CHAPTER 5 Major Findings and Recommendations

This report has evaluated the IMF's approach to capital account liberalization and other related capital account issues. It first reviewed the IMF's general operational approach and analysis as they evolved from the early 1990s into the early 2000s. The report then assessed the IMF's country work for 1990–2004 in terms of (1) its role in capital account liberalization, (2) advice to member countries on managing capital flows, including the temporary use of capital controls, and (3) ongoing work on capital account issues. Most of the analysis on country work was based on IMF documents for a sample of over 30 emerging market and developing economies.

This concluding chapter summarizes the major findings of the evaluation and presents two broad recommendations designed to help improve the IMF's operational work on capital account issues.

Major Findings

Major findings are summarized below under (1) the IMF's general operational approach and analysis, (2) the IMF's country work, and (3) overall assessment of the IMF's approach to capital account liberalization and related issues.

The IMF's general operational approach and analysis

The Articles of Agreement left considerable ambiguity about the role of the IMF in capital account issues. Even so, in the early 1990s the IMF responded to the changing international environment, characterized by large cross-border capital movements, by paying greater attention to issues related to the capital account. From the mid-1990s, staff analyses began clearly to advocate capital account liberalization. Concurrent with the initiatives to amend the Articles to give the IMF an explicit mandate for capital account liberalization and jurisdiction on members' capital account policies, management and staff expanded the scope of the IMF's operational work on capital account issues in Article IV consultations and technical assistance in an effort to promote capital account liberalization more actively.

The IMF's analysis prior to the mid-1990s tended to emphasize the benefits to developing countries of greater access to international capital flows and to pay comparatively less attention to the potential risks of capital flow volatility. More recently, however, the IMF has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the more fundamental causes and implications of their boom-and-bust cycles. Still, the focus of the analysis remains on what emerging market countries should do to cope with the volatility of capital flows (for example, through macroeconomic and exchange rate policy, strengthened financial sectors, and greater transparency). The IMF has addressed the moral hazard aspect of boom-and-bust cycles, for example, by encouraging greater exchange rate flexibility in recipient countries and attempting to limit access to IMF resources during a crisis, but has not been at the forefront of the debate on what, if anything, can be done to reduce the cyclicality of capital movements through regulatory measures targeted at institutional investors in the source countries.

From the beginning of the 1990s, the IMF's management, staff, and Executive Board were aware of the potential risks of premature capital account liberalization and there is no evidence to suggest that they promoted capital account liberalization indiscriminately. They also acknowledged the need for a sound financial system in order to minimize the risks of liberalization and maximize its benefits. Such awareness, however, largely remained at the conceptual level and did not lead to operational advice on preconditions, pace, and sequencing until later in the 1990s. At the same time, a subtle change was taking place within the institution. As preliminary evidence emerged on the apparent effectiveness of Chile's capital controls in the mid-1990s, some in the IMF began to take a favorable view of the use of capital controls as a temporary measure to deal with large capital inflows.

In the event, the proposed amendment of the Articles put forward in the late 1990s failed to garner sufficient support, leaving ambiguity about the role of the IMF. In the meantime, something of a consensus—the so-called "integrated" approach—has emerged within the IMF that places capital account liberalization as part of a comprehensive program of economic reforms in the macroeconomic policy framework, the domestic financial system, and prudential regulations. While few would disagree with the prudence and judiciousness of the new approach, it has proved to be difficult to apply as an operational guide to sequencing because it emphasizes all of the potential interlinkages but does not provide clear criteria for identifying a hierarchy of risks. Moreover, these views remain unofficial, as they have not been explicitly endorsed by the Board. The IMF still does not have a formal statement from the Board providing guidance on what its policy advice is, and a number of senior staff expressed unease about this lack of clarity on the IMF's formal position.

The IMF's country work

The evaluation reviewed the IMF's country work in a sample of emerging market economies and assessed its approach in terms of the following criteria: (1) Was there any difference between the IMF's general policy pronouncements and the advice it gave to individual countries? (2) Was the IMF policy advice operational and based on solid evidence? (3) How did the IMF's advice change over time, and did this change keep pace with available evidence? (4) Did the IMF give similar advice to countries in similar situations? and (5) Was the policy advice on the capital account set in a broader assessment of the authorities' macroeconomic policies and institutional framework?

The role of the IMF in capital account liberalization

During the 1990s, the IMF encouraged capital account liberalization in its country work, but the evaluation suggests that in all the countries that liberalized the capital account, partially or almost fully, the process was for the most part driven by the country authorities' own economic and political agendas. In none of the program cases examined did the IMF require capital account liberalization as formal conditionality, although aspects of it were often included in the authorities' overall policy package presented to the IMF. In the early years, the issues of pace and sequencing were seldom raised. Occasionally, staff expressed concern over financial sector weakness or macroeconomic instability, but this did not lead to operational advice to individual countries on pace and sequencing. From around 1994, and certainly after the Mexican crisis, some within the IMF became more cautious in their policy advice on capital account issues in country work, but it was only after the East Asian crisis that the whole institution's approach clearly changed. In later years, the IMF took a more cautious attitude toward capital account liberalization in country work, emphasizing pace and sequencing and the need to satisfy certain preconditions. Through much of the 1990s, there was apparent inconsistency in the IMF's advice on capital account liberalization (for example, sequencing was emphasized in some countries but not in others), suggesting that the staff took a pragmatic approach in country work in the absence of clear official guidelines. On the other hand, there was little systematic difference in terms of policy advice between program and nonprogram countries.

Advice on managing capital flows

As countries experienced large capital inflows and associated macroeconomic challenges in the 1990s, the question of how to manage large capital inflows became a routine subject of discussion between the IMF and the country authorities. The staff's policy advice on managing capital flows did not deviate much from the policy conclusions typically derived from the scholarly literature on open economy macroeconomics. To deal with large capital inflows, it advocated tightening fiscal policy and greater exchange rate flexibility. Advice on sterilization, in line with the conventional wisdom, emphasized its quasi-fiscal costs and its longer-term ineffectiveness but, to a surprising extent, was supportive of country authorities' policy choices, whatever they may have been. In a few instances, the staff also recommended further trade liberalization, liberalization of capital outflows, and tightening of prudential regulation as measures to deal with large capital inflows, but these and other structural measures received relatively little attention. In terms of detail and emphasis, the staff's views differed both across time and across countries, but country documents do not provide a clear analytical basis to make a definite judgment about the consistency of the IMF's overall advice on managing capital inflows.

Temporary use of capital controls

Use of capital controls has been a controversial subject, not only within the IMF but also in the academic and official policymaking communities. It is possible here to make a broad characterization that the IMF staff was in principle opposed to the use of such instruments, either on inflows or outflows. Its view was that they were not very effective, especially in the long run, and could not be a substitute for the required adjustments in macroeconomic policies. Even so, from the earliest days, the IMF staff displayed a remarkable degree of sympathy with some countries in the use of capital controls. In a few cases, both before and after the crises of 1997–98, it even suggested that market-based controls could be introduced as a prudential measure. As a general rule, the IMF staff in its country work, in line with the evolution of the institution's view, became much more accommodating of the use of capital controls over time, albeit as a temporary, second-best instrument.

Ongoing country dialogue on capital account issues

In ongoing country work (as documented for 2003–04), IMF staff has been quite accommodating of authorities' policy choices when they have involved a gradual approach to capital account liberalization or temporary use of controls. In terms of capital account liberalization, the staff has sometimes been more cautious than the authorities (for example, Russia in 2003) when their preferred policy was to liberalize the capital account quickly. In most cases, the staff has taken a medium-term perspective and emphasized the importance of meeting certain preconditions, the most important of which are fiscal consolidation, a sound financial system, and the adoption of a floating exchange rate (usually with inflation targeting). There has been some variation across countries, however. For example, at least in one country (South Africa), the IMF staff has urged the authorities to move more quickly in removing the remaining restrictions in view of favorable external conditions.

In terms of advice on temporary use of capital controls, IMF staff seldom challenged the authorities' decision and even supported market-based controls in some cases. There was a slight difference in emphasis across countries. In a few countries (as in Russia in 2004), the staff expressed forcefully the view that capital controls, no matter how useful they might be in the short run, could not be expected to be effective over time and should not be used as a substitute for appropriate adjustment in macroeconomic policies. In others (as in Colombia), the use of controls introduced by the authorities did not figure prominently in policy discussions. In still other cases (as in Croatia), the staff recommended a market-based control, albeit as a last resort measure.

Overall assessment

These findings allow us to provide answers to the following fundamental and related questions: (1) Did the IMF pressure member countries to liberalize the capital account in the 1990s? and (2) Did the IMF encourage capital account liberalization prematurely, without ensuring that necessary institutions and regulations were in place to maximize its benefits and minimize its risks?

The answer to the first question is a definitive no, at least for the emerging market countries examined. In none of these countries did the IMF use the most binding tool of influence at its disposal: conditionality in the use of its resources. This is consistent with the interpretation of the Articles of Agreement, which states that the IMF, as a condition for the use of its resources, cannot require a member to remove controls on capital movements. In several program countries, however, aspects of capital account liberalization were included in the authorities' package of economic policies presented to the IMF. These may well reflect different degrees of "pressure" in specific instances, but the evaluation has not uncovered any such cases. In summary, the IMF undoubtedly encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader when it wished to do so, especially before the East Asian crisis, but there is no evidence that it exerted significant leverage to push countries to move faster than they were willing to go. The process of liberalization was often driven by the authorities' own considerations, including OECD or EU accession and commitments under bilateral or regional trade agreements.

The answer to the second question is less clearcut. Yes, the IMF did encourage capital account liberalization and this encouragement probably got ahead of the prevailing evidence in the early 1990s. At the same time, in so doing, it made the point of highlighting the risks inherent in an open capital account as well as the need for a sound financial system, even from the beginning. The problem was that these risks were insufficiently highlighted and the recognition of these risks and preconditions did not translate into operational advice on pace and sequencing until later in the 1990s (and even thereafter the policy advice has often been of limited practical applicability).

In this connection, it should also be noted that the IMF's analysis in the earlier period emphasized the benefits to developing countries of greater access to international capital flows, while paying comparatively less attention to the risks inherent in their volatility. As a consequence, its policy advice was directed more toward emerging market recipients of capital flows, focusing on how to manage large capital inflows and their boom-and-bust cycles. Little policy advice was offered, in the context of multilateral surveillance, on how source countries might help reduce the volatility of capital flows through regulatory measures on the supply side. In more recent years, the IMF's analysis of supply-side factors has become more sophisticated, and the institution has also addressed the moral hazard aspect of investor behavior. Even so, the focus of policy advice remains on the recipient countries. Admittedly, this reflects the lack of a theoretical and empirical consensus on what practical steps could be taken in this area, but the IMF has played a relatively limited role in exploring options.

The evaluation suggests that the IMF has learned over time on capital account issues. This seems to have affected the work of the IMF through two channels. First, the IMF's general approach did respond—albeit gradually—to new developments or new evidence. Second, independent of how the general approach changed, some of the learning became more quickly reflected in the IMF's country work through its impact on individual staff members. As a result, in the case of capital account issues, the IMF's general approach lagged behind developments in some of the country-specific approaches taken in the field.

The lack of a formal IMF position on capital account liberalization and the associated partial disconnect between general operational guidelines and country work had different consequences. On the one hand, it gave individual staff members freedom to use their own professional and intellectual judgment in dealing with specific country issues. On the other hand, the disconnect reflected the inherent ambiguity of this aspect of the IMF's work on capital account issues and led to some lack of consistency in country work. Country work must of necessity be tailored to country-specific circumstances, so uniformity cannot be the only criterion for judging the quality of the IMF's policy advice. Even so, it appears that the apparent inconsistency to a large extent reflected reliance on the discretion of individual staff members, and not necessarily the consistent application of the same principles to different circumstances.

In more recent years, somewhat greater consistency and clarity have been brought to bear on the IMF's approach to capital account issues. For the most part, the new paradigm upholds the role of country ownership in determining pace and sequencing; takes a more consistently cautious and nuanced approach to encouraging capital account convertibility; and acknowledges the usefulness of capital controls under certain conditions, particularly controls on inflows. But these are still unofficial views, though they may well be widely shared within the institution. While the majority of staff members now appear to accept this new paradigm, some continue to feel uneasiness with the lack of a clear formal position by the institution.

Recommendations

The evaluation suggests two main areas in which the IMF can improve its work on capital account issues.

Recommendation 1. There is a need for more clarity on the IMF's approach to capital account issues. The evaluation is not focused on the arguments for and against amending the Articles of Agreement, but it does suggest that the ambiguity about the role of the IMF with regard to capital account issues has led to some lack of consistency in the work of the IMF across countries. This may reflect the lack of clarity in the Articles, but with or without a change in the Articles it should be possible to improve the consistency of the IMF's country work in other ways. For example:

- *The place of capital account issues in IMF surveillance could be clarified*. It is generally understood that while under current arrangements the IMF has neither explicit mandate nor jurisdiction on capital account issues, it has a responsibility to exercise surveillance over certain aspects of members' capital account policies. However, much ambiguity remains on the scope of IMF surveillance in this area. The clearest statement of the basis for surveillance of capital account issues is embodied in the 1977 Executive Board decision calling for surveillance to consider certain capital account restrictions introduced for balance of payments purposes, but the qualification limiting the scope to balance of payments reasons is too restrictive to cover the range of capital account issues that surface in the IMF's country work. On the other hand, the broader statement of the IMF's surveillance responsibility, found in the preamble to Article IV, is too wide to serve as an operational guide to surveillance on capital account issues. There would be value if the Executive Board were formally to clarify the scope of IMF surveillance on capital account issues. Such a clarification would recognize that capital account policy is intimately connected with exchange rate policy, as part of an overall macroeconomic policy package, and that in many countries capital flows are more important in this respect than current flows; capital controls can be used to manipulate exchange rates or to delay needed external adjustment; and a country's capital account policy creates externalities for other countries. Capital account policy is therefore of central importance to surveillance.

- *The IMF could sharpen its advice on capital account issues, based on solid analysis of the par-*

ticular situation and risks facing specific countries. Given the limited evidence that exists in the literature on the benefits or costs of capital account liberalization in the abstract, the IMF's approach to any capital account issue must necessarily be based on an analysis of each case. For example, if a capital control is involved, the IMF must ask in the context of a specific country what objectives the control is designed to achieve; if it is accomplishing them; and whether there are more effective or less distortionary ways of achieving the same objectives. Such assessments need to be set in an overall consideration of the macroeconomic policy framework and whether controls are being used as a substitute for, or to seek to delay necessary changes in, such policies. The evaluation indicates that this is already done in some but not all cases. If a capital control measure is judged useful to stem capital flight under certain circumstances, the IMF should ask what supporting policies are needed to make it more effective or less distortionary (for example, setting up a system of monitoring external transactions). In terms of providing advice on capital account liberalization, just to spell out all the risks inherent in opening the capital account is of limited usefulness to countries seeking IMF advice. To assist the authorities decide when and how to open the capital account, the IMF should provide some quantitative gauge of the benefits, costs, and risks (and, indeed, practicality) of moving at different speeds. Admittedly, this is not an easy task. Drawing on the well-established literature on welfare economics, the IMF must ask such questions as: What distortions are being created when one market is liberalized but not another? What is the nature of risks being borne by residents when capital account transactions are liberalized only for nonresidents? And what are the costs to the economy (in terms of investment flows) of allowing equity inflows but not debt inflows?

- *The Executive Board could issue a statement clarifying the common elements of agreement on capital account liberalization*. At present, there remains considerable uncertainty among many staff members on what policy advice to provide to individual countries. This has led to hesitancy on the part of some within the staff to raise capital account issues with country authorities. The Executive Board could provide clear guidance to staff on what the IMF's official position is. This is not to say that the Executive Board must come up with a definitive statement on all aspects of pace and sequencing. Given the lack of full consensus, one should not expect such a definitive view from the Board. However, Board guidance on what are the minimum common elements on which there is broad, if not universal, agreement would be useful to the staff and member countries. Although the details are for the Board to decide, such a statement might include some or all of the following elements: (1) that in a first-best world there would be no need for controls over capital movements (though financial markets may not always operate accordingly); (2) that controls should not be used as a substitute for adjusting macroeconomic or structural policies; (3) a broad (as opposed to unnecessarily complex) framework of sequencing based on the consensus in the literature on the order of economic reforms; (4) the importance of taking country-specific circumstances into account; and (5) that risks can never be totally eliminated, so they should not be used as a reason for permanently delaying liberalization.

Recommendation 2. The IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and what can be done to minimize the volatility of capital movements. The IMF's policy advice on managing capital flows has so far focused to a considerable extent on what recipient countries should do. While this is important, it is not the whole story. As discussed in the evaluation report, the IMF's recent analyses have given greater attention to supply-side factors, including the dynamics of boom-and-bust cycles in emerging market financing. The IMF has also established an International Capital Markets Department (ICM) as part of an effort to better understand global financial markets; it participates actively in the work of the Financial Stability Forum, which was established to monitor potential vulnerabilities in global financial markets; and it has proposed a Sovereign Debt Restructuring Mechanism (SDRM), encouraged the use of collective action clauses (CACs), and has attempted to place limitations on countries' access to IMF resources in a crisis, in an effort to reduce the perceived moral hazard that may have led capital markets to pay insufficient attention to the risks of investing in developing countries and contributed to the boom-and-bust cycles of capital movements. These are important and welcome initiatives, but the IMF has not yet fully addressed issues of what, if anything, can be done to minimize the volatility of capital flows by operating on the supply side— as yet, little attention seems to be paid to supply-side risks and potential mitigating actions in the industrial countries that are home to the major global financial markets. The IMF could usefully provide more input into advanced country financial supervision and other financial market policy issues globally. Are current global supervision guidelines designed to help create stability?[1] What if any action could be taken on the supply side to reduce cyclicality and herd behavior? Admittedly, this is a difficult topic on which little professional consensus exists. Yet, this is an area where a significant debate has taken place in the academic and policymaking communities and to which the IMF could contribute further. Indeed, one of the broad themes identified as potential priorities for the IMF's research program over the medium term—on institutions and contractual mechanisms that can help protect countries from external volatility—goes some way in this direction, but should not focus only on policies in countries that are recipients of capital inflows.

[1]To give one example where the IMF did provide such inputs, in July 2003, the staff commented on the proposed New Basel Capital Accord (Basel II), pointing to its potentially procyclical effects.