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IMF ADVICE ON CAPITAL FLOWS

EVALUATION REPORT **2020**

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CATALOGING-IN-PUBLICATION DATA
IMF LIBRARY

Names: Loungani, Prakash. | Batini, Nicoletta. | Balasubramanian, Sriram . | Pedraglio, Roxana. | Chen, Yishu. | International Monetary Fund. Independent Evaluation Office, issuing body. | International Monetary Fund, publisher.
Title: IMF advice on capital flows : evaluation report 2020.
Other titles: International Monetary Fund advice on capital flows. | Evaluation report (International Monetary Fund. Independent Evaluation Office) ; 2020.
Description: Washington, DC : International Monetary Fund, 2020. | "This report was prepared by an IEO team led by Prakash Loungani and Nicoletta Batini, and including Sriram Balasubramanian, Roxana Pedraglio, and Yishu Chen." | Evaluation report (International Monetary Fund. Independent Evaluation Office). | Includes bibliographical references.
Identifiers: ISBN 9781513558073 (paper)
Subjects: LCSH: International Monetary Fund—Evaluation. | Capital movements.
Classification: LCC HG3881.5.I58 L68 2020

Publication orders may be placed online, by fax, or through the mail:
International Monetary Fund, Publication Services
P.O. Box 92780, Washington, DC 20090, U.S.A.

Tel: +(1) 202.623.7430 | Fax: +(1) 202.623.7201
E-mail: publications@IMF.org
bookstore.IMF.org
elibrary.IMF.org

CONTENTS

FOREWORD . . . v

CONTRIBUTORS . . . vi

ABBREVIATIONS . . . vii

EXECUTIVE SUMMARY . . . 1

1. INTRODUCTION . . . 8

2. CONTEXT . . . 12
   - Capital Flows and Capital Account Liberalization Since the Global Financial Crisis . . . 12
   - The Evolution of IMF Policies on Capital Account Issues . . . 15

3. MANAGING CAPITAL FLOW VOLATILITY: THE DESIGN OF THE IMF'S APPROACH . . . 18
   - Recent Conceptual and Empirical Work . . . 18
   - Concerns About the Design of the Institutional View . . . 20
   - Assessment . . . 22

4. DEALING WITH CAPITAL FLOW VOLATILITY: IMPLEMENTATION ISSUES . . . 23
   - Challenges in Implementation: Capital Inflows . . . 24
   - Challenges in Implementation: Disruptive Capital Outflows . . . 28

5. REAPING LONG-TERM BENEFITS FROM OPEN CAPITAL MARKETS . . . 32

6. MULTILATERAL CONSIDERATIONS . . . 36
   - Attention to Spillover Effects . . . 36
   - Multilateral Coordination Issues . . . 39

7. MONITORING, ANALYSIS, AND RESEARCH ON CAPITAL ACCOUNT ISSUES . . . 41

8. FINDINGS, LESSONS, AND RECOMMENDATIONS . . . 44
   - Findings . . . 44
   - Lessons . . . 48
   - Recommendations . . . 49

BOXES
   1. List of Background Papers . . . 10
   2. IMF Judgments on Housing-Related Measures . . . 27
   3. Technical Assistance Activities on Capital Flow Issues . . . 35

FIGURES

1. Gross and Net Cross-Border Capital Flows 13
2. Capital Flows to Emerging Markets 13
3. Volatility of Non-Resident Capital Inflows for EMDEs by Components 14
4. Measures of Capital Account Openness in Emerging Markets 14

REFERENCES 52

STATEMENT BY THE MANAGING DIRECTOR 58

THE CHAIR'S SUMMING UP 61

BACKGROUND WORK

The following Background Papers are available on the IEO website at IEO.IMF.org.

BP/20-02/01. Managing Capital Flows: Theoretical Advances and IMF Policy Frameworks
BP/20-02/02. IMF Advice on Capital Flows: How Well is it Supported by Empirical Evidence?
BP/20-02/03. Analysis and Advice on Capital Account Developments: Flows, Restrictions, and Policy Toolkits
BP/20-02/04. IMF Advice on Capital Flows: Multilateral Issues
BP/20-02/05. The COVID-19 Crisis and Capital Flows
BP/20-02/06. IMF Advice on Capital Flows to Latin America
BP/20-02/07. IMF Advice on Capital Flows to Korea and Selected ASEAN Economies
BP/20-02/08. IMF Advice on Capital Flows to China and India
BP/20-02/09. IMF Advice on Capital Flows to Croatia, Israel, and Poland
BP/20-02/10. IMF Advice on Crisis-Driven Capital Controls in Europe
BP/20-02/11. IMF Advice on Capital Flows to Africa and the Middle East
BP/20-02/12. Capital Flow Measures and Housing-Related Issues in Advanced Economies

The following conventions are used in this publication:

- An en dash (–) between years or months (for example, 2020–21 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash (/) between years or months (for example, 2020/21) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY2020).
- "Billion" means a thousand million; "trillion" means a thousand billion.

Some of the documents cited and referenced in this report were not available to the public at the time of publication of this report. Under the current policy on public access to the IMF's archives, some of the documents will become available three or five years after their issuance. They may be referenced as EBS/YY/NN and SM/YY/NN, where EBS and SM indicate the series and YY indicates the year of issue. Certain other types of documents may become available 20 years after their issuance. For further information, see IMF.org/external/np/arc/eng/archive.htm.

As used in this evaluation report, the terms "country" and "state" do not in all cases refer to a territorial entity that is a state as understood by international law and practice.

FOREWORD

Giving advice to countries on how to handle volatile capital flows and capital account liberalization has been a long-standing challenge for the IMF. Since the Global Financial Crisis, emerging and developing economies have continued to be exposed to strong surges and sudden reversals in capital flows, including most recently from the COVID-19 pandemic. The IMF's advice in this area has evolved, and since 2012 has been guided by the so-called Institutional View on the Liberalization and Management of Capital Flows (IV), which sought to provide a coherent framework for IMF advice in this core area.

This report evaluates the influence and value added of IMF advice on capital flows focusing on the period since the approval of the IV. Lessons from this evaluation are particularly germane as the global outlook for capital flows following the COVID-19 shock remains highly uncertain. Together with the IMF staff's own work program on an Integrated Policy Framework (IPF), the evaluation provides important material for the review of the IV that is scheduled to take place in 2021.

The evaluation finds that the IV represented a considerable step forward. Together with other IMF policy frameworks, it has endowed staff with a stronger conceptual template for engaging with country authorities on how to contain risks from capital flow volatility while garnering long-term benefits from international financial integration. The evaluation finds that in practice most countries' policy approaches have been in line with the IV and that countries have avoided using unconventional tools as a substitute for warranted macroeconomic adjustment.

Despite these accomplishments, our review points to a number of concerns about Fund advice that is undercutting its traction. The guidance in the IV discouraging the pre-emptive or long-lasting use of capital flow measures is at odds with country experience and recent research that such use can be helpful to address financial stability concerns and to provide more space for macroeconomic policy. The IV could also pay more attention to the impact of capital flow measures on distribution and other social objectives such as housing affordability. In practice, labeling distinctions required by the IV have proven both contentious and unproductive, crowding out attention to policy discussion. The report also finds that the Fund could have provided more nimble support on dealing with capital outflows outside a "crisis or imminent crisis" context.

The report sets out three recommendations aimed at refreshing the Fund's advice on capital flows management. I am glad that all three were broadly endorsed by the Managing Director and by the Executive Board when it met to discuss the report in September 2020. I look forward to more detailed decisions to move this agenda forward in the year ahead.

Charles Collyns
Director, Independent Evaluation Office

CONTRIBUTORS

This report was prepared by an IEO team led by Prakash Loungani and Nicoletta Batini, and including Sriram Balasubramanian, Roxana Pedraglio, and Yishu Chen.

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The evaluation benefited from discussions with participants at several workshops and many interviews with officials, academics, and private sector participants. However, the final judgments are the responsibility of the IEO alone.

The report was approved by Charles Collyns.

ABBREVIATIONS

AE	advanced economy
ARA	assessment of reserve adequacy
AREAER	*Annual Report on Exchange Arrangements and Exchange Restrictions*
ASEAN	Association of Southeast Asian Nations
BIS	Bank for International Settlements
CBM	currency-based measure
CDIS	Coordinated Direct Investment Survey
CFM	capital flow management measure
CPIS	Coordinated Portfolio Investment Survey
EBA	external balance assessment
EM	emerging market economy
EMDE	emerging market and developing economies
ESR	External Sector Report
ETF	exchange-traded fund
FCL	Flexible Credit Line
FDI	foreign direct investment
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FXI	foreign exchange intervention
GFC	Global Financial Crisis
GFSR	*Global Financial Stability Report*
GSIBs	global systemically important banks
IIF	Institute of International Finance
IOSCO	International Organization of Securities Commissions
IPF	Integrated Policy Framework
ISD	Integrated Surveillance Decision
IV	Institutional View on the Liberalization and Management of Capital Flows
LEG	Legal Department (IMF)
MCM	Monetary and Capital Markets Department (IMF)
MPM	macroprudential measure
NDF	non-deliverable forward
OECD	Organisation for Economic Co-operation and Development
RES	Research Department (IMF)
RBM	residency-based measure

SPR	Strategy, Policy, and Review Department (IMF)
STA	Statistics Department (IMF)
UMP	unconventional monetary policy
WEO	*World Economic Outlook*
WHD	Western Hemisphere Department (IMF)

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.

1

INTRODUCTION

This evaluation assesses the value added and influence of IMF advice on capital flows, focusing on the period since the approval of the Institutional View on the Liberalization and Management of Capital Flows (IV) in 2012.

Safe handling of the capital flows associated with increasing international integration of financial markets has long been a concern for policymakers and has remained a major challenge in recent years. While total flows recovered quickly after the Global Financial Crisis (GFC), capital flows to emerging market and developing economies (EMDEs) in particular have been subject to repeated surges and reversals. Sources of volatility have included shifts in risk appetite and policy expectations in the major source countries as well as shifting policies in the recipient countries. Capital flow dynamics have also been affected by very easy global liquidity conditions, by the increasing importance of portfolio inflows and resident outflows, by the growing role of institutional investors, by rising foreign currency indebtedness, and by the emergence of significant "South-South" flows, particularly out of China. The continuing relevance of capital flow volatility was underlined by the dramatic sudden stop in capital flows to EMDEs in March 2020 in the wake of the COVID-19 pandemic.

Drawing lessons from experience, national policymakers have adjusted policies and regulations to handle capital flow and asset price volatility and associated risks within their broader macroeconomic policy frameworks. Different countries have followed different approaches, reflecting different national circumstances. While advanced economies (AEs) with open capital accounts and deep financial markets have generally allowed their exchange rates to float freely and avoided any measures to interfere with capital movement, many EMDEs have actively used foreign exchange intervention (FXI), macroprudential measures (MPMs), and capital account measures, together with monetary and fiscal policy tools, to meet stabilization objectives. EMDEs have also taken different approaches toward further capital account liberalization, balancing hoped-for long-term gains from increasing integration and market development against the potential short-term risks from capital flow volatility.

IMF policy advice on capital flows has continued to evolve as the Fund has sought to help countries garner the benefits of international financial integration while containing the risks associated with volatile conditions and dealing with crises when such risks materialize. After the emerging market crises of the 1990s, the IMF emphasized the importance of appropriate pace and sequencing of capital account liberalization. Since the early 2000s, the IMF has strengthened the underpinnings of its advice on the policy toolkit that countries can use to deal with capital inflow surges. This work intensified after the GFC as capital flows rebounded to EMDEs in the context of exceptional easing by major advanced economy central banks and the recovery of global economic conditions. Two important milestones were the adoption of the IV (IMF, 2012), which provided a detailed framework for providing consistent advice on when capital account measures could be justified, and the development in parallel of a macroprudential framework aimed at safeguarding financial stability (IMF, 2013b), including in the face of large and volatile capital inflows (IMF, 2017). The IMF has also taken steps to understand and draw lessons from countries' experience with FXI (for example, Chamon and others, 2019), as well as refining tools to assess external imbalances and foreign exchange reserve adequacy. Recently, the staff has embarked on an ambitious agenda to develop an Integrated Policy Framework (IPF) to consider how best to combine the use of monetary policy, foreign exchange intervention, macroprudential measures (MPMs), and capital account measures to deal with external volatility, including capital flow shocks.

Despite this attention, IMF advice on these issues has continued to be criticized from various angles. While the IV was generally regarded as an important step forward and has become established as the cornerstone of IMF advice in this area, concerns have remained about the value added and influence of IMF advice. Some policymakers and experts, drawing from their own experiences of handling volatile flows and recent research, feel the Fund is still too unwilling to recognize that nonstandard policy elements such as capital account measures and FXI can play a useful role in handling particular challenges. Specific issues, related to the design of the policy frameworks the Fund uses and to how they are applied in practice, may reduce the traction of the Fund's advice. And there are concerns that the Fund may not pay sufficient attention to multilateral aspects and spillovers—including macroeconomic and regulatory policies in source countries that affect capital flow volatility—and to coherence with other policy frameworks like the OECD's Code of Liberalization of Capital Movements (OECD, 2018, 2019).

This evaluation aims to assess how well IMF advice on capital flows has succeeded in recent years in helping countries garner long-term benefits from international financial integration while containing short-term risks from volatility.[1] It focuses primarily on IMF advice in Article IV surveillance but also occasionally in the context of financial support and technical assistance. It is intended to shed light on a broad range of issues about how much value added and influence IMF advice on capital flows has had over the years since the IV was approved. Building on extensive country case studies, it pays particular attention to the role of capital account measures but also considers the role of FXI and macroprudential measures and how such measures fit within the macroeconomic policy toolkit. Together with the more model-based and empirical work program being advanced in the IPF, it can provide useful material for the review of the IV that is scheduled to take place in 2021.

The evaluation is organized around four main themes:

- Managing capital flow volatility:
    - The IMF's frameworks: Has the development of the Institutional View and the Macroprudential Framework, along with refinements of related frameworks for external sector and reserve adequacy assessments, provided an effective basis for IMF advice to countries on how to deal with capital flow volatility? (Chapter 3)
    - Issues in implementation: What issues have arisen in the implementation of these frameworks and how have they affected the value of the IMF's advice on dealing with capital flow volatility? (Chapter 4)
- Garnering net benefits from open capital markets: How well has the IMF advised countries that are still well short of full capital account liberalization on the best approach for achieving the likely net benefits from further liberalization? (Chapter 5)
- Multilateral considerations: How well has IMF analysis and advice on capital flows contributed to the Fund's multilateral mandate to strengthen the operation of the international monetary system? (Chapter 6)
- Monitoring, analysis, and research on capital account issues: To what extent has the IMF provided useful data, analysis, and research on capital account issues? (Chapter 7)

Chapter 2 sets the context for the evaluation, first highlighting some recent developments in capital flows and the use of capital account measures, and then laying out the evolution of Fund policies on these issues. Chapter 8 concludes by summarizing the main findings of

[1] Earlier IEO work in this area includes *The IMF's Approach to Capital Account Liberalization* (IEO, 2005) and the update of that evaluation (IEO, 2015).

BOX 1. LIST OF BACKGROUND PAPERS

Thematic papers:

- Managing Capital Flows: Theoretical Advances and IMF Policy Frameworks (Korinek)
- IMF Advice on Capital Flows: How Well is it Supported by Empirical Evidence? (Montiel)
- Analysis and Advice on Capital Account Developments: Flows, Restrictions, and Policy Toolkits (Batini and Durand)
- IMF Advice on Capital Flows: Multilateral Issues (Towe)
- The COVID-19 Crisis and Capital Flows (Batini)

Country case studies cover IMF advice on capital flows to:

- Selected countries in Latin America (Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru, Uruguay) (Batini, Borensztein, and Ocampo)
- Korea and selected ASEAN economies (Indonesia, Malaysia, and Thailand) (Everaert and Genberg)
- China and India (Patnaik and Prasad)
- Selected European countries (Croatia, Israel, Poland) (Flug and Towe)
- Crisis-driven capital controls in Europe (Cyprus, Iceland, Ukraine) (Honohan)
- Sub-Saharan Africa and MENA (broad coverage with particular attention to Ethiopia, Kenya, and Morocco) (Balasubramanian and others)
- Advanced economies with housing-related issues (Australia, Canada, Hong Kong SAR, Singapore, New Zealand) (Everaert)

the report and provides recommendations to improve the quality and influence of IMF policy advice in this area.

The findings of the evaluation are based on case studies covering a broad range of country experience and on several background papers on thematic issues (Box 1), as well as extensive interviews and desk reviews of documents.[2] The country case studies cover 28 countries spanning a wide range of experience: a wide selection of countries in Asia and Latin America demonstrating a rich variety in the use of policy approaches to address concerns from volatile flows; three countries in Europe that have refrained from use of capital account measures, given their commitments to supranational institutions;[3] three other European countries that used capital outflow controls in the face of balance of payments crises; some frontier economies that have tapped into global capital markets; and five AEs that have acted to dampen house price appreciation in the face of capital inflows. Two of the thematic background papers assess how well IMF advice is grounded in empirical support and reflects recent advances in professional research on the use of capital account and macroprudential measures. The other three cover multilateral issues; provide an overview of recent developments in capital flows, use of capital account measures, and policy toolkits; and provide a factual overview of the impact of the COVID-19 crisis on capital flows and the policy responses thus far. More than 200 interviews were conducted with IMF staff members, current and former policymakers, experts on capital flow issues, and market participants. The evaluation also draws on the discussion of capital flow issues and findings of the

[2] The interviews and document review were largely completed before the onset of the COVID-19 crisis. While the study has been updated to report on recent developments, it does not seek to evaluate the recent experience.

[3] Israel is included with the European case studies here, mirroring its inclusion in the group of countries for which the IMF's European Department conducts surveillance.

IEO's recent evaluation of *IMF Advice on Unconventional Monetary Policies* (IEO, 2019).[4]

A note on terminology: This evaluation uses the term "capital account measure" to refer to the broad set of measures that affect the terms of capital account transactions covered in the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*. These measures are either residency-based (RBMs) or currency-based (CBMs) (see Batini and Durand, 2020). The term "capital flow management measure" (CFM) is reserved for the group of measures judged by IMF staff to be designed to limit capital flows, as defined in the IV.[5] Under the IV, all RBMs are classified as being CFMs. Whether a CBM is a CFM is judged depending on country circumstances—the same measure may be classified as a CFM or not in different countries and at different times in the same country. The more common term in the academic literature, "capital control," is used more strictly to refer to residency-based restrictions on capital flows.

[4] That evaluation includes background papers on the Fund's macroprudential framework (Turner, 2019) and spillover analysis (Klein, 2019), and case studies of China and India (Mohan, 2019), South Africa (Darius, 2019), and Turkey (Kalemli Ozcan, 2019a).

[5] Most CFMs but not all of them are covered in the *AREAER*.

2

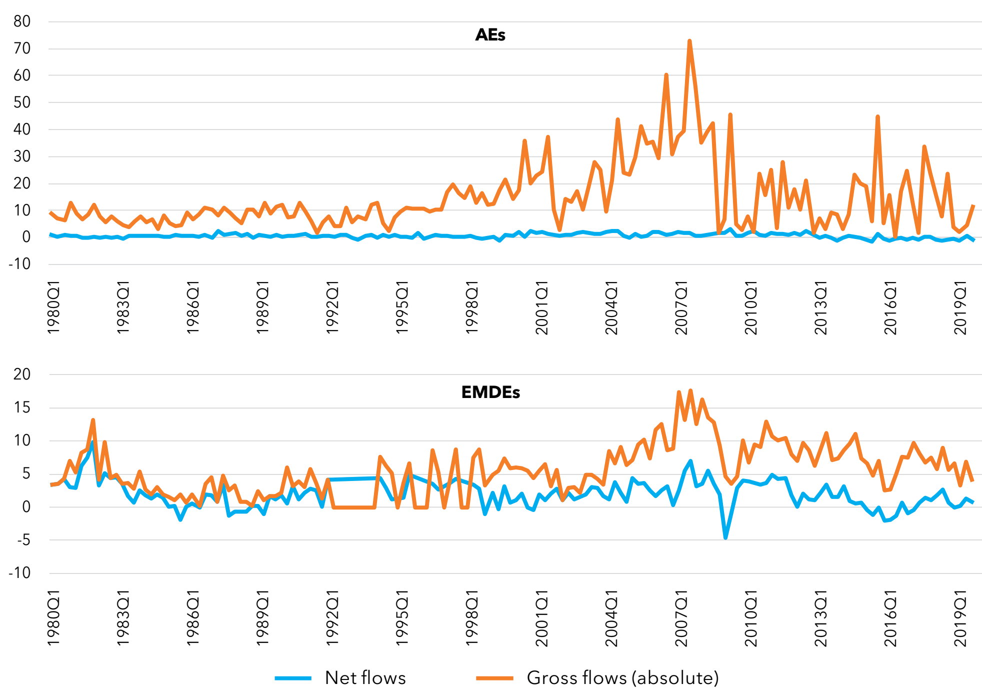
CONTEXT

CAPITAL FLOWS AND CAPITAL ACCOUNT LIBERALIZATION SINCE THE GLOBAL FINANCIAL CRISIS[6]

International capital flows have oscillated widely since the GFC. Both AEs and EMDEs saw a sharp drop in gross capital flows at the start of the crisis (Figure 1). Flows to AEs suffered another setback in late 2011 as the crisis in the euro area periphery intensified. For EMDEs, non-resident inflows recovered strongly over 2010–12, responding to the rising confidence in these countries' economic performance and the very easy global liquidity conditions following the adoption of exceptionally loose monetary policies in major advanced-economy central banks. On average, net inflows to EMs have amounted to a similar share of GDP to that before the GFC (Figure 2). However, EMDEs have experienced several episodes of reversals since the GFC, including the "taper tantrum" in 2013, the China risk shock in 2015, and a broader EM stress shock in 2018. Most recently, the COVID-19 crisis in March–April 2020 led to a dramatic reversal of non-resident portfolio flows that was much larger than during the GFC and later stress events, although preliminary data suggest that the overall scale of the capital flow reversal was more in line with previous episodes.

FIGURE 1. GROSS AND NET CROSS-BORDER CAPITAL FLOWS

(In percent of group GDP)



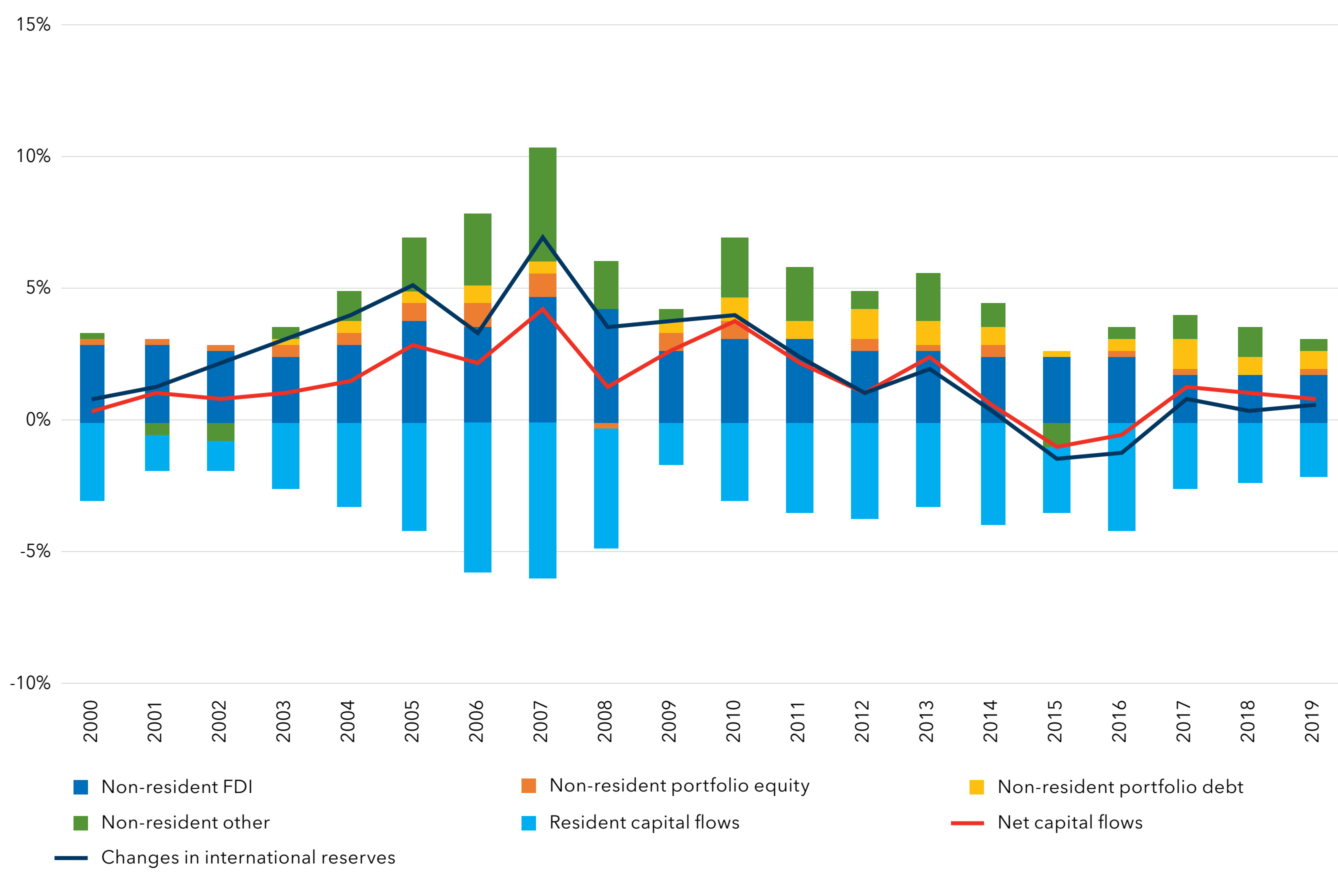
Source: IMF, *International Financial Statistics*.

[6] This chapter draws on Batini and Durand (2020) and Batini (2020).

Capital flow dynamics have been affected by shifts in the composition of flows to EMDEs as portfolio flows and "South-South" flows—particularly flows from China—have grown in importance. Bank-intermediated flows to EMs have fallen, as large global banks have deleveraged and curtailed their cross-border operations in response to the sweeping overhaul of banking regulations under Basel III (Figure 2). For many countries, portfolio flows into equity and debt markets have become an increasingly important source of financing, facilitated by the rising role of institutional investors and the widespread use of index funds and exchange-traded funds and encouraged by the search for yield in a sustained low interest rate environment, all of which have helped to expand the investor base for EM assets beyond a narrow niche product. This shift has meant that capital flow shocks have been channeled increasingly through shifts in investor risk aversion rather than in bank behavior. While FDI has remained the largest source of external financing, it has increasingly included flows driven by treasury management and tax considerations as well as greenfield investments. Capital flows to EMDEs continue to be dominated by exchanges with AEs but transactions within the group ("South South" flows) have increased. The rise in Chinese outward FDI and related external lending since the launching of the Belt-and-Road Initiative has been particularly striking but intra-regional flows have also become increasingly important (see background papers by Patnaik and Prasad, 2020; Balasubramanian and others, 2020).

Capital flows to EMDEs have remained as volatile as in the pre-GFC period. While gross capital flows remain volatile for both AEs and EMDEs, net capital flows to the latter have typically shown larger swings, because in the AEs resident flows tend to offset non-resident flows. After a spike in the aftermath of the GFC related to a sharp retrenchment in

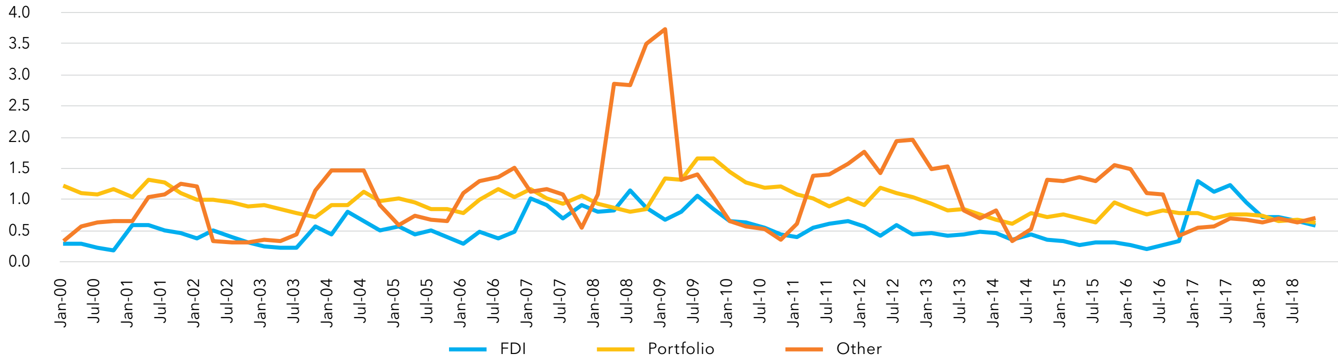
FIGURE 2. CAPITAL FLOWS TO EMERGING MARKETS
(In percent of group GDP)



Source: IMF, *International Financial Statistics*.

FIGURE 3. VOLATILITY OF NON-RESIDENT CAPITAL INFLOWS FOR EMDES BY COMPONENTS

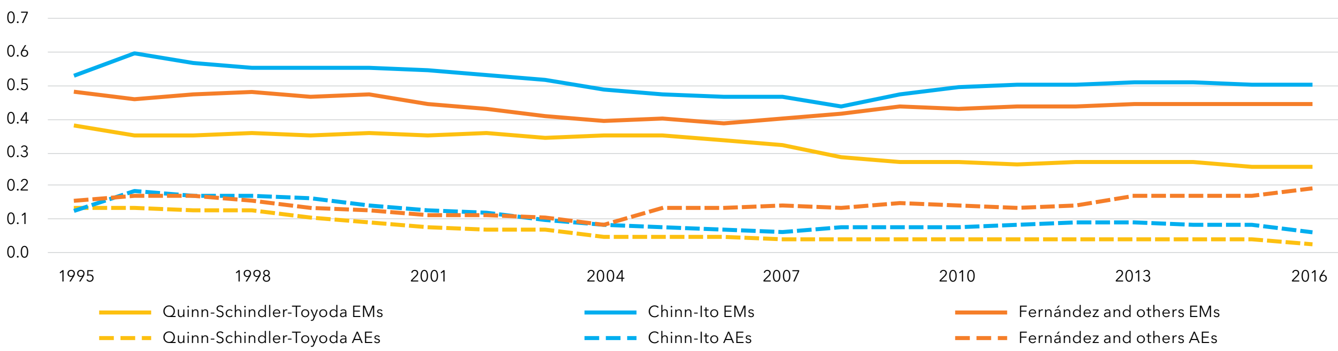
(In percent of group GDP)

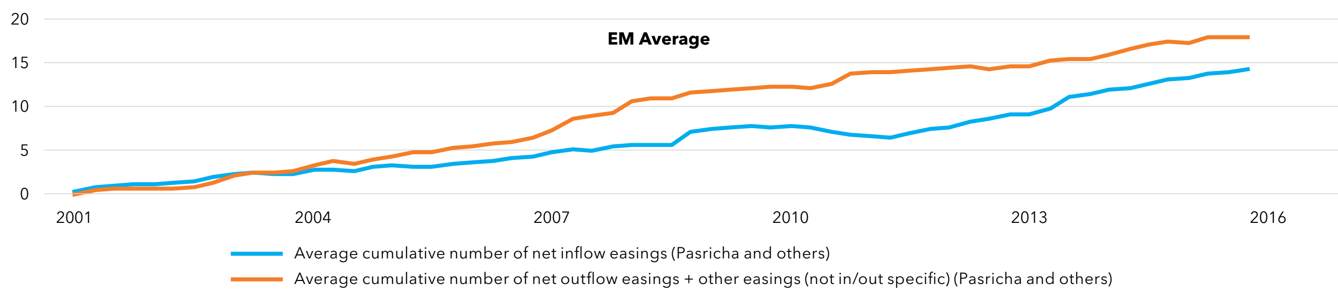


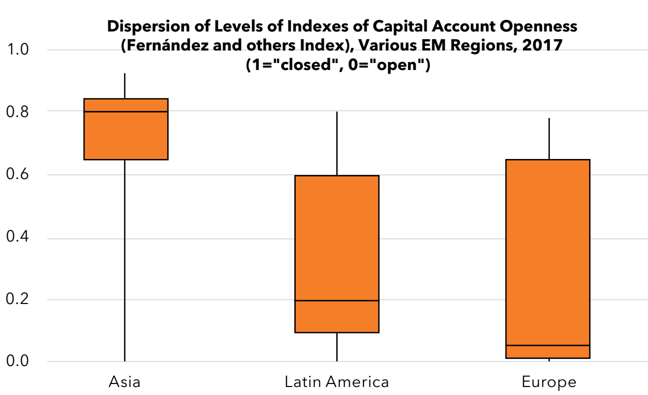
Source: Updated version of a figure in Pagliari and Hannan (2017) using IMF, *International Financial Statistics*.

Note: Estimated standard deviations expressed in percent of group GDP.

FIGURE 4. MEASURES OF CAPITAL ACCOUNT OPENNESS IN EMERGING MARKETS







Sources: Chinn and Ito (2008); Fernández and others (2015); Pasricha and others (2018); and Quinn, Schindler, and Toyoda (2011).

Notes: (i) Emerging market economies: Argentina, Brazil, Chile, China, Colombia, Egypt, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Russia, South Africa, Thailand, and Turkey. Advanced economies: Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Malta, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, United Kingdom, and United States. (ii) In panel (3), the horizontal line indicates the median aggregate level of controls in each region as measured by the Fernandez and others (2015) index. The top of the box indicates the third quartile, while the bottom of the box indicates the first quartile of the regional distribution.

bank cross-border flows, capital flow volatility in EMDEs has gone through several cycles related to periods of international market exuberance and stress, although on average volatility has been similar to pre-crisis levels (Figure 3). Reflecting these cycles, capital flows to EMDEs have continued to be subject to surges and reversals in recent years (Eichengreen and Gupta, 2018). Reversals have been particularly challenging especially at times of high stress when non-resident and resident flows are reinforcing rather than offsetting. FDI flows have generally remained less volatile than other flows, though as the composition of FDI shifts, these flows appear to be becoming more volatile.

Capital account liberalization has continued since the GFC, but at a more gradual pace overall and with periods of selective tightening. Though measuring the openness of capital accounts is challenging, taken together various indexes suggest that EMDEs have continued to liberalize since the GFC, though the overall pace has been much slower than before the GFC, and these countries still remain much less open on average than AEs (Figure 4, first panel). Opening has been more pronounced for resident outflows, and there have been periods in which limits on inflows were tightened, particularly during the 2010–12 surge (Figure 4, second panel). It is noteworthy that, while comprehensive data are not yet available, policy trackers suggest that countries made relatively little use of capital account measures in responding to the COVID-19 crisis; some countries eased limits on capital inflows, but recourse to tightening restrictions on outflows was rare. Within EMDEs, capital accounts appear more closed in Asia than in Latin America, while these in turn appear more closed than those in emerging Europe, though there is important heterogeneity within each group (Figure 4, third panel).

THE EVOLUTION OF IMF POLICIES ON CAPITAL ACCOUNT ISSUES

The Fund moved to advocate a sequenced approach to capital account liberalization in the early 2000s. Through the 1990s, the IMF generally encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader, especially before the East Asian crisis (IEO, 2005). While Fund documents had generally included the caveat that liberalization should be carefully paced and sequenced, this more cautious advice became more prominent in word and deed after the East Asian crisis in 1998. A policy paper discussed at the Board in 2001 (IMF, 2001) stressed the importance of an integrated approach that considered capital account liberalization as part of a more comprehensive and coordinated program of economic reform, particularly by strengthening the domestic financial system ahead of opening the capital account.

The Fund's policy advice on policy options to deal with capital flow volatility has also evolved over time. Traditionally, the Fund emphasized the use of standard macroeconomic tools such as fiscal, monetary, and exchange rate policies to respond to external shocks. However, it has long recognized that policymakers have often found textbook prescriptions to deal with surges to be insufficient, and have thus turned to other tools including capital account measures and prudential measures (IMF, 1993). In practice, the IMF staff was usually supportive of the countries' choices "whatever they may have been," including sympathy for the use of capital account measures (IEO, 2005).

The IV consolidated the evolution in IMF advice on capital account issues. As the GFC unfolded, many countries started to use capital account and prudential measures more extensively, initially to limit capital outflows during the crisis and then to dampen inflows during the subsequent resurgence of flows to EMDEs. This led the Fund to attempt to clarify its advice and ensure greater coherence, especially as some members were concerned that capital account measures could be distortionary and used instead of needed macroeconomic adjustments. The Fund's work included several policy papers that aimed to identify circumstances in which capital account measures could be justified as part of the broader policy toolkit to manage inflows (see Ostry and others, 2010; 2011). This effort culminated in Board approval of the IV in December 2012, covering advice regarding both capital account liberalization and responding to capital flow volatility. The IV noted that there is "no presumption that full liberalization is an appropriate goal for all countries at all times" and reiterated that the degree of liberalization appropriate for a country at a given time depends on specific circumstances, notably the country's level of financial and institutional development.

The IV supports measures designed to limit capital flows—which it labeled capital flow management measures or CFMs—under carefully circumscribed conditions. The IV recognizes that CFMs can be useful in certain circumstances as part of the policy response for countries faced with a surge in capital inflows or disruptive outflows but warns that "they should not substitute for warranted macroeconomic adjustment." The IV emphasizes that "appropriate macroeconomic policies to respond to inflow surges would include rebalancing the monetary and fiscal mix consistent with inflation and growth objectives, allowing the currency to strengthen if it is not overvalued, and building reserves if these are not more than adequate" (IV, para 30).[7] Circumstances where introducing inflow CFMs can help support macroeconomic policy adjustment and safeguard financial system stability include:

(i) when the room for adjusting macroeconomic policies is limited, for example if an economy is overheated, the exchange rate is overvalued, and accumulating additional reserves would be unduly costly;

(ii) when the needed policy steps require time to implement, or when the macroeconomic adjustments require time to take effect; and

(iii) when an inflow surge raises risks of financial system instability.

When inflow CFMs are used, the IV prescribes that their use should be "transparent, targeted and temporary, and preferably non-discriminatory," while being tailored to the country-specific context (IV, para 33). The IV cautions that only rarely would CFMs be the sole warranted policy response to an inflow surge and that, even when desirable, their likely effectiveness should be carefully examined. Moreover, they should not be used to influence exchange rates to gain unfair competitive advantage. Thus, while the IV does not necessarily restrict CFMs to being only "a measure of last resort," it nevertheless cautions that they should not be used preemptively but only in the face of an inflow surge and when certain conditions are met and then should be phased out when the inflow surge abates.

Similarly, the IV gives guidance on when and how outflow CFMs should be used. Capital outflows should usually be handled primarily with macroeconomic, structural, and financial policies, since outflow CFMs have potential domestic and multilateral costs and could damage investor confidence. However, in crisis situations or when a crisis is imminent, there could be a temporary role for CFMs on outflows to provide breathing space or avert a full-blown crisis, if they are implemented as part of a broader policy package to address the fundamental causes of the crisis (IV, paras 44–46). Again, measures should be transparent and as far as possible non-discriminatory, although the IV recognizes that to avoid circumvention and remain effective, CFMs need to be comprehensive and adjusted on an ongoing basis (IV, para 50).

In parallel with the IV, the IMF has developed a macroprudential framework to guide policy advice on using such tools for financial stability purposes, including dealing with capital flow volatility. As noted by IEO (2019), the Fund "has been at the forefront of international efforts" to track the deployment of MPMs by various countries and to assess the effectiveness of these measures in safeguarding financial stability (Alam and others, 2019).

Measures that are judged as designed to limit capital flows and used to safeguard financial stability are termed CFMs/MPMs and subject to both the IV framework and the Fund's macroprudential policy framework. For a measure to be classified as a CFM/MPM, there must be a potential source of systemic financial risk stemming from capital flows that has to be addressed and a path of transmission through which the measure can reasonably be expected to reduce such risks. For example, such a measure could be an unremunerated reserve requirement on short-term external borrowing. Under the guidelines, the use of CFMs/MPMs should take into consideration whether other available MPMs that are not CFMs could achieve the same objective. There should be a reasonable expectation that the CFM/MPM measure is more effective, efficient, and less distortionary than pure MPMs, in addressing financial risks. Even a CFM classified as also an MPM is subject to the requirement that it not be used preemptively, though "there may be scope to maintain CFMs/MPMs for longer

[7] The IV generally supports exchange rate flexibility in the face of an inflow surge but recognizes a role for foreign exchange intervention if reserves are inadequate or if FXI can limit excess exchange rate volatility and smooth the impact on balance sheets.

even after capital inflow pressures have abated" since such measures "may continue to be useful for managing systemic financial risks after the inflow surge is over," subject to a continuing assessment of "whether there are alternative measures to address the systemic risk that are not designed to limit capital flows" (IMF, 2017, paras 52 and 53).

Since the adoption of the IV, the Fund staff has worked to clarify its application and review experience with implementation. Since the 2012 document, the Fund has published guidance notes for its use by staff (IMF, 2013a) and discussed further operational considerations in managing outflows (IMF, 2015b). In 2016, the Fund reviewed countries' experiences with handling capital flows in the period since the introduction of the IV, concluding that practice had generally been in line with IV-implied guidance (IMF, 2016c). The Fund has also sought to clarify the treatment of measures that are classified as both CFMs and MPMs (IMF, 2017), made efforts to clarify how the IV is applied in particular circumstances (G20, 2018), and published a Taxonomy of CFMs (IMF, 2019d) that lists measures that have been assessed as CFMs in Article IV reports since the IV was issued, to help explain which measures receive this classification. Technical assistance has been geared up to help countries better understand and implement advice consistent with the IV.

In addition, the Fund has upgraded other related frameworks that are relevant to capital account issues and advice. The External Sector Report (ESR) was launched in 2012 to provide assessments of the extent to which external positions among the major advanced economies and large emerging market economies (EMs) were mutually consistent and to identify external imbalances, providing the basis for the IMF to assess exchange rate valuation. The staff has worked to strengthen the analytic support for ESR assessments through an external balance assessment (EBA) tool (IEO, 2017) and its update (Cubeddu and others, 2019), and developed a metric for the assessment of reserve adequacy (ARA). Both these methodologies include a measure of capital account openness, which is important because Fund advice on whether the use of capital account measures and FXI is justifiable relies partly on assessments of exchange rate overvaluation or undervaluation and the adequacy of foreign exchange reserves (Towe, 2020).

The Fund has also taken several initiatives to strengthen its framework for multilateral surveillance over risks posed by spillovers from cross-border capital flows. While the IMF has limited legal jurisdiction over capital account policies under the Articles of Agreement, it is tasked with analyzing capital account developments and advising on policies as part of its multilateral surveillance mandate to oversee international monetary stability. The 2012 Integrated Surveillance Decision (ISD) significantly expanded expectations regarding the Fund's multilateral oversight in this area. It required the Fund to cover "spillovers arising from policies of individual members that could significantly influence the effective operation of the international monetary system," with explicit refence to "policies respecting capital flows." Consistent with this requirement, Article IV consultations with individual members are tasked to focus on policies that may significantly influence the effective operation of the international monetary system, albeit still without any obligation on members to amend their policies in response as long as the member is promoting its own stability. This was reiterated in the IV, with the guidance note instructing that Fund multilateral surveillance products "assess the extent of push factors and structural changes in global capital flows." The Fund has also focused greater attention on strengthening its understanding and analysis of financial spillovers, initially under the auspices of a stand-alone report—the Spillover Report—and more recently through renewed initiatives to support this work.[8]

[8] In part, the renewed attention to financial spillovers responds to Board-endorsed recommendations of the IEO evaluation of *IMF Advice on Unconventional Monetary Policies*, as noted in the Management Implementation Plan (IMF, 2020c). As part of this work stream, Juvenal and Hale (forthcoming) have assembled a data set on the currency composition of cross-border debt positions to help better tracking of financial spillovers.

3

MANAGING CAPITAL FLOW VOLATILITY: THE DESIGN OF THE IMF'S APPROACH

RECENT CONCEPTUAL AND EMPIRICAL WORK[9]

The IMF's work culminating in the adoption of the Institutional View played an important part in the shift in professional opinion toward greater openness to the use of capital account measures as a policy tool. The work of many in the early 2010s highlighted economic risks associated with exposure to volatile capital flows and the possible role of capital account measures to address such risks. The Fund contributed significantly both through conceptual analysis and by bringing together the experience of countries using such measures.[10] This work influenced the thinking of the economics profession and positioned the Fund as an intellectual leader on capital flow policy. The IV's approach placing capital flow management policies in the context of containing financial risks and maintaining macroeconomic stability is well aligned with the literature on the topic.

That said, recent academic research has further advanced understanding of the mechanisms through which capital account measures can reduce financial risks and help stabilize macroeconomic conditions. The emerging market financial crises of the 1990s underlined the need for a new class of models to understand capital flows and how these may lead to balance sheet vulnerabilities and eventually even crises. Building on insights by Calvo (1998) and Krugman (1999), recent work shows that the balance sheet and financial amplification effects inherent in such episodes arise because individual investors and borrowers do not internalize their contribution to these effects, leading to "pecuniary externalities."[11] For example, individual borrowers who tap into foreign capital "excessively" do not take into account their contributions to the growing financial risk posed to the country as a whole. Similarly, actions by individuals to unwind their positions in the midst of a crisis do not account for their impact on the depreciation of the country's exchange rate and the consequent financial amplification of the effects of the crisis, implying "aggregate demand" externalities. Capital account measures can serve to adjust investor incentives in a way that modulates capital inflows in good times to lower the risk of crises or to mitigate the balance sheet and aggregate demand effects of crises that do nonetheless occur. Such measures can be particularly useful if macroeconomic stabilization policies such as interest rate and exchange rate adjustments are only partially effective.

A separate line of research has suggested that capital account measures can be useful to increase the degree of monetary autonomy of countries in a financially integrated world. A standard result in international macroeconomics—the "policy trilemma"—suggests

[9] This chapter draws on background papers by Korinek (2020) and Montiel (2020).

[10] Ghosh, Ostry, and Qureshi (2017) collects several papers by IMF authors and provides extensive references to work done by others at the Fund, while work outside the Fund is summarized in Stiglitz and Gurkaynak (2015).

[11] See Jeanne and Korinek (2010) and Farhi and Werning (2016), among several other papers.

that countries that adopt fully open capital accounts can only control monetary policy or their exchange rate but not both. Rey (2013) and Kalemli-Ozcan (2019b) have documented the increasing financial integration among countries, with Rey arguing that even countries with freely floating exchange rates cannot operate fully independent monetary policy if they are open to free capital flows—that is, the familiar trilemma turns into a dilemma. Capital account measures or limits on exchange rate flexibility are ways of regaining some degree of monetary autonomy or "rounding the corners of the trilemma" (Klein and Shambaugh, 2015). Recent work, including at the BIS, has looked at the apparent success of a "multiple targets, multiple instruments" approach in a number of countries to try to understand the merits and risks of such approaches relative to more textbook prescriptions (BIS, 2019; Acharya and Krishnamurthy, 2018).

At the same time, empirical evidence has reaffirmed that capital account measures can lower financial vulnerabilities by altering the composition of flows. Since 2012, there has been continued work trying to assess the impact of capital account measures relative to other tools, both at the country and cross-country level.[12] Overall, the literature has found that while such measures appear to have only a limited sustained impact on the volume of inflows, there is "stronger evidence" that such measures can "alter the composition of inflows away from debt toward equity, and from short-term to longer-term debt, under a variety of country circumstances" (Montiel, 2020). This work confirms that capital account measures can be helpful for mitigating risks related to particular types of capital inflows, although more granular and country-specific work is needed to ascertain what measures are most effective, for how long, and under what conditions. As regards limits on capital outflows, such measures appear to have been effective "but the number of such cases is limited, and there is little evidence of long-lasting effects" (Montiel, 2020).

A further issue relates to how the use of capital account measures or FXI may affect market conditions over the longer term. One concern is that the use of capital account measures or FXI as policy tools could be seen as market unfriendly and raise country risk premia and deter market development. Here the jury is still out. While there is some evidence that borrowers in countries using capital account measures pay a higher risk premium for borrowing on international markets,[13] interviews with market participants, including at rating agencies, suggest that what matters more is that policymakers clearly signal what set of instruments they plan to deploy to deal with volatility and that they avoid negative surprises. While long-standing use of capital account measures and FXI can have a dampening effect on incentives for market development, participants also recognize that the use of such measures need not be an unequivocal sign of market unfriendly behavior but rather can be helpful by limiting the buildup of vulnerabilities and containing market volatility, thus reducing the risks of very damaging crises.

The Fund's ongoing efforts to develop an Integrated Policy Framework have already resulted in substantive research papers—and insights for policy advice—that are consistent with, and extend, the results from outside research. The IPF seeks to reassess the costs and benefits of some of the tools—monetary policy, macroprudential policy, exchange rate interventions and capital account measures—that countries use and to understand better how these tools interact with one another and with country circumstances (Adrian, 2018; Gopinath, 2019; Adrian and Gopinath, 2020). A recent working paper coauthored by the Fund's Economic Counsellor lays out the theoretical underpinnings of the IPF in a model with real and nominal frictions where countries differ in several characteristics such as severity of currency mismatches and depth of foreign exchange markets (Basu and others, 2020). This model suggests that there is "no strict assignment" of policies to goals: policies interact with each other in complex, sometimes unexpected, ways, making it essential that CFMs be considered jointly with other policies and that the policy mix be tailored to country circumstances. Another working paper, co-authored by the Fund's Financial Counsellor, uses a model similar to those widely used by central banks to help quantify how FXI and CFMs "may improve policy tradeoffs under certain conditions," especially for economies with less well anchored inflation expectations,

[12] See Klein (2012), Ahmed and Zlate (2014), and Magud, Reinhart, and Rogoff (2018) among many others.

[13] Andreasen, Schindler, and Valenzuela (2019) find, for a set of advanced and emerging economies, that restrictions on capital inflows raise corporate bond spreads.

substantial foreign currency mismatch, and that are more vulnerable to shocks likely to induce capital outflows and exchange rate pressures (Adrian and others, 2020).

While the IPF workstream is still mid-course and it is too early to make an assessment, some of the initial results would seem to have relevant lessons for the upcoming review of the IMF's framework for giving advice on dealing with capital flow volatility. The staff's presentation to the Board in May 2020, on the concrete policy advice drawing on the conceptual work, noted that CFMs and MPMs can be helpful as preemptive measures alongside monetary and fiscal policies before adverse shocks lead to binding constraints, in order to contain overborrowing and exposure to sudden stop risks—particularly in countries that have currency mismatches in domestic balance sheets and shallow foreign exchange markets. Moreover, in countries with shallow foreign exchange markets facing capital account volatility, the use of CFMs and foreign exchange intervention can sometimes help provide more macroeconomic policy space, for example to ease policies in the face of capital outflows associated with the COVID-19 crisis (IMF, 2020e).[14]

CONCERNS ABOUT THE DESIGN OF THE INSTITUTIONAL VIEW

Since its adoption in 2012, the IV has become the established framework for the Fund's country advice on capital flows. As discussed in Chapter 4, in many countries the underlying principles and overall design of the IV have provided a useful overall approach for giving advice on a range of complicated issues related to capital flows. This conclusion is supported by the experience of a range of countries in the case studies, particularly those that are already committed to capital account openness—such as, for example, Chile and Mexico and the European countries—and for countries still at an earlier stage of capital account opening. Officials in these countries seem broadly satisfied with the IV's design, although there may have been some issues with implementation as discussed in the next chapter.

However, in a range of other countries that have been interested in using capital account measures more actively for both financial stability and macroeconomic management purposes, there are concerns that the design of the IV does not provide sufficient flexibility in combining different tools to respond to country circumstances. These concerns have some support in recent research as well as country experience. Particular issues include:

(i) The limited circumstances in which the IV supports use of capital flow measures.

(ii) The presumption of effectiveness of traditional instruments may not always hold true.

(iii) Questions about the clear distinction in the IV regarding policy advice on capital flow measures versus advice on macroprudential measures.

(iv) The role of social and political considerations, such as housing affordability.

Treatment of CFMs under the IV framework

In many respects, CFMs are treated in the IV as measures to be used only in limited circumstances. Some of these restrictions may not be fully justified.

- The IV suggests a long set of preconditions to be met before CFMs are appropriate.
    - For inflow CFMs, these preconditions include an overheated economy, an overvalued exchange rate, an adequate level of reserves, and an inflow surge. As noted above, recent theoretical and empirical work questions whether capital account measures should necessarily be used only in such limited circumstances.
    - For dealing with outflow episodes, the IV guides that CFMs may be useful only in a crisis or when a crisis is imminent, which sets a high bar. In practice, some countries that still have quite extensive controls on capital flows have

[14] Gelos and others (2019), Mano and Sgherri (2020), and Pasricha (2020) also explore the effect, interaction, and trade-offs of such integrated policies and how country characteristics have influenced countries' choices of targets and instruments, while a recent *WEO* chapter (IMF, 2020d) looks at how the use of macroprudential policies by EMDEs can help dampen the macroeconomic effects of global financial shocks.

adjusted both inflow and outflow CFMs when faced by capital account pressures that while serious do not clearly meet the "imminent crisis" threshold.

- The guidance in the IV that new capital flow management measures 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 seems to conflict with the recent research suggesting that capital account measures may be a useful part of the financial stability framework and that limits on capital account openness can usefully increase the scope for orthodox stabilization policies, such as monetary policy.

- There is also mixed empirical support for the notion that restrictions are only effective temporarily, especially if the goal is to influence the composition of flows or contain domestic credit growth or guard against balance sheet mismatches, rather than to affect the total volume of flows.

Thus, recent research as well as country experience supports the notion that preemptive and lasting measures may be a useful part of the policy toolkit as a country seeks to balance multiple objectives, although their value and use would depend on country circumstances. The IV's guidance that use of capital flow measures should be strictly temporary and only in the context of a surge or a crisis/near-crisis, and not used preemptively, does not have solid empirical or conceptual foundations and serves to curtail the menu of policy options available to policymakers.

Effectiveness of traditional instruments

The efficacy of traditional instruments in managing capital flow volatility continues to be a subject of debate and active research. The IV rests on the presumption that textbook macro prescriptions, particularly exchange rate adjustment, are an effective stabilizing response to capital flow surges and reversals. Recent research outlined above tends to validate the concerns of some country policymakers that the exchange rate may have limits as a stabilization tool because it may amplify rather than dampen the impact of external shocks, particularly through balance sheet effects in countries with substantial foreign currency mismatches, whether in financial institutions, corporates, or households. Such concerns seem particularly relevant in countries with shallower financial markets, weaker financial oversight, and heavier dollarization. Other recent research on the impact of dominant currency pricing on trade responses to exchange rate moves also has raised questions about the stabilizing role of the exchange rate (Adler, Cubeddu, and Gopinath, 2019). That said, policymakers in countries with deeper markets and more robust financial institutions are more sanguine about using the exchange rate as shock absorber. (For an illustration of the range of views, see discussion of Latin American experience in Batini, Borensztein, and Ocampo, 2020.)

Distinction between capital account measures and macroprudential measures

Recent research suggests that the IV framework draws too sharp a distinction between CFMs and MPMs in its policy guidance. The IV supports the use of capital flow measures only for a limited period while other "non-discriminatory measures" are developed, and not preemptively, even where the measure is judged to have financial stability purposes (and is therefore classified as a CFM/MPM); in contrast, macroprudential measures are seen as a legitimate permanent part of the policy toolkit. Based on research reported in Korinek (2020), since foreign currency mismatches can be a genuine source of vulnerability, and a currency based measure can be the most direct, non-distortionary means to address the vulnerability, there would seem to be a good case for accepting that preemptive and lasting application of certain currency-based tools can be useful for financial stability purposes even if these tools are likely to impact capital flows.[15] There are also related tensions between the IV's treatment of CFMs/MPMs and rules under the Basel III framework, as discussed in Chapter 6.

[15] In principle, a CBM may be judged to be a pure MPM not an MPM/CFM if the Fund assesses that it is not designed to limit capital flows (see for example the Costa Rica case study in Batini and Durand, 2020). However, in another country the same measure may be judged as an MPM/CFM, implying that the country should be advised to look for "alternative" measures that are not designed to limit capital flows."

How this distinction between CFMs, CFMs/MPMs, and MPMs plays out in practice is discussed in Chapter 4 below.

Role of social and political considerations

The IV is largely couched in terms of efficiency, stability, and growth objectives and gives limited attention to broader social and political goals. However, recent research at the IMF and elsewhere has shown that capital account opening can have adverse distributional consequences (Furceri, Loungani, and Ostry, 2019). Another concern relates to house price developments, as recent IMF research has shown the increasing importance of international capital flows in driving house-price synchronization, especially in major cities around the world (IMF, 2018). As a result, some countries have used CFMs for social purposes, such as residency-based measures in the housing sector to promote affordable housing for residents. However, in applying the IV, staff has advised against such measures other than on a temporary basis in the context of an inflow surge, even though the document does provide a general recognition that would allow for certain CFMs to be maintained over a longer term, provided that "they are imposed for reasons other than balance of payments purposes" and that "no less discriminatory measure is available that is effective" (IMF, 2012, para 33).[16]

ASSESSMENT

Overall, the adoption of the IV represented a major advance in the IMF's policy framework guiding advice on the management of capital flows. In the two decades before the IV, the IMF's policy stance was perceived as being generally discouraging of capital account measures. In practice, as noted earlier, IMF country teams took into account circumstances in which such measures were used and were often sympathetic to them, but there was no consistent framework. The IV was a major step towards filling this gap and was broadly in line with research at that time, much of it produced within the Fund. Outside the Fund, the IV was seen as a welcome demonstration of the institution's flexibility and willingness to embrace new developments (IEO, 2015; Grabel, 2017). In parallel, the IMF developed a well-regarded macroprudential framework that has provided useful assessments of the effectiveness of macroprudential policies in dealing with volatility, as well as working to sharpen other external assessment tools.

Nevertheless, recent research and country experience raise a number of concerns with the IV's design. Some of the carefully circumscribed set of conditions that the IV places around the use of capital account measures, particularly related to limits on preemptive use, are called into question by recent theoretical work and lack firm empirical support. Moreover, the IV has been out of step with practices in a number of countries that have found capital account measures to be useful tools to deal with volatile flows in a broader range of circumstances than envisaged in the IV. These concerns have been reflected in some serious differences with authorities when the IMF has provided advice to countries in line with the IV framework, as discussed in the next chapter.

[16] There is an explicit carve-out for measures taken for national security purposes in IMF (2012), footnote 49.

4 DEALING WITH CAPITAL FLOW VOLATILITY: IMPLEMENTATION ISSUES

IMF policy advice to countries for dealing with capital flow volatility has been broadly consistent with the IV framework. This was the finding of the staff's 2016 review (IMF, 2016c) and the country case studies and interviews with staff members suggest that attention to consistency issues has only increased following guidance in the 2017 IMFC Communiqué (IMFC, 2017). Consistency is achieved through an intense internal review process in which the area departments that conduct the Article IV consultation missions and hold direct discussions with country authorities interact with IMF functional departments (especially SPR, MCM, and LEG on capital flow issues) to ensure coherence with Fund policies such as the IV and more broadly the ISD.

Intense efforts to ensure consistency in application have also contributed to a perception that application of the IV has generally been evenhanded. The series of follow-up papers since 2012—such as the notes for the G20 and the Taxonomy report—have helped to explain to the membership the rationale behind classification of some measures as CFMs. Care taken to be evenhanded is illustrated by the staff's application of the IV framework to many advanced economy cases of capital account measures in the housing sector even though the IV was not designed with their situations in mind. Country officials interviewed for this evaluation generally appreciated these efforts, although, as discussed below, there have been concerns about the IV's application in particular circumstances.

It is also encouraging that countries' policy choices during periods of capital inflow surges and reversals seem to have been broadly in line with the IV's overall framework. Consistent with standard IMF guidance, countries typically have used the standard macroeconomic toolkit, such as monetary policy, fiscal policy, and exchange rate policy, when faced by these circumstances (Batini and Durand, 2020), and this seems to have been the experience thus far in response to the COVID-19 crisis as well (Batini, 2020). Restrictions on capital outflows have generally been used by only a few countries facing crisis or imminent crisis. Moreover, there is little evidence that capital account measures are systematically used as a substitute for other policy changes or to protect an undervalued exchange rate.[17]

Our country case studies discuss several instances in which the IV proved useful in guiding staff engagement with authorities on the use of CFMs in the face of capital flow volatility. The existence of a framework that recognized explicitly that CFMs could play a role in dealing with pressures arising from capital inflow surges provided a basis for policy discussion and for the Fund to provide an official blessing for unorthodox policy measures. One example is *Brazil*, which has long varied the level of a tax on certain foreign financial investments—referred to as the IOF—to manage capital flows. When the IOF was reintroduced in 2009 amid large inflows,

[17] There is some empirical work to suggest that use of capital account measures may occasionally encompass both precautionary and mercantilist motivations (see, for example, Choi and Taylor, 2017; Alfaro, Chari and Kanczuk, 2017; Pasricha, 2020).

the IMF staff took a pragmatic view of it as part of the "feasible policy response" and was concerned more about its effectiveness than its imposition (Batini, Borensztein, and Ocampo, 2020). The passage of the IV provided the staff and authorities with a clearer framework within which to discuss the use of the IOF. Likewise, when *Uruguay* placed limits on short-term capital flows in 2012, the staff essentially used the framework of the IV—which was then under discussion—to support the decision, noting that with Uruguay's exchange rate being fairly valued, foreign exchange reserves above the Fund's metric, and inflation well above target, there was no room to lower policy rates to curb inflows.

Nevertheless, the country case studies also suggest many examples where the IMF's advice has in practice been less well received and not gained much traction. Particular challenges to implementation of the IV included:

- Difficulties in measuring key concepts needed to assess whether the use of capital account measures is justified.
- Reliance on other Fund assessment tools such as the EBA and ARA.
- Challenges in making clear distinctions between capital flow and macroprudential measures.
- The application of the IV to housing-related measures.
- Application in some cases with heavy capital outflows.

CHALLENGES IN IMPLEMENTATION: CAPITAL INFLOWS

Difficulties in measuring key concepts

Key concepts used by the staff to judge whether to label certain measures as CFMs and to assess whether CFMs are justified have often proven difficult to measure. These include assessing when the country is facing an inflow surge and thus when a CFM could be justified under the IV; when a country is "in a crisis or near-crisis;" and whether the impact of a capital control is macro-relevant. While the recourse to staff judgment on these matters is useful to allow considerations of country circumstances, in practice the staff has faced difficulties in justifying the CFM label to authorities. This has on occasion led to perceptions of a lack of evenhandedness, especially since the same measure can in principle be classified differently depending on circumstances.

Two recent examples illustrate some of these challenges. In *Iceland*, as confidence returned in June 2016 eight years after the start of a deep crisis, the authorities introduced capital inflow measures out of concerns about "easily reversible inflows driven by short-term speculation" (Honohan, 2020). The Fund staff opposed the measure, in part because the surge was incipient and—at the point at which the measure was introduced—was much smaller than what had been experienced before the crisis. As Honohan (2020) notes, it is not surprising that the staff's judgment "did not resonate in a country whose 2008 crisis had been enabled by a lack of restraint on pre-crisis inflows." In other cases, the staff itself has had difficulty judging whether certain measures were macro-relevant. For instance, interviews indicate that there were a range of views within the staff on whether the housing-sector measures taken by two provincial authorities in *Canada* cleared the bar for macro relevance (Everaert, 2020). In the event, the judgment was reached that the measures were macro-relevant and were inconsistent with the IV, to the strong disagreement of the authorities.

Reliance of IV application on EBA and ARA assessments

Implementation of the IV in some cases requires judging whether a currency is undervalued or whether reserves are adequate using the EBA and the ARA metrics, whose findings the authorities have not always accepted as convincing. Under the IV, if a currency is undervalued then the country should let its rate appreciate rather than intervene or use CFMs in face of a capital inflow surge; similarly, if reserves are already adequate the country should desist from persistent one-way intervention. However, authorities have sometimes disagreed with the results of EBA and ARA exercises. The case studies provide some examples where officials felt that the Fund's models were not convincing and did not adequately reflect country circumstances, and thus they were unpersuaded by IMF advice drawing on these assessments.

Examples of disagreements over exchange rate assessment:

- In *Israel* for most of the period under review, the Bank of Israel's view, based on its range of in-house models, was that the shekel was overvalued and at times significantly so, partly because of portfolio flows driven by ultra-expansionary monetary policy in the major advanced economies. The Fund staff attributed the appreciation—more than 25 percent in real effective terms between 2009 and 2017—to fundamentals, allowing for some possibility of overvaluation only in the 2018 Article IV Report. As a result, it was generally less supportive of the Bank of Israel's foreign exchange intervention over this period (Flug and Towe, 2020).
- In *Poland*, large exchange rate movements in both directions were judged consistent with fundamentals in the 2008 and 2010 Article IV Staff Reports. Though the authorities did not question staff assessments at the time, such episodes of large apparent changes in the staff's view from year-to-year can undermine the credibility of staff models for judging deviations of exchange rates from fundamentals and raise questions about whether the models take sufficient account of the possible role of capital flows in driving such deviations (Flug and Towe, 2020).
- Other country cases where authorities were unconvinced by the EBA assessment of the appropriate level of the exchange rate include *Malaysia*, *Peru*, and *Thailand*.

Differences in view about the valuation of the exchange rate feed into different assessments about the role of foreign exchange intervention. A recurring theme in many Article IV reports is that a flexible exchange rate should be the first line of defense against the consequences of variations in capital flows and that FXI should be used only to moderate excessive exchange rate volatility, particularly in situations where the staff views the exchange rate as undervalued. However, the authorities have been more inclined to use FXI on a sustained basis. For example, in *Thailand* the authorities believed that exchange rate fluctuations were largely driven by temporary changes in risk preferences and herding behavior in the foreign exchange market, expressing doubts that the exchange rate can be a shock absorber under such conditions, and arguing that the Thai currency was already fairly valued (Everaert and Genberg, 2020).

Similarly, staff concerns about the use of capital account measures have sometimes been exacerbated by concerns that at least in part these measures were being used to keep the exchange rate weak. In practice, we did not find many cases of this. One example, discussed further below, relates to Korea, where the staff urged the authorities to phase out currency-based measures that the Koreans argued were intended for financial stability purposes rather than to contain capital inflows.

Examples of disagreements over reserve adequacy:

- In *China*, the IMF consistently weighed against one-way intervention against appreciation of the renminbi, arguing that international reserves were more than adequate according to the ARA (IMF, 2015a). However, the loss of about US$1 trillion of foreign exchange reserves (about 25 percent of the peak stock) over the next two years indicated to some officials that the Fund was being too sanguine about the level of reserves that even a large emerging market economy needs to protect itself from capital flow volatility (Patnaik and Prasad, 2020).
- By contrast, in *Poland*, the staff's 2010 call for increased reserves did not convince the authorities, who felt that the IMF Flexible Credit Line arrangement and EU transfers provided adequate insurance (Flug and Towe, 2020). Similarly, in Croatia, the authorities disputed the staff's call to boost foreign exchange reserves, arguing that the Fund's metric overestimated vulnerabilities to a capital flow reversal by not accounting for the limited scope to short the currency.

Capital flow measures vs. macroprudential measures

The distinction made in giving policy advice on use of CFMs and CFMs/MPMs vs. pure MPMs raises some conceptual concerns, as noted earlier, and has proven a challenge in practice as well. The implementation of the IV has led to some differences of opinion between staff and country authorities, driven by difficulties in deciding whether a particular measure was taken for financial stability reasons or with the intent of limiting capital flows or both. In some cases, the staff and authorities have disagreed on the intent of the measure, with the staff arguing that measures have been taken to limit capital flows rather than for, or in addition to, financial stability purposes, and the authorities maintaining that the measure was solely for financial stability purposes without any intent to limit capital flows. Even in cases where the staff and authorities (eventually) agreed on the classification of a measure as a CFM, MPM, or CFM/MPM, interviews with staff members and authorities suggest that an inordinate amount of time during policy discussions has been taken up with making that determination; in cases of disagreement, the time and attention taken up by issues of classification has been greater still.[18] Sometimes the staff had difficulty identifying good alternative measures when it advocated the removal of CFMs or CFMs/MPMs—for example, alternative forms of MPMs that avoided discriminating by residency or currency. Such difficulties are perhaps not surprising when the source of the vulnerability relates to currency mismatches or when purely domestic MPMs may not have much impact on external financing that does not pass through the domestic banking system.

Disagreement over the labeling of *Korea's* currency-based measures is a case in point. Korea has had in place certain CBMs since 2011, which the authorities have viewed as prudential measures that have proven useful for financial stability reasons after a series of external crises in part related to excessive short-term foreign currency indebtedness (Everaert and Genberg, 2020). The staff offered guarded support for these measures when they were first introduced, and maintained this stance for some years after the adoption of the IV. However, by 2017 the Article IV Staff Report explicitly referred to the measures as CFMs/MPMs and called for their removal, since the capital flow surge that had prompted the introduction of the measures had by then receded. The authorities strongly rejected the designation of their measures as partly CFMs, emphasizing that they were not residency-based and had never been designed to limit capital flows but only to reduce systemic risk. They felt that the measures were an integral part of their macroprudential framework and essential to boosting Korea's resilience to external market volatility and that they therefore ought to be classified as MPMs. In interviews, staff members noted that they had had difficulty suggesting alternative measures that the Korean authorities could adopt; they considered a currency-differentiated net stable funding ratio as a broader measure to achieve the same outcome but were not sure if it would avoid the CFM designation.

Similar disagreements have surfaced in ASEAN (Everaert and Genberg, 2020). In all three ASEAN countries featured in the case studies, the authorities have introduced measures that they consider as motivated by purely macroprudential reasons and therefore should not be labeled as CFMs or CFMs/MPMs. In *Thailand*, the Fund staff advised in 2019 that "the recent tightening of existing CFMs to address speculative flows should be phased out" in favor of "appropriate" traditional policies. The authorities pushed back on the grounds that: the CFM "neither prevents nor limits the quantity of inflows into Thai financial markets" and that their goal of countering risks to financial stability was more directly met by such measures "to address the source of the pressure" than by alternative policies such as raising interest rates. In *Indonesia*, authorities objected in 2019 to the CFM/MPM label given to a foreign exchange hedging requirement for domestic corporates, arguing that the "regulation aims to ensure macro-financial stability through the adoption of prudential principles on corporate foreign borrowing." In Malaysia, the authorities disagreed with the IMF's assessment and advice to phase out measures taken in 2016 and 2019—classified respectively as CFMs and CFMs/MPMs—arguing that the former were needed to prevent excessive exchange rate volatility and the latter to limit speculative demand in real estate markets.

Application of the IV in Latin American dollarized economies further demonstrates the difficulties of judging which label to pin on currency-based measures (Batini, Borensztein, and Ocampo, 2020). In *Peru*, the authorities have long used a variety of CBMs to discourage dollar deposits, and currency mismatches as a tool to reduce financial vulnerabilities. After considerable and often contentious debate, the IMF staff accepted some of these measures as MPMs and judged them as useful but assessed

[18] The discussions have on occasion been further complicated by external communication challenges as a lot of these discussions tend to be kept confidential in order to avoid adverse market reactions.

others as CFMs or CFMs/MPMs and encouraged the authorities to find alternative tools for the purpose. In *Costa Rica*, another dollarized economy, an MCM team encouraged the use of a combination of CBMs as a financial stability tool—a recommendation that the Article IV Report endorsed, classifying the package as a pure MPM since it was not designed to limit capital flows.

Application of the IV to housing-related measures

Assessment of the housing sector measures implemented by some advanced economies in recent years has proven quite contentious. Typically, these have been residency-based measures, such as a residency-based stamp duty, and thus automatically qualified as CFMs. Sometimes, for example, with *Australia*, *Hong Kong SAR*, and *Singapore*, these measures have been supported but only on a temporary basis in the face of a capital inflow surge, and only until nondiscriminatory measures could be identified or until the surge dissipated (Box 2). In other cases, such as *Canada* and *New Zealand*, where there is no evidence of an inflow surge, the staff has found the measures to be inconsistent with the IV and called for their removal.

In all these cases, the authorities have resisted staff advice. Comprehensive packages of housing measures to manage supply and demand as well as financial stability risks were already in place, but had not proved sufficient to deal with the price impact of foreign investments in real estate markets, particularly since such purchases were not subject to macroprudential measures on domestic bank lending and were not subject to local taxes. Officials judged that measures discriminating against foreign buyers tackled a specific source of imbalance and using more macroeconomic measures to deal with these foreign inflows would have created more distortions than it solved. A recent BIS report notes that the growing importance of foreign investors in real estate markets presents policy challenges since “foreign demand is less sensitive to macroprudential measures that affect the supply of domestic credit for property investments” (BIS, 2020). Interviews with staff

BOX 2. IMF JUDGMENTS ON HOUSING-RELATED MEASURES

Australia: MPM/CFMs, consistent with the IV. Residency-differentiated stamp duties adopted by some regional authorities responded to a capital inflow surge and did not substitute for other policies. However, the staff urged that the measures be replaced with non-discriminatory policies as soon as feasible.

Canada: CFMs, inconsistent with the IV. An additional property transfer tax and a non-resident speculation tax adopted by selected provinces were not designed to deal with financial stability risks and there was no evidence of a capital inflow surge.

Hong Kong SAR: CFM/MPM, consistent with the IV. Stamp duties on non-residents were designed to stem a surge in capital inflows, not used as a substitute for appropriate macroeconomic adjustment, and imposed because macro-prudential measures would not be effective to deal with systemic risks arising from non-resident investment in the housing sector. However, staff reports have consistently called for phasing out the measure once the systemic risk dissipates.

New Zealand: CFM, inconsistent with the IV. A ban on non-resident investment in the housing sector implemented in October 2019 was seen as unjustified as there was no evidence of a surge in capital inflows or a link between house prices and activity by foreigners, while macroeconomic and macroprudential policy settings were broadly appropriate.

Singapore: CFMs/MPMs consistent with the IV. The IMF supported the continued use of an additional stamp duty on non-residents, first introduced in 2011 and increased in 2013 and 2018, in the face of systemic risks, given comprehensive property market cooling measures in place and an evident link between foreigners and property price developments. However, staff reports have urged phasing out the measure once the systemic risk dissipates.

Source: Everaert (2020).

members suggest that they are well aware of such considerations, with which they have often had sympathy although they also felt that the authorities' housing goals could often be achieved with non-discriminatory measures. At the same time, the staff emphasized the need to be evenhanded in ensuring that Fund advice is fully consistent with the IV.

The process of applying the IV in these cases was regarded as a cumbersome and time-consuming labeling exercise by country authorities, even when measures were ultimately judged to be consistent with the IV. Authorities interviewed observed that discussions of how to characterize a given measure (CFM, CFM/MPM, or MPM) took too much time away "from a more substantive discussion on how to maintain a stable domestic housing market in the presence of volatile capital flows," with some calling the labeling "a distraction or an irritant" (Everaert, 2020). Similarly, Executive Board discussions of Article IVs of countries where such measures had first been labeled as CFMs devoted a lot of their time (more than half in some cases) to clarifying these issues.

Interviews indicate lack of internal agreement within the IMF staff on the validity of the label ultimately chosen in some cases. For instance, in the case of *Canada*, area department staff were not fully comfortable with the CFM designation on the grounds that there was no intent to curb capital inflows and that the effect of the tax on aggregate capital flows was likely to be minimal. Other staff felt that the measure was a legitimate MPM in response to pressures facing the housing sector. In the end, a relatively strict reading of the IV prevailed, centered on the key feature that the measure made a clear and explicit discrimination between residents and non-residents and was therefore a CFM, and was not explicitly put in place for financial stability reasons and was therefore not a CFM/MPM.

CHALLENGES IN IMPLEMENTATION: DISRUPTIVE CAPITAL OUTFLOWS

The IV's guidance on how to deal with episodes of disruptive capital outflows tries to balance a pragmatic recognition that limits on capital outflows can play a useful role when a country faces extreme capital account pressures, against the recognition that measures that interfere with investors' existing rights and expectations can have damaging long-term consequences for investor confidence and capital allocation. Too-rapid recourse by a country to measures that impose losses will encourage both domestic and foreign investors to find ways over time to move their capital elsewhere. On the other hand, in extreme circumstances, recognition from the Fund that capital controls are part of a coherent plan to deal with a clearly unsustainable situation can itself play an important stabilizing role, because IMF support can influence whether or not a given policy will hurt investor confidence. If a country in crisis imposes outflow controls that the IMF judges to be necessary to restore economic stability, their effect on investor confidence is likely to be far more benign.

In practice, the staff provided useful advice on capital outflow restrictions in three recent crisis cases with IMF-supported programs—*Cyprus*, *Iceland*, and *Ukraine*—which paved the way for restoring investor confidence and eventual removal of the controls (Honohan, 2020). The case studies found that the Fund staff was "not in the driving seat for some of the major initial steps in these key episodes" and not immediately supportive of the need for capital outflow restrictions—which is not surprising since such measures are typically introduced suddenly and without extensive consultation with IMF staff.[19] Nevertheless, the staff broadly supported the measures that were announced in all three cases and the authorities generally reported getting good technical advice on the implementation of outflow controls to maximize their effectiveness, which seems to have helped limit the degree of leakages.[20] In *Ukraine*, the authorities resisted IMF staff concerns about how controls were being implemented and failed to stabilize their situation under the 2010 Stand-By

[19] In *Croatia*, officials had developed a contingency plan in 2009 if outflow pressures intensified but this was not discussed in detail with the Fund (Flug and Towe, 2020).

[20] In the case of *Cyprus*, Honohan (2020) discusses some concerns about the timing and design of outflow restrictions, but in this case the IMF's role was constrained by its participation in the "Troika" with the European Central Bank and the European Commission.

Arrangement, but subsequently they were more successful with outflow controls in the context of a broader reform package supported by the 2015 Extended Fund Facility Arrangement after following Fund guidance more closely.

A challenging issue in each case was the pace at which controls should be liberalized. The IV guidance is that while outflow controls should be temporary, the timing of liberalization needs to reflect country circumstances, in particular when macroeconomic stability is restored and confidence is regained. In the three program cases just discussed, controls were successfully dismantled with limited problems; indeed, national authorities often wanted to remove them more quickly than the Fund staff considered advisable.

In the surveillance context, Fund advice has generally been less supportive of the use of capital account measures in the face of capital outflows, raising the issue of whether the IV's guidance to limit such measures to crisis or near-crisis situations is too constraining. In two of our case studies, for *China* and *India*, Fund advice when these countries faced outflow pressures in 2013 and 2015, respectively, received mixed reviews from authorities, with suggestions that the Fund could have been more helpful as the countries grappled with difficult circumstances (Patnaik and Prasad, 2020).

- In mid-2015, authorities in *China* responded to depreciation pressures on the renminbi and persistent heavy net capital outflows by tightening outflow controls as well as taking other steps to clarify the foreign exchange regime and stabilize domestic markets. Officials interviewed for this evaluation felt that the country team was reasonably supportive of the capital account measures taken to stem the outflows. However, these officials felt that the IV, while giving the country team the room to approve outflow measures in exceptional circumstances, also constrained them by requiring that measures be justified and vetted internally within the Fund on an item-by-item basis rather than being seen as components of an overall strategy, and they observed that the Fund did not provide overall public support for these measures until early 2016. Even some staff members felt the Fund could have provided earlier broad strategic support instead of a bottom-up analysis using the complex criteria embedded in the IV. During this period, the Chinese authorities also undertook aggressive measures to intervene in foreign exchange markets, both onshore and offshore, in order to support the currency and they introduced a "countercyclical adjustment factor" intended as a signal to markets that the Central Bank would intervene to prevent rapid currency depreciation. The Fund took issue with this approach, arguing that it would hurt the Central Bank's credibility with market participants and make it harder to eventually transition to a more market-determined exchange rate. Some officials felt that the Fund overemphasized the benefits of exchange rate flexibility at such a critical time.

- *India* came under significant market pressure in the summer of 2013 after the "taper tantrum." Debt and equity outflows both accelerated and the rupee depreciated by 15 percent over just three months, as the Central Bank struggled to convince markets that the outflow from India was not in line with fundamentals of the Indian economy. These developments led to a wide-ranging and heterodox response from the authorities that included monetary policy tightening (through both the policy rate and direct controls) as well as changes to a number of current account and capital account measures, primarily restrictions on gold imports and lending against gold, direct dollar sales to oil marketing companies, and subsidized foreign exchange swaps to attract inflows from non-resident Indians. Interviews with staff members indicate that the authorities would have welcomed a statement of Fund support for the various measures they were undertaking to help calm markets. While this was discussed within the Fund, and there was considerable sympathy for the measures taken—including many of the capital account measures—the IMF did not in the end make a public statement, in part because of difficulties in quickly assessing the consistency of some measures with the IV. The various actions taken by the authorities were eventually endorsed in the 2014 Article IV Report and in a speech by the IMF Managing Director during a visit to India in 2015.

Most recently, in response to the COVID-19 crisis, EMDE policymakers have followed an aggressive multi-pronged approach that was broadly consistent with the IV (Batini, 2020). Countries responded to the devastating health shock and heavy exogenous blow to the real economy with aggressive fiscal and monetary easing and used financial policies to maintain financial market functioning and avoid cascading bankruptcies. Countries with flexible exchange rates have been willing to let depreciations take the brunt of the adjustment to capital outflow pressures in line with the IV, while many intervened in spot or derivative foreign exchange markets to avoid market disruptions. The scale of foreign exchange intervention was generally limited, as aggressive easing by advanced-economy central banks and actions by the U.S. Federal Reserve to support dollar liquidity helped to rally international financial-market conditions by mid-year. Capital account measures were not extensively used. Only about a third of the countries among our EM case studies used measures classified as CFMs or CFMs/MPMs by the Fund under the IV and most of these cases involved relaxation of inflow controls.

The Fund's financial support to help member countries tackle the COVID-19 crisis has been provided through a variety of channels. More than 70 countries had accessed emergency financing facilities with no ex post conditionality by end-June 2020, while other countries have benefited from augmentation of existing arrangements.[21] There was also increased interest in precautionary facilities. The Fund approved two new Flexible Credit Line arrangements (Peru and Chile) and renewed the FCL arrangement for Colombia, while Morocco drew on its existing Precautionary Liquidity Line. The Fund also introduced a new precautionary facility, the Short-term Liquidity Line, specifically to be used to address balance of payments needs from volatility in international capital markets, although this facility has not been used so far.

One striking feature of the policy response to the crisis was that a number of EMDE central banks have resorted to unconventional monetary policies and other new tools. In some cases, such as Poland, central banks turned to asset purchase programs to ease monetary conditions further as the room for cutting policy rates dwindled, but several central banks, for example in Colombia, Indonesia, South Africa, and Turkey, have used asset purchases more to support local currency government bond markets disrupted inter alia by heavy foreign investor sales. The Fund staff quickly prepared a special series of technical guidance notes on the use of these and other tools to respond the COVID-19 crisis.[22]

The Fund's counsel on external sector issues during the crisis seems to have been closely aligned with the IV.[23] The flagship multilateral documents counseled that in the "face of an imminent crisis," capital outflow measures could be part of a broad policy package but that they should not substitute for warranted macroeconomic adjustment. An April 2020 *GFSR* chapter that focused on the challenge of managing portfolio flows suggested that temporary and transparent minimum holding periods and caps and other limits on non-resident transfers abroad could be considered if non-resident outflows are a significant driver of overall outflows. Similarly, it proposed that macroprudential buffers, such as foreign currency reserve requirements, could be relaxed to mitigate foreign exchange funding pressures (as done by Peru). In addition, MCM provided a "how to" note to area department teams to guide country advice on how to handle the large challenges of volatile flows or external pressures in the COVID-19 crisis.

Assessment

Overall, the staff deserves credit for conscientious efforts to implement the IV in a consistent and evenhanded manner. The process has worked well in many countries, with officials expressing broad satisfaction with the design and implementation of the IV as marking a significant step forward in facilitating policy discussions on how to address capital flow issues.

Nevertheless, authorities interviewed in our case studies often felt that Fund advice on dealing with capital flows in the surveillance context does not bring much value added

[21] Twenty-seven of the poorest members have also benefited from debt service relief under the Catastrophe Containment and Relief Trust.

[22] See for example "Monetary and Financial Policy Responses for Emerging Market and Developing Economies" (IMF, 2020f).

[23] This report does not attempt to evaluate Fund advice during this period since the experience is too recent to allow adequate perspective and in view of the limited opportunities to interview staff and policymakers involved.

and is not very influential on their policy choices. These concerns reflect a number of challenges in implementing the IV.

Discussions about the appropriate labeling of measures have sometimes become quite contentious, squeezing the time available for policy discussions. In many of the cases mentioned above, authorities expressed concerns that implementation of the IV can become a cumbersome and rigid labeling exercise, with discussions revolving around disagreements on classification issues, crowding out time and staff attention to more concrete policy advice. In part this attention to labeling relates to the constraints built into the design—once a measure receives a "CFM" label, that limits the circumstances in which it can be judged as appropriate under the IV and limits the scope for staff support. Officials also raised concerns about "stigma effects:" countries still see a CFM label as suggesting that a measure is not approved by the IMF staff and therefore bodes badly for market or political acceptance.

A related concern is that the staff's advice on capital account issues has tended to be quite generic rather than granular and not provided countries with detailed assessments of the benefits and costs of alternative approaches. The staff has typically not provided detailed suggestions about how to use CFMs most effectively in circumstances when they could be useful or are being used quite actively to address financial stability concerns—as, for example, in ASEAN (Everaert and Genberg, 2020) and dollarized Latin American economies (Batini, Borensztein, and Ocampo, 2020). The staff has been more willing to provide specific advice on other instruments such as FXI, although even here it has often been prone to stick with general advice to confine intervention to address disorderly conditions, rather than to offer specific advice on the practice of intervention. In this area, there has been a willingness to learn from authorities' innovations, e.g., on use of discretionary rather than pre-programmed intervention and intervention in the non-deliverable forward market rather than the spot market, as discussed in the Latin American case studies. In monetary policy too, IMF advice has often been kept at a rather general level. By contrast, advice on the use of MPMs is one policy area where the IMF has consistently taken the lead in analyzing polices and promoting best practices.[24]

A clear exception must be made for IMF advice on handling disruptive capital outflows in the program context, where advice has been more granular and influential. In these circumstances, the Fund staff has generally been fully engaged with authorities in advising on approaches taken even though initial steps may have preceded the IMF's involvement. The Fund staff deserves credit for being willing to support strong actions judged as necessary in very difficult circumstances, even while pushing back in some cases where actions have been judged as likely to be ineffective or to encourage corrupt practices inconsistent with program success.

IMF advice on handling disruptive outflows from countries in a surveillance context has tended to be much less detailed and engaged. The staff has generally followed the IV's guidance closely, which encourages use of the exchange rate as shock absorber as part of a broader policy package and discourages use of CFMs unless a country faces a crisis or imminent crisis. The China and India case studies suggest that the Fund staff was not particularly proactive in giving specific advice or being supportive as these countries faced difficult external circumstances.

A further challenge for the staff in implementing the IV is the important role of the exchange rate assessment provided by the EBA, which the authorities have not always found convincing. Part of the Fund's general reluctance to advise on active use of CFMs and FXI seems to stem from concern that these measures could be used to depress a currency's value. The staff has also been ready to push against use of CFMs in circumstances where the EBA has found the country's exchange rate to be undervalued, as in Korea in 2013. However, country authorities have often argued that EBA assessments are not convincing and do not pay enough attention to local circumstances, while maintaining that the principal purpose of their measures is to promote financial stability, not to reduce capital inflows or depress the exchange rate.

[24] This assessment chimes with IEO (2019); see in particular, Klein (2019), which evaluated advice to countries being affected by spillovers from unconventional monetary policies in major advanced economies.

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.

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 macroprudential 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.

7

MONITORING, ANALYSIS, AND RESEARCH ON CAPITAL ACCOUNT ISSUES

The Fund has continued to do important work to understand the drivers of capital flows and consider policy tools. The extent to which changing market structures and regulation can impact cross-border capital flows has received considerable coverage, especially in the *GFSR*. Recent issues have covered the growing role of retail investors in portfolio flows to EMs and to advanced-economy mutual funds in EM debt markets, and the spillover risks from investment activities of large insurance companies (IMF, 2019e). The Fund has also explored the implications of post-GFC financial reform for capital flows (e.g., implications of the U.S. Dodd-Frank legislation (IMF, 2011) and illuminated some "dark corners" through its work on capital flows through offshore financial centers and FDI channeled through low-tax destinations (Damgaard, Elkjaer, and Johannesen, 2019).

The Fund has been engaged in multilateral initiatives to fill data gaps to strengthen monitoring of international capital flows. In the aftermath of the GFC, there was broad recognition of the need to address data gaps to strengthen the monitoring of capital flows. In 2009, the G20 called on statistical agencies, led by the IMF and the FSB, to address these deficiencies under the Data Gaps Initiative. While continued data generation and dissemination by member countries remain key to supporting effective monitoring and analysis of capital flows, this initiative has led to better monitoring of international capital flows, including in the context of revamped balance sheet and flow-of-funds data, and to better data on cross-border derivatives exposures and direct investment. Key elements of the Fund's work in this area include:

- *Coordinated Portfolio Investment Survey (CPIS) and Coordinated Direct Investment Survey (CDIS)*: Led by the IMF, the CPIS is a global survey of cross-border portfolio investment holdings since 2013 for 83 countries. To enhance cross-border financial interconnectedness and balance sheet analysis, the Fund is upgrading the CPIS infrastructure to move from securities information across countries toward "from-whom-to-whom" financial information of portfolio stocks by sector of issuers and holders. The IMF has also led efforts to improve the tracking of countries' inward and outward foreign direct investment positions through the CDIS, conducted since 2009.

- *International Investment Position*: The IMF has led efforts to improve the measurement of the stocks of assets and liabilities held by residents vis-à-vis other countries, reported quarterly for more than 120 countries. Efforts are under way to enhance the coverage of offshore financial centers and to require data on the currency denomination of financial assets and liabilities.

In addition, the Fund staff continues to help maintain the External Wealth of Nations database (Lane and Milesi-Ferretti, 2018), which contains detailed cross-country information on the stock of domestic and foreign assets and has been widely used in academic and policy circles, including the Fund's assessments of capital account openness and the effects of financial market integration.

The Fund has also been an important partner in other multilateral initiatives to improve the monitoring of capital flows.

- As part of a broader IMF effort to enhance the use of balance sheet analysis in its bilateral and multilateral surveillance, the Fund has been actively engaged in multilateral efforts to establish a global flow of funds database.
- With the FSB and BIS, the IMF helped launch the initiative to track detailed, institution-to-institution funding exposures for global systemically important banks (GSIBs). Given the confidentiality of the data, the Fund's role has been to assist in the design of reporting templates and to define the data needed for effective multilateral surveillance of financial stability. In addition, a joint public and private initiative was established to define a system of global legal economic identifiers that can now uniquely identify legal entities engaging in financial transactions; the IMF participated in the development of the system and has observer status in the regulatory oversight committee.

The Fund has long been an authoritative source in monitoring and disseminating information on countries' use of capital account measures. Since 1950, the Fund's *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)* has provided detailed information on countries' restrictions on current international transactions, capital account restrictions (since 1952), exchange rate arrangements, and monetary policy frameworks. The *AREAER* is based largely based on annual self-reporting by member countries, but is often augmented to reflect information gathered by IMF Article IV missions. Data from the *AREAER* provide the building block for most analyses of de jure measures of openness. Some of these indexes have been prepared by the IMF staff—e.g., the index constructed by Schindler (2009) and subsequently extended by Fernández and others (2015)—but the Fund has not established or disseminated a globally recognized measure of capital account openness (Batini and Durand, 2020). As a result, the most widely used indexes are those prepared by outside researchers, such as those based on the approaches of Chinn and Ito (2008) and Quinn, Schindler, and Toyoda (2011).

As noted above, the IMF has also provided a Taxonomy of CFMs (IMF, 2019d).

Knowledge sharing within the Fund on capital flow issues has improved. A Capital Flows Group established in 2010 provides a forum for disseminating research on capital flow issues—including through a regular seminar series that features cross-departmental presentations on key topics as well as outside speakers—and provides regular reports to Fund management. MCM prepares several internal monitors that cover capital flows: the daily Global Market Monitor covers global capital developments; a monthly EM Capital Flows Monitor tracks monthly cross-border portfolio flows to and from emerging markets, albeit partly based on secondary sources (such as the Institute of International Finance); and a monthly Fintech Update aggregates news and data on the fintech sector.

Assessment

While the IMF is widely regarded as a source of key data and intellectual contributions on capital account issues, efforts have not always been well sustained or followed through. Following a burst of attention at the time that the IV was developed, there has been a tendency toward one-off efforts, putting together data sets and analytic frameworks but not maintaining them adequately, particularly after the responsible staff members rotated off to other tasks. The IMF has certainly worked hard to fill important data gaps, but in some areas the Fund has relied on other sources. For example, capital account openness indexes are largely compiled outside the Fund even though the raw data comes from the Fund, while the IIF's high-frequency monitoring of flows sets the industry standard and is extensively used by Fund staff.

The staff's efforts are handicapped by several factors. One is that staff resources are spread across multiple departments and are stretched thin. Research and analysis of capital flows is carried out by MCM, RES, SPR, and STA, among others, plus the Capital Flows Group—without a clear sense of who has responsibility for ensuring that key issues are covered in a systematic and timely manner. The division covering capital account issues in MCM has to cover both research and operational work, and macroprudential policies as well as capital account measures. The *GFSR* team has the capacity to do a periodic deep dive into an issue but not to sustain attention to any particular issue over time. In addition, the staff's research and analysis efforts are constrained by lack of access to some confidential data (e.g., on the cross-border counterparty exposures of GSIBs) and lack of adequate access to commercial databases due to budgetary constraints.

The *AREAER* represents an important public good that clearly merits greater investment by the Fund. The Fund staff deserves great credit for providing this report to IMF members despite only a skeleton crew being devoted to the task, alongside additional responsibilities such as building up the macroprudential database. Greater investment in the *AREAER*'s ongoing maintenance would improve its timeliness, reduce reputational risk, and give greater scope for the experts involved to provide needed support for Fund policy advice and analysis on capital account policies. For similar reasons, there would seem to be merit in constructing and publishing in-house the indexes of capital account openness that are used for core surveillance benchmarks, including EBA, rather than leaving this task to others.

The recent IPF work program provides an opportunity to develop a more sustained and broader research agenda. This workstream has meant a substantial increase in resources for research and analysis of capital account issues as part of a Fund-wide effort to analyze the broad set of measures for handling external shocks. Without expecting that this degree of attention can be fully maintained, it would seem desirable to find a way to ensure that research and analytical work in this area are sustained with a medium-term agenda to ensure that the Fund remains a clear center of excellence in an area at the core of its mandate. To be most useful for guiding advice and influencing policy decisions, this agenda should cover a broader set of issues beyond the immediate focus of the IPF, including, for example, how source country policies and regulations affect the dynamics of capital flows and how the short-term use of different instruments can affect longer-term market and institutional developments.

8 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.

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STATEMENT BY THE MANAGING DIRECTOR

ON THE INDEPENDENT EVALUATION OFFICE REPORT ON IMF ADVICE ON CAPITAL FLOWS EXECUTIVE BOARD MEETING SEPTEMBER 18, 2020

I welcome the report of the Independent Evaluation Office (IEO) on IMF Advice on Capital Flows, and I generally support its broader messages. The report offers valuable analysis and recommendations, which will inform the forthcoming review of the Fund's Institutional View (IV) on the Liberalization and Management of Capital Flows. The review of the IV is currently scheduled for next year, and we will proceed on this timetable. I also broadly support the recommendations to build up monitoring, analysis and research and strengthen multilateral cooperation on policy issues affecting capital flows, which will be undertaken as soon as more critical work subsides and budget resources make it possible.

I welcome this timely and useful evaluation. I appreciate the detailed analysis presented in the main report and the background papers, which together with the parallel work on the Integrated Policy Framework (IPF) will serve as input for the review of the IV, scheduled for 2021.

As noted in the report, the adoption of the IV represented a major advance in the IMF's policy framework to provide advice on capital account liberalization and the management of capital flows. Before the adoption of the IV, there was no consistent framework to guide policy advice on these areas. The IV was a major step towards filling the gap existing at the time. It welcomed the economic benefits of capital flows while recognizing the risks associated with capital flow volatility, developed a playbook for safe capital account liberalization, and incorporated capital flow management measures (CFMs) into the policy toolkit. It also noted the importance of international cooperation on capital flow policies in allowing countries to harness the benefits of capital flows safely, while minimizing negative spillovers. It was a demonstration of the institution's flexibility and willingness to embrace theoretical advances and lessons from experience.

I am pleased with the report's finding that IMF policy advice to countries has been broadly consistent with the IV, and that member countries perceive that its application has generally been evenhanded. This consistent policy advice is achieved through an internal review process carried out by an interdepartmental group. In addition, in recent years, the Fund has stepped up efforts to explain to the membership the application of the IV in practice, including through notes for the G20, engagements with the membership during the Spring and Annual Meetings, the publication of the IMF Taxonomy of CFMs, and by cooperating with other international organizations such as the OECD.

It is also encouraging that countries' policy choices during periods of capital inflow surges and reversals seem to have been broadly in line with the IV's overall framework. Countries have generally relied on a mix of macroeconomic policies, including exchange rate flexibility, foreign exchange intervention, and monetary and macroprudential policies when faced with such circumstances, and CFMs have generally not been used to substitute for warranted policy adjustments. This seems to have also been the experience thus far in response to the crisis triggered by the COVID-19 pandemic.

I take note of the theoretical advances, empirical work, and lessons from experience described in the evaluation. At the time of its adoption in 2012, the Executive Board made clear that the IV did not mean to lay down a doctrine or set in place a view once and for all. On the contrary, it was expected that the IV would continue to evolve and be reviewed in the light of new experience, analytical research, and feedback from country authorities and others. All these will be given due consideration in the forthcoming review of the IV.

In sum, I generally support the broader messages of the IEO evaluation, with some qualifications. We will revisit the IV and consider some of the specific recommendations of the evaluation as inputs in its forthcoming review. We will also build up the monitoring, analysis and research of capital account issues and strengthen multilateral cooperation on policy issues affecting capital flows. The resource implications of these latter recommendations will be considered in budget discussions, recognizing that there are competing priorities, including in the context of the response to the COVID-19 pandemic. Given their importance, we will undertake these two latter recommendations as soon as critical crisis work abates and resources permit.

Below is my response to each of the three recommendations of the report.

RESPONSE TO IEO RECOMMENDATIONS

Recommendation 1—Revisit the Institutional View in the light of recent experience and research.

I generally support revisiting the IV but defer to the upcoming review to consider the specific elements of the recommendation.

I agree with the goal of maintaining the Fund's framework for advice on capital flows up to date with theoretical advances, empirical evidence, and lessons from experience, as envisaged when the IV was adopted. The Fund's capacity to provide cutting-edge convincing advice on capital flows depends on being prepared to continually learn and adapt. Therefore, I support the recommendation to revisit the IV in the context of the upcoming review, planned for 2021.

I agree that such a revisit need not involve a wholesale overhaul of the IV. The core principles underpinning 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. The IV should continue to aim to help countries reap the benefits of capital flows, while managing the associated risks in a way that ensures macroeconomic and financial stability.

I have reservations about some of the proposed changes, including those to give less attention to labeling of measures, change the definition of CFMs, and use CFMs to address social issues. On pre-emptive and long-lasting use of inflow CFMs, such use would be a departure from the current framework and would require further consideration of specific circumstances when it could be considered appropriate and safeguards to operationalize it. On the use of outflow CFMs to deal with disruptive outflows outside crisis or near-crisis circumstances, such use would also be a departure from the current framework and would require further scrutiny.

The key will be to consider any potential adaptations to the IV that incorporate the lessons from recent experience and analytical research (including the work on the IPF) while, putting in place adequate safeguards to prevent an "anything goes" environment, preserving the core principles of the framework, and maintaining the consistency of the IMF's advice on capital flow policies, which was a key motivation that led to the adoption of the IV. Such will be the undertaking of the forthcoming review of the IV, which will follow the due consultations required for such review.

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

I broadly support the recommendation, with one qualification.

I agree that the Fund should remain at the cutting edge of work on capital flow issues. As noted in the report, the current research agenda, both conceptual and empirical, already envisages work on many of the issues raised in the evaluation.

I welcome the acknowledgment of the important public good nature of the Fund's data bases on CFMs. I am also pleased that the report recognizes the important step undertaken by the Fund in developing an IPF to advance the understanding of the policy options available to policy makers to deal with shocks and the associated tradeoffs.

Building strong monitoring platforms and sustaining a coherent and well-coordinated research agenda will be key to ensure sustained coverage of key capital account issues. I broadly support conducting more research on the costs and benefits of capital account and macroprudential measures, ramping up resources committed to the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), and increasing research related to other capital account issues. These efforts will be coordinated with other workstreams to ensure efficiency, coherence, and attention to resource constraints.

Management will carefully consider how to best take this forward in the context of the Fund's budget with a view to implement them as soon as possible.

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

I broadly support the recommendation, with one qualification.

The Fund will continue to collaborate intensively with other multilateral organizations, with due regard of their different mandates, purposes, and memberships. I agree that we should sustain efforts to collaborate with the OECD on capital account issues. I also support undertaking work to strengthen the coordination of macroprudential and capital account policies together with the FSB and the BIS, and to address possible tensions between the IV and the Basel III framework. We should study in collaboration with other institutions how best to address systemic concerns from securities markets.

Continuing ongoing work on capital account provisions in trade and investment agreements will also be important to provide a basis to promote a consistent approach on how to handle capital flows.

In this area, too, Management will consider how to take this agenda forward in the context of the Fund's budget. We will implement the recommendations as soon as resources and competing priorities allow.

TABLE 1. THE MANAGING DIRECTOR'S POSITION ON IEO RECOMMENDATIONS

RECOMMENDATION	POSITION
(i) Revisit the Institutional View in the light of recent experience and resea rch	QUALIFIED SUPPORT
(ii) Build up the monitoring, analysis, and research of capital account issues as part of a sustained Fund- wide medium-term agenda	QUALIFIED SUPPORT
(iii) Make sure that the Fund is at the forefront of financial spillover analysis and provision of advice on dealing with capital flows.	QUALIFIED SUPPORT

THE CHAIR'S SUMMING UP

INDEPENDENT EVALUATION OFFICE—IMF ADVICE ON CAPITAL FLOWS

EXECUTIVE BOARD MEETING 20/93
SEPTEMBER 18, 2020

Executive Directors welcomed the report of the Independent Evaluation Office (IEO) on IMF Advice on Capital Flows. Directors appreciated the high quality of the report, and its thematic and background country studies. Directors welcomed the finding that the adoption of the Institutional View (IV), along with the development of other frameworks and additional tools, had represented a major advance in the Fund's policy framework to provide systematic advice to member countries on the management of capital flows and capital account liberalization. Directors also noted the conclusion that, in its application, the Fund had generally followed the IV and other policy frameworks to ensure that the advice was consistent, tailored to country circumstances, and evenhanded across countries. Directors welcomed that capital flow management measures (CFMs) have generally not been used to substitute for warranted policy adjustments. Directors also welcomed the finding that most authorities broadly support the IV's sequenced framework to capital account liberalization and appreciated the Fund's specific advice in many cases, especially in the context of technical assistance. More recently, faced with the abrupt capital flow reversals during the COVID 19 crisis, Directors noted that emerging markets and developing economies generally followed a multi-pronged approach broadly consistent with the IV framework and made relatively little use of CFMs.

Notwithstanding these accomplishments, Directors acknowledged that accumulated country experience and recent research had raised issues about the Fund's advice on managing volatile capital flows. These relate, inter alia, to the guidance in the IV that CFMs not be used pre-emptively—an issue which has been raised in the staff's work on the Integrated Policy Framework (IPF)—the distinction between measures classified as macroprudential measures (MPMs) and CFMs/MPMs, the role of foreign exchange intervention (FXI), the approach to dealing with disruptive outflows, and the role of social and political objectives. In a few specific cases, disagreements with country authorities about the labeling of measures crowded out a policy dialogue. There were also concerns raised that Fund advice on capital account liberalization was not paying adequate attention to the collateral benefits in terms of market and institutional development and the robustness of the macroeconomic policy framework, and to its social and distributional effects. Concerns also persist about the traction of multilateral surveillance to address issues related to spillovers and volatility of capital flows.

Against this background, Directors broadly agreed on the need to revisit the IV in the light of recent experience and research (Recommendation 1), with many Directors, however, agreeing that a major overhaul of the IV was not required. In this context, Directors emphasized that the review of the IV now scheduled for 2021 should consider carefully the IEO's recommendations and the ongoing work on the IPF. Directors underlined that the core principles of the IV remained valid, 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. The IV framework should continue to aim to help countries reap the benefits of capital flows while managing risks to ensure stability. Directors emphasized that it would be important to ensure that the Fund's policy framework on capital flows maintained adequate safeguards against possible misuse and that it be applied evenhandedly across countries.

There were different views on the extent of revisions required on specific elements of the IV. Many Directors thought that the IV could be more flexible in allowing preemptive and more long lasting use of CFMs on inflows in specific circumstances, for example to help address the build-up of financial stability risks from volatile capital flows. Some Directors saw merit in allowing the use of outflow CFMs outside of crisis or near crisis circumstances to deal with disruptive outflows. A number of Directors cautioned or were not in favor of such revisions. On the differences in advice between CFMs, MPMs, and CFMs/MPMs, some Directors were open to a reconsideration, some Directors thought the focus should be on assessing effectiveness rather than classification, and some other Directors were not in support of a dilution of the distinction. In a similar vein, there was a divergence of views on the role and effectiveness of FXI. Finally, a number of Directors thought that CFMs may have a valid role to address social issues such as housing affordability and many agreed that the strategy for capital account liberalization within the IV should consider distributional implications; some Directors had concerns or emphasized the need for further analysis.

Directors supported the building up of monitoring, analysis, and research of capital account issues as part of a sustained Fund wide medium term agenda (Recommendation 2) to help maintain the Fund as a thought and policy advice leader on capital flow issues. Directors emphasized the need for a better understanding of the costs and benefits of CFMs and MPMs, and more research on the longer-term implications of the use of different instruments for market development to support the upcoming review of the IV. Some also supported further developing the Fund's own indices of capital account openness based on the *AREAER*. These efforts should be coordinated with other workstreams to ensure efficiency and coherence with due attention to resource constraints.

Directors agreed with the need to strengthen multilateral cooperation on policy issues affecting capital flows (Recommendation 3). Directors emphasized close collaboration with other multilateral organizations, including the OECD, BIS and FSB—with due regard to their different mandates, purposes, and memberships—to promote a consistent and comprehensive approach to the handling of capital flows. More specifically, Directors emphasized that the Fund could intensify cooperation with other IFIs to increase attention to systemic issues in the regulation of securities markets that could reduce the risks of volatile portfolio flows and to address potential tensions between the IV and the Basel III framework, including in the treatment of reciprocity arrangements and liquidity regulations.

In supporting the recommendations, many Directors underlined the need to remain mindful of the resource implications which should be considered in budget discussions, recognizing that there are competing priorities, including in the context of the response to the COVID-19 pandemic. Many Directors emphasized that the upcoming review of the IV was an important task that needed to be adequately supported with staff analysis and research. A few Directors noted that reprioritizing resources could be needed in developing a work program based on the recommendations, since advice on capital flows is at the core of the Fund's mandate.

In line with established practice, management and staff will carefully consider today's discussion in formulating a follow-up implementation plan, including approaches to monitor progress.

ISBN: 978-1-51355-807-3

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IMF ADVICE ON CAPITAL FLOWS
EVALUATION REPORT 2020