The IMF, Capital Controls and Developing Countries

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Continuing with its rethink on capital controls, the International Monetary Fund has now formally suggested that there may be situations when developing countries can gain from placing regulations on the inward flow of foreign capital. However, the new "advice" comes with so many conditions and guidelines that the developing countries have rejected the recommendations and sent the IMF back to the drawing board. Rather than telling developing countries what to do and when, the IMF should perhaps focus more on helping governments enforce capital controls and it should stress the need for the global coordination of those controls.

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After more than a decade of advocating the liberalisation of capital flows across national borders, the International Monetary Fund (IMF) has begun to actively endorse the use of capital controls under some circumstances. In April 2011 the IMF went so far as to recommend guidelines and governance structures regarding when nations should deploy capital controls. That last step has been viewed as one step too far by developing countries.

Developing nations have welcomed that the IMF has come to recognise the limits of capital account liberalisation and the merits of capital controls. At the IMF/G-20 meetings in April 2011, however, they were not prepared to allow the IMF to sanction when nations should (and should not) deploy controls.

This article reviews the two new IMF reports that were released ahead of the April 2011 annual IMF meetings, discusses the developing country reaction to this work, and outlines areas where the IMF and other international institutions might devote more effort to the issue of managing global capital flows: developing a regime to enforce capital controls and navigating through the de facto regime for governing speculative capital – the more than 2,500 trade and investment treaties in the world economy.

There and Back Again

As recently as November 2009, IMF Managing Director Dominique Strauss-Kahn remarked that capital controls did not "come from hell" but "the Fund would not recommend them as a standard prescription either – as they carried costs and were usually ineffective" (Rodrik 2010). By April 2011 the IMF had authored three reports showing that capital controls can be effective, arguing that they should be part of the toolkit to promote financial stability, and outlining a set of guidelines for when such controls should be used.

Capital controls are limits on the level or composition of foreign private capital that can enter or leave a nation. They are often deployed to manage exchange rate volatility, avoid maturity mismatches, limit speculative activity in an economy, and provide the policy-space for independent monetary policy. Measures often come in two varieties, price- and quantity-based. Price-based measures alter the price of foreign capital such as with a tax on inflows or outflows. Quantity-based measures require that a certain quantitative cap on certain types of capital flows be administered. Some well-known measures combine each approach, such as in the case of unremunerated reserve requirements (URRs) that have been deployed by nations such as Chile, Colombia, and Thailand. Here, a certain percentage of a capital inflow has to be placed in a central bank for a minimum period. Such a measure has an impact on inflows as it implicitly taxes inflows. It is a quantity-based one as well, as it affects outflows because it keeps certain investments in the country in the event of capital flight (Ocampo et al 2008).

In the original design of the IMF it was charged with both permitting and helping to enforce capital controls. Both John Maynard Keynes and Harry Dexter White saw controls as a core component of the Bretton Woods system. Indeed, Keynes argued that, "control of capital movements, both inward and outward, should be a permanent feature of the post-war system". The IMF was not given jurisdiction over the capital account at all under its Articles of Agreement. Article VI of those articles goes further to say that members may "exercise such controls as are necessary to regulate international capital movements" (Helleiner 1994).

Although the IMF's independent evaluation office has shown that the IMF tacitly endorsed the use of capital controls in the 1990s, in a handful of instances, beginning in the 1980s the IMF became fairly hostile towards controls. IMF country programmes often made it a condition to dismantle controls, and IMF advice on the capital account was for nations to liberalise capital flows regardless of their level of development or the state of their financial systems. In the 1990s, the IMF went so far as to propose that the Articles of Agreement be changed to require nations to fully liberalise their capital accounts, only allowing capital controls as temporary safeguards under extreme circumstances (IMF 2005).

Strauss-Kahn's 2009 remarks signalled that the IMF would prescribe more of the same in the aftermath of the global financial crisis. Early in 2010, however, all that changed. In 2010 the IMF's independent evaluation office conducted self-assessments of the IMF's (mis)actions leading up to the crisis; the institution has become somewhat critical of inflation-targeting, and has held a full conference on rethinking macroeconomics where its organisers concluded that the crisis has shattered the economic orthodoxy behind the Fund's previous policies (Grabel 2010).

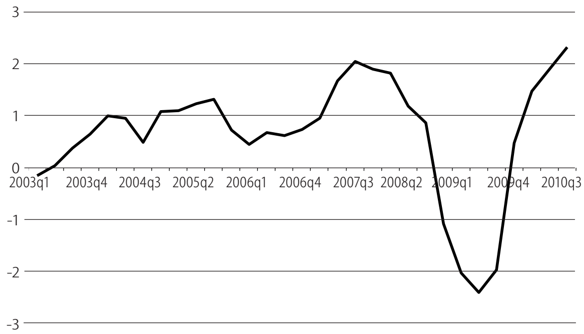
With respect to capital controls, in February of 2010 the IMF published a staff position note were the Fund found that capital controls on the inflows of capital that were deployed over the past 15 years have been fairly effective. This conforms with work by the National Bureau of Economic Research in the United States that found, in a comprehensive review of the economics literature that capital controls on inflows can make monetary policy more independent, and alter the composition of capital flows and reduce real exchange rate pressures. There is even some evidence that controls on outflows are prudent as well (Magud et al 2011). Moreover, the IMF conducted its own analysis and found that those nations that used capital controls were among the least hard hit during the worst of the crises up to 2007 (Ostry et al 2010).

Changed Prescriptions

As capital began to retreat from the developing world towards "safety", some nations' financial systems began to melt, particularly Iceland, Ukraine, Latvia, Pakistan and others. Rather than making it a condition that those nations liberalise their capital accounts as part of an IMF country programme, it actually recommended or at least sanctioned controls on outflows in Iceland, Latvia, and the Ukraine (Grabel 2010; IMF 2009).

In preparation for the IMF spring meetings in April 2011, the Fund took its work on capital controls a step further by issuing two reports (one "official report" titled "Recent Experiences in Managing Capital Inflows" and one "staff discussion paper" titled "Managing Capital Inflows: What Tools to Use?") outlining when nations should use capital controls, and which types of capital controls should be used under the proper circumstances.

Figure 1: Private Capital Flows to Emerging Markets Surpass Pre-Crisis Peak
(non-FDI, % of GDP)



Source: International Monetary Fund, World Economic Outlook Database, 2011.

The IMF reports have five key findings and/or proposals:

- The IMF recognises that private capital flows can be destabilising, and that such flows have had such an impact during the financial crisis;
- A driver of the recent surge in capital flows to developing countries has been low US interest rates;
- Some nations have deployed capital controls to manage mass inflows of capital, and some of those efforts have been moderately successful;
- Capital controls should be seen as part of the policy toolkit for financial stability, the nomenclature regarding controls should be changed so as to avoid the stigma attached to controls;
- The IMF proposes a series of guidelines regarding when nations should (and should not) deploy capital controls.

Figure 1 presents annual non-FDI (portfolio flows, derivatives, other) to emerging markets from the first quarter of 2003 to the third quarter of 2010. It is striking to note a sharp increase in capital inflows to the developing world between 2003 and the third quarter of 2007, followed by massive capital flight from the third quarter of 2007 until just after the first quarter of 2009. Since that time, private capital flows to the developing world have surpassed their pre-crisis peak.

The IMF has now recognised that capital flows can be destabilising – causing currency appreciation, asset bubbles, and volatility – for developing countries. Using data from the IMF's *World Economic Outlook*, we see that in the third quarter of 2007 private capital flows to the developing world were, on average, 2% of GDP, but reached 2.3% of GDP by the third quarter of 2010. With these swings came significant exchange rate volatility. From 2002 to the 2007 peak, nations such as Brazil and South Africa witnessed their private capital flows rising by 14% and 15% of GDP, and saw their currencies rise by 33% and 43%, respectively. During the mass capital flight after 2007, those two nations saw their currencies depreciate by 25% and 32%, respectively. Since early 2009, Brazil's currency has appreciated over 40%. These mass swings wreaked havoc for exporters and households.

The official report performs analyses of "push and pull" factors to try and determine what the key drivers of capital flows have been. Confirming what many developing country representatives have claimed, the IMF report shows that low interest rates in the US (and higher rates in the south), global risk aversion, and strained balanced sheets in the north were among the key push factors.

The official report notes that a number of countries have used capital controls to try and avoid the worst impacts of these mass swings in private capital, and with some success. The IMF's February 10 analysis of the measures taken previous to 2007 has already been noted. However, to deal with the upswing in capital flows in Figure 1 that have occurred since early 2009, nations such as Brazil, China, Argentina, Taiwan, Thailand, South Korea, Peru and Indonesia have put in place various forms of capital account regulations to limit excessive inflows. The IMF performs statistical analyses of many of these recent uses of capital controls and finds that they too have been a modest success. This works confirms work I have done earlier

this year which found that controls in Brazil and Taiwan were associated with a reduction in the pace of currency appreciation and with helping those nations achieve a more independent monetary policy (Gallagher 2011a).

Given their own analyses, the IMF now recognises that capital controls should be part of the policy toolkit for financial stability. Indeed, in the 1990s credit rating agencies would downgrade the credit of nations that deployed controls (Abdelal 2007). In their official report, the IMF has also recognised that by referring to these measures as capital "controls" brings great stigma. Therefore, the IMF importantly proposes a new nomenclature for capital controls, suggesting they be referred to as capital flow management measures(CFMs). Others have previously suggested an alternative nomenclature as well. In earlier work, former minister of finance in Colombia, José Antonio Ocampo, has referred to such measures as "capital account regulations" and other scholars have called them "capital management techniques" to the same end (Ocampo et al 2008).

The last point in need of attention here is the fact that the IMF goes on to offer guidelines pertaining to when a nation should and should not deploy controls. In a nutshell, the official report recommends that capital controls be used as a last resort and as a temporary measure, and only after a nation has accumulated sufficient reserves, tinkered with interest rates, and let its currency appreciate, among other measures. When capital control measures are used, the IMF suggests that controls be price-based and that they not discriminate against the residency of a capital flow.

The IMF reports have been limited to a discussion of the impacts of mass inflows to developing countries. That said, if a nation can manage the level of inflows, sudden stops of capital will be less severe and there will be less of a need for controls on outflows. However, in their country programmes since the crisis, the IMF has recommended or sanctioned controls on outflows in Iceland, Ukraine, and Latvia (IMF 2009).

Response of Developing Countries

The IMF report, especially the official report, has not been well-received in developing world. It was seen as welcome news that the IMF has recognised that capital flows can be disruptive and that capital controls can smooth such disruption. That said, the developing world was not about to accept the IMF as the keeper of when and when not to use controls. The most outspoken has been Brazil's Finance Minister, Guido Mantega, who told the IMF's steering-committee meeting:

> We oppose any guidelines, frameworks or 'codes of conduct' that attempt to constrain, directly or indirectly, policy responses of countries facing surges in volatile capital inflows.

Mantega added that capital controls were "self-defence" measures:

> Ironically, some of the countries that are responsible for the deepest crisis since the Great Depression, and have yet to solve their own problems, are eager to prescribe codes of conduct to the rest of the world, including to countries that are overburdened by the spillover effects of the policies adopted by them (Reddy 2011).

Without the advice of the IMF, many nations have deployed capital controls, both discriminatory and non-discriminatory, alongside a host of other macroeconomic and macro-prudential policies as they have seen appropriate. And, according to the IMF's own research, capital controls have been a success even though they have sometimes not met those guidelines.

The G-24, a group of many key developing nations within the World Bank and IMF, published a communiqué in the wake of the meetings that said "Ministers did not agree with the proposed framework for staff advice to member countries on managing capital flows" (G-24 2011).

Interestingly, the accompanying IMF staff discussion paper is somewhat less strident, saying that

> there is no unambiguous welfare ranking of policy instruments (though non-discriminatory prudential measures are always appropriate), and a pragmatic approach taking account of the economy's most pertinent risks and distortions needs to be adopted.

That same report notes that sometimes price-based capital controls may not be as effective in the face of uncertainty, and under such circumstances that quantity-based controls may be appropriate (Ostry et al 2011).

Even more important than setting guidelines for the use of capital controls, and well within the IMF's mandate, the IMF should focus equally on helping nations enforce such measures when they deem them appropriate. Many capital controls only work partially and for a short time because controls are evaded by foreign investors. This is pointed out in the staff discussion paper that accompanied the official report but did not find its way into it.

The official report notes that "The onus of policy adjustment from inflow surges rests solely on these countries". This is an aspect of the debate that Stephany Griffith-Jones and I noted in an earlier article in this journal (Griffith-Jones and Gallagher 2011). Capital account regulations could be coordinated on a global level as part of the global process to re-regulate finance. In the meetings leading up to the establishment of the IMF both Keynes and White agreed that capital controls be targeted at "both ends" of a capital flow (Helleiner 1994).

Rather than coordinating to enable developing countries to deploy capital controls, some nations, such as the US, continue to make it more difficult for nations to do so. The staff discussion paper also points out that there is already in existence a de facto regime for governing capital flows consisting of a tangled web of trade treaties, many of which prohibit the use of capital controls (Gallagher 2011b). To quote from the IMF staff discussion paper:

> There are about 2,500 BITS, as well as bilateral and regional trade agreements that provide legal protection for foreign investments. These agreements usually liberalise inward investments and provide for the free repatriation of that investment. They typically include "most-favoured nation" clauses. Most BITS and FTAS either provide temporary safeguards on capital inflows and outflows to prevent or mitigate financial crises, or defer that matter to the host country's legislation. However, BITS and FTAS to which the United States is a party (with the exception of NAFTA) do not permit restrictions on either capital inflows or outflows (Ostry et al 2011: 20).

In January of 2011, some 250 economists from across the globe called on the US to recognise the recent consensus on capital controls and to permit nations the flexibility to deploy controls to prevent and mitigate crises. The letter was rebuked by prominent business associations. In response to the letter, US Treasury Secretary Timothy Geithner replied that US policy would remain unchanged (GDAE 2011).

It is ironic that the US has now been shown to have been a key push factor for the massive inflows of capital to developing countries but is also restricting the ability of those nations to adequately manage that capital. The IMF, for its part, is to be applauded for taking a step towards having a more integrative and development-friendly approach to global finance. It still has a way to go.

Rather than telling developing countries what to do and when, the IMF should focus more on helping developing nations enforce capital controls and stress the need for the global coordination of those controls, including the establishment of safeguards in trade treaties. This debate will next move on to the G-20 meetings in Paris in November 2011. The IMF has been sent back to the drawing board by the developing world. Guidance to prevent the evasion of controls and how nations could coordinate controls at the global level will be more productive. The IMF's own research has shown that developing countries, despite push-back from the IMF, were prudent to deploy controls when they did, and in the manner they did.

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