IMF's New View on Capital Controls

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In the 1970s the International Monetary Fund became an advocate of capital account liberalisation, and in 1997 it tried to change its Articles of Agreement to include capital account convertibility among its mandates. In contrast, the IMF embraced in December 2012 a new "institutional view" on this issue. While it remains wedded to eventual financial liberalisation, it now acknowledges that free movement of capital rests on a weak intellectual foundation. This article claims that this is a step in the right direction, but that the new institutional view still suffers from a number of shortcomings.

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In December 2012, the International Monetary Fund's (IMF) Executive Board endorsed a new "institutional view" on capital account liberalisation and the management of capital flows. The same institution that once told emerging market and developing countries to liberalise their capital accounts has shifted gears to say that, under certain circumstances, it is adequate to regulate cross-border finance. The Fund thus now endorses – although only half way – the perspective of many emerging and developing countries. This new view will give official guidance to IMF surveillance and reporting efforts. In particular:

- The IMF now recognises that capital flows carry risks, and that the liberalisation of capital flows before nations reach a certain threshold of financial and institutional development can accentuate those risks.
- It also acknowledges that under certain circumstances, cross-border capital flows should be regulated to avoid the worst effects of capital flow surges and sudden stops.
- It rightly says that nations that are the source of excessive capital flows should pay more attention to the potentially negative spillover effects of their macroeconomic policies.
- Finally, the IMF boldly notes that its new view on capital flow management may be at odds with other international commitments, such as in trade and investment treaties that restrict the ability to regulate cross-border finance.

However, this institutional view on these matters suffers from a number of shortcomings. This short article will discuss the main features of the new IMF view on capital flows and expand on some of these shortcomings.

IMF's 'New' View

Although the IMF remains wedded to the liberalisation of a country's capital account as a long-term goal, it now recognises that the idea of free capital movements rests on much weaker ground than does the case for free trade. It now states that capital account liberalisation is only optimal after a nation has reached a certain threshold of financial and economic development, one that many emerging market and developing countries have not yet reached. It then recommends that liberalisation should be sequenced, gradual, and not the same for all countries at all times. This is the result of the acknowledgement that there are risks as well as benefits from cross-border financial flows. Such flows are particularly prone to sharp inflow surges followed by sudden stops that can cause a great deal of financial instability.

Furthermore, the IMF now recommends that nations could use "Capital Flow Management Measures (CFMs)" – Capital Account Regulations (CARs), in our terminology[1] – on previously deregulated portions of their capital account if done alongside other macroeconomic policies: counter-cyclical monetary and fiscal policies, active foreign exchange reserve management, and macro-prudential financial regulations. The IMF's guidelines on inflows recommend, nonetheless, that countries deploy CARs only as a sort of "last resort" – that is, after such measures as building up reserves, letting currencies appreciate and strengthening fiscal policy have been adopted. It is also more stringent on the use of regulation on outflows, arguing that by and large they should not be used but can be considered in crisis or near crisis conditions. Under all circumstances, in the IMF view, CARs could discriminate on the basis of currency but not on the basis of residence (IMF 2012a, b).

This new IMF view does have some precedents in the institution's practice. Thus, although generally in favour of capital account liberalisation, the Fund always expressed caveats. This point was brought forward in the IMF's Independent Evaluation Office (IEO) 2005 assessment of the institution's views on capital account liberalisation, which concluded that the IMF was aware of the risks of capital account liberalisation, particularly for countries without a strong domestic financial sector, and supported in particular regulation on inflows. But the IEO said it did not always highlight the risks of liberalisation or inappropriate sequencing to country authorities, and also tended to disregard or underscore such risks in some of their analyses of this issue (IMF/IEO 2005: 7).

The new institutional view builds upon this more cautious perspective. While incremental, it also breaks significant ground, particularly in highlighting the multilateral aspects of regulating financial flows: recognising the role of source country spillovers and the lack of consistency between the adopted guidelines and trade and investment treaties.

Shortcomings of the IMF View

Although a significant step forward, the new institutional view is still out of step with country experience and economic thinking in many respects. In particular, it continues to insist on eventual capital market liberalisation despite the lack of evidence supporting it, is too narrow concerning the sanctioned use of CFMs (i e, CARs) on inflows and outflows, and does not deal with the implications of their view for multilateral aspects of regulating cross-border finance.

Indeed, the IMF continues to advocate the eventual liberalisation of the capital account despite the fact that the literature overwhelmingly finds no strong correlation between capital account liberalisation and growth, especially in emerging and developing countries. Indeed, former IMF economists Jeanne and Subramanian, together with Williamson, have recently conducted a "meta-regression" on the literature and conclude that "the international community should not seek to promote totally free trade in assets – even over the long run – because (...) free capital mobility seems to have little benefit in terms of long-run growth and because there is a good case to be made for prudential and non-distortive capital controls" (Jeanne, Subramanian and Williamson 2012:5).

In turn, new research in economic theory shows that CARs can be the optimal policy for internalising the externalities associated with risky capital flows (Korinek 2011). Econometric analyses also show that CARs can be effective in their stated goals. The IMF's own research showed that those nations that deployed controls were among the least hard hit by the global financial crisis. These studies did not differentiate the sequence of use for different measures nor did it distinguish whether such measures were market-based and temporary (Magud, Reinhart and Rogoff 2011; Ostry et al 2010).

The IMF view stresses that priority should be given to letting the exchange rate appreciate, to accumulating reserves, and to tightening fiscal policy in order to reduce the amount of capital flowing into an emerging market. This perspective is correct in underscoring that CARs should never be a substitute for appropriate macroeconomic policy, but at the same time tends to disregard the point that CARs should be used to avoid excessive exchange rate appreciation and foreign exchange accumulation, and to equally avoid fiscal policy from becoming hostage to private capital flows. CARs should thus be seen as an integral component of the policy package to be adopted to guarantee macroeconomic stability (Ocampo 2008) and not as a last instance policy.

In this regard, it is not clear why a nation should wait for the exchange rate to appreciate to a certain level before utilising CARs. As Gabor (2011) points out, exchange rate over/under valuation is fairly difficult to adequately measure, especially ex ante. But, most importantly, some nations see a need for a competitive exchange rate as part of their (export-led) development strategies (Rapetti, Razmi and Skott 2012; Rodrik 2008).

Regulating capital flows should also be seen as an alternative to reserve accumulation. Accumulating reserves can be costly to emerging market and developing countries, as the interest rates on the safe instruments in which reserves are invested tend to be much lower than the financial costs of the capital flows that they are trying to neutralise, and equally lower than the costs of the domestic instruments used for sterilisation purposes; some central banks may not always have the capacity to sterilise without adverse effects (Gallagher and Shrestha 2012; Rodrik 2008; Aizenman 2010). Moreover, the accumulation of reserves by developing countries also resulted in global costs in the form of the global imbalances that played a role in the global financial crisis (Eichengreen 2007; Ocampo 2011).

Tightening fiscal policy to respond to capital inflows may also be suboptimal. Fiscal policy adjustments take time, and therefore are not agile enough to respond to short-term shocks associated with the capital account. Such response has also strong distributive effects, as it may imply cutting social public sector spending to give space to capital inflows that benefit richer sectors of society. It could also have adverse long-term implications, as it may lead to cutting public sector investment projects with public goods effects. In short, although counter-cyclical fiscal policy should be at the centre of macroeconomic management in economies subject to capital account shocks, fiscal policy should not be hostage to capital account volatility.

The IMF's stress that such measures be temporary and not discriminatory also misses some of the virtues of CARs. In order for CARs to be part of a counter-cyclical macroeconomic policy, a nation has to have permanent capacity to use measures as and when inflows and outflows occur. And by their very nature, CARs are discriminatory among residents and non-residents, for the basic reason that they have diverging demands between assets denominated in domestic vs foreign currencies.

The IMF's recommendations in this regard counter their own findings about the kinds of measures that worked. In econometric analyses that show a significant impact of CARs in changing the composition of inflows, allowing monetary policy to be more autonomous and, to a lesser extent, limiting exchange rate volatility, there is no such hierarchy of when a nation uses CARs, what form they took, and how long they lasted. New research drawing from the experiences of Brazil and South Korea shows that a mix of permanent and temporary macroprudential and CAR measures have been effective in those countries and a "one-size-fits-all" approach to the timing of regulation will not be effective (Fritz and Prates 2013).

Measures on capital outflows can be useful in preventing excessive inflows of capital or to steer other, long-term objectives. Focus on outflows is particularly important for the poorest countries. Least developed countries often do not experience massive inflow surges but do experience massive outflows (UNCTAD 2012).

The IMF's concern about the spillover effects of the prudential use of capital controls is unfounded. Korinek (2012) has shown that regulating capital flows in an efficient manner may cause increases or decreases of capital in neighbouring countries that may not necessarily be "negative" spillovers in the economic sense. These effects depend on the stock and composition of investment, the deepness of its capital markets, its current account balance, and its level of regulation. And, even if there are negative spillovers, they may be far outweighed by the benefit of not being the recipient of contagion in the form of crisis.

The IMF is, nonetheless, right to point out that source country policies "have likely affected the volume and volatility of capital flows to both advanced and emerging market economies" (IMF 2012b: 22). However, whereas the new institutional view scrutinises the exact types of capital account regulations in emerging markets, it does not equally examine which types of monetary and regulatory policy trigger the most risky capital flows from developed to developing countries (Fritz and Prates 2013).

Furthermore, the IMF is aware of the fact that it may recommend CARs to nations that do not have the policy space to deploy them because they would be deemed actionable under a trade agreement or investment treaty. In its own words:

> As noted, the Fund's proposed institutional view would not (and legally could not) alter members' rights and obligations under other international agreements. Rather, conformity with obligations under other agreements would continue to be determined solely by the existing provisions of those agreements. Thus, for example, even where the proposed Fund institutional view recognises the use of inflow or outflow CFMs as an appropriate policy response, these measures could still violate a member's obligations under other international agreements if those agreements do not have temporary safeguard provisions compatible with the Fund's approach (IMF 2012b: 42).

The Pardee Center Task Force on Regulating Capital Flows convened a "compatibility review" between capital account regulations and the trading system in 2012 that confirms that many trade and investment treaties lack the appropriate safeguards (Gallagher and Stanley, 2013). At the World Trade Organisation (WTO), nations that have made commitments to liberalise trade in cross-border financial services are not permitted to regulate capital flows. Although the WTO has more appropriate safeguards than many regional and bilateral agreements, there is considerable debate whether those safeguards amply allow nations to regulate capital flows, especially on inflows. In the case of regional and bilateral agreements, especially those of the US, all forms of capital must flow "freely and without delay" among trade and investment partners, with no exception.

The IMF suggests that its new institutional view could help guide future trade treaties and that the IMF could serve as a forum for such discussions. On top of that, it is important that the IMF recognise that, under the treaties in place, many nations will lack the policy space to implement new policy advice from the IMF.

Capital Flows for Long-Run Development: An Alternative View

It is important to note that the new IMF view is not a legally binding set of guidelines in any form. IMF member-nations are still free to regulate their capital accounts as they see fit. Article VI of the IMF Articles of Agreement still stands: "Members may exercise such controls as are necessary to regulate international capital movements." The IMF is making strides in the right direction, but the lead will have to continue to come from the example of many emerging markets. Developing countries remain the best judges of their own economies and should look at the new IMF advice on financial globalisation with great scrutiny.

In 2011 the Pardee Task Force on Regulating Global Capital flows, which the two of us co-chaired with Stephany Griffith-Jones, recommended that the goal for emerging market and developing nations should be to ensure that surges and sudden stops of external capital flows do not jeopardise national development priorities. Therefore, the task force noted, nations should have the policy space to deploy a package of measures that mitigates the risks and optimises the benefits of external capital flows in a counter-cyclical manner. To that end, the task force recommended a set of "rules of thumb" for nations seeking to regulate capital flows for long-run development (Gallagher, Griffith-Jones and Ocampo 2012). Those guidelines may serve as a more comprehensive and flexible set of guideposts for emerging market and developing countries hoping to achieve financial stability for inclusive growth and sustainable development. They indicate in particular that:

> These alternative guidelines state that CARs should be seen as an essential part of the macroeconomic policy toolkit and not as measures of last resort. They can be seen, in particular, as alternatives to foreign exchange reserve accumulation, particularly to reduce the costs of such accumulation.

In terms of the nature of CARs, they indicate that price-based regulations have the advantage of being more market-neutral, but quantity-based CARs may be more effective especially when incentives to bring in capital are very large, or in nations with relatively closed capital accounts or weaker central banks. Equally, CARs should not only be relegated to regulations on capital inflows. Capital outflow restrictions may be among the most significant deterrents of undesirable inflows and can serve other uses as well. Also, it may be essential for effective CARs to distinguish between residents and non-residents.

In turn, CARs should not be seen as solely temporary measures, but should be thought of as permanent mechanisms to be used in a counter-cyclical way to smooth booms and busts. Their permanence will strengthen institutional capacity to implement them effectively. And since investors can circumvent CARs, they should be seen as dynamic instruments, requiring a significant degree of market monitoring and "fine-tuning".

Going further than the new IMF institutional view, these alternative guidelines indicate that the full burden of managing capital flows should not be on emerging market and developing countries, but that "source" countries of capital flows should also play a role in capital flow management, including supporting the effectiveness of regulations put in place by recipient countries. Industrialised nations should also examine more fully the global spillover effects of their own monetary policies and evaluate measures to reduce excessive outflows of short-term capital that can be undesirable both for them and emerging countries.

Equally, according to these alternative guidelines, neither industrialised nations nor international institutions should limit the ability of nations to deploy CARs whether through trade and investment treaties or through loan conditionality. And, finally, the stigma attached to CARs should be removed, so nations have ample confidence that they will not be rebuked for taking action.

The IMF has made a significant contribution to removing that stigma. Moving forward, it remains to be seen how the IMF will advise nations during its surveillance activities and the extent to which it will work these views into country programmes. On the one hand, and thanks to many emerging market participants, the IMF has now dropped its blanket opposition to capital account management. That is a great step forward. But the conditions under which it will advise nations to regulate capital flows may be too narrow. It is too early to tell if the IMF has simply changed the tune but playing the same song. All eyes will be monitoring the application of the new institutional view.

NOTE

1 These measures have also been called capital management techniques (Epstein, Grabel and Jomo 2008).

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