5 REAPING LONG-TERM BENEFITS FROM OPEN CAPITAL MARKETS

The IV consolidated the evolution in the Fund's advice regarding full capital account liberalization as a long-run goal. As noted earlier, by the early 2000s, the IMF came increasingly to emphasize that the pace of liberalization should be gradual and sequenced with the achievement of preconditions, including that domestic financial and institutional development had reached certain thresholds and the macroeconomic and regulatory policy frameworks ensured adequate levels of stability. The IV reiterates the importance of careful pace and sequencing to help countries garner net benefits from capital account liberalization.

The IV's stance that the benefits of capital account liberalization are greater once countries have attained certain thresholds is broadly consistent with findings of empirical studies. While economic theory suggests that liberalization can potentially generate important growth benefits for developing countries, the "most reasonable interpretation" of the empirical evidence to date is that "reaping the benefits of capital account liberalization is contingent on domestic circumstances in the liberalizing economies" (Montiel, 2020). More specifically, studies have found the benefits from liberalization to be conditional on the degree of development of the domestic financial sector, institutional characteristics and quality, and macroeconomic conditions. While these conclusions are drawn mostly from studies that predate the IV, recent work within and outside the Fund continues to find support for them (see for example Binder, Georgiadis, and Sharma, 2016; Furceri, Loungani, and Ostry, 2019; Du, Nie, and Wei, 2019), suggesting that the IV's stance on liberalization still rests on solid empirical foundations.

The evidence on the "collateral benefits" of capital account liberalization remains a subject of intense debate. Some empirical studies have provided evidence that capital account liberalization may enhance domestic financial development, institutional quality, and macroeconomic discipline (Kose and others, 2009). The case for such collateral benefits of liberalization is supported by experience in some of our case studies. For example, in Chile and Mexico, officials pointed to their experience in which committed capital account opening in the 1990s and 2000s, combined with exchange rate flexibility and disciplined monetary and fiscal policies, had contributed to the development of resilient financial systems and increased the credibility and the effectiveness of countercyclical tools (Batini, Borensztein, and Ocampo, 2020). In China and India, some policymakers interviewed for this evaluation similarly argued that the collateral benefits of liberalization in spurring domestic financial reform and market development could be considerable. In contrast, Argentina's recent experience of quick dismantling of controls before a credible macroeconomic framework had been well established, followed by a serious crisis, provides a counterexample that highlights the risks involved.

While the IV's overall guidance on longer-term issues seems to remain broadly appropriate, one area that could receive more attention relates to the social and distributional effects of capital account liberalization. These effects are gaining increasing attention within the profession and the Fund's own recent work has highlighted the links between the financial system and inequality, but the IV does not address this issue.[25] For instance, the poor with limited access to banking services are much less likely to reap benefits than wealthier individuals. Ensuring greater financial inclusion thus may be relevant to the decision-making process of member countries that are considering when and how to liberalize, given increasing recognition of the need to ensure that growth is inclusive and welfare gains are widely distributed.

In practice, the Fund's policy advice on capital account liberalization has broadly been consistent with the IV, emphasizing the importance of sequencing issues. Evidence from the case studies of countries in Africa still working to meet the preconditions for full capital account liberalization to confer net benefits suggests that that they have felt little pressure from the Fund staff to liberalize, particularly since the adoption of the IV. The policy dialogue has focused on ways to develop the preconditions, for example deepening domestic financial markets and moving toward greater exchange rate flexibility (Balasubramanian and others, 2020). For example:

- In *Ethiopia*, where there had been criticism of the Fund's push for liberalization during the 1990s, the authorities appreciated the change in the Fund's stance over the past decade. Their recent decision to move to a more open capital account over time is part of a change in the country's reform strategy, backed by a Fund-supported program.

- In *Morocco*, the Fund supported the authorities in their gradual approach to opening up the capital account, both through technical assistance (e.g., on setting up an inflation targeting framework with greater exchange rate flexibility) and through a Precautionary and Liquidity Line arrangement. Authorities felt that, more than in the past, the Fund staff was ready to engage on how capital account liberalization fitted in their overall reform strategy.

A particularly difficult issue has concerned how capital account liberalization strategies in low-income countries should balance the opportunities from greater access to international markets against the risks of excessive debt accumulation on expensive or inflexible terms. In practice, opening up to allow increased external financing, together with increased investor interest in frontier markets and new opportunities for borrowing from non-traditional official lenders, has led to a dramatic increase in issuance of sovereign bonds and in borrowing for major infrastructure projects by African frontier economies. The Fund has sought to provide balanced advice and analysis in both bilateral and multilateral surveillance. In bilateral surveillance, tools for assessing debt sustainability in low-income countries have been sharpened (IMF, 2020b). External financing and debt developments have been covered on a frequent basis in the *Regional Economic Outlook* reports for the African region and in a new report on Macroeconomic Developments and Prospects for Low-Income Developing Countries launched in 2014. The staff has consistently recognized the potential benefits of external financing, particularly given the significant infrastructure investment needed to meet the region's development goals, as well as the risks to fiscal and external sustainability, particularly when the financing is accompanied by increases in public consumption. In the event, external debt vulnerabilities have risen rapidly in these countries, and many have reached a point where they pose rising risks of debt distress. This outcome reflects a wide range of factors, including problems in monitoring debt build-up outside the central government, the use of collateralization, guarantees, and subordination clauses, the effects of lower commodity prices since 2014 on resource-exporting economies, and governance issues in a few cases (IMF, 2020b). A full assessment of the Fund's role and impact in this area, including of the Fund's advice on debt management and broader macroeconomic policies for these countries, lies beyond the scope of this evaluation.

Another challenging issue has been to advise on an appropriate pace for liberalization that balances long-term gains against potential risks, with the staff generally being quite cautious. This issue has received considerable attention in *China* and *India*, two large EMDEs with still quite extensive

[25] See Cihak and Sahay (2020) for the Fund's work, and Baek and Chia (2020), Li and Su (2020) and Liu, Spiegel, and Zhang (2020) for work outside the Fund.

capital account restrictions. From 2010 to 2015, *China* embarked on an extensive series of initiatives to eliminate or reduce restrictions on cross-border capital flows. The Fund staff was sympathetic to the authorities' long-run goals "but repeatedly and consistently emphasized the risks of premature liberalization and the importance of adequately preparing the ground through other reforms" (Patnaik and Prasad, 2020). A few key senior officials felt that the Fund could have put greater emphasis on the important collateral benefits of capital account opening—including the development of domestic capital markets, more competition for the domestic banking system, opportunities for Chinese investors to diversify their portfolios, improved public and corporate governance, and incentives to improve regulatory and supervisory frameworks in the financial sector. Other officials felt that the Fund staff had been right in emphasizing the importance of getting the sequence right and the risks of premature capital account liberalization. Similarly, in *India*, many officials felt the Fund staff was right to be cautious about liberalization. But some senior officials felt the staff was "too captive" to the views of the Central Bank, which they felt viewed liberalization largely through the lens of the risks to financial stability rather than of the potential growth benefits (both direct and from dismantling an elaborate system of controls).

In contrast, in *Argentina* in 2015, the staff could have been more forceful in warning about risks involved in the rapid removal of capital account restrictions and the need to strengthen the macroeconomic framework to be consistent with an open capital account (Batini, Borensztein, and Ocampo, 2020). In December 2015, a new Argentine government quickly lifted most capital account restrictions that had been in place, including outflow restrictions and limits on short-term borrowing, as part of a broader market-oriented reform agenda. The staff had little chance to offer advice before the restrictions were lifted, but internal documents did not raise concerns and the issue did not figure prominently in the 2016 and 2017 Article IV consultations, even though Argentina experienced quite heavy resident outflows and a surge in short-term borrowing. Net capital flows deteriorated rapidly in 2018, following a turn in broader EM market sentiment and rising concern about slow progress in stabilizing the fiscal position and bringing down inflation. Eventually outflow restrictions were reimposed in the context of an IMF-supported program. The Fund supported these restrictions, stressing that the "capital flow management" measures were aimed at "protecting exchange rate stability and the savers."

One feature of the treatment of capital flow measures under the IV has been its focus on countries' recent actions, that is, actions taken since the IV was approved in 2012—focus that may have unintentionally discouraged countries, which may have unintentionally discouraged countries from taking liberalizing actions for fear these might need to be reversed. The IV does explicitly recognize that a country may need to temporarily reimpose a CFM in certain circumstances: when liberalization has "outpaced the capacity of the economy to safely handle the resulting flows, the reimposition of CFMs may be warranted until sufficient progress has been made" in strengthening the broader policy framework (IMF, 2012, para 23). Nevertheless, some country officials said that they still felt somewhat constrained by a concern that the Fund would push back if they sought to reintroduce a measure that previously had been in place and not received much attention from the Fund because it predated the approval of the IV.

Assessment

Authorities generally appreciated the Fund's cautious and pragmatic approach to long-term capital account liberalization. Adoption of the IV is seen as having been an important step in setting down on paper the Fund's policy line and ensuring consistent delivery of advice. The sequenced approach emphasized in the IV has provided a useful framework for the discussions, and the advice given is generally regarded as sensible. Officials particularly valued the granular advice provided in the context of IMF technical assistance work which has provided the basis for more in-depth expert advice on institutional and market development issues (Box 3).

In a complex area, it is not surprising that there have been occasional differences of view on sequencing issues and that some officials have felt that the Fund was at times overly cautious. However, the high costs of an external crisis arising from too rapid opening to capital flows before the preconditions have been established suggest that the IMF is generally right to lean on the side of prudence—and indeed the Fund could have warned more vigorously in the case of Argentina, at least to accelerate the steps needed to strengthen the macroeconomic framework to be consistent with an open capital account.

Further research on key propositions underlying the IV on the relationship between capital account opening and the long-term benefits would be useful and could enhance the Fund's ability to provide more granular advice in this area. New empirical work, including use of the enhanced and updated Fund database of structural reform measures, could address some key questions:

- Should the guidance be adjusted to reflect the changing structure of global capital markets? Several studies that laid the basis for the sequenced approach (e.g., for threshold effects beyond which liberalization can be beneficial) are now a decade old. In particular, is a "pecking order"—elevating FDI over other flows; preference for equity over debt flows—still a useful guide, given some blurring of the distinction among flows implied by shifting market dynamics and problems with FDI data?
- Under what circumstances does capital account liberalization generate ancillary benefits such as promoting institutional reforms and policy discipline, particularly fiscal discipline? How can capital account opening be structured and sequenced to foster more dynamic development of markets and institutions, such as derivatives markets to help the private sector manage risk from foreign exchange exposures, without opening up to excessive risk in the event of a capital flow reversal?
- How extensive are the social distributional implications of capital account liberalization and how can these consequences be addressed in developing strategies for capital account liberalization?

It would be useful to connect this work with the extensive research agenda represented by the IPF. Until now, this new work program has largely focused on the use of alternative instruments to achieve short-term stabilization goals in the face of external shocks including capital flow volatility, and has paid less attention to how such policies could affect longer-term goals such as market development and the development of policymaking institutional capability.

BOX 3. TECHNICAL ASSISTANCE ACTIVITIES ON CAPITAL FLOW ISSUES

As well as providing policy advice, Fund staff have been active through technical assistance in helping countries adapt their policy toolkits and institutions to a financially integrated world. For emerging markets, this has often taken the form of facilitating sharing of peer-to-peer experiences in dealing with capital flows, while for frontier and low-income countries the focus has been on market development. This work is generally appreciated by authorities as providing detailed guidance on best practices adapted to country circumstances and challenges. Recent examples include:

- Course for country officials in *China* on the macroeconomics of capital flows, their liberalization and management, with customization to China and cross-country comparisons to peer countries.
- Technical assistance to *Costa Rica* on how to address solvency and liquidity risks associated with high levels of dollarization (Batini and others, 2020).
- Technical assistance to *Morocco* to strengthen oversight of risks entailed by increasing financial openness and to Ethiopia on exchange rate reforms (Balasubramanian and others, 2020).
- Workshop for authorities in *South Africa* to develop a plan for further sequenced capital flow liberalization tailored to country circumstances.
- Technical assistance to the central bank of the *Philippines* on further steps in capital account liberalization and foreign exchange market development.
- High-level engagement with authorities in *Vietnam* on modernizing the monetary framework, with participation of senior policymakers from other countries to discuss managing challenges associated with greater flexibility of the exchange rate regime.