

Banking internationalisation process initiated in 1997 resulted discontinued after 2001, as foreigners become scared of the new political and macroeconomic situation[74]. Thereafter, national owned banks (private and public) gained in presence in the financial system. Local privately owned banks observed a new opportunity to expand, as exemplified by the cases of Bradesco and Itaú. The public sector also profited from the new scenario, as observed by the revival of BNDES, Caixa Economica Federal and Banco do Brasil[75].

Table 6: Brazilian Banking, market structure by assets and loans

	Total Assets				Loans			
Year	**SOBs**	**Private Banks**	**Foreign Banks**	**Total**	**SOBs**	**Private Banks**	**Foreign Banks**	**Total**
1993	50,8	40,8	8,4	100	n/d	n/d	n/d	n/d
1998	47,2	38,6	14,2	100	n/d	n/d	n/d	n/d
2002	41,5	32,6	25,9	100	37,4	36,9	25,7	100
2006	30	47,9	22,1	100	32,6	41,1	26,3	100
2009	28,4	51,1	20,6	100,1	n/d	n/d	n/d	n/d

Source: Hermann (2010) and Freitas (2010)

New measures were launched with the arrival of the 2008 crisis, particularly focused on reserve requirement and liquidity provisions, but also oriented to reduce exchange rate mistmaching[76]. Economic policy, on the whole, orientated towards a virtual separation among the monetary policy and liquidity administration (Mesquita e Torós, 2010). On the one hand, the National Monetary Council (CMN) introduced a series of measures aimed to protect the system liquidity, including the issuance of compulsory recognitions, the (re) introduction of an special fund alongside an aggressive policy of re-discounts – although scarcely used by fears to be signalled as facing liquidity problems (Mesquita and Toros, 2010). Capital coeficients were mantained well above the mininum required (Carvalho and Souza, 2010; Tabak et. al., 2010)[77].

[74] Whereas at 2001 local financial institutions participated with 27% of total assets, five years later their share was at the level of 53,8% (Sobreira and de Paula, 2010).

[75] At June 2009, among the ten largest banking groups operating in the country, three were institutions owned by the Federal Government (occupying positions 1, 5 and 6), four corresponding to private domestic banks (positions 2, 3, 8 and 9) and the three left corresponded to foreign groups (positions 4, 7 and 10) (Carvalho and Souza, 2010).

[76] Some measures were undertaken before the eruption of the international financial crisis. Thereafter, Brazilian authorities launched a battery of measures, including the active participation in the U$ dollar future market, introduced to minimize supply shortages. The swap agreement reached with the US administration (29/8/08) becomes another important measure in the previous direction (Moreira and Torós, 2010).

[77] With a 18,2% state – owned banks (SOBs) showed the highest margin requirement compared to other financial institutions, including private domestic banks (15,2%) and foreign owned banks (11,7%).

Nevertheless, Brazilian authorities mantained an eye on the monetary side, in order to withstand inflationary expectations at bay.

One of the main lessons arising from the latest crisis relates to the relevance of local actors in dealing with the crisis (Sobreira and de Paula, 2010), along to the institutional maturity showed by the financial system (Mesquita and Torós, 2010) and the reinansance of public banks (Sobreira and de Paula, 2010; Tabak, et. al., 2010). On the other hand, and despite the faible role played by the liberalization policy to estimulate long-term banking credits, the openess certainly helped to stimulate the equity market (Hermann, 2010). Anyway, financial liberalization has also introduced new risks into the national economy (Hermann, 2010), a point with deserves more governmental scrutinity.

India - Micro

India financial system become usually characterized as a represed model until the 1990s, with the state fixing prices (interest rates) and rationing quantities (credit). In order to accomplish with their development objectives, leading banks were nationalized in the late 1960s. At the early 1980s authorities nationalized six more banks, although the strategy would be discontinued thereafter[78]. Interest rate deregulation would become one of the main policy changes introduced by the government, although banking performance continued to be modest. On view of this performance, monetary authorities at the RBI[79] called a group of experts to analyse how to transform the industry. The first report was undertaken by the Narasimham Committee in 1991, who asked for a cutting-edge interest rate deregulation[80], and transforming the Indian financial sector by converting the former ICICI and IDBI into commercial banks. Experts also asked for an improvement at the institutional front, particularly in the strengthening of prudential norms and supervisory framework, and leading monetary authorities to adopt the Basle Accord in 1992.

[78] During the first wave, 14 largest Banks were nationalized, raising the public sector banks´ share of deposits from 31% to 86%. Following the second wave, the percentage raised to 92%. Among the main financial institutions advocated to development were: Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), and State Finance Corporations (SFCs). At the time the government launched the first liberalization measures public sector banks controlled about 90% of all deposits, assets and credit, but non-performing assets amounting to 24% of total credit (Shirai, 2001).

[79] The RBI encompasses both, monetary policy and financial regulation activities.

[80] The Narasimham Committee also recommended a reduction from 40% to 10% in priority sector lending, although the recommendation was not implemented.

From a structural perspective, the banking industry is divided between a commercial and a cooperative sector, with public entities leading the former[81]. The banking industry is not properly disseminated beyond public sector banks with nationwide presence[82]. Furthermore, banks are obliged to use about a quarter of their deposits to buy government debt (Economist, 2010). The exposure to government securities, henceforth, is particularly important, although not necessarily inaccurate. Asset quality of Indian banks, on the other hand, observed a constant improvement in recent years, although non-performing assets increased during 2009 (RBI, 2010)[83].

Table 7:India, percentage share of bank groups (only commercial banks)

Year	2007	2008	2009	2010
Public Sector Banks	70,60	69,90	71,90	73,70
New Private Sector Banks	16,90	17,20	15,20	14,60
Old Private Sector Banks	4,60	4,50	4,40	4,50
Foreign Banks	7,90	8,40	8,50	7,20
Total	100,00	100,00	100,00	100,00

Source:

Since the late eighties, opening up to foreign direct investment became an important part of India's reforms. In 2004, the Ministry of Commerce and Industry revised the existing guidelines on FDI in the banking sector (RBI, 2005). Nonetheless, the new trend did not imply a total break with past practices, since foreigners continued to need government approval to enter into the market (IBEF, 2008)[84]. Likewise, portfolio inflows continued to be subject to important restrictions as, for example, those constraining corporate bond ownership or equity investments by foreigners (Khurana, 2007). The government has also maintained a cautionary attitude towards debt inflows, including a close monitoring over banks 'access to external borrowing and a tight control on non-residents indexed (NRI) deposits (Mohan and Kapur, 2009).

[81] Public Sector Banks (PSBs) accounts for more of 75% of the industry total assets, followed by private (but national) banks with a participation of 18%, and foreign banks with a mere 6,5%. PSBs include three types of banks: the nationalized banks, the Bank of India and the regional rural banks (Economist, 2010).

[82] However those figures are beginning to change. Take for case the ICICI bank expansion, one of the leading private – owned Banks in India and with more than 2000 branches – from a previous figure of 755 in 2007 (Economist, 2010).

[83] Public sector banks performed better, whereas more doubtful and loss making assets were presented by foreign and new private sector banks (RBI, 2010).

[84] Although, an increasing number of foreign Banks entered thereafter, numbered over thirty by end-September 2005 (Reddy, 2009). Likewise, and surprisingly enough, India never refused foreigners to invest (make deposits) at the local bank system (Mohan and Kapur, 2009). Foreigners could subscribe rupee – denominated (NRERA) or foreign denominated deposits (FCNRB), where foreign exchange risk being borne by the depositors in the first case and lower interest rates recognized in the later scheme.

Remarkably, an in contrast to what happened in Brazil, reforms did not follow a financial crisis nor resulted the outcome of any structural support package (Reddy, 2009). This "*original virtue*" increased policy makers leverage, profiting from more degrees of freedom to introduce a proper sequencing (an approach certainly respected at the *Raghuram Rajam Report*) (Rajan, 2008)[85], and also avoided ideological endless debates whether state banks should be privatized (Economist, 2008). Legal restrictions continue to restraint, as for example those impeding banks to undertake overseas operations (Shah and Patnaik, 2004) or those preventing borrowing in hard currency (keeping the mismatching problem under control)[86]. The new financial opportunities given by the liberalization package, diversifying their basket of products by including insurance, asset management and similar products, led to the emergence of financial conglomerates.

The performance of the banking industry has certainly ameliorated, particularly among public sector entities (Mohan and Kapur, 2009; RBI, 2009; Economist, 2010), observing an important reduction in non-performing assets (from 6,8 per cent in March 2000 to 1,1 per cent in March 2009) along an improvement in the capital to risk – weighted ratio (CRAR) (from 11,3 per cent in March 2000 to 13,2 per cent in March 2009) (Mohan and Kapur, 2009). By April 2009, all commercial banks complained with Basel II. The entrance of (new) foreign banks did not affected incumbents insomuch, as their operations remained oriented to specific segments of the market or new products[87]. There are 34 foreign banks operating in India, although expansion ceased when the crisis emerged (RIB, 2011; BBA, 2011; Singh, 2011)[88]. The crisis reinstated SOBs, by contrast, and converted the State Bank of India in the main lending agent. Figures are demonstrating the resilience showed by the domestic banking industry during the crisis, demolishing the widespread perception than private banks, specially foreign owned ones, are better suited for financing emerging countries development.

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[85] The Committee on Financial Sector Reforms gave its latest report in April 2008, report that, according to Rajan and Prasad (2008) stressed three main conclusions. "*First, the financial system is not providing adequate services to the majority of Indian retail consumers. Second, the financial sector – if properly regulated, has the potential to generate millions of much-needed jobs and, more important, have an economic multiplier effect on economic growth. Third, in these uncertain times, financial stability is more important than ever to keep growth from being derailed by shocks, especially from abroad*".

[86] Currency mismatches are not totally absent, however. In particular, the problem could be affecting domestic companies that relied on ECBs and FCCBs (RBI, 2011b).

[87] Foreign banks have a long history in India, some of them with more than 150 years of history (Reddy, 2009, Singh, 2011). Three of the most important foreign banks were already established at the mid-nineteen century.

[88] Foreign banks not only reduced their lending, but some decided to exit or shrink its operations – as the case of the UK´s Royal Bank of Scotland (Singh, 2011).

The (inter-temporal) cohesion observed at the institutional front becomes a distinctive aspect of the liberalization process, an important pulling factor in attracting capital flows (Shah and Patnaik, 2004). Another distinctive aspect of the liberalization process resulted the recognition of the uniqueness of the national context when designing the policy. Above all, authorities stressed the importance on an appropriate mix between the elements of continuity and change in the process of reform (Reddy, 2009).

China - Micro

Chinese financial system is an archetypical example of financial repression, with a pronounced government involvement into the banking industry. Under Mao´s regime the People´s Bank of China (PBC) performed monetary policy functions but also acted as a commercial bank[89] to be only decoupled at 1984, when the government founded the Industrial and Commercial Bank of China (ICBC) to allocate PBC commercial activities and the PBC become the official central bank[90]. The new model comprised a multiplicity of competing large, medium-sized and small local banks, most of them state-owned[91]. At the first cluster prevailed a small group, "the big four" comprising the ICBC together with the Agricultural Bank of China (ABC)[92], China Construction Bank (CCB)[93] and the pre-existent Bank of China (BOC)[94]. This collective transformed into state-owned legal banks in 1995 with the enactment of "The People´s Republic of China Commercial Bank Law", whereas urban and rural cooperatives started to merge transforming into a new legal figure (City Commercial Banks – CCB). The new law also

[89] By the time PBOC controlled almost 4/5 of all bank deposits and provided 93% of all loans.

[90] A decade later, the State Council introduce further reforms, transforming the PBC into a modern central bank with responsibility for monetary policy and financial system supervision. A further step was taken at 2003 with the establishment of the China Banking Regulatory Commission (CBRC).

[91] Another transformation involved the "*fifth*" one, the Bank of Communications (BOCOM), which adopted a joint-stock figure in 1986 to become the first national state-controlled joint-stock commercial bank. Thereafter, an important number of Banks would adopt this legal figure, among others: CITIC Bank, China Merchants Bank (CMB), Shenzhen Development Bank (SDB), China Industrial Bank (CIB), Guangdong Development Bank (GDB), and Shanghai Pudong Development Bank (SPDB).

[92] Agricultural Bank of China raised $ 19,2 billion at the IPO launched on July, 2010, to become one of the world´s largest-ever stock market listing. ABC list among the top banks in the world by market capitalisation, but also because of the amazing number of customers it attends (more tan 320 million) (Economist, 2010b).

[93] After five years on the float, CCB has become the world´s second – largest by market value – after ICBC. Considering the whole period (2005-2010) CCB´s profits more than duplicated (Economist, 2010).

[94] China´s "big four" composition at 2009 was as follows: i) **ICBC**: Government of China 70,7%, H-shares 13,4%, foreign strategic investors 7,2%, A-shares 4,5%, and other domestic investors 4,2%; ii) **CCB**: Government of China 57,02%, H-shares 25,22%, foreign strategic investors 10,95%, A-shares 3,85%, and H-shares held by domestic firms 2,96%; iii) **BOC**: Government of China 70,79%, H-shares 26,65% and A-shares 2,56%; iv) **ABC**: Ministry of Finance 50% and Huijin (state-owned company) 50% (although this composition altered after the 2010 IPO, see previous footnote).

instrumented a market-based scheme for credit allocation, pushing SOBs to operate as commercial entities with accountability for profits and losses. Market competition strengthened in the late 90s after the irruption of new commercial banks, all of them locally owned[95]. Banking transformation continued throughout an important process of corporate reform and financial restructuring, including the transformation of state-owned banks into state-controlled joint-stock commercial banks (JSCBs)[96]. Reforms were strengthening by then Primer Minister Zhu Rongji, who aggressively wriggled to phase out non-performing loans (NPLs). A partial privatization process was launched in 2005, beginning with the public listing of BOCOM[97]. Following the reforms and after financial restructuring works, main commercial banks began to list at the main stock exchange markets of Hong Kong and Shanghai, transforming "*the wholly state-owned commercial banks to public banks with a more diversified shareholding structure"* (CBRC, 2011).

Financial repression combined with China´s high national saving rate (averaging 40% of GDP) has created a large deposit base as Chinese banking assets keep on growing, transforming the global league tables and even eclipsing those of the US system (Economist, 2010)[98]. Rules certainly counted in this process. Since 2001, Chinese authorities promulgated a series of banking regulations, which effectively controlled the expansion of local currency lending by foreign banks (Xiu, 2003)[99] and, afterwards, the regulatory field was mature for local banking to

[95] Shanghai Bank, Shenzhen Development Bank, Guangdong Development Bank and Everbright Bank were among the new entities. These SOBs are under different political control, provincial or citywide. Reforms also impulse a third tier, including the China Development Bank (CDB), Agricultural Development Bank of China (ADBC), the Export-Import Bank of China (EIBC), and the Bank of China (BCI foreign currency bank) and a fourth tier, financial institutions related to SOEs, local enterprises and local governments. The Postal Savings Bank of China (PSBC) is also worth mentioning, with more than 37.000 branches on its own, has becoming an important role in expanding the banking system in every corner of the country (CBRC, 2011).

[96]The first IPOs were launched in 2005. By the end of 2008, there were 14 Chinese Banks publicly listed (3 CCBs and 11 SOCBs & JSCBs). Banking equity involves different types of shares: i) class A, which are only allowed to be held by Chinese residents, ii) class H, for those traded at Hong Kong, and iii) class B for foreigners.

[97] BOCOM raised U$ 2 billion at the IPO. Short after, at October 2005 CCB obtained U$ 8 billion. In June 2006 BOC raised U$ 10 billion in capital, followed soon by ICBC U$ 22 billion. The last "big" of the Chinese commercial banks to be listed was ABC, who raised U$ 22.1 billion in July 2010. Listing, however, will also involve small-and-medium sized rural financial institutions a path initiated by the Chongquing Rural Commercial Bank in December 2010 (CBRC, 2011).

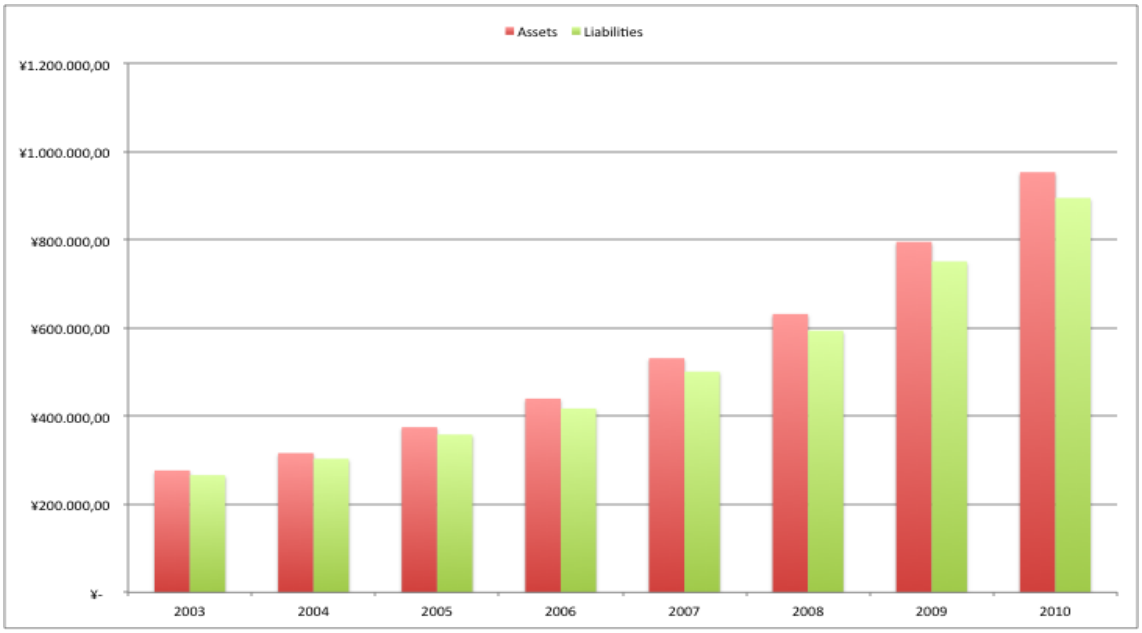
[98] The Chinese banking industry involves more tan 5,600 financial institutions, holding assets for 78,8 trillion Yuan ($ 11,54 trillion) in 2009. Despite the large number of institutions, almost half of the deposits are concentrated at the "big four" ("*Chinese Banks have become World Class Institutions*" Thomas White – Global Investing, BRIC Spotlight Report. February, 2010).

[99] In particular, the Regulations of the People´s Republic of China on the Administration of Foreign Funded Financial Institutions (December 2001); Detailed Rules for the Implementation of the Regulations of the People´s Republic of China on the administration of Foreign-funded Financial

develop and the "big four" to expand. Overall, banking development responded to "*a robust economy, lack of alternative, differential saving products and the limited scope to place deposits with foreign institutions*" (EU, 2007).

Foreign banks become active since 2002, with a majority coming from the region (Taiwan, Province of China; South Korea; and, Hong Kong SAR) and participating in a few markets. SOBs are certainly protected from international competition by the profound market penetration, after they presence at every corner of the country[100].

Graph 18: China´s Banking Institutions, Total Assets and Liabilities (Unit: RMB 100 million)



Source: CBRC 2011

China successful history is certainly indebted to the State participation and the low interest rates faced by productive firms. During the decade spanning from 1998 to 2007, average interest rate was fixed at 3.0% per year, a mere 2,1% in real terms. Thereafter, the government began to introduce more flexibility on rate fixing, although maintaining differentiated credit policies (PBC, 2010). State ownership, however, proved highly inefficient in allocating credits (Prasad and Wei, 2004), contributing to the highly level of non - performing loans (NPLs) observed in

Institutions (January, 2002), the Public Notice of the People´s Bank of China on Relevant Issues Concerning the Market Entry of Foreign-funded Financial Institutions (September 2001), People´ s Republic of China Foreign Exchange Control Regulations (Revised) (November, 2001), and Draft PBOC Temporary Administrative Regulations on RBM Inter-bank Borrowing.

[100] The big two banks of China have over 15.000 branches each, against a few hundred owned by foreign firms. Henceforth, this latest group have a small market share of 2% of total assets (Economist, 2010).

the 1990s[101]. The threat posed by these ratios (Yu, 2010) was immediately curtailed by the presence of capital controls and, thereafter by the issuance of a series of regulatory and prudential measures (Economist, 2010b). Chinese authorities implemented the Basel capital framework in 2004, though it was only recently when the "big four" raised the capital adequacy ratio from 3,5% to 8%. Nevertheless, authorities were forced to bailout NPLs along to introduce a series of [public] asset management companies (AMCs) to administrate it[102]. After a series of frustrated recapitalization attempts, monetary authorities decided to restructure the banking industry throughout consolidation and recapitalization, enabling the ICBC to become top among the leadings world banks in terms of assets[103]. More recently, the PBC raised the reserve requirement ratio for RBM deposits at commercial banks, although remaining unchanged for other financial entities (rural banks, credit cooperatives, etc.)[104]. The banking system was also highly benefited by the latest stimulus package launched by the government to deal with the global financial crisis[105, 106], although Chinese authorities are cautious on banking risk management.

From a policy perspective, regulatory measures were always on pace with the government´s macroeconomic and developmental objectives (Bell and Chao, 2010). Economic authorities shielded the domestic financial system from capital inflows by limiting the entry of foreign banks in the financial market[107] and by maintaining important convertibility restrictions on the

[101] NPLs were estimated in a range of 20% to 50% at that time.

[102] A major money injection occurred in 2004, benefiting two big state-owned banks [the Construction Bank of China (CBC) and Bank of China (BOC)]. Two years later, the government aided another state-owned bank, the "big one": the Industrial and Commercial Bank of China (ICBC).

[103] Among the top 10 biggest bank by market capitalisation at July 2010, 4 were Chinese: ICBC (1st), CCB (2nd), BOC (7nd), and ABC (8th) (Economist, 2010b).

[104] China´s regulator requires Banks to keep 17% of their deposits with the central bank (Economist, 2010).

[105] The governmental package totalized 4-trillion-yuans, about 601 billion U$ dollars ("China´s banking regulator urges structural reforms" Global Times, October 24, 2010). In sectorial terms, the PBOC directed banks to provide additional credit to ten key sectors, including infrastructure projects, public facility management, communication and transportation, real estate, postal service, warehousing, and environmental protection. The PBC not only guided financial institutions to increase lending to key industries and projects under construction, but also encouraged innovation in rural financial products and services across the country (PBC, 2010).

[106] Benefits might certainly be fleeting if loans are not refunded. Concerns over local government debt have recently appeared (Doubts deepen over Chinese Banks, FT – July 8, 2011).

[107] The Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions states that "*The equity investment provision of a single overseas financial institution in a Chinese financial institution shall not exceed 20 per cent, and the activities shall be granted the approval of the CBRC, and operates under its regulation and supervision*".

foreign currency transactions of domestic financial institutions[108]. Likewise, the government prevented banks to raise funds abroad and redirecting them to the local market so, reducing the currency mismatch threat to soothing levels[109]. Authorities followed a conservative approach at the regulatory front[110], which helped to shield commercial banks from contagion in the latest crisis. The Chinese government also made important advances on the prudential front, which helped to ameliorate the governance of the financial system, including a more harsh control on banks´ lending practices to real estate markets (BCRC, 2011). Authorities also raised the capital adequacy ratio for JSCBs from previous effective 5% level to the actual 11,4 %[111]. Along a set of new dynamic provisioning requirement, the CBRC also introduced new leverage and liquidity requirements (CBRC, 2011). The banking sector also improved, significantly, both in asset structure and credits performance, lowering NPLs ratio at near 5% in 2005 and even further in 2010. Corporate governance structures have been improved (He and Fan, 2004; Xu, 2009; Zhaoxing, 2010), although the State´s dominant position remains vital, meaning a strong voice in their governance, including the appointment of management (Bell and Chao, 2010)[112] and convincing guidance to optimize banks´ credit allocation (CBRC, 2011).

Thirty years ago, the financial system in China was, without doubt, an example of repressed and underdeveloped banking industry. By the end of 2010, Chinese "big four" lines among the top world league, whereas 84 local banks could be found listed at the world top 1000. At the end of 2010, the total assets of China´s banking institutions increased by RMB 15,8 trillion, totalizing assets for almost RMB 100 trillions (CBRC, 2011). Astonishingly most of the local banks operations originate locally[113]. Again, an important number of academics and policy makers

[108] The inconvertibility prevents offshore banks to make foreign currency loans to Chinese companies.

[109] The problem has not been eliminated, however. The relevance of foreign loans was practically nil until recently, and minimal the participation of short-term foreign loans at the total foreign loans. But, because exchange rate appreciation and a large increase of the foreign exchange repertory, China´s credit currency mismatch degree ascends quickly (Cui and Wang, 2010).

[110] The China Banking Regulatory Commission (CBRC) is the main regulator of the banking sector, although there are several other regulators as the China Securities Regulatory Commission (CSRC) and the China Insurance Regulatory Commission (CIRC).

[111] Although China accepted international standards, only a small part of state-owned Banks and some shareholding commercial banks meet the 8% per cent capital ratio requirement in 2003 ((He and Fan, 2004). Actually, all 239 commercial banks met the capital adequacy requirement. The percentage in the main paragraph (11,4%) corresponds to the weighted average capital adequacy ratio of commercial banks by the end-2009 (PBC, 2010). Nevertheless, authorities and Chinese bankers are also aware that a capital infusion will be required in future (Economist, 2010).

[112] It worth to remember that Chinese main commercial firms are also majority owned by the government, and the main source of external financing for those entities is bank loans.

[113] In other words, despite the relevance acquired by the Chinese Banks their attitude towards internalization resulted extremely cautious. For instance, the Bank of China (BC) generated 22% of its 2009 pre-tax profits outside Mainland China but most of this was from Hong Kong and Macau. ICBC,

agree on the strength of the Chinese financial system along the advances observed in the regulatory and prudential front. Nobody could deny this remarkable advance; although few recognized the fact that China maintained important restrictions on the industry during all the reforms. Likewise, nobody could refuse the role played by the banking industry in economic development, which basically associates to the guiding role of the state over credit decisions. As for example, consider the solidity of licensing practices´ policy pursued by the authorities, honouring [i.e.: authorizing the entry to] those who accept the national strategy of balanced economic development (CBRC, 2011, page 77). In other words, they matched market deregulation with development and financial repression.

which has shown the most expansionist instincts, derived only 4% of profits form abroad (Economist, 2010).

4. Financial Globalization, Capital Controls and Institutions

Liberalization at the multilateral level

A "regulatory consensus" was floating in academic circles since the *Bretton Woods* Conference, even the IMF explicitly recognized to member states the right to institute capital controls[114]. The previous consensus broke up with the collapse of the dollar-standard in 1971, however, signalling the beginning of a new era of financial liberalization and market deregulation.

Thereafter, a relatively small group of investor countries, led by the USA, took advantage of the unique historical events to implement a strong push towards foreign investment liberalization at developing countries and economies in transition. Changes originated from the increasing negotiating strength of investors' countries and weakening negotiating strength at host countries.

Financial services deregulation became one of the leading issues for those representing the US delegation at the Uruguay Round. Since the early 1980s American negotiators were pulling developing nations to open their financial markets and to bring capital convertibility. The objective was finally achieved with the signature of the GATS, which became a constitutive part of the newly constituted WTO. The agreement included all internationally – related services, defining four ways or modes of trading services[115]. WTO financial commitments, in particular, are included in the GATS Annexes on Financial Services, the Second and Fifth Protocols of the GATS (commonly referred under the Financial Services Agreement – FSA), the Understanding on Commitments in Financial Services, and countries´ GATS schedules of financial services commitments. Specific commitments made by members are backed by national treatment and market access clauses, both determining the liberalization impact of the agreement (Hoeckman & Kostecki, 2009). Commitments made under GATS also advanced in behalf of foreign suppliers of financial services, particularly by improving market access conditions and providing them a non-discriminatory treatment.

Table 8: Comparison of capital account liberalization and financial service liberalization

[114] According to IMF [original] Chapter VI, all member countries had the right to control capital movements.

[115] Usually referred as modes. Mode 1 includes services supplied from one country to another. Mode 2 encompasses consumers or firms making use of a service in another country (officially consumption abroad). Mode 3 relates to those operations involving a foreign company setting up subsidiaries or branches to provide services in another country (officially commercial presence). Finally, mode 4 includes individuals travelling from their country to supply services in another (presence of natural persons). Considering its composition, three are the principal elements conforming GATS: a main text, including general obligations and disciplines[115]; annexes dealing with rules for specific sectors; and individual countries´ specific commitments applying selectively to each of the sectors covered by the agreement

Concept	Domestic Funds (I)	International Funds (II)
Credit provided by domestic supplier (A)	Neither financial service trade nor international capital flow	Capital account liberalization
Credit provided by foreign supplier abroad (B)	Financial services liberalization	Capital account liberalization and financial services liberalization
Credit provided by a foreign bank in the country (C)	Financial services liberalization plus inward FDI	Financial services liberalization plus inward FDI and capital account liberalization

Notes: 1) capital account under regulation, 2) capital account liberalization A) No GATS, B) GATS mode 1 (lending by a foreign bank established abroad), C) GATS mode 3 (lending by a foreign bank established in the host country).
Source: Kono and Schuknecht (2000)

WTO Members are required to allow international transfers and payments for transactions without restrictions (GATS - Article XI)[116], although members could be exceptional exempted (GATS – Article XVI, footnote 8)[117]. National treatment at GATS is specific and conditional (Article XVII). The above table illustrates that commitments made under mode 1 require the liberalization of capital inflows and outflows which are an "essential part of the (liberalized) services", while those made under mode 3 require the liberalization of capital inflows which are "related to the supply of the service" without specifying in more detail whether this refers only to capital and equipment to "set up shop" or whether this also includes capital inflows related to service provision.

As GATS follows a "*positive list*" approach, NT applies only to sectors explicitly included by a Member in its schedule of commitments. GATS Annex on Financial Services contains a "carve out" provision ensuring that the agreement will not undermine domestic law or regulations[118]. This prudential provision aims to grant the Member full right to seek the financial stability.

[116] "*Nothing…, provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund*".

[117] "*If a Member undertakes a market Access commitment in relation to the cross-border supply of a service and if the cross-border movement of capital is an essential part of the service itself, that Member is committed to allow such movement of capital. If a member undertakes a market Access commitment in relation to the supply of a service through commercial presence, that Member is committed to allow related inflows of capital into its territory*".

[118] "*Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement*".

GATS Article XII also entitles Members to introduce temporary restrictions on trade in services if facing serious balance of payments and external financial difficulties. Member states can also maintain other regulations, not prudential in nature that can affect conditions of operation and competition in a market (Xiu, 2003). The presence of several loopholes, however, could ultimately prevent the introduction of prudential regulation or other measures benefiting emerging economies and developing countries (Public Citizen, 2009; TWN, 2010; Gosh, 2010)[119], although the converse could also be true as China exemplifies.

Capital exporters countries considered investment-related rules settled at the Uruguay Round suddenly outdate and went for more at the Doha Round (Public Citizen, 2009). Surprisingly, a group of developing countries accepted, a common signalling practice back to the nineties[120]. Signalling practices of this sort were unsurprisingly common at mid-nineties. Developed countries promptly realize this additional concession, and began to promote further compromises at the bilateral front.

Liberalization at the bilateral and regional level

Bilateral Investment Agreements (BITs) made their appearance on the international scene at the instigation of European countries seeking more protection for their investment and to depoliticize foreign investment disputes with developing countries[121]. The numbers of PTAs (basically BITs, later RTAs & FTAs) really exploded after the Uruguay Round, and were mainly directed to increase foreign investors guarantees along the prosecution of more pro-market policies (liberalization) among Latin America and Eastern European countries.

The US became now the most enthusiastic diffuser, firstly under a bilateral scheme, been the signature of the NAFTA agreement in 1994 the first step in that direction[122]. Foreign investment liberalization translated, among others, into a broad definition of investment, increasing restrictions on expropriations along other WTO plus requirements. The model also advanced in protecting the free transference of funds, introducing an absolute standard with mostly no

[119] Prudential measures could be challenged if they are undermining the regulatory constraints otherwise established in the agreement. The absence of any definition for "prudential regulation" left the issue subject to interpretation by WTO dispute resolution panels.

[120] Commitments appears in *schedules*, listing the sectors being opened, the extent of market access being given along any limitation on national treatment introduced by the parties.

[121] BITs fundamental provisions include a wide variety of principles and rules, counting those asserting the non-discriminative treatment among foreign investors (including the Most Favoured Nation, MNF clause), entry and establishment conditions, definition of investors and investments, specific dispute settlement provisions, and free transfer of payments.

[122] The framework introduced at NAFTA Chapter 11 would become known as "the 1994 model". This model text was replaced by a modified version in 2004.

exceptions (as those related to balance of payments crisis)[123]. Likewise, it also followed a "negative list" approach, practically eliminating all exceptions[124]. Above all, the 2004 model BIT essentially forces partners to liberalize their capital accounts, regardless of the nation's institutional capacity (Anderson et. al., 2009). Henceforth, host country policy room for capital controls or safeguards provisions are practically inexistent.

Brazil - Institutions

In spite of the magnitude of FDI inflows and a clearer definition of what Brazilian authorities expected from them in terms of its impact on national development, Brazil stands out for its active resistance to various aspects of post-WWII foreign investment protection and liberalization initiatives. First, it never ratified the Washington Convention of 1965 (the ICSID Convention), which laid the basis for an international framework for the resolution of investment disputes by way of international arbitration between individual foreign investors and host country governments. Secondly, Brazilian national FDI legislation maintained several important exceptions to national treatment[125] of foreign investment and legal provisions for compensation in case of expropriation did not wholly meet the commonly accepted international practice of "prompt, adequate and effective" compensation. Thirdly, Brazil negotiated fourteen BITs during the pro-FDI époque following the fall of the Berlin Wall in the 1990s[126], but never ratified them mainly because of the risks associated with the IA-ISDS clauses[127]. Fourthly, Brazil negotiated the two fundamental foreign investment agreements of the Southern Market (Mercosur) integration scheme, one covering investments by Mercosur members (Colonia

[123] In the vocabulary of US BITs, funds could be transferred [by the foreign investor] freely and without any delay. FTAs, however, recognized the balance of payments crisis exception.

[124] By virtue of the negative list approach, everything goes liberalized unless the countries list the exceptions to the market access at the time of signing the FTA. Two particular problems: a) at the time of listing, the government may not know that a particular financial instrument actually present (and not being listed), could become dangerous later; and, b) even if the government is aware of all current financial instruments, because of the list of exceptions is decided once and for all at the time of signing the FTA, the government cannot list as an exception financial instrument that come into existence in the future (TWN, 2010).

[125] As a consequence, Brazil continued to limit TNCs' ability to contract foreigners by granting only three permanent visas; whereas no such limit applied to nationally owned companies. The federal government also introduced some differences in the area of governance. In this sense, it obliged TNCs to introduce voting rights if listed on stock exchanges– another restriction not applying to nationally owned companies. Finally, foreign-owned companies were prevented from operating in the domestic capital market in times of serious balance of payments conditions.

[126] With industrialized countries, such as Belgium/Luxemburg, Denmark, France, Finland, Germany, Italy, Netherlands, Portugal, Switzerland, and the United Kingdom, and others, like Chile, Cuba, Republic of Korea, and Venezuela.

[127] For the members of Congress, it was inappropriate to grant foreign investors the right to settle investor-State disputes via international arbitration while was not available to national investors.

Protocol) and the other those of non-members (Buenos Aires Protocol), but never ratified them either. Finally, Brazil actively opposed several aspects of the US RTA-like Free Trade Area of the Americas before its suspension in 2004 because it considered the initiative to be asymmetric and containing undesirable constraints on Latin American and Caribbean countries, including the proposed IA-ISDS procedures. In particular, its refusal to participate at the ALCA initiative could be explained by the stringent conditions introduced by the US in the financial front, banning any sort of control on capital flows (Pudwell, 2003)[128]. As a result of these actions, Brazil is not involved in any known ISDS investment disputes and carries virtually no IIA risks.

In sum, Brazil is a country that has demonstrated a welcoming approach to FDI, has accumulated a significant stock of inward FDI, thereby increasing its integration into the global economy. At the same time, Brazil has used its increasing negotiating strength, which derives in part from its attractiveness to TNCs (its large market and growing economy), to implement cautious policies that carefully limit or reduce to a minimum its IA-ISDS risks with respect to IIAs.

India - Institutions

The new fervour towards market liberalization was reflected in the IIA network signed by India, which included close to 50 BITs, on top of a special agreement with the United States in 1987[129]. More recently, the country began to be more active on the IIA front, adhering to several new RTAs and FTAs, several of which contain special chapters dealing with investment issues, reflecting the new focus of Indian policy to consolidate regional trade agreements in South Asia, ASEAN and, in the future, in Northeast Asia. India has also initiated talks with Japan in July 2005 and initiated negotiations with the EU at 2007. Yet, India's policy with regards to IIAs resulted quite cautious. It still is not a signatory of the ICSID Convention. Its 48 BITs in force[130] do not provide foreign investors any rights to establish investment in its territory (D'Agnostino and Nair, 2008) whereas more recent RTAs and FTAs with countries like Canada and

[128] The signature of the FTA agreement with Chile could have worked as guidance, as Chile was forced to accept free movements of capitals and resign its former policy in the matter - included in all BITs signed by the country.

[129] The *Investment Incentive Agreement* aimed to protect and promote American investment in India, particularly in energy and power, telecommunications, manufacturing and services. The agreement contained a State-to-State dispute resolution mechanism.

[130] With Australia, Austria, Belgium/Luxemburg, Denmark, Finland, France, Germany, Italy, Netherlands, Portugal, Spain, Sweden, Switzerland, and United Kingdom; and others, like Argentina, Belarus, Bulgaria, China, Croatia, Cyprus, Czech Republic, Egypt, Hungary, Indonesia, Israel, Kazakhstan, Korea Rep., Kuwait, Kyrgyzstan, Lao PDR, Malaysia, Mauritius, Mongolia, Morocco, Oman, Philippines, Poland, Qatar, Romania, Russian Federation, Serbia, Sri Lanka, Taiwan, Tajikistan, Thailand, Ukraine, Uzbekistan, Vietnam.

Singapore carry important qualifications that limit future IA-ISDS risk. In sum, this large market developing country has attempted to use its increasing negotiating strength to reduce or limit risks associated with IA-ISDS clauses in IIAs[131].

As stated in previous paragraphs, foreign owned banks were almost inexistent under the Raj model – in terms of their market share at Indian banking system. Liberalization measures launched in the nineties and benefiting foreign investors were certainly not expanded to the banking sector. As India applied for WTO membership, pressure mounted to liberalize its financial sector. The first attempt made during the nineties become halted by the Asian crisis, although it permitted an important expansion of foreign banks (Gopalan and Pajan, 2010). The government launched a new "*roadmap for presence of foreign banks in India*" in 2005, stipulating a two-phase approach basically oriented to consolidate local banks.

Under India´s legal system, foreign banks are allowed to operate either through a wholly owned subsidiary (WOS) or branches, although monetary authorities incentives branches[132]. At this point it when the debate starts (RBI, 2011; BBA, 2011). Besides legal organization, the RBI roadmap advanced on corporate governance issues, asking for a predominant role for Indian directors[133]. Monetary authorities are also debating whether foreign banks would be allowed to raise funds at the local market in order to augment their non-equity capital in India. Foreign banks, on the other hand, are required to extend lending to the priority sector up to 32%, below the percentage fixed for local banks. Monetary authorities also limited the number of licences (12 per year). Finally, and despite the liberalization trend, authorities maintained a very restricted measure by limiting the issuance of new licenses if the share of foreign bank branches exceeds 15% of the banking system total assets. By contrast it has no restrictions as regards to the acceptance of retail deposits by a foreign bank branch ("Canada – India Joint Study Group Report: Exploring the Feasibility of a Comprehensive Economic Partnership Agreement" Foreign Affairs and International Trade Canada). Pressures to foster financial services

[131] Indian official maintained a similar attitude until the EU negotiators ("*India rejects clause on litigation*" LiveMint.com, 4 July, 2011). EU negotiators are also proposing the removal of all restrictions on capital controls ("India, Foreign Investors´ Paradise: The Devastating Impacts of the EU-India Free Trade Agreement" By Kavaljit Singh – Global Research, February 1, 2011).

[132] The dispute on whether an international bank should legally constitute as a legal branch (i.e.: legally attached to the headquarters) or subsidiary (locally separated legal entities) involves the deposit insurance scheme.

[133] In particular, monetary authorities were suggesting that: i) not less than 50% of the directors should be Indian nationals residents in India, ii) not less than 50% of the directors should be non-executive directors, iii) a minimum of one-third of the directors should be totally independent of the management of the subsidiary in India, its parent or associates and, iv) the directors shall conform to the "Fit and Proper" criteria settled at former RBI circular of June, 25 2004 (RBI, 2011).

liberalization are also observed in their FTA negotiations with the EU, particularly towards the removal of all barriers to market access and the grant of national treatment commitments (Singh, 2011)[134]. UK and German representatives, countries hosting the main players of the EU banking industry, are aggressively pushing the discussions on the banking sector[135].

India restrictive approach is also observed under the ECB scheme. As for example, ECB guidelines unambiguously state a series of restrictions for overseas lenders, particularly in respect of the acquisition of immovable property [136].

China - Institutions

In the case of the PRC, it makes sense to recall that, to an important degree, the closing of the economy during the Mao tse Tung era had as much to do with China's reaction to colonial practices as Marxist ideology (Mortimore and Stanley, 2010). For this reason, the PRC's opening to foreign investment as of 1978 can be considered so dramatic and also suggests why the FDI policy was so cautious, evolving slowly based on the PRC's own experience of linking FDI directly to national goals defined in the national development strategy. In the past 30 years, the PRC has progressively opened up to foreign investment and as a consequence been host to exceedingly voluminous FDI inflows.

International investment treaties became a progressively more important aspect of aforementioned FDI policy. In 1982, China became a signatory of the ICSID Convention (ratified much later) and subsequently assembled the second most important global web of BITs, after Germany, encompassing more than one hundred agreements[137]. The PRC signed

[134] Key demands include: complete market access (commercial presence, cross-border supply and consumption) and national treatment commitments. EU negotiators are also asking for the removal of regulations pertaining to bank branches, numerical quotas, foreign ownership, equity ceilings, voting rights and investment by State-owned companies in foreign Banks in India (The India-EU Free Trade Agreement: Should India Open Up Its Banking Sector? By Kavaljit Singh. Global Research, March 16, 2009)

[135] Foreign banks have a 7,65% of market share, with 9 EU – based controlling 65% of this total. In terms of asset size, 6 of top 10 foreign banks are EU-based. Those figures might be explaining the relevance of actual discussions [figures from RBI (2011) and Singh (2011)].

[136] In case of borrowers´ insolvency, the property should be sold to a resident and then the sale proceeds can be used to repay the outstanding ECB.

[137] China's BIT partners were Albania; Algeria; Argentina; Armenia; Australia; Austria; Azerbaijan; Bahrain; Bangladesh; Barbados; Belarus; Belgium and Luxembourg, Benin; Bolivia; Bosnia and Herzegovina; Botswana; Brunei Darussalam; Bulgaria; Cambodia, Cameroon; Cape Verde; Chile; Congo; Congo DR; Côte d´Ivoire; Croatia; Cuba; Cyprus; Czech Republic; Denmark; Djibouti; Ecuador; Egypt; Estonia; Ethiopia; Finland; France; Gabon; Georgia; Germany; Ghana; Greece; Guyana; Hungary; Island; Indonesia; Iran, Islamic Republic; Israel; Italy; Jamaica; Japan; Jordan; Kazakhstan; Kenya; Korea, DPR; Korea Republic; Kuwait; Kyrgyzstan; Lao PDR; Latvia; Lebanon; Lithuania; Macedonia; TFYR; Madagascar; Malaysia; Mauritius; Moldova Republic; Mongolia; Morocco; Mozambique; Myanmar; Netherlands; New Zealand; Nigeria; Norway; Oman; Pakistan; Papa New Guinea; Peru; Philippines;

with Pakistan its first FTA containing a formal investment chapter, initiating a new institutional path[138].

The first BITs were signed in the early 1980s in the context of a very restrictive FDI policy and were extremely restrictive limited in terms of FDI protection and guarantees. Most treaties excluded the National Treatment clause (Berger, 2008). Originally, foreign investors were allowed to enter only throughout a joint venture contract or associated to local a local partner (basically a SOEs), the national currency did not become convertible at the mid 1990s, and the full protection of private property in the PRC was full consolidated in a Constitutional amendment of 2005. They generally excluded any sort of IA-ISDS provisions by which individual foreign investors could take the PRC to international arbitration, although this was possible exclusively for the definition of the amount of compensation payable following an expropriation (Heyman, 2008; Rooney, 2008). PRC government policy also delayed implementing the New York and Washington treaties, which naturally affected the enforcement of any awards (Rooney, 2008).

The second generation of BITs transformed the existing situation and marked the beginning of a new era for investment protection in the PRC. The China-Barbados BIT signed on July 1998, resulted the first treaty to offer foreign investors unrestricted access to international arbitration (Berger, 2008), matching with the new "Go Global" strategy launched by the government. Since then, China negotiated higher risk BITs (for example, with Netherlands, Bosnia-Herzogovina, Germany and Finland)[139], and even some RTAs (for example with Pakistan), which increased FDI protection and including g national treatment and further aspects of FDI liberalization. The PRC has become confident enough with its modern FDI policy to begin negotiating access to the Energy Charter Treaty and a RTA with ASEAN, which entails certain FDI liberalization measures. In other words, the Chinese approach to foreign investment originally very cautious is becoming increasingly liberal.

New agreements enhanced foreign investors´ protection both in their broad and effective IS-DS provisions, and in their comprehensive and unqualified substantive protections (Dulac and

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Poland; Portugal; Qatar; Romania; Russian Federation; Saudi Arabia; Serbia and Montenegro; Sierra Leone; Singapore; Slovenia; South Africa; Spain; Sri Lanka; Sudan; Swaziland; Sweden; Switzerland; Syrian Arab Republic; Tajikistan; Thailand; Trinidad and Tobago; Tunisia; Turkey; Turkmenistan; Uganda; Ukraine; United Arab Emirates; United Kingdom; Uruguay; Uzbekistan; Vietnam; Yemen; Zambia; and, Zimbabwe. China currently has 89 BITs in force, 14 with industrialized countries and 75 others.

[138].

[139] In order to include these new clauses, China also re-negotiated some old BITs with countries, such as Sweden, Trinidad and Tobago, and Tunisia.

Savage, 2008). The shift to riskier FDI policy in China with regards to IA-ISDS clauses reflects its new status as a major outward investor with significant external assets to protect. Thus, the PRC represents the clearest case of a larger market / fast growing economy, which carefully calibrated its foreign investment policies to take advance of its growing negotiating strength. It defined the economic goals that it wanted to achieve taking advantage of foreign investment without being coerced into exaggerated or unwarranted risks with regards to IA-ISDS clauses.

In relation to the opening of the Chinese financial system, the wide-ranging promises made before the accession until the WTO in 2001, particularly in terms of foreign banks access ended relatively modest (Gopalan and Pajan, 2010).

Table 9: WTO – China commitments in the banking sector

Major WTO commitments	Remaining Practical restrictions
Establishment of Subsidiaries and Branches (2002)	- Branches are treated as separated legal entities - Limited RMB borrowing from CN banks - Liquidity requirements - High performance requirements for foreign institutions - Foreign shareholding in CN banks restricted
Engagement in RMB business in China - Corporate banking (Dec 2002) - Retail banking (Dec 2006) - No geographic restrictions (Dec 2006)	- High performance requirements for foreign institutions - Limited refinancing possibilities - Limited access to deposits (and refinancing) - Difficult access to SOE loan clients - To participate in retail RMB business and bank card business foreign banks have to incorporate subsidiaries
Engagement in foreign currency business (Dec 2001)	- CN companies can open only one account for currency loans, in city of location - Trade finance facilities granted by foreign banks are subject to tedious extra registration as "foreign debt of China"
Lifting of Non-Prudential Regulation (Dec 2006)	- Commercial land ownership restricted to 40 yrs.

Source: EU (2007)

Banking commitments made under GATS fixed a gradual opening strategy starting at 2002 to end by December 2006, before that China´s services markets were heavily regulated and in extremely closed for foreigners. Commitments were certainly important and far-reaching (Whalley, 2003; Crosby, 2007; Yu, 2010), generating both "opportunities and challenges" (PBC, 2001)[140]. Theoretically, China agreed to opens its financial markets, allowing foreign banks to conduct foreign currency business with all customers (although on a partial basis) and engage in local currency services (Xuan, 2003). Furthermore, and in compliance with their

[140] According to the Popular Bank of China (PBC, 2001), China committed to phase out all restrictions on foreign banks, including those preventing them to attend local customers or expands geographically. Foreign banks were also promised to participate at the foreign exchange business, in two years with enterprises and in five with all Chinese customers.

WTO commitments, authorities were conceding them national treatments status. In practice, China certainly profited from all legal ambiguities to blind their financial market from foreign competition (EU, 2007). Notwithstanding promises, the commercial value of their commitments remained conditional on the interpretation and implementation of its obligations (Crosby, 2007). Among others, prudential regulatory measures were widely used to restrict foreigners' participation, as for example by imposing high minimum capital requirements and treated all branches as being separate legal entities and not part of a consolidated network[141]. Foreign banks are also subject to excessive liquidity ratios, and seriously limited to engage in RMB lending[142]. On the other hand, participation in Chinese banks continues to be seriously limited. The foreign strategic investment rules issued by China´s Banking Regulatory Commission continue to limit the participation of foreign banks in local banks to a minority stake: 20% per investor, and an aggregate of 25%. Furthermore, and despite their seat at the Board, foreign investors have little or no ability to influence in the company´s (bank) management (Bell and Chao, 2010).

China´s GATS schedule stated that after December 10, 2006, any "*non prudential measures restricting ownership operation and juridical form of foreign financial institutions, including on internal branching and licences, shall be eliminated*" along with all remaining geographical restrictions. Commercial presence under GATS encompassed a variety of forms including the constitution of new banks, the acquisition of existing ones, along the autonomy [for foreign banks] to decide its corporate scheme (Crosby, 2007)[143]. At September 2007, and following the pass of the new rules, 25 foreign banks entered the market, principally arriving from the US, EU and Japan (Raja, 2007). However, and almost five years later, restrictions might continue to be binding. Chinese authorities might also provide "national treatment to foreign institutions, which means they cannot treat Chinese banks more favourably than they treat "like" foreign institutions – except when exceptions were included in China´s service schedule.

Henceforth, and considering China´s (apparent) misconduct, a number of WTO members launched a series of complaints (Raja, 2007; Crosby, 2007), although their validity remains

[141] Another limitation challenging foreign bank participation relates to the ban impeding opening more than one new branch per year – particularly if we consider that a "competitive" nationwide network would consist of around 25.000 branches.

[142] Although foreign banks are allowed to engage in RMB lending, they are not entitled to use foreign currency deposits of the borrower as security/ colateral for such RMB loans.

[143] A "commercial presence" commitment in banking services requires the relevant Member to allow banks of other WTO members to establish in their market by constituting a new bank or acquiring state-owned, state-invested, or privately owned banks that wish to sell all or part of their business subject only to the limitations that the Member has scheduled on market access and/or national treatment.

questionable (Crosby, 2007). In particular, dispute arises on whether Chinese authorities were refusing the entry of foreign rivals or whether foreign banks were expecting a unilateral opening from local ones.[144] China also asserted that some of the actions were undertaken to nurture the country financial regulatory and prudential measures.

The approach towards the entry of foreign banks undertake by Chinese financial authorities was not only cautious but strategist, and certainly not given foreign banks room for any dream "*to obtain controlling positions in existing banks, accessing infrastructure and customers through branches or subsidiaries on a level playing filed, and in operation independent electronic payment networks*" (Crosby, 2007).

[144] The GATS only limits certain restrictive or discriminatory government measures, and does not create rights for foreign firms to invest in particular Chinese banks. The GATS neither compels privately owned banks to sell interest to foreign investors, nor requires full or partial privatization of government-owned services suppliers (Crosby, 2007).

5. Conclusions

At the beginning of the nineties international financial institutions were proclaiming the irruption of a new panacea, and (financial) deregulation and (capital account) liberalization presented as the unique feasible route to be followed by emerging economies in the search for development. Developing countries policy options were significantly reduced as predicted by the impossibility *trilemma*, particularly in terms of exchange rate and monetary policy. Controls on capital inflows were, suddenly, out of questions. Savvy investors were benefiting responsible countries but penalizing lazy ones, as financial agents performed the role impartial arbitrators. In short, policy makers at developing countries lost, suddenly, most of their policy autonomy.

Americans were certainly too harsh with other nations distinctive responses to the trilemma (Mankiw, 2010), but disagreement proved effective. Henceforth, and because of the policy options following during the period, they were exempted from the trilemma die-hard options emanated from the North, particularly the giants from Asia.

Controlling the amount of capital flows might help to disentangle the trilemma. Under circumstances like this, interest rate differential could be maintained and pressures to exchange rate reduced (Magud et.al., 2011; Habermeier et.al., 2011). China and India maintained important controls on their capital account, postponing both the full convertibility of the local currency and permitting for monetary policy. Brazil, by contrast, becomes more enthusiastic with the neoliberal agenda, although not great supporter of all of their recipes. In the midst of both financial crises (1998 and 2008), authorities were certainly very pragmatic, introducing capital controls in order to curb financial volatility. Likewise, the three countries become very active in the latest financial crash, from which they are emerging as the new economic super-power. To a greater extent, the high levels of international reserves were necessary to cushion the financial sector from external shocks[145]. For policy-makers, to count with high levels of international reserves becomes a necessary condition to increase their autonomy.

A similar picture emerges from the micro level. Around thirty years ago, IFIs were alarming on the evils posed by the presence of financial repressed systems, claiming the superiority of deregulated markets and the benefits associated with the entry of financial operators from abroad. Markets were seen as solving all the problems, if any. Shocks policies were optimal; as any interruption would induce local banks to prevent the entrance of competitors from abroad

[145] Certainly, with a total of foreign assets valued at $ 2,7 trillion, China´s reserve dwarf those of Brazil and India. Reserve composition, on the other hand, modified following the crisis, with US treasuries increasing their share.

and, henceforth, delay the gains of private agents. Brazil exited with the message, pushing for bank privatization and denationalization. China liberalization path, by contrast, become subtler, despite promises and original agreements. As an example, see at their attitude towards foreign banks entrance despites promises made at the WTO system. In this sense, "*if the crisis has transformed the status of emerging-market banks, it has also transformed the role of the state in banking*" (Economist, 2010)[146].

The three countries have also advanced in regulation measures and supervision issues, issue that began to be interpreted as determinant in protecting the domestic banking system form the global financial turmoil. Regulatory authorities at those countries were profoundly conservative a behaviour that become to be fashionable "*most bank executives now also concedes that old-fashioned regulation was shown to have its merits*" (Economist, 2010).

Similarly, the fall of the Berlin Wall at the beginning of the 1990s that epitomized the end of Communism in Europe was followed by a wave of multilateral and bilateral agreements promoted primarily by OECD countries, which ushered in a new era of market friendly policies characterized by foreign trade liberalization and foreign investment protection and liberalization. While most developing countries and transition economies actively bought into or passively acquiesced in the neoliberal packages offered them, especially the new trade and investment treaties, larger market reworked their national development strategies to define a more complementary role for foreign investment and actively sought to limit or reduce the risks associated with FDI, or those related to portfolio investment. In other words, this group of countries were very cautious at the institutional front[147], reducing their legal risks and Brazil directly rejected any sort of legal constraint[148].

China and India also profited all the legal loopholes presented at the WTO/GATS system. In particular, the right gave to member countries by GATS to maintain sovereignty over prudential and related regulations of all financial firms resident in the countries. Increasing foreign presence adds more competition on the domestic saving pool. This explains why local authorities demonstrate a suggestive incentive to restrict the amount of foreign owned branches

[146] Certainly, the relevance of the state is not new, something observed by Helleiner (1994) in relation to the process of banking internationalization and financial globalization in the twenty century. But not all emerging economies, not all developing states profited from this and, henceforth, deprived to match financial deepening with economic development.

[147] Or transforming into an aggressive capital exporting country (i.e.: China), requiring stronger investment protection than it was willing to previously admit.

[148] Particularly those associated with procedures in international investment agreements that facilitated individual foreign investors recurring to international arbitration in their disputes with host governments (Mortimore and Stanley, 2010).

and limit foreign ownership of existing local banks. In the process of financial deepening and development the role of the state become fundamental, not only because of their involvement in the operative side, but fundamentally throughout its active institutional role.

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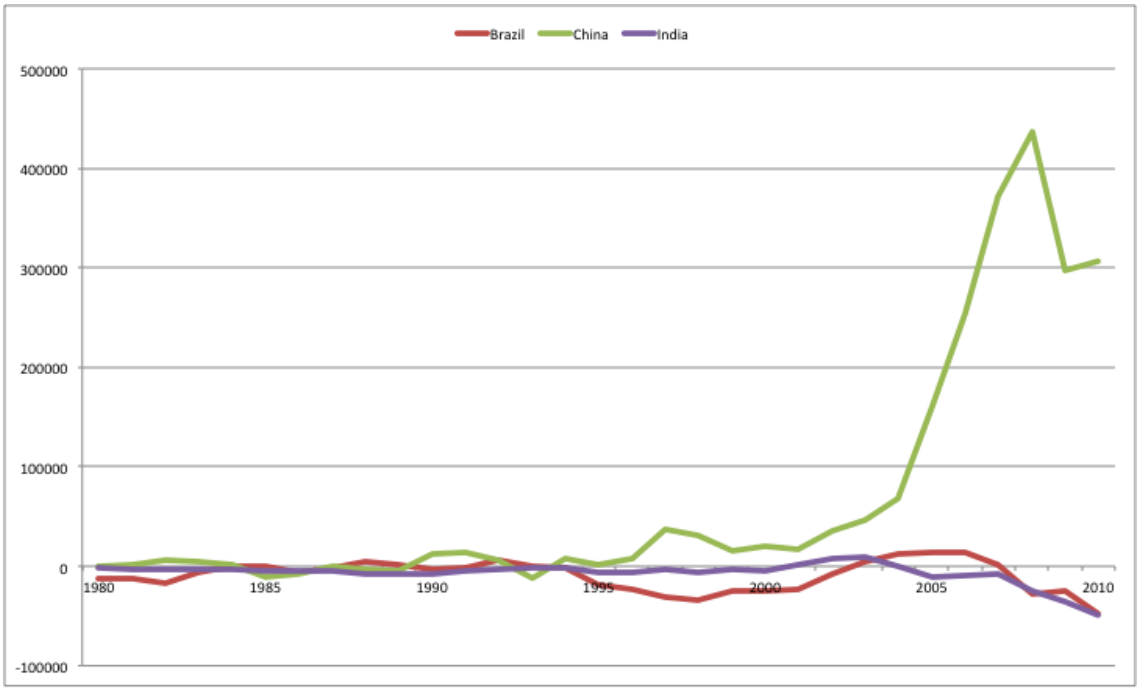
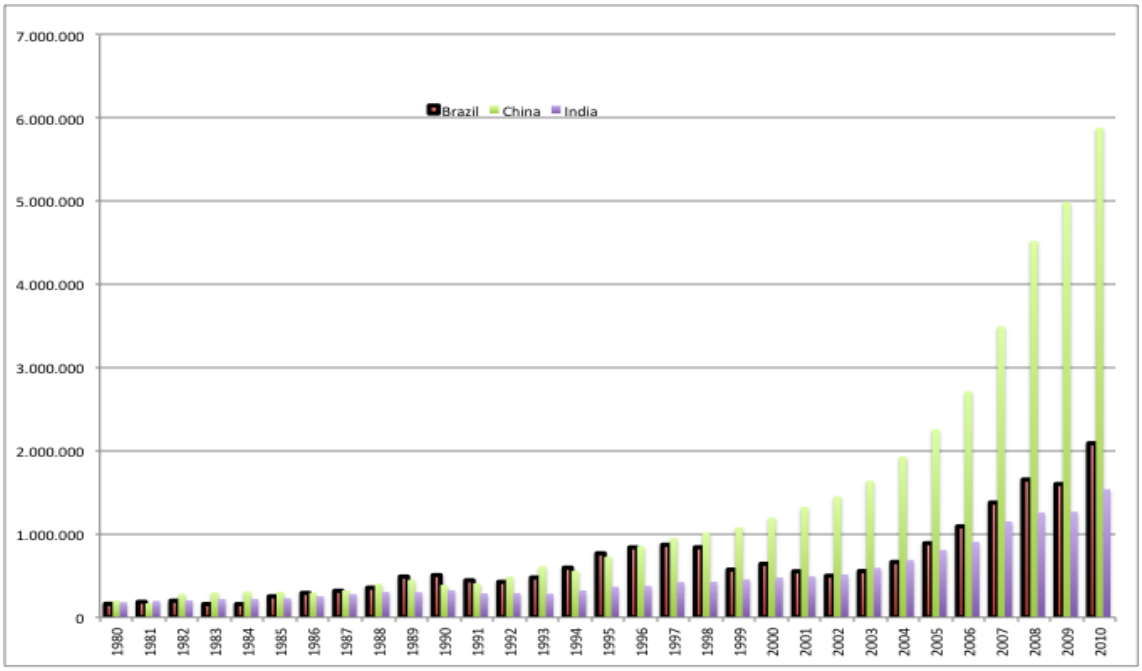
Annex

Graph 19: BICs current account balance (U$ Billions) (1980-2010)



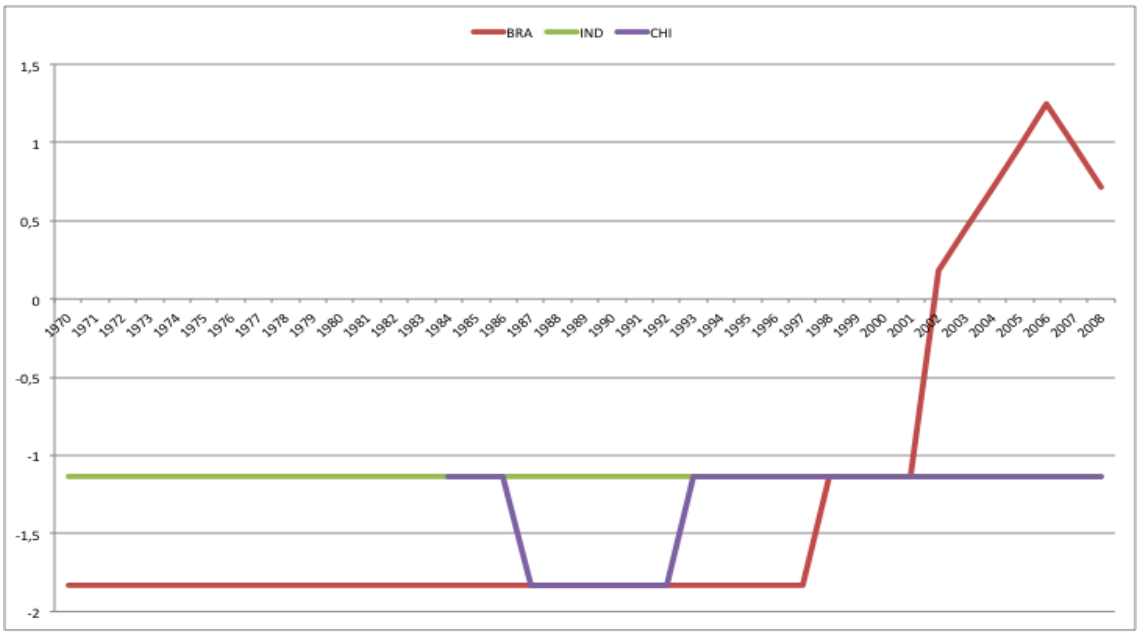
Source: IMF – WEO 2010

Graph 20: BICs GDP evolution



Source: IMF – WEO 2010

Graph 21: Chin – Ito Capital Account Index



Source:

Chin-Ito capital account openness index (KAOPEN) is one index measuring the degree of capital restrictions and regulations imposed by a country (a *de jure* capital control). It measures a country´s international financial openness on a scale from -2,54 to +2,54, with the former value indicating a completely closed capital account, and the later indicating full liberalization.

The IMF annual reports on exchange arrangements and exchange restrictions (AREAR) analysing data on thirteen different categories of capital transactions. One problem with those indexes is that they are not capturing differences in the intensity of capital control enforcement.

In a separated paper, professors Aizenman, Chinn and Ito expanded the aforementioned indicator, including two new indexes trying to measure the trilemma – as observed in the graphs included at the main text. Monetary autonomy or independence (MI) is measured by the (lack of) interest rate correlation with base country interest rate, whereas exchange rate stability (ERS) by the inverse of the standard deviation of the monthly nominal exchange rate changes between the home country and the base country. MI maximum and minimum values are 1 and 0, with higher values meaning more monetary policy independence. For the ERS index, if the rate of monthly change in the exchange rate stayed within +/- 0,33 per cent bands, the exchange rate is consider to be fixed, and assigned a value of 1. Higher values of this index indicate a more stable movement of the exchange rate against the currency of the base country. The paper also introduce a fourth index measuring the ratio of international reserves to GDP, recognizing the particular relevance of foreign reserves accumulation to shield the national economy against financial speculators along to reduce macro volatility.

Table 10: Aizenman, Chinn and Ito data for BICs, Evolution 1984-2009

Country	Brazil			India			China		
Year	ERS	MI	KAOPEN	ERS	MI	KAOPEN	ERS	MI	KAOPEN
1984	0,492	0,359	-1,831	0,494	0,706	-1,136	0,292	0,537	-1,136
1985	0,387	0,276	-1,831	0,304	0,599	-1,136	0,317	0,537	-1,136
1986	0,158	0,287	-1,831	0,378	0,519	-1,136	0,191	0,537	-1,136
1987	0,118	0,403	-1,831	0,458	0,546	-1,136	1,000	0,500	-1,831
1988	0,206	0,646	-1,831	0,405	0,574	-1,136	1,000	0,500	-1,831
1989	0,063	0,587	-1,831	0,507	0,524	-1,136	1,000	0,423	-1,831
1990	0,061	0,713	-1,831	0,518	0,525	-1,136	1,000	0,310	-1,831
1991	0,096	0,580	-1,831	0,156	0,444	-1,136	0,692	0,310	-1,831
1992	0,386	0,658	-1,831	1,000	0,458	-1,136	0,489	0,377	-1,831
1993	0,242	0,642	-1,831	1,000	0,351	-1,136	0,732	0,490	-1,136
1994	0,047	0,535	-1,831	1,000	0,442	-1,136	0,078	0,572	-1,136
1995	0,403	0,409	-1,831	0,346	0,442	-1,136	1,000	0,540	-1,136
1996	0,916	0,275	-1,831	0,343	0,526	-1,136	1,000	0,579	-1,136
1997	0,899	0,477	-1,831	0,361	0,624	-1,136	1,000	0,395	-1,136
1998	0,838	0,679	-1,136	0,413	0,556	-1,136	1,000	0,568	-1,136
1999	0,059	0,839	-1,136	0,682	0,509	-1,136	1,000	0,529	-1,136
2000	0,336	0,908	-1,136	0,562	0,231	-1,136	1,000	0,630	-1,136
2001	0,165	0,945	-1,136	0,665	0,181	-1,136	1,000	0,481	-1,136
2002	0,085	0,672	0,180	0,711	0,142	-1,136	1,000	0,481	-1,136
2003	0,167	0,393	0,447	0,601	0,123	-1,136	1,000	0,339	-1,136
2004	0,260	0,206	0,713	0,342	0,103	-1,136	1,000	0,357	-1,136
2005	0,220	0,499	0,980	0,467	0,171	-1,136	1,000	0,205	-1,136
2006	0,191	0,501	1,247	0,339	0,357	-1,136	0,841	0,486	-1,136
2007	0,239	0,675	0,980	0,354	0,570	-1,136	0,747	0,348	-1,136
2008	0,133	0,436	0,713	0,264	0,599	-1,136	0,617	0,501	-1,136

Table 11: Bank return on equity, selected countries (2006-2009)

Country	2006	2007	2008	2009
US	12,3	7,8	0,4	0,9
UK	8,9	6,2	-10,3	2,6
Euro area	13,6	11,9	-8	1,2
Japan	8,5	6,1	-6,9	4,7
Brazil	27,3	28,8	15,3	20,4
India	12,7	13,2	12,5	12,3
China	14,9	16,7	17,1	15,1

Source: Reserve Bank of India, RBI (2010a)

Table 12: Banks NPLs to Total Loans ratio, selected countries (2006-2009)

Country	2006	2007	2008	2009
US	0,8	1,4	2,9	5,4
UK	0,9	0,9	1,6	3,5
Brazil	3,5	3	3,1	4,2
India	3,3	2,5	2,3	2,3
China	7,1	6,2	2,4	1,6

Source: Reserve Bank of India, RBI (2010a)

Table 13: Bank Regulatory Capital to risk – weighted asset

Country	2005	2006	2007	2008	2009
US	12,9	13	12,8	12,8	14,3
UK	12,8	12,9	12,6	12,9	14,8
Japan	12,2	13,1	12,3	12,4	15,8
Brazil	17,9	18,9	18,7	18,3	18,8
India	12,8	12,3	12,3	13	13,2
China	2,5	4,9	8,4	12	11,4

Source: Reserve Bank of India, RBI (2010a)