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FINDINGS, LESSONS, AND RECOMMENDATIONS

The findings of this evaluation provide the basis for recommendations on how the IMF can continue to evolve and innovate in its policy advice on capital account issues. Krugman (2012) noted that the adoption of the IV in 2012 was an “indicator of the IMF’s surprising intellectual flexibility.” At the time of the Board discussion of the IV, Directors stressed that it would have to be reviewed and kept updated in the light of experience. This evaluation is intended to contribute to this process.

FINDINGS

Framework for and delivery of IMF capital flow advice in bilateral surveillance

The IMF deserves considerable credit for upgrading the framework for its advice on capital flows over the past ten years. There is broad agreement among policymakers and academics that the IV was a major step forward in providing an approach for considering when the use of capital flow measures could be justified and would likely prove effective, in the context of a broader framework for thinking about capital account liberalization and the challenges of handling capital flow volatility. In parallel, the Fund developed a framework for advice on macroprudential measures, which provided cutting-edge guidance on the effectiveness of various additional tools that can be used in the face of large and volatile capital flows as well as to safeguard financial stability more broadly. Together, the two frameworks—along with continuing IMF analysis of the effectiveness of foreign exchange intervention, further evolution of the Fund’s EBA tool, a new metric for assessing reserve adequacy, and a new ISD—have provided staff with a stronger basis for a structured engagement with country authorities on the policies best suited to deal with capital flow issues.

In practice, the Fund’s bilateral advice on capital flows has generally followed the IV and other policy frameworks quite carefully. Considerable effort has gone into making sure that advice is consistent, tailored to country circumstances, and evenhanded across countries, and that the basis for the advice is well understood. Dealing with surges and sudden stops is challenging and there has been considerable heterogeneity in the approaches and policy toolkits that countries employ to deal with them. The Fund has generally been able to adapt its advice to reflect the different circumstances and approaches.

The extensive case studies conducted for this evaluation find that in practice country authorities have generally combined a mix of measures in line with the IV rather than use CFMs to delay warranted policy adjustments. Many country officials appreciated that the Fund had become more open to the use of CFMs as a policy tool to handle inflow surges, and that it was now more cautious in pushing capital account liberalization. The staff’s advice on handling disruptive capital outflows in crisis or near-crisis situations was

considered pragmatic and effective, especially in the context of Fund-supported programs.

Faced by an abrupt capital flow reversal during the COVID-19 crisis, EMDEs generally followed a multi-pronged approach consistent with the IV framework and successfully managed the severe external strains. Countries provided aggressive fiscal and monetary support while letting exchange rates bear the brunt of the external adjustment with limited recourse to intervention or CFMs. Most EMDEs were able to weather the sharp outflows in March–April 2020 and benefit from recently improved conditions, although the outlook remains highly uncertain.

Notwithstanding these accomplishments, recent country experience and research, including the IMF’s recent work on an Integrated Policy Framework, have raised a number of questions about the Fund’s advice on managing volatile capital flows:

- ▶ **Preemptive use of CFMs.** At times, the guidance in the IV that new CFMs should not be used preemptively and should be imposed at most on a temporary basis during an inflow surge, or during a crisis or near-crisis situation has received considerable push-back from country authorities. Moreover, it seems to conflict with recent research suggesting that in some circumstances capital account measures may be a valuable part of the financial stability framework, and that in some conditions, maintaining limits on capital account openness can usefully increase the scope for orthodox stabilization policies such as monetary policy. Financial market participants and credit rating agencies also seem increasingly ready to recognize that well-designed capital account measures can have a useful function to contain risks of instability in certain situations.
- ▶ **Distinction between CFMs/MPMs and MPMs.** Trying to make fine distinctions between very similar measures classified as CFMs/MPMs and MPMs has led to repeated disagreements. Authorities object to measures they have taken to achieve financial stability objectives being labeled as CFMs or CFMs/MPMs, in part because of concern about “stigma” but also because of the restrictive guidance in the IV on how a measure labeled as a

CFM or CFM/MPM should be used, in particular that such measures (unlike MPMs) should not be used preemptively. This restrictive guidance also raises potential tensions with the Basel III financial regulatory framework.

- ▶ **Role of FXI.** There seems to be a greater role for FXI than sometimes recognized in IMF advice. Country experience and recent research suggest that that exchange rate flexibility may bring less stabilization benefits through the trade account than previously believed and that exchange rate movements can sometimes be a shock amplifier in the face of volatile flows, for instance when the balance sheet effects of such movements dominate competitiveness effects.
- ▶ **Dealing with disruptive outflows.** The Fund’s surveillance could have provided more nimble and tailored advice and support outside a “crisis or imminent crisis” context. When countries face serious external stresses amid diminished policy buffers, there would seem to be value in greater attention to out-of-the-box thinking about possible policy responses well before the situation has evolved into a crisis or imminent crisis.
- ▶ **Role of social and political objectives.** Fund advice on capital flows has been constrained in recognizing that limits on non-residential inflows can be a helpful tool for meeting countries’ social and political objectives, for example where non-resident inflows are impacting housing affordability.

There are also more technical challenges to applying the IV:

- ▶ **Reliance on metrics.** Staff advice on use of CFMs and FXI draws on other metrics, particularly exchange rate valuation and adequacy of foreign exchange reserves, that are not fully convincing to authorities. Despite recent upgrades to the Fund’s methodologies for reaching these assessments, officials continue to question the results they deliver in their specific country circumstances.
- ▶ **Quantification of thresholds.** In applying the IV, the advice provided on certain CFMs depends on a judgment of whether a measure is designed to limit

capital flows and an assessment of subjective definitions of a “surge,” “macro relevance,” and “crisis or near crisis.” The use of judgment allows the staff to account for country circumstances but has also led to some sharp differences of opinion with authorities on the labeling of measures and to perceptions of a lack of evenhandedness.

These challenges have contributed to concerns about the extent of the value added and influence of IMF advice on managing capital flow volatility. At least in some cases, Fund advice on the use of both CFMs and FXI is seen by officials as too restrictive for the country circumstances. Moreover, serious disagreements about the labeling of a measure have crowded out time for policy dialogue and have led to perceptions of a lack of evenhandedness.³¹ In discouraging the use of CFMs and FXI, the staff has sometimes had difficulty recommending specific alternative measures or providing convincing evidence that alternative measures would be more effective and less distortionary than the measures they advocate phasing out. Many policymakers feel that, while generally sensible, IMF advice on dealing with volatile capital flows can be too generic, and they would value more granular guidance on how best to use different policy instruments in particular circumstances. Timely advice on dealing with outflows has proven easier to deliver in the context of a Fund-supported program than in a surveillance setting.

Turning to Fund advice on longer-term capital account liberalization, we found general support for the IV’s sequenced framework and appreciation for the Fund’s specific advice in many cases, but also some examples where Fund advice was seen as not paying enough attention to the broader implications of capital account liberalization. Officials particularly valued the detailed advice given in the context of technical assistance. Most authorities appreciated the caution demonstrated by the Fund in countries where the conditions to reap net benefits of capital account liberalization were still lacking. However, in a few instances, concerns were expressed that the IV could sometimes discourage liberalization measures, since reversing them would trigger greater staff scrutiny. Moreover, some policymakers and experts felt that the

Fund had backed into such a cautious approach regarding the conditions needed for capital account opening that it was failing to give much-needed country-specific advice on whether and how best to advance toward liberalization; nor was it paying enough attention to the collateral costs and benefits of capital account opening in terms of market and institutional development and the macroeconomic policy framework. The concerns expressed cut both ways, however; in at least one important case the Fund may have not warned with sufficient force on the need to strengthen the macroeconomic policy framework following very rapid capital account opening. Another area that could receive more attention relates to the social and distributional effects of capital account liberalization, and how to mitigate any adverse consequences.

Multilateral issues

The Fund has worked hard to adapt its multilateral surveillance to address concerns about spillovers and volatility of capital flows. The 2012 ISD required staff to focus on spillovers from a country’s policies during Article IV consultations, and this guidance was reiterated in the IV. This guidance has led to substantial expansion in coverage of such spillovers in Article IV reports for the major advanced and emerging economies and in the multilateral flagship reports. The Fund’s multilateral surveillance has paid attention to the impact of source country developments and policies on other economies, including ways in which source country regulatory structures can affect capital flows to recipient countries. Spillover effects from the use of CFMs have also been analyzed but these effects seem to be less enduring or systemically important.

Nevertheless, concerns persist about the traction of this work. While the ISD has led to greater discussion of spillovers in source country Article IV consultations, the impact of Fund advice has been quite limited, as assessed in the IEO’s evaluation of *IMF Advice on Unconventional Monetary Policies* (IEO, 2019). While IMF support for aggressive monetary easing and liquidity support in response to the COVID-19 crisis has appropriately emphasized the important spillover benefits for EMDEs, care

³¹ To be sure, disagreements between Fund staff and country officials have occurred in other areas too, such as exchange rate assessment, but the extent of the friction encountered in some of the countries documented in the case studies has been intense and often has seemed out of line with the macro criticality of the issues being discussed.

will be needed when these policies are unwound to avoid strains like those observed after the GFC. The Fund could also intensify efforts to work with partners to strengthen financial regulatory oversight outside the banking system, including greater analysis and advocacy on systemic issues in the regulation of securities markets that could reduce the risks of volatile capital flows for recipient countries. The Fund has certainly contributed in this area but could do more. The volatility in non-resident portfolio flows during the COVID-19 crisis has underlined the relevance of this issue.

Efforts to ensure greater coherence between the IMF's IV and other multilateral frameworks should be maintained and extended. The IMF and OECD staffs have worked closely in a number of country cases to resolve potential tensions between the IV and the OECD Code of Liberalization of Capital Movements, while recognizing that the two frameworks differ in nature. Moreover, the 2019 revision of the OECD Code—with IMF staff members participating actively in the advisory task force—has improved coherence, including by providing greater flexibility in the revised Code on the treatment of currency-based measures for financial stability purposes. Continued strong cooperation between the IMF and OECD will be essential as the revised Code is implemented, helping to avoid mixed or confusing signals to members. Less has been achieved so far to meet the aspiration in the IV document to promote a more consistent approach to treatment of CFMs with other international agreements, including trade and investment treaties. Possible tensions between the IV and the Basel III framework, including the treatment of reciprocity arrangements and liquidity arrangements that are classified by the Fund as CFMs/MPMs will need to be addressed.

Monitoring, research, and analysis

The Fund has made important contributions to the monitoring and research of capital flows and restrictions. Cutting-edge research by the Fund staff played an important role in the design of the IV in 2012. Since then, the impact of changing market structures and regulations on capital flows has received continuing attention in the Fund's multilateral surveillance products. Working in tandem with the FSB, the Fund has worked hard to fill data gaps, including to improve tracking of portfolio and

FDI flows and measurement of countries' international investment positions, and has developed better templates to track funding exposures for GSIBs. Through the *AREAER*, the Fund has continued to lead the way in providing the basic data needed to monitor countries' use of capital account measures.

The lack of a sustained medium-term work agenda, coupled with resource constraints, have limited the staff's contributions on these fronts. Staff resources are spread across multiple departments and are stretched thin. The Fund's monitoring and research of capital flow issues has varied over time and often been the result of individual initiative rather than part of an agreed Fund-wide agenda. The *AREAER* has long been maintained by a very few staff members, who also have other responsibilities including developing and maintaining the very useful database of cross-country usage of macroprudential measures. Hence the task of using the *AREAER* data to summarize and analyze capital account restrictions has been left to outside researchers, who have constructed useful indexes—albeit motivated by their specific research purposes and updated infrequently—some of which are used by the Fund itself in its own exercises such as EBA. Budgetary constraints also keep the staff from subscribing to some commercial databases that could enhance their ability to do high-frequency monitoring and analysis of capital flows, as does lack of access to some data (e.g., cross-border counterparty exposures of GSIBs) for confidentiality reasons.

Most recently, the IMF's work to develop an Integrated Policy Framework on dealing with external shocks is already generating useful insights that should start to inform IMF advice. While this work is still in progress, preliminary results suggest some lessons about the range of circumstances in which CFMs may play a useful role that are consistent with the concerns raised above from country experience and outside research. As this work matures, its conclusions should be reflected in IMF policy advice, while being mindful of broader considerations, such as implications for market and institutional development and investor confidence, that do not fit easily within the IPF's short-term conceptual framework.

LESSONS

While recognizing the major step forward marked by the approval of the IV in 2012, and conscientious efforts to implement the framework since then, the various concerns raised in this evaluation suggest a need to refresh the IMF's approach to advice on capital account issues in light of country experience, empirical evidence, and conceptual advances. Reaching agreement in an area involving multiple complex issues is challenging, but the Fund's capacity to provide cutting-edge convincing advice on capital flows depends on being prepared to continually learn and adapt, as was acknowledged when the IV itself was approved. The relevance of this point is reinforced by the clear possibility that many EMDEs may continue to face serious bouts of capital flow volatility during the difficult and highly uncertain recovery process post-COVID, as well as the insights from the IMF's ongoing work on an Integrated Policy Framework, which is well geared to provide the intellectual basis for the refresh of the IV that we have in mind.

Design of the policy framework

A key element of the refresh would be to consider adaptations to the IV that would address the concerns now affecting the value added and influence of IMF advice on capital flows. The IV was an important milestone in the Fund's attempts since the EM crises of the 1990s and early 2000s to de-stigmatize the use of capital flow measures and make them a more accepted part of policy toolkits. However, in some important respects the IV's attempt to circumscribe the use of CFMs seems too limiting in light of recent experience and conceptual work. While not quite restricting CFMs to be a measure of last resort, the IV supports their use only under limited circumstances while placing strong emphasis on adjustment through macroeconomic policies as the preferred course of action. By contrast to the guarded advice on the use of CFMs, the Fund's approach places few restrictions on the use of macroprudential tools, even though some CFMs may have a very similar form and are adopted at least in large part for financial stability purposes. Moreover, in some circumstances, CFMs may increase the scope for macroeconomic policies to play their stabilization role.

Such a revisit of the IV need not involve a wholesale overhaul. The broad principles laid out in the Executive

Summary of the IV—including the overall presumption that capital flows can bring substantial benefits for countries and that CFMs, while useful in certain circumstances, should not substitute for warranted macroeconomic adjustment—remain valid. They continue to enjoy broad support among the membership and should be retained. The key issue would be to consider some well-defined extensions of the circumstances in which CFMs would provide a helpful policy tool, particularly when preemptive and longer-lasting use could be justified.

Implementation

Modifying the design of the IV to recognize a potential role for CFMs in a somewhat broader range of circumstances would promote richer policy dialogue with the authorities. With some greater flexibility on how capital account measures could be appropriately used, there would be less attention to labeling issues, leaving more time for policy dialogue. And there would be more room to consider how best to tailor the policy mix to country political and social circumstances and to provide more granular advice. Another possible approach would be to allow more flexible implementation of the current framework. This would avoid needing to seek agreement on a modified framework, but would occur at the expense of a loss of transparency and risk greater frictions over evenhandedness concerns.

Firm surveillance within a structured framework would continue to provide a safeguard against the valid concern that a more flexible approach could foster an “anything goes” environment. While recognizing the importance of this concern, we do not believe it should be a reason not to modify a framework that is no longer state-of-the-art and is not providing a fully coherent basis for Fund advice. Under a modified IV, IMF surveillance would still be tasked with providing advice on how to address concerns related to capital flow volatility, based on a careful assessment of the costs and benefits of alternative instruments to achieve specific goals. The staff would still be required to assess whether the conditions in which CFMs may be useful have been met, and to caution where capital account measures would likely be ineffective or distortionary or have other adverse repercussions. The IMF should continue to push back firmly against capital account measures that may be ineffective or distortionary for countries themselves, could

have negative spillovers for others, or could be aimed at depressing currency values.

Further research on the Fund's external balance assessment would also help to address the concern that capital account measures or FXI are being used to depress currency values. More attention could be given to looking at the overall structure of a country's capital account restrictions as a potential source of policy distortions. The concern that CFMs are used to manipulate exchange rates does not seem to have been subject to rigorous empirical tests at the Fund (or elsewhere). Such an exercise would require further research for the EBA to provide a more granular analysis of the link between capital account measures and external balances, to justify a judgment that particular measures indeed had significant impacts on capital flows and the exchange rate.

RECOMMENDATIONS

Our principal recommendation is that it is time to refresh the IMF's approach to dealing with capital account volatility. Such an exercise would involve revisiting the IV to consider: (i) advances in conceptual understanding of the use of capital account measures and MPMs; (ii) the rich cross-country experience with the use of various tools to meet macroeconomic and financial stability goals; (iii) concerns about how the IV is applied in certain situations, in which country authorities have found that it provides too inflexible a framework for useful policy dialogue.

The recommendation to revisit the IV is complemented by two additional recommendations: (i) to sustain a strong, adequately resourced, medium-term work program on monitoring, analysis, and research on capital account issues; and (ii) to strengthen cooperation with multilateral partners on issues related to capital flows. Together, the recommendations would be mutually reinforcing to help raise the value added and influence of the IMF's advice on capital flows.

Recommendation 1—Revisit the IMF's Institutional View in the light of experience and recent research. An updated approach would provide the basis for more fruitful policy dialogue with country authorities and increase the value added and influence of IMF advice. This

revisit should draw on the lessons from the IPF work program as well as this evaluation and be folded into the review of the IV that is scheduled for 2021. In our view, the general principles set out in the Executive Summary of the 2012 document remain broadly valid, and adjustments to be considered would mainly focus on adapting the IV guidance for some specific issues that would give the staff greater leeway to base policy advice on assessments of the pros and cons of different policies in given country circumstances rather than on how a measure is classified. In particular, the following changes to the IV should be carefully considered:

- ▶ *Allow for preemptive and more long-lasting use of capital flow measures in some circumstances.* Some of the carefully circumscribed conditions that the IV places around the use of capital flow measures, particularly the IV's hard injunction against preemptive and enduring use of CFMs other than during a surge of inflows or a crisis or near-crisis situation for outflows, do not seem justified in light of recent theoretical work and lack firm empirical support. Three changes would seem particularly relevant:
 - *Reducing the hard distinction made in the IV for policy purposes between MPMs and CFMs/MPMs.* Allowing for preemptive use of CFMs/MPMs would remove the sharp policy distinction currently drawn in the IV between different measures designed for financial stability purposes; it would encourage less attention in policy dialogue to labeling issues and more to a discussion of what tool would work most effectively to meet financial stability objectives.
 - *Recognizing that capital account measures may have a valid role to address social issues such as housing affordability.* In particular, the IV could be modified to allow for housing-related restrictions on non-resident investments on a preemptive and lasting basis, subject to an assessment that such measures are contributing to alleviate house price pressures and that the

objective cannot be achieved more effectively by other means. This change would be consistent with the standard guidance in the Articles that the Fund should recognize a country's economic and political circumstances.

- *Recognizing that capital account measures can play a useful role in increasing macro policy space, especially for dealing with disruptive outflows.* In particular, the IV could be modified to allow a possible role for capital flow measures as part of a broader policy package responding to severe stresses amid diminishing policy buffers and trying to avoid a “crisis or near-crisis” situation. Advice would need to weigh the possible short-term gains, from stabilizing flows and adding to the space for domestic policy easing, against the long-term costs related to market development and investor confidence.

▶ *Consider distributional implications as part of the strategy for capital account liberalization within the IV.* While the IV's guidance on capital flow liberalization seems generally still valid, there would be merit in explicitly acknowledging that capital account liberalization has implications for income distribution, and providing guidance on appropriate ways to mitigate an adverse impact where this is a concern for the authorities.

▶ *Rethink the concept of the CFM.* The present definition of a CFM combines both the form and function of the measure and an assessment of its purpose (i.e., “designed to limit capital flows”). This approach to classification has caused confusion and disagreement and has raised evenhandedness concerns since a measure with the same form and function may receive a CFM label or not in different countries and at different times in the same country. While not essential to the changes suggested in the bullets above, it would seem worth considering a shift to a concept of capital account measure based on form and function only, and not its intent, consistent with the well-established approach in the *AREAER*.

Recommendation 2—Build up the monitoring and research of capital account issues as part of a sustained Fund-wide medium-term agenda.

Having a Fund-wide medium-term agenda would help ensure sustained coverage of key capital account issues. An agreed Fund-wide medium-term agenda would help keep the Fund at the cutting edge of work on capital flow issues and ensure that the IV and macroprudential framework rest on more solid empirical ground. This work program would build on the ambitious efforts currently under way on the IPF. While it may not be possible to devote substantial additional resources beyond the IPF, given the other demands on the staff's time, work in this area would need to be sustained with adequate resources over the medium term.

Particular priorities could include:

▶ *More research on the costs and benefits of capital account and macroprudential measures.* It will be helpful to ensure that such research is tailored to country conditions and provides a basis for more granular assessment of particular measures since the impact of macroprudential and capital account measures depends very much on the details.

This work could usefully assess and draw lessons from the experience during the COVID-19 crisis. Relevant issues would include:

- to what extent measures can have a lasting or just a temporary impact on capital flow outcomes, including composition and balance sheet effects, as well as total flows, and thus can contribute to financial stability goals or increase the macroeconomic policy space;
- the distortionary costs of capital account measures, both short-term and through the longer-term impact on market and institutional development and risk management;
- the complementary role of broader policy instruments that have not been included in the IPF work program up to this point—particularly fiscal policy, since fiscal policy settings are crucial determinants of macroeconomic

dynamics, including through confidence effects, and therefore the effectiveness of capital account measures and MPMs;

- the scale and persistence of spillover effects of capital account measures and macroprudential tools; and
- the role that capital account opening can play in the long-term growth and development of economies, including collateral benefits for institutions and markets as well as aggregate effects on growth and the distribution of income.

- ▶ *Ramp up and ring-fence resources committed to the AREAER to ensure that the Fund is able to: (i) carry out needed quality checks of the data; (ii) construct practical indexes of openness that it can provide to others as summary statements of progress toward liberalization and for use in its own exercises such as the external balance assessment (EBA); and (iii) monitor the use of capital account measures, complementing the efforts currently made through Article IV reports.*
- ▶ *Further research on capital account issues in the EBA and ARA exercises.* Inter alia, this would allow concerns about potential misuse of capital account measures as tools for currency manipulation to be handled more effectively using EBA metrics.

Recommendation 3—Strengthen multilateral cooperation on policy issues affecting capital flows.

The Fund's collaboration with other multilateral institutions and with bilateral partners on capital account issues could be strengthened. Specifically, the Fund should:

- ▶ *Sustain efforts to ensure that the OECD and IMF work coherently on capital account issues.* Consideration should be given to establishing a cooperation agreement on capital account issues with the OECD to institutionalize the basis for sustained collaboration in applying the IV and the revised OECD Code.
- ▶ *Work together with the FSB and BIS to strengthen the monitoring and coordination of macroprudential*

and capital flow policies, including the spillover effects of such policies. The impact of capital flow measures depends in part on the effectiveness of macroprudential policies; thus it is important to address issues of spillovers.

- ▶ *Address possible tensions between the IV and the Basel III framework, including on treatment of reciprocity arrangements and liquidity regulations.*
- ▶ *Step up the Fund's interactions with the FSB, IOSCO, and national regulators to promote regulation to address systemic concerns from securities markets, especially related to cross-border flows.*
- ▶ *Launch a new initiative to promote coherence between the treatment of capital account issues in international trade and investment treaties and the IMF's approach to capital account issues.* Recent work by the Fund staff could provide the basis for a renewed effort to work with shareholders to ensure coherent approaches to capital account issues in the IMF and in international trade and investment agreements.

Resource implications

Full implementation of these recommendations could require a modest increase in net staff resources for capital flows work. While details of implementation are in the staff's domain and a detailed costing of recommendations lies outside the scope of this evaluation, providing a sense of the resource implications for effectively implementing the recommendations could be useful. Completion of the research on the IPF and the review of the IV is already anticipated as part of the Fund's work program; therefore implementing Recommendation 1 to revisit the IV need not require significant additional resources. Implementation of an updated IV to provide more granular advice and more attention to assessment of costs and benefits of alternative policies could require additional resources, but there should also be resource savings as less staff time should be needed to adjudicate labeling issues. There could be some additional resource needs for sustaining the research and data work on capital flows beyond the IPF as suggested in Recommendation 2 and for strengthening multilateral cooperation on capital flow policy issues as suggested in Recommendation 3.