6 MULTILATERAL CONSIDERATIONS[26]

ATTENTION TO SPILLOVER EFFECTS

The growth in cross-border capital flows and heightened concerns about volatility of flows and contagion from capital account crises in recent decades have led the Fund to adapt its multilateral surveillance framework to bring increased attention to these issues. As described in Chapter 2 above, the 2012 ISD expanded the Fund's multilateral oversight by requiring Article IV consultations to focus on individual countries' policies that may significantly influence the effective operation of the international monetary system—albeit without any obligation on members to amend their policies in response as long as the member is promoting its own stability. Largely keying off the ISD, the IV reiterated that multilateral aspects of capital flows or related policies, including from the use of CFMs, should be discussed in Article IV consultations when their spillovers risked adversely affecting global economic and financial stability and/or the effective operation of the international monetary system.

Since the adoption of the ISD and IV, there has been considerable coverage of the multilateral aspects of capital flow issues in Article IV reports. As reported in the 2019 evaluation of *IMF Advice on Unconventional Monetary Policies* (IEO, 2019), there has been quite extensive analysis of spillover effects from the major economies as called for in the ISD. This attention has continued over the past year.[27]

Multilateral surveillance documents have also discussed the impact of source country macroeconomic developments and policies on capital flows to other economies. The *WEO*, *GFSR*, and Spillover Reports have featured empirical assessments of the extent to which AE monetary policies were driving capital flows and yields, as well as likely effects of different policy choices by source countries on capital flows to EMDEs. For instance, the 2013 Spillover Report called for "more complete" policies by the AEs—including fiscal policies—to avoid an undue reliance on monetary stimulus that would risk adverse spillovers for emerging markets (IMF, 2013d). Likewise, the April 2016 *WEO* assessed the factors, including source country developments, that were causing a slowdown in capital flows to emerging markets (IMF, 2016a).

In addition, the Fund has brought its attention to other ways in which source country financial conditions, regulatory structures, and tax policies may affect capital flows to recipient countries. Building on its work on how the evolving structure of securities markets may lead to risks of market disruption, the *GFSR* called for greater attention

[26] This chapter draws on Towe (2020).

[27] The 2019 U.S. Staff Report (IMF, 2019b) noted that an abrupt tightening of U.S. financial conditions—including from an unanticipated tightening of monetary policy—could adversely affect non-U.S. corporates and others with large U.S. dollar debts. The 2019 Japan Staff Report (IMF, 2020a) noted the potential for Japan's easy monetary policy to offset the effects on capital flows of a normalization of U.S. monetary policy. The 2019 China Staff Report (IMF, 2019c) documented how equity markets in other EMs had become more sensitive to Chinese equity price developments

to such systemic concerns in regulating these markets (e.g., IMF, 2019e). The *GFSR* has introduced a "capital-flows-at-risk" measure for assessing the probability that emerging markets could face a sudden stop resulting from advanced economy financial conditions (IMF, 2018). The effect of corporate tax arbitrage on FDI flows has also been a topic of Fund policy analysis. For example, the Fund has highlighted the extent to which FDI flows were being distorted by corporate efforts to take advantage of low tax jurisdictions, including through relocation of activities and profit shifting, with particularly damaging effects on the tax bases for lower-income countries (IMF, 2014). The Fund has emphasized the importance of multilateral tax coordination, including in the context of the G20/OECD Base Erosion and Profit Shifting Initiative (IMF, 2019a).

The Fund staff has tried to assess the multilateral consequences of the use of capital flow measures in the recipient countries, but in general has not found such spillovers to be systemically important. The IV refers specifically to the multilateral consequences of CFMs, including deflection of capital flows to other recipient countries, the potential for contagion from countries experiencing crises or near-crises, or the possibility that the imposition of CFMs could encourage other countries to take the same actions. It correspondingly calls for bilateral and multilateral surveillance to assess and to encourage countries to "moderate their use of CFMs if these lead to costly spillovers." An IMF study conducted just prior to the adoption of the IV found only inconclusive evidence that capital account restrictions caused a deflection of capital from countries using such measures (IMF, 2011). More recent Fund research finds some evidence of temporary spillovers (e.g., Brazil's 2009 measures deflected capital flows to South Africa). Some studies done outside the Fund (e.g., Forbes and others, 2012) also find that capital account restrictions adopted by individual EMs had significant, albeit temporary, spillovers to other emerging markets, especially since the GFC. Nevertheless, the topic has thus far received little prominence either in the Fund's Article IV consultations—because the effects are difficult to identify in real time and are not long-lasting—or in multilateral surveillance—because they generally do not appear to be of systemic importance. One exception is that China's imposition of outflow controls in 2015 as part of its broader effort to stabilize pressures on the foreign exchange market was welcomed by other countries and by the Fund, because it was perceived as reducing the odds of a crisis and the consequent damaging spillovers that could have resulted.[28]

The Fund staff has also contributed to the growing literature on spillover effects of macroprudential policies. While promoting macroprudential policies as the "first line of defense" to promote a country's financial stability, the Fund recognized that such policies can have spillovers, both adverse and positive (Vinals and Nier, 2014). Adverse spillovers could arise if tighter regulations in one country led to the relocation of risky financial activities to other countries. However, as with capital account measures, there could be positive spillovers if greater resilience to shocks as a result of macroprudential regulations fosters less volatile trade and financial linkages with other countries. The Fund staff has been active in studying the extent of spillovers in several specific cases and, while there is evidence—based on the work conducted at the Fund and elsewhere—for both adverse and positive spillovers, their magnitude has thus far been assessed as small (Towe, 2020). That said, the work to date is far from the final word: for instance, by necessity, many studies cover a short time period, making it difficult to be definitive about longer-term spillovers. Hence, the staff has stressed the importance of reexamining these findings as "the quality of macroprudential data continues to improve" and as longer time series allow for better modeling of "dynamic effects and for a richer interplay of macroprudential regulation with other policy tools and country characteristics" (IMF, 2020d).

IMF attention to multilateral cooperation during the COVID-19 crisis has mainly focused on encouraging synchronized macroeconomic policy easing, cooperation on health initiatives to deal with the pandemic, and external financing support. The IMF quickly endorsed the synchronized monetary policy easing by the major advanced-economy central banks, recognizing that as well as supporting domestic activity, such action also generated space for EMDEs to use monetary policy to respond to weakening domestic conditions. The Fund also partnered with the World Bank to press for a G20 initiative to provide debt-service relief for the poorest countries. Internally, the Fund staff debated whether a multilaterally coordinated

[28] For instance, Bank of Japan Governor Kuroda and the IMF Managing Director both publicly welcomed China's measures (WEF, 2016).

approach to the application of outflow capital account measures could be helpful in the face of a massive global capital account shock as a way of preserving domestic policy space and avoiding a "race to the bottom."

Assessment

Overall, the Fund has made substantial strides in strengthening its coverage and analysis of capital flows and related policies in its multilateral surveillance. The Fund deserves credit for increasing attention to spillovers, with the Fund providing important assessments of the risks to EMDEs from some of the shifts in capital market structures and regulations. The Fund's attention to issues of corporate tax arbitrage has been welcomed by authorities in emerging markets and developing economies.

Despite these achievements, some important challenges remain. Notably, obtaining greater traction for advice to source countries on spillovers from their policies remains a concern.

- The recent evaluation on *IMF Advice on Unconventional Monetary Policies* (UMP) found that source country authorities have generally not been very responsive to discussions of spillovers of their policies as part of Article IV consultations (IEO, 2019). Hence while the ISD is a step forward, it has not greatly improved the traction of Fund advice.

- The UMP evaluation suggested that IMF warnings to source countries about the implications of their policy mix for spillovers to EMDEs could have come earlier and been more forceful. This observation will become pertinent as the exceptional monetary easing and steps to support liquidity by central banks in the major advanced economies during the COVID-19 crisis will eventually need to be unwound. Experience during the post-GFC period demonstrated the risks for damaging spillovers unless this occurs in a careful and transparent manner.

- The Fund's multilateral analysis of effects from source country policies on capital flows and macroeconomic conditions in recipient countries is handicapped by lack of models that effectively incorporate financial channels (Klein, 2019). Some of the EM authorities interviewed for this evaluation echoed findings of the IEO evaluation of *IMF Advice on Unconventional Monetary Policies* (IEO, 2019) that Fund analysis does not adequately capture the effects of financial spillovers (see, for example, the China case study in Patnaik and Prasad, 2020).

The IEO UMP evaluation recommended (as have others) reviving efforts to strengthen international policy cooperation but such suggestions have so far not gained much support. As stated in the Board discussion of the UMP evaluation, "while recognizing that stronger international monetary cooperation would be desirable," many members of the IMF Board did not want to "unduly constrain policy implementation in pursuit of their domestic objectives."

The Fund might have greater success by encouraging multi-agency multilateral initiatives to influence source country regulatory policies that affect capital flows. The relevance of this issue has been underlined by the sharp reversal in portfolio flows to EMDEs observed during the initial months of the COVID-19 crisis. While the regulatory structure for systemic banks has been substantially overhauled since the Global Financial Crisis, much more remains to be done to address systemic risks for non-bank financial intermediation, which has grown to represent "nearly half of financial activity" in the major economies (Quarles, 2019). One particular task would be to reexamine securities market regulation to see how it can address the systemic risks that can apply to cross-border flows, building on suggestions by the European Central Bank (2016), Carney (2019), and *GFSR* (IMF, 2019e). While the Financial Stability Board (FSB) plays the lead role in the area of international financial regulation, the IMF can use its voice and analytical contributions to bring attention to concerns for systemic stability. To this end, in addition to its regular input to the FSB, the Fund staff has been stepping up its engagement with International Organization of Securities Commissions (IOSCO) and national regulators on areas of securities regulation relevant for financial stability, including hosting a regulatory roundtable. An

IOSCO report (IOSCO, 2019) highlighted the importance of international standards and harmonization in countering the fragmentation of securities and derivatives markets.

The IMF staff should continue to monitor and analyze the possible multilateral spillover effects of capital account and macroprudential measures. As the measurement of these policies continue to improve, and longer time series become available, the Fund will be better placed to take a clear position on the relative benefits and costs of these measures in its bilateral and multilateral policy advice.

MULTILATERAL COORDINATION ISSUES

The approval of the IV raised questions about potential inconsistencies with the OECD's Code of Liberalization of Capital Movements and other international agreements relating to treatment of capital flows.[29] The IMF and the OECD have different mandates and memberships, so full consistency is not necessarily the goal. But coherence between the approaches would help to avoid sending contradictory signals to members and aspiring members, and the two institutions should be learning from each other's experience. There are also issues related to coherence with other bilateral and regional agreements, including the international financial regulatory architecture and trade and investment treaties that include capital account commitments. Indeed, the IV document explicitly suggests that the IV could play a "vital role in promoting a more consistent approach towards the treatment of CFMs under other international agreements" by fostering "a global dialogue on the management of capital flows to promote macroeconomic and financial stability" to "reduce the potential volatility and distortions that could result from the current complex patchwork of bilateral, regional and multilateral agreements" (IMF, 2012, para 65).

In practice, issues of consistency and coherence with the OECD Code have emerged in a number of country cases, prompting close interaction between the IMF and OECD staffs on these issues. As discussed in Batini, Borensztein, and Ocampo (2020) and Everaert and Genberg (2020), the Fund's advice to Brazil and Korea on the use of CFMs raised questions about whether it was consistent with the IV but in contravention of that member's obligations under the Code. The OECD accession discussions with Costa Rica featured similar issues. The 2019 revision of the OECD Code—with the IMF staff actively involved in the advisory task force—has improved coherence between the two frameworks, including by providing greater flexibility in the revised Code on the treatment of currency-based measures for financial stability purposes and by specifying that the OECD could draw on the IMF for its balance of payments assessment.

While the staffs of both the Fund and the OECD deserve credit for efforts to resolve possible tensions between the IV and the Code, this cooperative effort needs to be sustained and could be extended. Continued close cooperation between the two institutions will be essential as the revised Code is implemented, helping to avoid mixed or confusing signals to members. There could be value in institutionalizing collaboration between the IMF and OECD in this area, for example through a memorandum of understanding to guide how the two institutions would interact on issues related to treatment of capital account measures, while respecting the different roles and mandates of each.

Tensions between the IV and the Basel III framework could emerge on the treatment of reciprocity arrangements and liquidity ratios. While the Fund's MPM framework advocates for reciprocity arrangements, the current framework of the IV does not provide flexibility to avoid classifying reciprocity arrangements as outflow CFMs. Given their residency-based discriminatory nature, these can be implemented consistently with the IV only in crisis or near-crisis circumstances, which would hardly ever be the case given the fact that in the reciprocating country these tend to become necessary at times of capital buoyancy not during crises. Other tensions could arise in the calibrations of the Basel III liquidity coverage ratio and net stable funding ratio, which countries may set in a way that is consistent with the Basel III guidance but possibly inconsistent with the IV outside of an inflow surge. It would be important to avoid situations where the Fund advises that a countercyclical buffer requirement or a Basel III liquidity measure is an "inappropriate" CFM/MPM under the IV, even when the calibration of these measures are in line

[29] Members of the OECD are required to sign this Code, introduced in 1961, committing to move towards capital account liberalization over time, and to avoid reintroducing restrictions except in limited circumstances (OECD, 2019).

with Basel and the Fund's own guidance under its macro-prudential framework.

While the IV document suggested that the IV could play a "vital role in promoting a more consistent approach towards the treatment of CFMs under international trade and investment agreements," progress in this regard has so far been quite limited. Recent bilateral and regional trade and investment treaties—which are typically legally binding and enforceable—have continued to rule out the use of many kinds of outflow restrictions, while including a balance of payments crisis safeguard that allows the imposition of capital account restrictions in some circumstances. They have also sometimes included a role for the IMF in evaluating macroeconomic crisis exceptions (for example, the United States–Mexico–Canada agreement in 2018 and the 2016 Canada–EU Comprehensive Economic and Trade Agreement).[30] However, these treaties have typically been concluded with limited if any consultation with the Fund. Staff members interviewed for this evaluation commented that the proliferation of such treaties has raised a host of questions about their implications for countries' capital account policies and about their consistency and coherence with the IMF's IV, and that the Fund staff is reviewing these issues in-house. This work could provide the basis for a renewed effort to work with member countries to ensure coherent approaches to capital account issues across the IMF and international trade and investment agreements.

[30] In practice, no case has ever come forward based on violation of the free transfer clause when a country claimed the balance of payments crisis safeguard.