Independent Evaluation Office Comments on Management/Staff Response to the Evaluation of the IMF's Approach to Capital Account Liberalization

Executive Board Meeting
May 11, 2005

We would like to offer a few points of clarification, in response to the comments made by management and staff on the IEO report.[1]

The staff suggests that the report is critical of the discretion exercised in tailoring policy advice on capital account liberalization to country-specific circumstances (paragraph 3). This is not what the report says. The report tries to explain how the staff tailored its advice on capital account issues to country-specific circumstances but concludes that a full assessment is not possible because country documents generally do not provide sufficient analytical basis for understanding why a particular combination of policies was advised in a particular case. The IEO report does not take issue with discretion as such and we certainly agree that the IMF did not adopt a "one size fits all" approach in its approach to capital account liberalization (and other related issues) in individual countries. Rather, the message of the report is that this potentially admirable discretion needs to be guided by general principles and therefore would have benefited from a clearer official position in the IMF on capital account issues. Indeed, we read the staff response as agreeing that it would be useful to have some further operational guidance that lays out the broad principles that staff should follow in its policy advice across countries.

The staff notes that the IEO report does not do justice to the role played by external forces in promoting capital account liberalization (paragraph 5). We agree that the exogenous factors noted by the staff were an important influence on capital account liberalization in many countries. Indeed, the report does refer to these external forces; some of the detailed country cases in Appendix 1 and some boxes on country experiences are quite explicit in spelling out the external forces that influenced the decisions of these countries to open their capital accounts. The focus of the report, however, remains on the IMF's approach. If the forces driving capital account liberalization were indeed beyond the IMF's control, this does not alter the fact that the IMF had a potentially critical role to analyze the risks involved and to offer appropriate policy advice to minimize those risks. An assessment of the IMF's approach to capital account liberalization does not depend on where the impetus came from.

Regarding Recommendation 1, the broad approach to the IMF's future work on capital account issues set out in the third bullet of paragraph 7 of the staff response is consistent with what we had in mind. The staff also notes the practical difficulty of providing a quantitative gauge of the benefits, costs, and risks of liberalizing the capital account at different speeds. We concur that it is not an easy task, but assessing the trade-offs involved in different approaches is critical if the IMF's advice on sequencing capital account liberalization is to be useful. Sequencing necessarily involves a piecemeal process in which some markets are liberalized while others remain closed. Then, sequencing is the right approach only if the risks avoided exceed the risks created by partial liberalization. While it is unlikely to be possible to quantify precisely the trade-offs involved, policy advice would be of limited usefulness unless some guidance on the nature and magnitude of the trade-offs were provided. Welfare economics—in which the consequence of opening a market when domestic distortions exist has been an important topic—may provide insight for thinking about how to make policy advice on sequencing more operational.

Finally, regarding Recommendation 2, the staff notes a number of initiatives that are already under way, to analyze supply-side factors influencing the volatility of international capital flows. We welcome these initiatives, some of which, but not all, were noted in the report. The point we make in the report

[1]Paragraph references are to the staff response.

is that the IMF's analysis of supply-side factors has been largely descriptive and that the policy implications drawn are mainly targeted at recipients of capital flows. There are, of course, good reasons for this—including the evolving nature of the literature which has generated limited consensus on specific actions that could be taken on the supply side to minimize volatility and cyclicality. Therefore, our recommendation was not a call for the IMF to back any specific policy measure but rather to strive to enhance further its understanding of supply-side factors and their operational or policy implications, with the focus on how such factors influence interlinkages between countries. But we agree that considerable progress has already been made in this direction, including through the various forthcoming activities noted by the staff in its response. Not all of these were known to us at the time the IEO report was prepared. For example, the planned thrust of the next *GFSR* is the type of activity we had in mind.