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Would the real IMF please stand up?

By Kevin P. Gallagher
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Clear and consistent proposals toward crisis recovery and prevention are needed at the International Monetary Fund upcoming annual meetings. Unfortunately, the IMF has been sending mixed messages over the past two months on the subject of capital controls.

In a landmark report in February the IMF broke its longstanding fixation on capital account liberalisation. In a staff position note the IMF found that temporary controls on capital inflows have been effective and should be an essential part of a nation's macroeconomic toolkit.

Capital controls include measures such as taxes on short-term debt (like those put in place by Brazil in 2009) or requirements famously used by Chile and Colombia where a portion of inflows of short-term debt must be parked in the central bank for a set period of time.

The goal of these measures – often used when capital flows start to overheat and removed when things cool – are to prevent inflows of hot money that can appreciate the exchange rate, cause asset bubbles or balance-of-payment problems, and threaten financial stability.

In its study, the IMF performed an econometric analysis of the global financial crisis and found that "the use of capital controls was associated with avoiding some of the worst growth outcomes associated with financial fragility."

This view is consistent with peer-reviewed economics literature. In a 2006 National Bureau of Economic Research assessment of the literature on capital controls, Carmen Reinhart and Nicholas Magud examined the most rigorous studies and concluded "capital controls on inflows seem to make monetary policy more independent, alter the composition of capital flows and reduce real exchange rate pressures."

Based on this evidence, you would think the IMF is poised to cautiously call for the appropriate use of capital controls in the aftermath of the crisis. Such advice coming from the IMF could be well timed.

Once again the carry trade is triggering a mass inflow of capital to emerging markets that many worry is causing a reappearance of asset bubbles. A clear IMF endorsement would provide cover for a policy that has received a shaky response from investors.

Indeed, in a recent book titled Capital Rules: The Construction of Global Finance, Harvard Business School's Rawi Abdelal shows how credit rating agencies have been known to downgrade a nation's debt for using controls.

But rather than taking a stand, the IMF has back-peddled from its study and in its April's Global Financial Stability Report argues capital controls are inefficient, can divert hot money to other countries, and "prevent the global rebalancing of demand and thus hinder the recovery of global growth."

The more recent study appears to be the old IMF which is driven more by ideology than rigorous research. The GSFR says capital controls are inefficient, but fails to acknowledge that controls, when designed properly, are seen as second-best instruments to make markets more efficient by correcting distortions—not creating distortions.

The GSFR is right to point out that capital controls can lead to diversions of speculative capital to other emerging markets. Yet, the IMF does not acknowledge its own former economist Arvind Subramanian who has called for the coordinated use of capital controls across emerging market economies to avoid the diversionary effects of capital controls.

Finally, the GSFR does not acknowledge that by their very nature capital controls are intend to be re-balancing, by taking pressure off local currencies and subsequently alleviating the balance of payments problems that set the stage for the current crisis.

Under Dominique Strauss-Kahn there has indeed been change of sorts at the IMF. The organisation was shunned after the Asian crisis of the late 1990s. Yet, in the wake of the current crisis the IMF has transferred new Special Drawing Rights (SDRs) to developing nations, opened up a temporary liquidity facility with funds available without condition, published studies recommending that the inflation target be raised to four percent and that SDRs be used to finance climate change adaptation, and has even started a discussion about changing its current voting system where Luxembourg, the Netherlands and Belgium have more votes than China, India and Brazil.

This change has been welcome, but most nations remain unimpressed and steer clear of the institution. This week the IMF has the opportunity to shed its draconian image and be a force for financial stability. Sending mixed messages on capital controls is not in good standing with economic thinking and its own research on this issue.

The IMF should leave ideology aside and ensure that nations have all possible instruments at their disposal to combat and prevent crises. If ideology wins, the IMF's efforts to get back in good standing will remain futile.

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