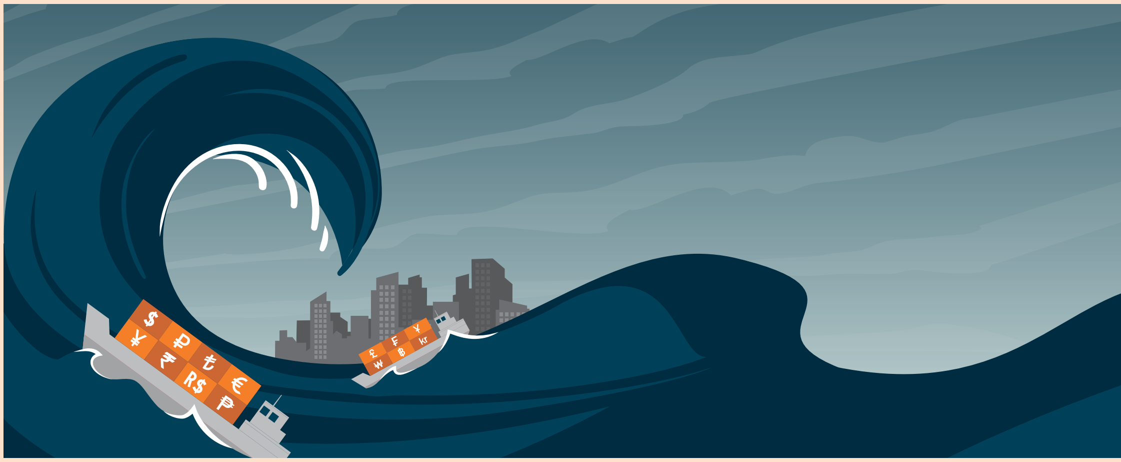
EXECUTIVE SUMMARY

FINDINGS

Bilateral advice

The IMF deserves considerable credit for upgrading the framework for its bilateral advice on handling volatile capital flows over the past ten years. Since the Global Financial Crisis (GFC), emerging market and developing economies (EMDEs) have continued to be exposed to strong surges and sudden reversals in capital flows, including most recently from the COVID-19 pandemic. The Institutional View on the Liberalization and Management of Capital Flows (IV) approved in 2012 was a major step forward in providing a consistent approach to guide Fund advice on when the use of capital flow management measures (CFMs) could prove effective in the context of a broader policy framework for thinking about capital account liberalization and the challenges of handling capital flow volatility. In parallel, the Fund has developed a framework for advice on macroprudential measures (MPMs) to provide cutting-edge guidance on the effectiveness of various additional tools to use in the face of 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 external balance assessment tool, a new metric for assessing reserve adequacy, and a new Integrated Surveillance Decision (ISD)—have given the staff a stronger basis for structured engagement with country authorities on policies best suited to deal with capital flow issues.

The Fund's bilateral support to countries on capital flow issues 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. Technical assistance has been geared to help countries better understand and implement advice consistent with the IV. The extensive case studies conducted for this evaluation find that, in line with the IV, country practice has generally been to combine a mix of measures, rather than using CFMs to delay warranted policy adjustments. Many country officials



appreciated that the Fund had become both more open to the use of CFMs as a policy tool to handle inflow surges and more cautious in pushing capital account liberalization. The staff's advice on handling disruptive capital outflows in crisis or near-crisis situations was considered as 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 endured 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 foreign exchange 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 has faced considerable pushback from country authorities. It also 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, 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 CFM/MPMs and MPMs.* Trying to make fine distinctions between very similar measures classified as CFM/MPMs and MPMs has led to repeated disagreements. Authorities object to measures they have implemented to achieve financial stability objectives being labeled by the IMF as CFMs or CFMs/MPMs, in part because of concern about "stigma" but also because of 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.

- *Role of foreign exchange intervention (FXI).* There also seems to be a greater role for FXI than sometimes acknowledged in IMF advice. Country experience and recent research suggest 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.

- *Dealing with disruptive outflows.* Some country authorities have felt that the Fund's surveillance could have provided more nimble advice on the use of capital account measures 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, in some circumstances, limiting non-residential inflows can be a helpful tool for achieving 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 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 on 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.

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 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. 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 capital flow volatility can be too generic and would value more granular guidance on how best to use different policy instruments in particular circumstances.

Turning to Fund advice on longer-term capital account liberalization, the assessment found broad 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 more detailed advice given in the context of technical assistance. Most authorities appreciated the caution shown by the Fund in countries where the conditions to reap net benefits of capital account liberalization were still lacking. In a few instances, however, concerns were expressed that the IV could sometimes discourage liberalization measures, since reversing them would be subject to greater staff scrutiny. There were also some examples where policymakers and experts felt that the Fund was too cautious about the conditions needed for capital account opening and that it was not paying enough attention to the collateral benefits of capital account liberalization in terms of market and institutional development and the robustness of the macroeconomic policy framework. That said, in one important case the Fund may not have 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 Integrated Surveillance Decision (ISD) has led to substantial expansion in coverage of spillovers from a country's policies in Article IV reports for the major advanced and emerging economies and in the multilateral flagship reports. The Fund has also paid attention to ways in which source country regulatory structures can affect the scale and volatility of 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. Countries receiving net capital inflows remain concerned that the Fund could do more to encourage more balanced macroeconomic policies relying less on extremely easy monetary conditions. And care will be needed when the current extraordinarily easy monetary policies in advanced economies are unwound to avoid the type of strains observed after the GFC. The Fund could also intensify efforts to work with partners to strengthen financial regulatory oversight outside the banking system, including giving greater attention to systemic issues in the regulation of securities markets that could reduce the risks of volatile capital flows—a point brought home by the extreme volatility in non-resident portfolio flows during the COVID-19 crisis.

Efforts to ensure greater coherence between the IMF's IV and other multilateral frameworks should be maintained and extended. Progress towards greater coherence between the IMF's IV and the OECD's Code of Liberalization of Capital Movements has been achieved through efforts by both institutions, which will need to be sustained. While recognizing that the two frameworks differ in nature, the IMF and OECD staffs have worked closely to resolve potential tensions, while the revised OECD Code provides some greater flexibility in the treatment of currency-based measures for financial stability purposes. Potential tensions between the IV and the Basel III framework, including in the treatment of reciprocity arrangements and liquidity regulations, measures classified as CFMs/MPMs under the IV, will also need to be addressed. More work is also needed to achieve the aspiration in the IV framework to promote more consistency in the approaches to capital account issues taken by the IMF and in international trade and investment agreements.

Monitoring, research, and analysis

The Fund has made important contributions to the monitoring, research, and analysis of capital flows and restrictions. Cutting-edge IMF research played an important role in the design of the IV in 2012. The impact of changing market structures and regulations on capital flows has received continuing attention over the past decade. Working in tandem with the Financial Stability Board, the Fund has worked hard to fill data gaps to improve tracking of capital flows and to develop better templates to monitor funding exposures for globally systemically important banks. Through the *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*, the Fund has continued to lead the way in providing the basic data needed to monitor countries' use of capital account measures.

However, the staff contribution on these fronts has been hindered by the lack of a sustained medium-term work agenda and by resource constraints. The Fund's attention to analysis of capital flows has varied over time and often been the result of individual initiative rather than part of an agreed Fund-wide agenda on these issues. The *AREAER* has long been maintained by a very small staff team. Due to resource constraints, the task of using the *AREAER* data to summarize and analyze capital account restrictions in the form of indexes has been largely left to outside researchers rather than driven by the IMF's own policy needs. Budgetary constraints also keep the staff from subscribing to some commercial databases needed for high-frequency monitoring and analysis of capital flows and there is lack of access to some data for confidentiality reasons.

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

LESSONS

While recognizing the IV as a major step forward and the strenuous 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. The Fund's capacity to provide cutting-edge convincing advice on capital flows depends on being prepared to continually learn and adapt, as was recognized 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, and the insights from the IMF's ongoing work on an IPF, which seems well geared to provide the intellectual basis for the refresh that we have in mind.

Such a revisit need not involve a wholesale overhaul of the IV. 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 would be retained. The key issue would be to consider some well-defined extensions of the circumstances in which CFMs would provide a helpful part of the policy toolbox, particularly when their preemptive and longer-lasting use could be justified.

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 for more granular advice.

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 that 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 authorities when 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.

Specifically, on the concern that capital account measures or FXI are being used to depress currency values, such a possibility would still need to be evaluated as part of the Fund's external assessment in Article IV surveillance and in the *External Sector Report*. More attention could be given to looking at the overall structure of capital account restrictions as a potential source of policy distortions. The concern that CFMs may be 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 Fund's external balance assessment (EBA) to provide a more detailed 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 in light of recent experience and research. This recommendation is complemented by two additional recommendations: (i) to sustain a strong, adequately resourced, medium-term work program on monitoring 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 Institutional View in the light of recent experience and research needed. An updated approach would provide the basis for more fruitful policy dialogue with country authorities and increase the value added and traction 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 particular, the following changes to the IV should be carefully considered:

- *Allowing 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 of 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 and 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.

- *Acknowledging 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 for a possible role for CFMs as part of a broader policy package for 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 policy 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 ways to mitigate adverse impacts when these are a source of concern to the authorities.

- *Rethink the concept of the CFM.* The present definition of a CFM combines both the form and function of the measure and 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, analysis, and research of capital account issues as part of a sustained Fund-wide medium-term agenda. An agreed Fund-wide medium-term agenda would help ensure sustained coverage of key capital account issues, keep the Fund at the cutting edge of analysis of capital flows, and ensure that the IV and macroprudential framework rest on solid empirical ground. Building on the work under way in the IPF, particular priorities could include: more research on costs and benefits—including potential cross-border spillovers and collateral impact on market development—of capital account and macroprudential measures, including to draw lessons from the experience during the COVID-19 crisis; ramping up resources committed to the *AREAER*, including to build the Fund's own indexes of capital market openness; and further research to deepen coverage of capital account issues in the EBA and Assessment of Reserve Adequacy (ARA) methodologies.

Recommendation 3—Strengthen multilateral cooperation on policy issues affecting capital flows. Specifically, the Fund should:

- Sustain efforts to ensure that the OECD and IMF work coherently on capital account issues, including by considering a cooperation agreement with the OECD.

- Continue interactions with the Financial Stability Board (FSB) and International Organization of Securities Commissions, particularly to promote regulation to address systemic concerns from securities markets related to cross-border flows.

- Work with the FSB and Bank for International Settlements to strengthen the monitoring and coordination of macroprudential and capital account policies, including possible cross-country spillovers.
- Address possible tensions between the IV and the Basel III framework.
- Launch a new initiative to promote treatment of capital account issues in international trade and investment treaties that is consistent with IMF policies.

Resource implications

Full implementation of these recommendations could require a modest increase in net staff resources for capital flows work. Completion of the research on the IPF and the review of the IV is already anticipated as part of the IMF 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 these could be funded via the resource savings generated by staff spending less time adjudicating 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.