The Acting Chair's Summing Up

IEO Report on the Evaluation of the IMF's Approach to Capital Account Liberalization

Executive Board Meeting
May 11, 2005

Executive Directors welcomed the report by the Independent Evaluation Office (IEO) on the IMF's approach to capital account liberalization. They noted that financial integration can confer benefits to the global economy by promoting an efficient allocation of savings and a diversification of risks, with some Directors emphasizing the importance of orderly and well-sequenced liberalization. Directors stressed the increasing significance of capital account issues in Fund surveillance, and of fully understanding and addressing the difficulties and complexities faced by the Fund in providing advice in this area. They thus welcomed the opportunity that the report provides to explore how the Fund's effectiveness in this area can be further advanced.

Directors appreciated the IEO's efforts in evaluating the Fund's experience since the early 1990s with a large sample of representative countries. They noted that the report offers a broadly accurate account of the evolution of Fund thinking and practice on the issues surrounding capital account liberalization and capital flow management, including the temporary use of capital controls. Such a history provides a crucial background for a discussion of these issues. Directors welcomed the IEO's confirmation that the Fund did not apply an inappropriate "one-size-fits-all" approach to capital account liberalization in individual countries. Some Directors noted that, while it was important to apply discretion in individual cases, it would have been helpful for policy advice to have been guided by general principles. Directors concurred with the report's finding that the Fund did not pressure members to liberalize their capital account sooner than desired by the authorities, and generally did not challenge the use of temporary capital controls. They considered that the Fund should continue to adopt a flexible approach to capital account liberalization that takes due account of countries' specific circumstances and preferences. At the same time, Directors recognized that in the earlier period the risks of an open capital account had not always been sufficiently highlighted in the Fund's operational policy advice, and that little policy advice had been offered in the context of multilateral surveillance. Directors were encouraged, however, that in recent years substantial strides have been made, based on the lessons of experience and supported by the Fund staff's extensive analytical work on capital account issues and financial system stability. In this connection, some Directors suggested that the IEO report could have offered specific suggestions on how to ensure greater consistency and coordination between ongoing analyses on capital account liberalization issues at a conceptual level and their practical application in country operational work.

Directors expressed a variety of views on the importance of factors motivating capital account liberalization, such as free trade agreements and bilateral investment treaties. It was acknowledged that such agreements are negotiated voluntarily by country authorities when they are considered to be in the national interest. Some Directors felt that the role of such agreements in capital account liberalization should not be underestimated. At the same time, many Directors saw a key role for Fund involvement in policy advice on capital account issues as a means of promoting orderly and nondiscriminatory capital account liberalization.

Directors also commented on the two main recommendations of the IEO report.

Recommendation 1. There is a need for more clarity on the IMF's approach to capital account issues.

Directors stressed that the Fund has long attached importance to capital account issues and vulnerabilities, and that the process of clarifying their role in surveillance is well under way. They noted that the

Executive Board, in its various discussions including in the context of the Biennial Surveillance Reviews, has called for Fund surveillance to adjust to the changing global environment, notably the expansion in capital flows. The Fund has provided country-specific guidance to member countries on strengthening domestic policies and practices to manage risks related to capital account liberalization, including in the context of FSAPs and ROSCs. Furthermore, regional and global surveillance has increasingly focused on global financial market linkages, looking at demand- and supply-side factors, and the implied costs and benefits of capital account liberalization. Some Directors, however, saw merit in further clarifying the scope of Fund surveillance to recognize explicitly the central importance of capital account policies. Such clarification will also serve to improve the consistency of the Fund's approach in this area across countries. Directors agreed that the Fund has an inherent responsibility to its members to analyze the benefits and risks involved in a world of open capital markets, and to provide practical, sound, and appropriate policy advice to its members on those issues. On the broader aspects of the Fund's role in capital account liberalization, most Directors did not wish to explore further at present the possibility of giving the Fund jurisdiction over capital movements. However, a number of Directors felt that the Fund should be prepared to return to this issue at an appropriate time. Directors also noted that additional work on capital account issues is contemplated in the context of the Fund's ongoing strategic review.

Directors expressed a variety of views on the merit of an Executive Board statement clarifying the elements of agreement on capital account issues. A number of Directors supported such a statement, which could build on the "integrated" approach that has gradually evolved in the Fund's operational work, as outlined in the IEO report. However, many Directors underlined the challenge that would be faced in developing such a statement in view of the inherent difficulty in developing common guidelines that adequately take into account country-specific circumstances. Further, these Directors noted that, at present, firm theoretical and empirical conclusions are lacking, and accordingly, such a statement might need to be crafted in rather general terms, thereby not providing significant additional guidance. Directors noted that they would have an opportunity to come back to this issue in the context of the Fund's ongoing strategic review. More generally, Directors stressed that staff will need to continue to exercise their informed professional judgment and discretion.

Directors saw scope for sharpening the Fund's advice on capital account issues. They emphasized that Fund staff should continue to draw upon all available research in its policy advice to members, and that further research and study are needed to fully understand how best to obtain the benefits and manage the risks of capital account liberalization, including sequencing issues. Directors urged the staff to base its policy advice on solid analysis of individual country situations. To this end, a number of Directors recommended that staff reports should include a clearer and more systematic and analytical rationale for Fund advice. Directors also encouraged the staff to further strengthen its technical expertise on capital account issues. With regard to the IEO's suggestion that the Fund staff should aim to provide more quantitative assessments of the benefits, costs, and risks of liberalizing the capital account at different speeds, a few Directors saw merit in the proposal, while others considered it to be very difficult to implement because of the technical challenges and economic complexities involved.

Recommendation 2. The IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and to what can be done to minimize the volatility of capital movements.

Directors welcomed the various initiatives under way in the Fund to strengthen research, analysis, and surveillance of the supply side of capital flows, and agreed with the IEO's view that considerable progress has already been made in this area. A number of recent analytical staff studies have examined supply-side features of capital flows, and Directors noted that the recent *Global Financial Stability Reports* have examined the determinants and volatility of capital flows to emerging market countries including their institutional investor base. Directors further pointed to the Capital Markets Consultative Group, which serves as an informal forum for dialogue between participants in international capital markets and Fund management, as well as to the visibility given to supply-side issues by staff at the Financial Stability Forum and the Basel Committee of Bank Supervisors. A number of Directors accordingly felt that the Fund is already paying due regard to supply-side factors that influence the volatility of capital flows.

Directors encouraged the staff to continue to build on the work already being undertaken at the Fund in order to further its understanding of supply-side factors and their operational and policy implications, including how such factors influence interlinkages and imbalances among countries in the context of the Fund's multilateral and bilateral surveillance. In particular, they suggested that more attention be devoted to the spillover effects from regional developments and from policies in systemically important advanced and developing countries. Directors cautioned that any expanded work on supply-side issues should not entail Fund involvement in the regulation of the sources of capital, noting that the Fund should instead coordinate with the FSF and other fora that have the necessary expertise and mandate in the setting of standards. Some Directors would have welcomed suggestions by the IEO for additional specific actions that the Fund could take to address risks related to the volatility of capital flows.

In concluding, Directors agreed that the Fund's future work on capital account issues should seek to buttress efforts to promote financial stability, while helping ensure that controls are not used as a substitute for adjustment. The aim would be to build on the existing Fund expertise in this area, and to ensure that policy advice on capital account issues is fully incorporated into the mainstream of bilateral and multilateral surveillance, with analytical work being used to strengthen the basis for policy advice and technical assistance. This strategy would imply orderly and nondiscriminatory liberalization aimed at facilitating countries' integration into the global economy while maintaining stability. As a follow-up to the findings of the IEO report, Directors looked forward to capital account issues being addressed in the context of the Fund's ongoing strategic review.