Executive Summary

Against the background of highly volatile international capital flows and the associated financial instability experienced by a number of major emerging market economies in recent years, the role of the IMF in capital account liberalization has been a topic of major controversy. The IMF's role is particularly controversial because capital account liberalization is an area where there is little professional consensus. Moreover, although current account liberalization is among the IMF's official purposes outlined in its Articles of Agreement, the IMF has no explicit mandate to promote capital account liberalization. Indeed, the Articles give the IMF only limited jurisdiction over issues related to the capital account. Nevertheless, the IMF has given greater attention to capital account issues in recent decades, in light of the increasing importance of international capital flows for member countries' macroeconomic management. In view of these facts, an independent assessment of how the IMF has addressed capital account issues seems warranted.

The evaluation seeks to (1) contribute to transparency by documenting what in practice has been the IMF's approach to capital account liberalization and related issues; and (2) identify areas, if any, where the IMF's instruments and operating methods might be improved, in order to deal with capital account issues more effectively. The issues addressed in the evaluation cover not only capital account liberalization but also capital flow management issues, including particularly the temporary use of capital controls. The evaluation, however, does not address the question of whether liberal capital accounts are intrinsically beneficial—on which the broader academic literature has not been able to provide a definitive answer—or whether the Articles of Agreement should be amended to give the IMF an explicit mandate and jurisdiction on capital account issues. Many aspects of these issues are not amenable to evidence from the evaluation. However, the evaluation does shed some light on the consequence of the lack of explicit mandate and jurisdiction on the IMF's work on capital account issues.

The report begins by reviewing the IMF's general operational approach and analysis as they evolved from the early 1990s into the early 2000s. It then assesses the IMF's country work in terms of (1) its role in capital account liberalization during 1990–2002, (2) its policy advice to member countries on managing capital flows during the same period, and (3) its ongoing work on capital account issues (where outstanding issues are identified for 2003–04). The report concludes by offering two broad recommendations.

The IMF's General Operational Approach and Analysis

Despite the ambiguity left by the Articles of Agreement about its role in capital account issues, the IMF responded to the changing international environment by paying increasing attention to issues related to the capital account. Concurrent with the initiatives to amend the Articles to give the IMF an explicit mandate for capital account liberalization and jurisdiction over members' capital account policies, the IMF expanded the scope of its operational work in the area. It encouraged the staff to give greater emphasis to capital account issues in Article IV consultations and technical assistance and to promote capital account liberalization more actively.

In multilateral surveillance, the IMF's analysis prior to the mid-1990s tended to emphasize the benefits to developing countries of greater access to international capital flows and to pay comparatively less attention to the potential risks of capital flow volatility. More recently, however, the IMF has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the more fundamental causes and implications of their boom-and-bust cycles. Still, the focus of the analysis remains on what emerging market countries should do to cope with the volatility of capital flows (for example, in the areas of macroeconomic and exchange rate policy, strengthened financial sectors, and greater transparency). Although the IMF has addressed the moral hazard aspect of boom-and-bust cycles by encouraging greater exchange rate flexibility in recipient countries and attempting to limit access to IMF resources during a crisis, it has not been at the forefront of the debate on what, if anything, can be done to reduce the cyclicality of capital movements through regulatory measures targeted at institutional investors in the source countries.

From the beginning of the 1990s, the IMF's management, staff, and Executive Board were aware of the potential risks of premature capital account liberalization and there is no evidence to suggest that they promoted capital account liberalization indiscriminately. They also acknowledged the need for a sound financial system in order to minimize the risks of liberalization. Such awareness, however, largely remained at the conceptual level and did not lead to operational advice on preconditions, pace, and sequencing until later in the 1990s. At the same time, a subtle change was taking place within the institution. As preliminary evidence emerged on the apparent effectiveness of Chile's capital controls in the mid-1990s, some in the IMF began to take a favorable view of the use of capital controls as a temporary measure to deal with large capital inflows.

In the event, the proposed amendment of the Articles put forward in the late 1990s failed to garner sufficient support, leaving ambiguity about the role of the IMF. In the meantime, something of a consensus—the so-called "integrated" approach—has emerged within the IMF that places capital account liberalization as part of a comprehensive program of economic reforms in the macroeconomic policy framework, the domestic financial system, and prudential regulations. While few would disagree with the prudence and judiciousness of the new approach, it has proved to be difficult to apply as an operational guide to sequencing because it emphasizes all of the potential interlinkages but does not provide clear criteria for identifying a hierarchy of risks. Moreover, these views remain unofficial, as they have not been explicitly endorsed by the Executive Board.

The IMF's Country Work

The evaluation assesses the IMF's country work in terms of the following criteria: (1) Was there any difference between the IMF's general policy pronouncements and the advice it gave to individual countries? (2) Was the IMF's policy advice operational and based on solid evidence? (3) How did the IMF's advice change over time, and did this change keep pace with available evidence? (4) Did the IMF give similar advice to countries in similar situations? and (5) Was the policy advice on the capital account set in a broader assessment of the authorities' macroeconomic policies and institutional framework?

Capital account liberalization

During the 1990s, the IMF clearly encouraged capital account liberalization, but the evaluation suggests that, in all the countries that liberalized the capital account, partially or almost fully, the process was for the most part driven by the country authorities' own economic and political agendas. In none of the program cases examined did the IMF require capital account liberalization as formal conditionality (which is understood to mean prior actions, performance criteria, or structural benchmarks), although aspects of it were often included in the authorities' overall policy package presented to the IMF. This is consistent with the interpretation of the Articles of Agreement, which states that the IMF, as a condition for the use of its resources, cannot require a member to remove controls on capital movements. In the first half of the 1990s, in encouraging capital account liberalization, the IMF seldom raised the issue of pace and sequencing. The staff occasionally expressed concern over financial sector weakness or macroeconomic instability, but this did not translate into concrete operational advice. From around 1994, and more noticeably following the East Asian crisis, the IMF began increasingly to give emphasis to the need to satisfy certain preconditions; in general, the IMF's approach in its country work was quite pragmatic, especially in this later period, and often accepted the authorities' own views on the appropriate pace and sequencing of liberalization.

Managing capital inflows

As countries experienced large capital inflows and associated macroeconomic challenges in the 1990s, the issue of how to manage large capital inflows became a routine subject of discussion between the IMF and the country authorities. The staff's policy advice was largely in line with the policy conclusions typically derived from the scholarly literature on open economy macroeconomics. To deal with large capital inflows, it advocated tightening fiscal policy and greater exchange rate flexibility. The staff's position on sterilization emphasized its quasi-fiscal costs and longer-term ineffectiveness but was, to a remarkable extent, supportive of the country authorities' policy choices, whatever they may have been. In a few instances, the staff also recommended further trade liberalization, liberalization of capital outflows, and tightening of prudential regulation as measures to deal with large capital inflows. These and other structural measures, however, received relatively little attention in the IMF's policy advice, although in recent years increasing attention has been given to strengthening the financial sector regulatory framework, primarily in the context of the Financial

Sector Assessment Program (FSAP). Given the IMF's focus and comparative advantage, this was probably appropriate.

Temporary use of capital controls

Use of capital controls has been a controversial subject, not only within the IMF but also in the academic and official policymaking communities. It is possible here to make a broad characterization that the IMF staff was in principle opposed to the use of such instruments, either on inflows or outflows. Its view was that they were not very effective, especially in the long run, and could not be a substitute for the required adjustments in macroeconomic and exchange rate policies. Even so, from the earliest days, the IMF staff displayed a remarkable degree of sympathy with some countries in the use of capital controls. In a few cases, both before and after the crises of 1997–98, it even suggested that market-based controls could be introduced as a prudential measure. As a general rule, the IMF staff, in line with the evolution of the institution's view, became much more accommodating of the use of capital controls over time, albeit as a temporary, second-best instrument.

Ongoing country dialogue on capital account issues

In ongoing country work, as documented for the period of 2003–04, IMF staff has been quite accommodating of the authorities' policy choices when they have involved a gradual approach to capital account liberalization or temporary use of controls. In terms of capital account liberalization, the staff has sometimes been more cautious than the authorities (as in Russia in 2003) when their preferred policy has been to liberalize the capital account quickly. In most cases, the staff has taken a medium-term perspective and has emphasized the importance of meeting certain preconditions, the most important of which are fiscal consolidation, a sound financial system, and the adoption of a floating exchange rate (usually with inflation targeting).

In terms of advice on temporary use of capital controls, IMF staff seldom challenged the authorities' decision and has even supported market-based controls in some cases. There was a slight difference in emphasis across countries. In a few countries (as in Russia in 2004), the staff expressed forcefully the view that capital controls, no matter how useful they might be in the short run, could not be expected to be effective over time and should not be used as a substitute for appropriate adjustment in macroeconomic policies. In others (as in Colombia), the use of controls introduced by the authorities did not figure prominently in policy discussions. In still other cases (as in Croatia), the staff recommended a market-based control, albeit as a last resort measure.

Overall Assessment

Throughout the 1990s, the IMF undoubtedly encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader when it wished to do so, especially before the East Asian crisis. However, there is no evidence to suggest that it exerted significant leverage to push countries to move faster than they were willing to go. The process of liberalization was often driven by the authorities' own economic and political agendas, including accession to the Organization for Economic Cooperation and Development (OECD) or the European Union (EU) and commitments under bilateral or regional trade agreements. In encouraging capital account liberalization, the IMF pointed out the risks inherent in an open capital account as well as the need for a sound financial system, even from the beginning. The problem was that these risks were insufficiently highlighted, and the recognition of the risks and preconditions did not translate into operational advice on pace and sequencing until later in the 1990s (and even thereafter the policy advice has often been of limited practical applicability).

In multilateral surveillance, the IMF's analysis emphasized the benefits to developing countries of greater access to international capital flows, while paying comparatively less attention to the risks inherent in their volatility. As a consequence, its policy advice was directed more toward emerging market recipients of capital flows, and focused on how to manage large capital inflows and boom-and-bust cycles; little policy advice was offered, in the context of multilateral surveillance, on how source countries might help to reduce the volatility of capital flows on the supply side. In more recent years, the IMF's analysis of such supply-side factors has intensified. Even so, the focus of policy advice—beyond the analysis of macroeconomic policies covering large current account imbalances—remains on the recipient countries.

In country work there was apparent inconsistency in the IMF's advice on capital account issues. Sequencing was mentioned in some countries but not in others; advice on managing capital inflows was in line with standard policy prescriptions, but the intensity differed across countries or across time (with no clear rationale provided for the difference); and a range of views was expressed on use of capital controls (though greater convergence toward accommodation was observed over time). Policy advice must of necessity be tailored to country-specific circumstances, so uniformity cannot be the only criterion for judging the quality of the IMF's advice. Country documents, however, provide only an insufficient analytical basis for making a definitive judgment on how the staff's policy advice was linked to its assessment of the macroeconomic and institutional environments in which it was given. While one can explain why certain types of advice were offered in some individual cases, no generalization is possible about the consistency of the IMF's overall policy advice. Even so, it appears that the apparent inconsistency to a large extent reflected reliance on the discretion of individual IMF staff members, and not necessarily the consistent application of the same principles to different circumstances.

The evaluation suggests that the IMF has learned over time on capital account issues. This seems to have affected the work of the IMF through two channels. First, the IMF's general approach did respond—albeit gradually—to new developments or new evidence. Second, independent of how the general approach changed, some of the learning became more quickly reflected in the IMF's country work through its impact on individual staff members. The lack of a formal IMF position on capital account liberalization and the associated partial disconnect between general operational guidelines and country work had different consequences. On the one hand, this gave individual staff members freedom to use their own professional and intellectual judgment in dealing with specific country issues. On the other hand, the disconnect reflected the inherent ambiguity of this aspect of the IMF's work and led to some lack of consistency in country work, as noted above.

In more recent years, somewhat greater consistency and clarity has been brought to bear on the IMF's approach to capital account issues. For the most part, the new paradigm upholds the role of country ownership in determining pace and sequencing; takes a more consistently cautious and nuanced approach to encouraging capital account convertibility; and acknowledges the usefulness of capital controls under certain conditions, particularly controls on inflows. But these are still unofficial views, no matter how widely they may be shared within the institution. While the majority of staff members now appear to accept this new paradigm, some continue to feel uneasiness with the lack of a clear position by the institution.

Recommendations

The evaluation suggests two main areas in which the IMF can improve its work on capital account issues.

Recommendation 1. There is a need for more clarity on the IMF's approach to capital account issues. The evaluation is not focused on the arguments for and against amending the Articles of Agreement, but it does suggest that the ambiguity about the role of the IMF with regard to capital account issues has led to some lack of consistency in the work of the IMF across countries. This may reflect the lack of clarity in the Articles, but with or without a change in the Articles it should be possible to improve the consistency of the IMF's country work in other ways. For example:

- *The place of capital account issues in IMF surveillance could be clarified*. It is generally understood that while under current arrangements the IMF has neither explicit mandate nor jurisdiction on capital account issues, it has a responsibility to exercise surveillance over certain aspects of members' capital account policies. However, much ambiguity remains on the scope of IMF surveillance in this area. The clearest statement of the basis for surveillance of capital account issues is embodied in the 1977 Executive Board decision calling for surveillance to consider certain capital account restrictions introduced for balance of payments purposes, but the qualification limiting the scope to balance of payments reasons is too restrictive to cover the range of capital account issues that surface in the IMF's country work. On the other hand, the broader statement of the IMF's surveillance responsibility, found in the preamble to Article IV, is too wide to serve as an operational guide to surveillance on capital account issues. There would be value if the Executive Board were formally to clarify the scope of IMF surveillance on capital account issues. Such a clarification would recognize that capital account policy is intimately connected with exchange rate policy, as part of an overall macroeconomic policy package, and that in many countries capital flows are more important in this respect than current flows; capital controls can be used to manipulate exchange rates or to delay needed external adjustment; and a country's capital account policy creates externalities for other countries. Capital account policy is therefore of central importance to surveillance.
- *The IMF could sharpen its advice on capital account issues, based on solid analysis of the particular situation and risks facing specific countries*. Given the limited evidence that exists in the literature on the benefits or costs of capital account liberalization in the abstract, the IMF's approach to any capital account issue must necessarily be based on an analysis of each case.

For example, if a capital control is involved, the IMF must ask in the context of a specific country what objectives the control is designed to achieve; if it is accomplishing them; and whether there are more effective or less distortionary ways of achieving the same objectives. Such assessments need to be set in an overall consideration of the macroeconomic policy framework and whether controls are being used as a substitute for, or to seek to delay, necessary changes in such policies. The evaluation indicates that this is already done in some, but not all, cases. If a capital control measure is judged useful to stem capital flight under certain circumstances, the IMF should ask what supporting policies are needed to make it more effective or less distortionary (for example, setting up a system of monitoring external transactions). In terms of providing advice on capital account liberalization, just to spell out all the risks inherent in opening the capital account is of limited usefulness to countries seeking IMF advice. To assist the authorities decide when and how to open the capital account, the IMF should provide some quantitative gauge of the benefits, costs, and risks (and, indeed, practicality) of moving at different speeds. Admittedly, this is not an easy task. Drawing on the well-established literature on welfare economics, the IMF must ask such questions as: What distortions are being created when one market is liberalized but not another? What is the nature of risks being borne by residents when capital account transactions are liberalized only for nonresidents? And what are the costs to the economy (in terms of investment flows) of allowing equity inflows but not debt inflows?

- *The Executive Board could issue a statement clarifying the common elements of agreement on capital account liberalization.* At present, there remains considerable uncertainty among many staff members on what policy advice to provide to individual countries. This has led to hesitancy on the part of some within the staff to raise capital account issues with country authorities. The Executive Board could provide clear guidance to staff on what the IMF's official position is. This is not to say that the Executive Board must come up with a definitive statement on all aspects of pace and sequencing. Given the lack of full consensus, one should not expect such a definitive view from the Board. However, Board guidance on what are the minimum common elements on which there is broad, if not universal, agreement would be useful to the staff and member countries. Although the details are for the Board to decide, such a statement might include some or all of the following elements: (1) that in a first-best world there would be no need for controls over capital movements (though financial markets may not always operate accordingly); (2) that controls should not be used as a substitute for adjusting macroeconomic or structural policies; (3) a broad (as opposed to unnecessarily complex) framework of sequencing based on the consensus in the literature on the order of economic reforms; (4) the importance of taking country-specific circumstances into account; and (5) that risks can never be totally eliminated, so they should not be used as a reason for permanently delaying liberalization.

Recommendation 2. The IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and what can be done to minimize the volatility of capital movements. The IMF's policy advice on managing capital flows has so far focused to a considerable extent on what recipient countries should do. While this is important, it is not the whole story. As discussed in the evaluation report, the IMF's recent analyses have given greater attention to supply-side factors, including the dynamics of boom-and-bust cycles in emerging market financing. The IMF has also established an International Capital Markets Department (ICM) as part of an effort to better understand global financial markets; it participates actively in the work of the Financial Stability Forum, which was established to monitor potential vulnerabilities in global financial markets; and it has proposed a Sovereign Debt Restructuring Mechanism (SDRM), encouraged the use of collective action clauses (CACs), and has attempted to place limitations on countries' access to IMF resources in a crisis, in an effort to reduce the perceived moral hazard that may have led capital markets to pay insufficient attention to the risks of investing in developing countries and contributed to the boom-and-bust cycles of capital movements. These are important and welcome initiatives, but the IMF has not yet fully addressed issues of what, if anything, can be done to minimize the volatility of capital flows by operating on the supply side—as yet, little attention seems to be paid to supply-side risks and potential mitigating actions in the industrial countries that are home to the major global financial markets. The IMF could usefully provide more input into advanced country financial supervision and other financial market policy issues globally. Are current global supervision guidelines designed to help create stability? What if any action could be taken on the supply side to reduce cyclicality and herd behavior? Admittedly, this is a difficult topic on which little professional consensus exists. Yet, this is an area where a significant debate has taken place in the academic and policymaking communities and to which the IMF could contribute further. Indeed, one of the broad themes identified as potential priorities for the IMF's research program over the medium term—on institutions and contractual mechanisms that can help protect countries from external volatility—goes some way in this direction, but should not focus only on policies in countries that are recipients of capital inflows.