IMF's Independent Evaluation Office Announces Release of Report on the IMF's Approach to Capital Account Liberalization

IEO Press Release No. 05/02

Independent Evaluation Office

of the International Monetary Fund

Washington, D.C. 20431 USA

May 25, 2005 - The Independent Evaluation Office (IEO) of the International Monetary Fund (IMF) today released the report ***Evaluation of the IMF's Approach to Capital Account Liberalization***. The report reviews the IMF's policy advice on capital account liberalization and related issues in a sample of emerging market economies over the period 1990-2004.

Major findings:

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*. 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.

The evaluation finds that the IMF encouraged countries that wanted to move ahead with capital account liberalization, 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 OECD or EU accession 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. These risks, however, 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.

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 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; 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 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. Even so, it appears that the apparent inconsistency to a large extent reflected reliance on the discretion of individual IMF staff members.

The evaluation suggests that the IMF has learned over time, and 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 gave individual staff members freedom to use their own professional and intellectual judgment in dealing with specific country issues. 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. But these are still unofficial views, not formally adopted by the IMF. While the majority of staff members now appear to accept this new paradigm, there continues to be some 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. 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. Possible steps could include the following (although other approaches are also possible and the specifics would be for the Board to decide):

The place of capital account issues in IMF surveillance could be clarified. It is generally understood that the IMF has a responsibility to exercise surveillance over certain aspects of members' capital account policies, to the extent that capital account policy is intimately connected with exchange rate policy. There would be value if the Executive Board were formally to clarify the scope of IMF surveillance on capital account issues.

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 consensus in the literature, the IMF's approach to any capital account issue must necessarily be based on an analysis of each case. To assist the authorities in deciding when and how to open the capital account, the IMF should provide an operationally meaningful indication of the benefits, costs, and risks (and, indeed, practicality) of moving at different speeds.

The Executive Board could issue a statement clarifying the common elements of agreement on capital account liberalization. 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.

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. Building on recent initiatives, the IMF should also provide analysis of what can be done to minimize the volatility of capital flows by operating on the supply side. However, as was clarified during the Board discussion, the intention of this recommendation is not to suggest that the IMF should become heavily involved in detailed regulatory matters.

The report was discussed by the IMF's Executive Board on May 11, 2005. The Board welcomed the report and broadly endorsed the thrust of its findings. Views, however, were divided on the merits and feasibility of the specific recommendations. As a follow-up to the findings of the IEO report, Directors looked forward to capital account issues being addressed in the context of the Fund's ongoing strategic review. The report, along with IMF management and staff responses and the summing up of the Board discussion are available on the IEO's website at www.imf.org/ieo.

IEO Contact:

Tel. +1 202 623 7312

Email. **press@ieo-imf.org**

Fax. +1 202 623 9990

IMF External Relations Department Contacts:
Public Affairs: (202) 623-7300
Media Relations: (202) 623-7100