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# BACKGROUND PAPER

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# IMF Advice on Crisis-Driven Capital Controls in Europe

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# IMF Advice on Crisis-Driven Capital Controls in Europe

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The views expressed in this Background Paper are those of the author and do not necessarily represent those of the IEO, the IMF or IMF policy. Background Papers report analyses related to the work of the IEO and are published to elicit comments and to further debate.

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## ABBREVIATIONS

| | |
|---|---|
| BOC | Bank of Cyprus |
| CBI | Central Bank of Iceland |
| CDS | credit default swap |
| ECB | European Central Bank |
| EEA | European Economic Area |
| ELA | Emergency Liquidity Assistance |
| ESM | European Stability Mechanism |
| EU | European Union |
| FSAP | Financial Sector Assessment Program |
| GDP | gross domestic product |
| ISK | Icelandic krona |
| IV | Institutional View on the Liberalization and Management of Capital Flows |
| OECD | Organization for Economic Cooperation and Development |
| SBA | Stand-By Arrangement |
| TARGET2 | Trans-European Automated Real-time Gross Settlement Express Transfer System |
| UAH | Ukrainian hryvna |

## I. OVERVIEW

1. The three cases of use of capital flow controls examined here (Iceland, Cyprus, and Ukraine) primarily involve emergency controls on outflows introduced at times of economic, financial, or security crisis in the context of IMF-supported stabilization programs.[1] In the key episodes, the introduction of controls was, at the time, generally considered to be inevitable and sensible. Nevertheless, the cases differ sharply in their objectives, their outcomes—both for the economy at large and for the wealth holders whose export of capital was blocked or delayed—and the likely counterfactual if the controls had not been put in place.

2. The main goal of Iceland's 2008 controls was to halt the depreciation of the local currency when the banking system collapsed. Those trapped by the restrictions in Iceland included foreign investors in Icelandic securities, as well as creditors of the estates of the failed banks. Some were able to repatriate their funds only after a long interval (about eight years) and after payment of a significant exit tax in the form of a "stability contribution."

3. Cyprus introduced controls in March 2013 in the context of a substantial "bail-in" of deposits at the two largest banks, which had both failed. In this case, there was little danger of exchange rate change because Cyprus is part of the euro area (indeed it is less clear that controls were advantageous for Cyprus or for the euro area) but any alternative would have required the vigorous support of the European partners in the Troika. Since Cyprus was in a Troika-negotiated program and since the largest bank had been recapitalized through the bail-in, and the second largest bank was wound down, the euro system could have chosen to finance any outflows, albeit assuming a degree of credit risk, given that the prior measures should have been sufficient to limit that risk.[2] Financing by the euro system would have removed the need for restrictions and perhaps accelerated the economic recovery. On the other hand, the controls were operated with numerous exemptions and they were progressively liberalized on a more rapid schedule than Iceland's.

4. Ukraine's emergency measures of February 2015 were much more successful than its earlier attempts to maintain stability through capital controls. They succeeded in their aim of protecting the level of foreign exchange reserves and stabilizing the exchange rate in the midst of an economic and security panic. Domestic wealth holders were arguably protected from the capital losses that would have hit them had outflows caused an overshooting depreciation of the

[1] Some inflow restrictions were introduced in Iceland in 2016 and are mentioned below. In both Iceland and Cyprus, a period of strong, reversible inflows preceded a crisis; should capital inflow controls have been considered at that time? This possibility is not examined here. The Iceland inflows, which are likely to have been accentuated by the high interest rate policy that the Central Bank was pursuing before the global financial crisis, preceded 2008 and as such are outside the scope of this study. Capital inflow restriction in Cyprus would have been prohibited by EU rules on freedom of capital movements and thus incompatible with euro area membership.

[2] Earlier introduction of controls in Cyprus during 2012 would have allowed the bail-in of bank depositors to be spread over a wider set; large depositors who withdrew during 2012 received full value, whereas those who remained loyal to the troubled banks suffered haircuts which in some cases are expected to be higher than 90 percent.

local currency. To that extent, as with a "stop-loss" rule, each might have been protected from the externalities caused by a race to the exit.

5. Capital outflow restrictions in times of crisis are typically introduced suddenly and without much notice to anyone outside a narrow circle of decision makers and their advisors. Accordingly, the IMF staff was not in the driving seat for some of the major initial steps in these key episodes. Nevertheless, the staff broadly supported the approach taken in these three cases of emergency outflow restrictions. By contrast, it did not view favorably the measures that Ukraine maintained in earlier years, nor did it support the inflow measure that Iceland introduced in 2016. In each case, the Fund's stance can be seen as consistent with the Institutional View on the Liberalization and Management of Capital Flows (IV) (IMF, 2012a) (which was not issued until after the early measures).

6. The Fund staff provided what the national authorities considered to have been good technical advice on implementation of controls. It is possible that this advice helped limit the degree to which the measures were, through loopholes or leaks, vulnerable to abuse or corruption—an oft-mentioned hazard with such regimes—though this is inherently difficult to confirm. Significant loopholes that were detected in Iceland's 2008 regime were closed during 2009–10 (IMF, 2012b). The relatively flexible implementation in Cyprus and lax approach (albeit in a quite different macroeconomic setting) in the earlier phase in Ukraine raises some questions as to how effective some of the measures were in limiting outflows.

7. As conditions stabilized, the Fund staff helped in the design of programs or roadmaps for phasing out restrictions, especially in Cyprus and Ukraine, where actions were conditions-based as recommended in the IV. In Iceland, too, the actions taken were conditions-based, but there the situation differed because of the need to deal with the trapped claims on the estates of the failed banks and other holdings. In all three cases, the timing and nature of the removal of controls remained firmly in the hands of the authorities and differed in significant respects from what the Fund had in mind at first.

8. All in all, discussions with officials in all three countries suggest that the introduction of the controls reflected in each case more an intuitive reaction to protect against extreme events than a thought-through strategy adopted with a clear endpoint in mind. The desire to limit exchange rate movements was clearly in play in two of the three cases. Such a goal could make sense where an overshoot of equilibrium rates is a serious threat.[3] Another goal could have been to provide time to design and implement debt restructuring, but it took a long time for such thinking to mature in Iceland, and in Cyprus there had already been a bail-in which should have been sufficient to avoid the need for further debt restructuring.

[3] In Ukraine, unwarranted adherence (through measures including lighter capital controls) to nominal exchange rate stability (at an overvalued rate) had been criticized by the Fund staff before the crisis of 2014. The severity of the 2014 crisis, clearly threatening an overshoot, displaced these concerns.

9. There is a widespread view that, even when they are introduced in response to an acute crisis, capital controls are hard to remove in a straightforward manner. That the removal of controls often takes years rather than months is evidenced from the experience recounted here. In each country, national authorities often wanted to liberalize more quickly than the Fund staff considered advisable. Nevertheless, all three countries were able to proceed to systematically and progressively remove controls and are (almost) completely free of controls at the time of writing.

10. There would be a case for the Fund to develop best-practice guidelines for the purpose and objectives, design, and roadmap for phasing out controls introduced in emergency situations. It is not clear that the IV (IMF, 2012a) or its implementation manual deliver what is needed here. While the IV provides a set of conditions that should be satisfied by such policies, it is not seen by practitioners as a constructive handbook for the development of a fully integrated suite of policy actions.

## II. Iceland: Policy Evolution

### A. The 2008 Measures

11. It was the reckless expansion of the Icelandic banking system from 2004 that made Iceland so vulnerable to a sudden stop. The expansion was financed largely from abroad and much of it was used to buy foreign assets, though with a material spillover into the Icelandic economy. The sums involved were small relative to the international markets but vast in relation to Iceland's economic capacity. A spike in credit default swap (CDS) spreads for Icelandic banks in early 2006 signaled how fragile was the confidence of the international financial markets, which had financed the banks' buccaneering growth in the ample global liquidity conditions of those years. With the increasing tension in global financial markets in 2007–08, the banks faced increasing difficulties in accessing liquidity, with their CDS spreads soaring to more than 1000 basis points early in 2008.

12. In their response to increasingly stressed financial conditions during 2008, the authorities did seek additional support from other central banks but with limited success; they underestimated the scale of the external liquidity risk cliff-edge at which they were teetering. They managed to secure swap arrangements with three Nordic central banks, but for amounts totaling well under 1 percent of the banking system's liabilities. Their efforts to persuade the banks to downsize or to transfer their headquarters elsewhere were unsuccessful.

13. With the benefit of hindsight, the Fund might have urged more vigorous preemptive actions that might have allowed the banks' emerging insolvencies to be managed and contained in a more orderly manner (although it has to be acknowledged that by 2008 it was probably already too late to save much). Following a short ad hoc mission that the authorities requested in Spring 2008, an IMF Financial Sector Assessment Program (FSAP) team visited Iceland to conduct a financial sector assessment update in June 2008. The FSAP mission report (which was completed in mid-August but was not published until December) did express specific and well-

founded concerns about the fragility of the banks, and it urged the authorities to prepare promptly for the contingency of a sudden stop crisis, focusing mainly on how to deal with the potential for severe liquidity strains in the major institutions. But overall "the tone of the report was relatively reassuring" (IEO, 2011).[4] And, as noted by the downbeat Article IV report that was completed in early September 2008, the authorities' main focus of concern lay elsewhere and they remained insufficiently prepared for the failure of the entire banking system. While potential "debt-servicing difficulties" were mentioned in the Article IV report, there is no indication that introduction of capital flow restrictions was on the Fund's radar before the crisis.

14. When the crisis broke in September 2008, the Fund was not called on to provide financial assistance until after the authorities had launched the main crisis management actions. Relying on advice from investment banking consultants (J.P. Morgan), who pointed out that Iceland did not have the resources to credibly guarantee the banks' liabilities (with prospective losses amounting to a multiple of Iceland's GDP), the authorities allowed the main banks to fall into default and introduced legislative measures to protect domestic financial stability. Over a ten-day period from September 29, 2008, all three of the main banks failed. Replacement banks assumed local assets and liabilities, but the failure disrupted foreign payments because the replacement banks could not immediately establish international correspondent relationships for making payments.[5] For some weeks, foreign payments had to be conducted through the central bank, which sought to prioritize these through guidance and rationing.[6]

15. An IMF team arrived in Reykjavik on October 12, 2008 and within a few weeks a two-year Stand-By Arrangement (SBA) had been negotiated, providing for temporary maintenance of exchange controls with the intention of preventing a further sharp depreciation of the Icelandic krona (ISK). "All foreign exchange transactions unrelated to current transactions were prohibited with only limited exceptions" (IMF, 2012b).

16. The decision to formalize controls as a prior action of the program was at the initiative of the Fund. This was a striking departure from the Fund's usual position on capital controls at that time, and it came as a "bombshell" to the authorities, who had envisaged an early end to the

[4] Pointing to specific areas in which the Central Bank of Iceland's stress tests missed evident vulnerabilities, the FSAP report specified ways in which more stringent tests were warranted given the "increasingly difficult conditions in global markets." Stressing that "[D]evelopment of contingency plans for a possible bank failure, particularly of one of the three large banks, is critically important," the team pointed out that "[t]he banks are so large that Iceland would have difficulties addressing significant cross-border stress alone. For that reason, a clear understanding on a shared diagnosis of the conditions of the banks is required and agreement on the allocation of responsibilities in the resolution of the banks is critical." Still, the Fund's concerns related more to liquidity issues than to issues of bank solvency.

[5] The access of depositors at branches of the failed banks in other European Economic Area countries to the Icelandic deposit guarantee system was removed by the emergency Icelandic legislation restructuring the banking system. This decision was challenged unsuccessfully at the European Free Trade Association Court by the governments of the Netherlands and the United Kingdom. In the end, the deposit insurance funds of both those countries fully recovered from the estates of the failed banks the outlays they had made to depositors.

[6] Notably, under initial Central Bank of Iceland guidelines, "non-resident holders of ISK assets were blocked and could not be converted into other currencies or transferred abroad" (IMF, 2012b).

ad hoc restrictions that had been introduced by the central bank. The authorities encountered considerable political push-back to the idea. Nevertheless, they welcomed the prospect that maintaining the controls would prevent a further depreciation of the currency and thus help protect the balance sheets of households and businesses, many of whom were heavily indebted in foreign currency terms. In the documentation for the IMF SBA, the Fund staff presented the controls as a reasonable temporary response to a confidence shock, noting that "[e]ven if capital account restrictions are retained for now, the porosity of Iceland's financial and corporate sectors means that there is a notable risk of large capital outflows as current account transactions are gradually allowed back into the on-shore foreign exchange market."

17. Rather optimistically, the Letter of Intent (dated November 15, 2008) stated that the newly formalized exchange controls would be removed during the two-year program period.[7] This may help explain why funding in the program was so large: outflows did not turn out as high as they might have had the controls been removed. (The authorities requested and received approval for those parts of the controls that were incompatible with the Fund's Article VIII, Section 2(a) and undertook as a continuous performance criterion not to impose or intensify current restrictions or multiple currency practices.)

18. The 2008 control measures (together with a few days of currency intervention by the central bank) were insufficient to bring the ISK back even to the levels of September, let alone the much higher levels that had prevailed earlier in the year. A parallel offshore foreign exchange market quickly emerged on which the ISK traded for several years at a large discount (typically more than 50 percent, see Figure 1).

## B. Towards an Exit Tax

19. Soon (in October 2009), the Fund staff and the authorities agreed that a more gradual pace of capital account liberalization than initially envisaged was appropriate, reflecting the overhang of non-resident ISK holdings, estimated at some 40 percent of GDP, that might still flow out. Some loopholes in the initial controls enabled residents holding foreign exchange to use the offshore market to acquire ISK, and the Fund assisted in the authorities' steps to close these loopholes.[8]

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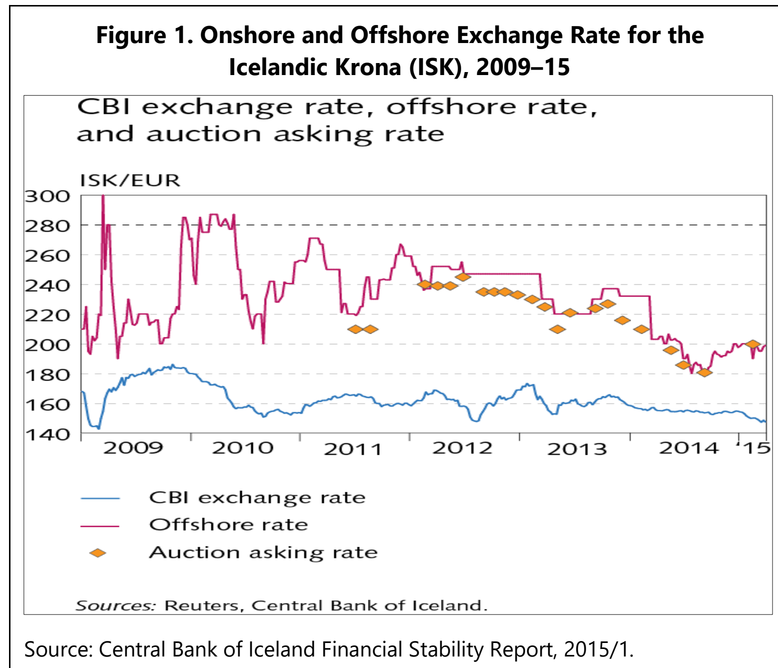
[7] Thomsen (2018) stresses that the Fund's endorsement of these capital controls was controversial among key shareholders who had to be convinced that Iceland "would be seen as an extreme outlier" and that endorsement "did not foreshadow their imminent imposition in other cases." Academics expressed a range of views as to whether the controls were necessary. Baldursson, Portes, and Thorlaksson (2017) state that "simply scrapping the capital controls after a short 'emergency' period was never a serious option." On the other hand, Danielsson and Arnason (2011) argue that "the imposition of capital control was both unnecessary and unjustified."

[8] Loophole-closing measures were adopted notably in October 2009 (IMF, 2012c; CBI *Financial Stability Report* 2010/11) and in May 2010. They included: ring-fencing of non-resident ISK holdings with foreign banks; stopping a practice whereby reversed purchases of big-ticket items abroad enabled residents to ship funds; eliminating multiple acquisitions of the foreign exchange travel allowance; prohibiting invoicing in ISK; and removing non-resident financial institutions' access to the equity market using offshore ISK.

**Figure 1. Onshore and Offshore Exchange Rate for the Icelandic Krona (ISK), 2009–15**




Source: Central Bank of Iceland Financial Stability Report, 2015/1.

20. In October 2010, the Fund staff emphasized in the Article IV report that "[u]ntil the stability of the financial system is secure, capital controls ...must be maintained." But there was still no suggestion anywhere of an expectation that the capital controls would trap a very large block of foreign-owned assets for almost a decade and then release them only after a haircut.

21. As time went on, though, it became clear the overhang of demand for foreign exchange blocked by the capital controls was big enough to require a long-term solution. Added to the pent-up demand by domestic investors to acquire foreign assets, there was an overhang of offshore holdings of ISK assets, reflecting pre-crisis inflows, as well as the claims of offshore creditors (especially a handful of U.S.-based investment funds) related to the failed banks.[9]

22. A conditions-based strategy, prepared with technical assistance from the Fund, for the progressive removal of controls was announced in August 2009 and substantially recast in March 2011 (IMF, 2012b; CBI, 2011).[10] Despite strong lobbying from some of the creditors for early liberalization, it was clear that the removal of controls must not be allowed to result in a new and macroeconomically destructive ratchetting down of the ISK. Besides, political resistance had emerged in Iceland to seeing foreign creditors paid in full. By 2011, the possibility of

[9] The term "offshore" in this context means assets held in custody of foreign financial institutions whether by residents or non-residents. In practice, most related to non-residents. It was arguably less discriminatory to focus on "offshore" rather than "non-resident."

[10] "Preconditions for removal of the controls included (i) government access to international capital markets; (ii) a strengthening of the banking sector; (iii) improved financial sector supervision; and (iv) a sufficient level of international reserves" (IMF SBA document, 2011).

employing an exit levy to be paid by holders of offshore ISK assets wishing to acquire foreign exchange was beginning to be mentioned (IMF 2011 SBA document; CBI, 2011).[11]

23. The scale of the "failed banks" issue had been masked by the complex holding company structures that the banks had been using, which made what were ultimately, in legal terms, assets in Iceland appear to be assets abroad. Some local experts saw as early as mid-2009 that exchange rate stability could be threatened when the creditors of the failed banks came to cash in whatever they could recover from these assets. But the issue was so complex that its scale does not seem to have been fully recognized before 2011. The general public became aware of it only in 2012 when the authorities moved to extend the capital controls regime to the foreign claims on the estates of the failed banks.

24. The Fund staff endorsed Iceland's gradual and cautious approach to liberalization as the years progressed. At least while enhanced surveillance continued into 2015, internal documents make clear that the staff were pressing the authorities not to move too fast. But this particular extension of the controls caused the Fund staff some concerns (IMF, 2012 Article IV Staff Report; Baldursson and others, 2017).

25. After five years during which liberalization of the capital controls was slow, the period 2014–17 saw much more rapid progress, with the authorities taking what the Fund staff described in retrospect as a "leap in the dark" to solve the overhang problem. The main issue was how to prevent the creditors of the estates of the failed banks from destabilizing the currency if the controls were removed. The bank liquidators had recovered substantial assets, many of which were in Iceland and denominated in ISK. Attempts by the creditors of the failed banks to cash in these assets would impact the value of the ISK; the authorities wanted to forestall such an outcome. There followed a complex sequence of legislation and negotiation between the Icelandic authorities and the creditors of the failed banks.

26. The Fund's observations, in Article IV documents for 2015, on the "renewed push towards liberalization in 2014" did not make clear the degree to which the staff endorsed the authorities' approach. The staff was largely hands-off on these matters, but clearly it remained a constructive and helpful source of advice to the authorities.

27. In the end, in order to access their trapped funds—and in the shadow of legislation announced in mid-2015 that threatened to impose a stability tax on the estates of the failed banks—the creditors agreed in 2015 to meet stability conditions set out by the Central Bank by making a very sizable "stability contribution" (amounting to 17 percent of GDP) as part of

[11] In contrast, the Financial Stability reports of the central bank continually emphasized that the debt overhang was a liquidity problem that could be solved by refinancing over a longer term.

composition agreements with the estates of the failed banks.[12] The Fund did not design this process—it was conscious of a duty of neutrality in such disputes—but it did not critique the homegrown solution that was adopted.[13]

28. From 2016, holders of other offshore ISK portfolio assets saw the proceeds of maturing bonds frozen in central bank of Iceland accounts carrying below-market interest rates. Unsurprisingly, these creditors lobbied strongly for their assets to be released. Since 2011, special auctions of foreign exchange had enabled holders of offshore ISK assets to convert some of their holdings into foreign exchange by selling them to domestic holders of foreign exchange committed to long-term investment; the special auctions entailed rates of exchange implying an exit tax relative to the exchange rate prevailing for uncontrolled transactions (Baldursson and others, 2017).[14] The authorities considered a variety of mechanisms to speed the working out of this overhang and they appreciated the comments of the Fund staff on the alternative plans. Ahead of the substantial liberalization measures that were adopted in March 2017, a final fixed-price auction at off-market prices in 2016 disposed of some more of these claims. Some holdouts remained subject to restriction until early 2019.

29. Despite its earlier words of caution, by 2017 the Fund staff noted in the Article IV report that "the recent lifting of capital controls seized an opportune moment."

## C. The Inflow Measure of 2016

30. As confidence returned, and with the exchange rate boosted further by a huge surge in tourism receipts, a capital inflow measure was introduced (from June 2016). The authorities had become concerned about easily reversible inflows driven by short-term speculation.[15] The measure was opposed by the Fund staff, with the 2018 Article IV report still devoting several paragraphs to this issue. Bearing in mind the IV's guidance that inflow controls were only

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[12] Roughly speaking, the creditors surrendered most of the ISK-denominated assets as the stability contribution and were then able to realize the remaining assets. The authorities' aim in this negotiation was to achieve finality on the matter, while meeting all international obligations, avoiding litigation, and ensuring that there would be no balance of payments effect from the liberalization.

[13] The matter can be seen as an instance of the international "transfer problem" studied by economists since the inter-war period. All in all, by avoiding a rush to the exit, Iceland's arrangement may have enabled the creditors (most of whom had acquired the assets at lower prices) to access FX assets on better terms than would have ensued if they had tried to sell ISK securities into a free market.

[14] Figure 1 shows how the auction prices for ISK tended to be somewhat more appreciated than the offshore exchange rate. The Fund did not view these auctions as a multiple currency practice under its Articles of Agreement. Its acceptance of the measures went a long way to ensuring that the OECD and the EEA authorities also treated Iceland as complying with the capital account requirements of those organizations. Nevertheless, national experts recall lengthy delays in getting Fund approval for some important loophole-closing measures; one case took two years.

[15] The measures involved an unremunerated 12-month "special" reserve requirement, initially set at 40 percent on most new foreign currency inflows to ISK bank deposits. From March 2019 the requirement ratio was set at zero, effectively eliminating the restriction.

appropriate in the face of a surge, and were not to be used preemptively to limit incipient inflows, it was seen by staff as relevant that Iceland's inflows in 2016 were rather small and certainly nowhere near what had been experienced before the crisis. Given that the measure was being introduced while outflow restrictions were still in place, it was arguable that Iceland should instead take advantage of the inflow to liberalize the outflows.

31. Today, the national authorities still regard the 2016 measure as having been effective in damping what could have become a serious obstacle to effective monetary restraint, and they arguably have a point in noting that it may be too late to introduce such restrictions when an inflow surge is fully under way.[16] Still, quite apart from matters of principle, the effectiveness of the measure to curb inflows can be questioned: in line with the experience of other countries, it did more to shift the composition of inflows into the—presumably safer—form of equity inflows than to reduce total capital inflows (Forbes, 2018),[17] though this interpretation does not go unchallenged.

## III. CYPRUS: POLICY EVOLUTION

### A. Banking Weaknesses

32. Severe balance sheet weaknesses in the Cypriot banking system were evident to the Fund staff in 2011 and became entangled with other pressures on the government's finances in the context of the fast-moving euro area crisis. The government began to encounter difficulties in market funding (and met some of its needs in 2011 by securing a bilateral loan from the Government of Russia). The combined difficulties, but especially the banking problems, led directly to the introduction in early 2013 of administrative controls on withdrawal of bank deposits and restrictions of international transfers, in the context of a Troika support package that drew on the Extended Arrangement under the Extended Fund Facility and the European Stability Mechanism (ESM). The sizable haircuts imposed on bank depositors—many of them non-residents—as part of the resolution of these banks were intimately entwined with the perceived need for capital flow measures as part of a package to stabilize the Cypriot economy. While depositor haircuts might trigger damaging outflows for fear they might be repeated, a steeper or earlier haircut could reduce the likelihood of a repeat being needed.

33. The two largest Cypriot banks, Bank of Cyprus and Laiki Bank, were struggling partly because of the sizable position that they had taken in Greek government debt not long before that debt was restructured in 2012. In addition, one of these banks was threatened by a large block of non-performing loans to the Greek private sector (including some associated with the Marfin Investment Group, a major shareholder of Laiki). Furthermore, the recession that took hold in 2012 exposed the poor underwriting of commercial and residential property loans in

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[16] The reserve requirement was eventually reduced to zero.

[17] Similar permanent inflow management measures which helped lengthen maturities contributed to financial stability in other countries (see Everaert and Genberg, 2020).

Cyprus which overhung the entire banking system, following huge inflows from abroad until 2011.[18]

34. The Fund staff recognized the nature and scale of the problem and judged that a full bailout of the bank creditors by the Cypriot government would not be fiscally sustainable, because of the relatively large size of the Cypriot banking system in the economy (bank balance sheets totaling eight times GDP). It responded to belated approaches from Cypriot and European Union authorities from the middle of 2012 and engaged with the European Commission and the European Central Bank (as the Troika) with a view to finding a solution. While discussions continued, growing public awareness of the scale of the banking problem led to an acceleration of bank outflows.

35. With an estimated capital shortfall in the banking system of 50 percent to 60 percent of GDP, it became clear during these discussions that the government could not simultaneously meet such a requirement and maintain a sustainable debt profile. Under the circumstances, the Fund staff strongly advocated the use of direct recapitalization of the failing Cypriot banks by the new ESM. Although the idea of empowering the ESM to make such investments had been under discussion in the European Union and had been approved in principle in the EU leaders' Summit in June 2011, the EU was not willing to activate this mechanism.[19] Note, however, that activating the mechanism would have reduced the need for bail-in only if the ESM were prepared to make an investment with the expectation of losing a sizable part of it.[20]

## B. Step-by-Step to a Program

36. Discussions between the parties were very protracted. This partly reflected different perspectives on the best way forward—participants recall that the staff of the European Commission and the European Central Bank were at first reluctant to endorse any bail-in of depositors—and partly a reluctance of the government to enter a program shortly before the elections that were scheduled for February 2013.[21] Contingency plans, including draft legislation to deal with a bank resolution, were prepared by the authorities in consultation with Troika staff. The idea of administrative controls to limit the outflow of banking funds was already being

[18] These inflows were associated with a current account deficit which peaked at 15 percent of GDP in 2008. From their peak in late 2008, real house prices had fallen by some 20 percent by mid-2012.

[19] EU legislation granting the European Stability Mechanism such powers has been in place since the end of 2014, but the powers have not yet been used.

[20] Still, an ESM capital injection sufficient to bring the restructured banks from zero to a capital adequacy ratio satisfying regulatory requirements would have reduced the scale of the needed haircut and avoided converting the uninsured depositors into shareholders of the restructured entity; it would have offered an adequate rate of return to the ESM's investment; and it would possibly have removed the need for administrative (including capital flow) measures.

[21] Michaelides (2014) and Orphanides (2014) are particularly critical of the delays in this period.

considered at this time, presenting unforeseen technical questions about the use of capital controls within a currency union.

37. Meanwhile, by mid-2012, the heavy withdrawals were making the Bank system ever more dependent on central bank financing; at the same time, the restructuring of Greek government debt and ratings downgrades eroded the two main banks' stock of collateral eligible for refinancing at the ECB. Furthermore, depletion of the two main banks' capital led to their losing the eligibility as counterparties in normal ECB refinancing operations. This meant that the run could now be fully financed only with the help of emergency liquidity assistance (ELA) from the Central Bank of Cyprus.[22] Under the prevailing circumstances, in practice this required a government guarantee to provide sufficient backing for the emergency lending. In that way the government's finances became further entangled in the bank failures even though the government had not given any guarantee to the depositors. The ELA that was provided—mainly to Laiki Bank which had lost one-third of its deposit base—came to about EUR 11 billion by early 2013.[23] The outflow of funds during this period escaped any haircut, ultimately leaving the remaining losses to be borne by the banks' remaining depositors, who suffered a worse haircut as a result.

38. The change of government following the election helped break the log-jam in discussions with official lenders.

## C. Bank Depositor Bail-in and Administrative Restrictions

39. Unable to secure a further loan from Russia, the new government had to face the fact that the Fund would be legally precluded from lending to a member whose debt situation was unsustainable. If direct bank recapitalization by the European Stability Mechanism was not on the cards, that meant bail-in. The government discussed with EU (and, to a lesser extent, IMF) officials various options for bailing in the creditors of the banks. Observing that large depositors had enjoyed high interest rates (4–5 percent per year) in the previous years, the new government felt that the fairest and most effective approach would be to apply a "horizontal" levy on the deposits at all banks in the system (including deposits below the guarantee ceiling of EUR 100,000). The government calculated that a levy of 6.75 percent for deposits of less than EUR 100,000, and 9.99 percent for larger deposits, would be sufficient to fill the hole. Fears about how large non-resident depositors would react to a haircut in excess of 10 percent may have contributed to this plan.

[22] Under Eurosystem procedures, ELA to a solvent but illiquid bank may be provided—at its own credit risk—by the national central bank unless the European Central Bank Governing Council objects.

[23] Much of the need for ELA in Laiki can be seen as resulting from the high loan-to-deposit ratio of the bank's Greek operations. These were previously run as a subsidiary, but became a branch of Laiki in early 2011, in a transaction that had the effect of greatly increasing the exposure of the Cyprus deposit guarantee system, inasmuch as Greek deposits previously covered by the Greek system would now be contingent liabilities of the Cyprus system.

40. Although the Fund made it clear that this was not its preferred approach, the plan was nevertheless endorsed in a late night Eurogroup meeting on March 16, breaking the deadlock that was threatening failure of the program negotiations.

41. A bank holiday was announced for all of the banks pending the introduction of the controversial "horizontal" depositor levy scheme. But the proposed scheme met with immediate and widespread criticism, both within Cyprus (especially from some banks that relied mainly on foreign deposits and that were not failing) and elsewhere (especially from parties who saw the proposed levy as undermining the credibility of the European deposit insurance regime in general (see Gulati and Bucheit, 2013; Wyplosz, 2013). Within days, the Parliament of Cyprus overwhelmingly rejected the proposal.

42. As a result, the "horizontal" approach, not distinguishing between failing banks and others, was quickly abandoned and replaced on March 25 by the resolution of the two largest commercial banks only. This was the approach that the Fund had advocated all along in case of bail-in. Insured deposits were now unaffected by levies, but large depositors suffered haircuts that were sizable enough to restore capital adequacy.[24] One of the two large failing banks (Laiki) was resolved immediately and its restructured liabilities transferred to the other (Bank of Cyprus).[25] Depositors received equity stakes in the restructured bank.

43. Although the haircuts were sizable, they applied only to large deposits.[26] As a result, the aggregate amount of the haircut came to 15 percent and 25 percent of the total deposits in each of the two banks, respectively. Of this, two-thirds belonged to non-residents. Thus, haircuts on

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[24] The treatment of large deposits differed between the two banks. Those in legacy Laiki remained in the entity to be liquidated; recovery of only 5–6 cents per euro was being projected in 2019. Those in Bank of Cyprus received an initial haircut of 37.5 percent, with a further 22.5 percent frozen pending further clarification of the bank's finances; about half of these deposits were later released, making the final BOC haircut 47.5 percent, for which the depositors received equity in the resolved bank.

[25] The three largest banks, including BOC and Laiki, sold the sizable assets and liabilities of their Greek branches, accounting for about a quarter of their balance sheets, to one of the largest Greek banks, Piraeus. Deposits in the Greek branches amounted to about EUR 15 billion (about 75 percent of Cyprus's GDP), of which only EUR 9 billion was insured by the Cypriot deposit insurance system. This transaction, which seems to have been developed by ECB staff and endorsed by Fund staff, was designed to ensure that the confidence of Greek depositors in Greek banks would not be damaged by a haircut being applied. It also served to protect the selling bank from Greek tail-risk. As is inevitable in such circumstances, the transaction was controversial in relation to the valuation of the assets. Although the acquiring bank Piraeus promptly recognized a valuation gain, reflecting the below-face-value price that it had paid, it subsequently had to take provisions against these assets. Even if the assets were fairly priced, though, it is worth noting that this transaction had the effect of protecting the large depositors in the Greek branches from haircut and of increasing the needed haircut on the remaining depositors. (Note that the European Court of Justice found in July 2018 that the sale of the Greek branches did not constitute an infringement of the right to property. See https://curia.europa.eu/jcms/upload/docs/application/pdf/2018-07/cp180108en.pdf). A somewhat similar ringfencing of the assets of the London branch of the failing Laiki was arranged by transferring its assets and liabilities to the London subsidiary of BOC.

[26] Unlike in the case of Greece, there was no restructuring of the sovereign debt of Cyprus.

Cypriot depositors amounted to about EUR 2 billion (a little more than 10 percent of GDP) spread over some 15,000 individuals and 4,000 corporates.[27]

44. Although the Fund staff would have preferred the Emergency Liquidity Assistance outstanding in Laiki Bank to be left as a claim of the Central Bank of Cyprus in the liquidation (and had argued for this in earlier discussions), this was not the solution adopted. Furthermore, the ELA was not haircut but was transferred to become a liability of the surviving large bank, Bank of Cyprus, after its restructuring. In that way the Central Bank was able over time to fully recover the amount that it had provided, thereby reducing the negative balance in its TARGET2 account vis-à-vis the remainder of the Eurosystem pro tanto. It was almost four years after the program before the ELA was finally cleared.

45. Even though no new funds were injected into BOC, the bail-in had, by reducing the bank's liabilities, the effect of recapitalizing this bank.[28] Although the de facto recapitalization might have been thought sufficient to restore confidence among the remaining depositors, there were lingering concerns that further measures would be needed to stop the drain of deposits. The Fund staff felt that, absent commitment from the ECB to a sufficient liquidity backstop, an acceleration of outflows to an extent that undermined bank liquidity should prompt the introduction of administrative controls on deposit withdrawals and capital movements.

46. During the bank holiday that followed the levy announcement, the skeletal contingency plans for administrative controls and bank resolution that the authorities had been sketching out in collaboration with Troika staff were rushed to completion. When the bank holiday ended, the banking system (apart from the bailed-in deposits) was reopened, but with ceilings imposed on cash withdrawals from all banks in Cyprus and on transfers both within and outside Cyprus. As the measures restricted certain current international payments, they were considered by the Fund as not only capital flow management measures but as exchange restrictions (under Article VIII, Section 2(a)) (Box 1).

**Box 1. Cyprus: Some of the Initial Restrictions Introduced in March 2013**

- Cash withdrawals from banks by individuals were limited to EUR 300 per day, per person, per credit institution.
- Export of bank notes abroad was limited to EUR 1,000 per person per journey.
- Payments abroad via cards were limited to EUR 5,000 per month. Otherwise, transfers abroad by individuals were subject to official approval.
- Individuals could make limited transfers to another domestic bank.
- Maturing time deposits were extended for one month.
- Ceilings for businesses were higher (initially EUR 5,000 per day, per account), and businesses (as well as individuals) could seek official approval for transfers above the ceilings.

[27] Depositors with loans were allowed to benefit from netting in the restructuring.

[28] Direct recapitalization (on a much smaller scale) was used for some smaller banks/credit cooperatives.

47. The decision to introduce such controls on the entire system was controversial. The Central Bank of Cyprus recommended instead that, to limit the damage to the economy as a whole, administrative controls should be limited to the creditors of the BOC, despite any additional stigma that would have attached to this bank in resolution (Demetriades, 2017). Indeed, had there been sufficient trust, outflows from Cyprus (whether to other parts of the Euro area or elsewhere) could easily have been financed by the Eurosystem and (unlike in Ukraine and Iceland) would not have resulted in an exchange rate collapse. Despite the administrative restrictions, total deposits fell by almost 20 percent in the first year of the program, most of the fall happening in the first six months.

48. Even though the European Central Bank could have risked financing what might have become substantial outflows following the program, this was not the course of action adopted. The government, supported by the European Commission, felt that confidence in banking as a whole, and not just in the two failing banks, had been shaken by the confusion surrounding the haircuts and that controls would have a stabilizing effect.[29] Furthermore, the government was unwilling to accumulate the further contingent liabilities that might have been involved if there were to be more ELA.

49. Neither in the imposition of administrative controls nor in the lack of direct recapitalization funding from the ESM was the Fund's preferred solution adopted, but, satisfied that the government of Cyprus was not bailing out the bank creditors and judging that there would not be an unsustainable debt overhang, the Fund acquiesced in the administrative controls.[30]

50. All of these measures were adopted, and the bank holiday ended, before staff-level negotiations for the Troika package were completed on April 2, 2013, though it was publicly understood that the measures formed part of the program package. The IMF staff report recommending the Extended Arrangement to the Executive Directors in May 2013 opined that "safeguarding financial stability required the introduction of capital controls and restrictions on deposit withdrawals." Nevertheless, the program included specific structural conditionality designed around an agreed roadmap to lift capital controls, with the government explicitly promising that "restrictions [would] be lifted as soon as funding conditions normalize."

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[29] Financing of outflows from the BOC would likely have implied more government-guaranteed ELA; the government was reluctant to increase its exposure under that heading.

[30] Unlike the previous Fund programs in response to the euro area crisis, which had involved "exceptional access," the IMF's funding of the Cyprus program was "normal access," implying a much smaller financial participation. At about EUR 1 billion, the Fund's share was about one-tenth of Cyprus's total program, compared with about a third in the cases of Greece, Ireland, and Portugal. Although, as always, the Fund insisted on debt sustainability in the program projections for Cyprus, it did not require this to be attested at the demanding "with high probability" standard it required for exceptional access.

## D. Liberalization

51. Soon, the restrictions began to be relaxed to avoid too harsh an impact on economic activity in Cyprus. In addition, most normal current payments above the unrestricted amounts were being permitted, and numerous exemptions were applied by the government. Progressively, as confidence returned, the controls continued to be liberalized, though they were not finally removed in full until two years after their introduction.

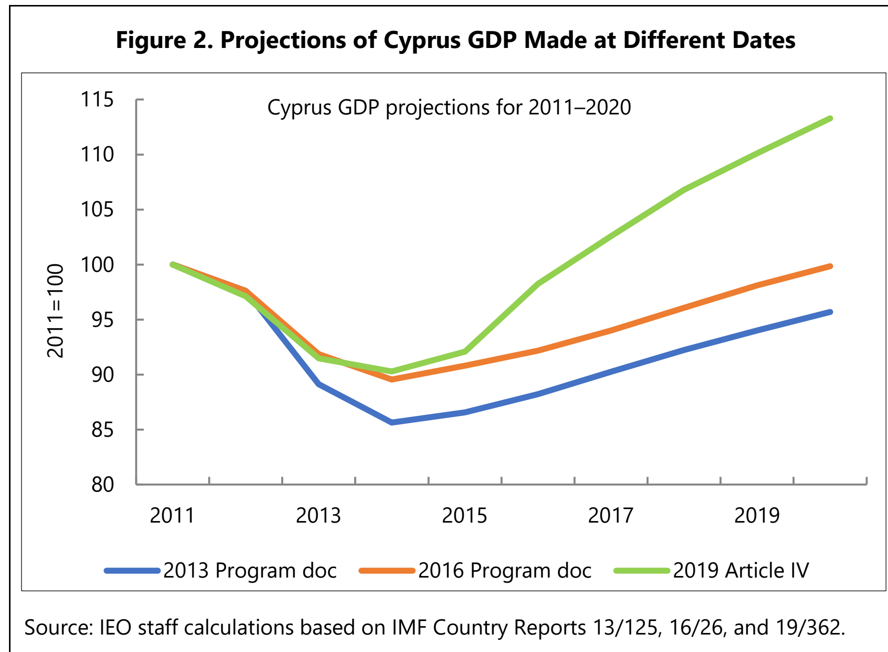
52. In the end, depositors were able to access their (post-haircut) funds in full and in un-depreciated currency. This contrasts with the situation in Iceland, and indeed in many other countries where capital controls have coincided with substantial currency depreciations so that holders of domestic assets have lost value during the period in which their funds have been trapped by the controls. Nevertheless, being without access to their funds will have been costly to some of Cyprus's depositors inasmuch as they were unable to completed desired transactions during the period of administrative restrictions.

53. The progressive easing of the restrictions was somewhat faster than, though otherwise generally in line with, initial ideas that had been prepared in collaboration with the Fund and the other lenders. The Fund continued to caution against excessive speed in the liberalization: this caution reflected persistent doubts into 2014 about the adequacy of the recapitalization of BOC. These concerns were, however, qualified by the Fund's desire to see the economy return to normal. Cypriot authorities recall that the final removal was enacted, ahead of schedule, at national initiative.

54. Many observers concurred with the Fund's initial expectation that the adverse psychological and confidence impact of the haircut, the fiscal adjustments, and the period of administrative restrictions would combine to produce a steep and long-lasting decline in economic activity in Cyprus ("Cyprus's output loss is expected to be larger than most except Greece over the long run" (IMF, 2013). In the event, however, the economy recovered more quickly than forecast (Figure 2).[31]

[31] The program documentation in early 2013 showed that the Fund staff's forecast for 2018 was for GDP to be 8 percent lower than in 2011, and the expectation was that GDP would not pass the 2011 mark until the mid-2020s. In reality GDP seems to have turned out at least 5 percent *higher* in 2018 than in 2011 (Figure 2).

**Figure 2. Projections of Cyprus GDP Made at Different Dates**




Source: IEO staff calculations based on IMF Country Reports 13/125, 16/26, and 19/362.

## E. Were the Controls Really Needed?

55. What was gained by the imposition of these systemwide bank restrictions and international payments controls? It is not unreasonable to ask this question given that, as mentioned, they did not stop the fall in deposits from domestic or foreign depositors. Besides, the bank insolvencies, which were the major driver of the loss of confidence to which policy was responding, were supposed to have been corrected by the bail-in. The main banks had been resolved, and their capital was supposed to have been restored to an adequate level.

56. If the recapitalization was not adequate to meet prospective losses—and there are indications of the Fund staff remaining concerned about this—it should have been.[32] Indeed, ensuring a solid underpinning for the recapitalization was the purpose of the conservative asset valuations that were carried out in early 2013 by international consultants PIMCO.

57. Recapitalization was not enough to restore depositor confidence fully. But outflows even at a much higher level than actually happened could have been financed by the ECB/Eurosystem without compromising euro area price stability. It is doubtful that there was much long-term benefit to retaining deposits purely by trapping them behind controls. ECB financing could have covered the gap. According to normal practice, though, ECB lending would have required

[32] The paragraph on risks in the Fund's program document for the 2013 Extended Arrangement stated: "Even though the banking system is expected to be adequately recapitalized, given the expected downturn, asset quality could deteriorate sharply… Liquidity and solvency problems could then reemerge and require additional actions." Internal documents suggest that such concerns persisted at the IMF well into 2014.

sufficient collateral to be presented; central banks rarely lend unsecured even to a bank they consider well capitalized.

58. The Fund staff repeatedly but unsuccessfully called on the ECB to provide explicit assurance of open-ended financing of the Cypriot banks as a buffer for the liberalization of controls. Absent such a commitment, market uncertainty remained as to whether adequate liquidity would be provided, whether by the national central bank, or the ECB.[33]

## IV. UKRAINE: POLICY EVOLUTION

59. The evolution of Ukraine's capital controls and the Fund's relationship with Ukraine on this and related matters over the past decade is complex and multi-phased. Broadly speaking, three phases can be identified. First is the collapse of Ukraine's banking system, whose weaknesses were acutely exposed by the global financial crisis in 2008–09. This led to a tightening of exchange controls. IMF programs were launched in 2008 and again in 2010 to support a recovery, but they lacked domestic ownership. Ukraine's monetary and foreign exchange policies were not kept on a sustainable and transparent path and, for this and other reasons, both programs soon went off track. Relations with the Fund were strained, with a lack of confidence about the authorities' administrative capacity and their policies. This was unsurprising, given the authorities' preference for a fixed exchange rate out of line with fundamentals, Central Bank funding of the public sector deficit, and unevenly enforced capital controls with some de facto discrimination against non-residents.

60. The second phase is the crisis of 2014–15. This period began with a political transition to a new administration that was determined to deliver market-oriented and "European" monetary and economic policies but was almost overwhelmed by the economic consequences of the Russia/Ukraine conflict, leading to a financial and balance of payments crisis. The IMF was called in again. The initial engagement was fraught, particularly when the security conditions deteriorated sharply, leading the authorities to introduce draconian and effective exchange controls in steps that had not been foreseen by the Fund staff. (The new controls were introduced suddenly in the interval between staff-level agreement and IMF Executive Board approval of a new program under the Extended Fund Facility.) Subsequently, however, relations between the Fund and the authorities improved significantly.

61. The third phase can be considered to have begun by 2016. Underpinned by the 2015 Extended Fund Facility Arrangement and a subsequent SBA, as well as a sovereign debt restructuring, it continues to the present. This phase has been marked by a constructive engagement, with the Fund staff helping to formulate a credible conditions-based road map towards full liberalization of the exchange controls and monetary policy now based on inflation

[33] At the time of the program negotiations, the European bank resolution legislation (Bank Recovery and Resolution Directive of May 2014) had not yet been formulated, nor had the Single Supervisory Mechanism been established. The resolution measures were adopted under Cypriot law and implemented by Cypriot authorities.

targeting rather than monetary programming or an exchange rate peg.[34] This third phase is generally recognized by all interlocutors to have involved a very productive collaboration between the Fund and authorities; it will not be further discussed in this study.

## A. Phase I

62. In Ukraine as in many other countries that were subsequently caught up in the global financial crisis, the years 2005–07 were marked by sizable capital inflows which fueled a rapid expansion in bank credit to households and enterprises. Continuing a pattern that had already become established, a high and increasing proportion of the lending was in foreign-exchange-denominated loans to unhedged borrowers, often to connected parties or otherwise poorly underwritten in a non-transparent manner. Much of the funding was sourced through wholesale foreign funding, including by foreign-owned banks which formed a growing share of the market. About a third of customer deposits were denominated in foreign currency. Average annual real credit growth in 2001–07 was about 40 percent, but foreign direct investment inflows were also strong. With soaring prices for its metals exports boosting government revenue (and expenditures), Ukraine recorded rapid GDP growth combined with double-digit inflation rates. Despite this febrile economic evolution, the authorities maintained the exchange rate close to USD1=UAH5 from the turn of the century.

63. The strong real exchange rate appreciation in this period could be partly explained by the structural transformation of the Ukrainian economy (Balassa-Samuelson effect). On the other hand, the capital inflows, which were encouraged by a tight interest rate policy ostensibly adopted for counter-inflationary purposes, also made it possible for the authorities to sustain the de facto nominal peg they had adopted. The Fund staff had been advocating a gradual move away from the peg towards a floating exchange rate anchored by inflation targeting.[35] This gradualist policy recommendation was, however, overtaken by events.

64. The crisis of 2008 was marked by two specific shocks to Ukraine. First, there was a sharp deterioration in the international terms of trade with the price of Ukraine's metals exports falling and the price for gas bought from Russia—previously well below the world price—increasing sharply. Second, the inflow of capital to banks suddenly stopped and was replaced by an outflow of funds, with a decline in aggregate bank deposits by about 20 percent between October 2008

[34] Per the National Bank of Ukraine–IMF liberalization roadmap, three overlapping stages of liberalization were proposed, beginning with the current account and foreign direct investment, followed by portfolio investment and the financial operations of corporations, and ending with individuals. Priority was given to measures that had lost effectiveness, and to those seen as most costly, non-transparent, and with adverse effects on confidence. Sequencing was arranged so that removal of one control did not undermine a remaining control. The main macro-financial conditions considered were related to reserve accumulation targets, price and foreign exchange market stability (the latter measured by an exchange market pressure index), and maintenance of financial stability.

[35] Though, according to the 2008 Article IV report, "The weight of evidence suggests that the exchange rate in 2007 was broadly consistent with fundamentals," the staff "emphasized that the situation could deteriorate" if the exchange rate remained unchanged.

and April 2009 and a shift from locally-owned to foreign-owned banks. CDS spreads on Ukrainian debt soared to 5000 basis points even though public sector gross debt was only about 10 percent of GDP. The long-standing exchange rate peg could no longer be sustained.

65. The key concern of the Ukrainian authorities in relation to the exchange rate was the impact that a large devaluation would have on unhedged borrowers of foreign exchange. The authorities promptly responded to this serious crisis with measures that included a tightening of exchange controls, including restrictions on early withdrawal (both by residents and non-residents) of time deposits; a ceiling on foreign exchange transfers abroad by individuals; prohibition of early repayment of FX loans by banks; a five-day delay on conversion of local currency receipts into FX; and a limitation on the spread between bid and ask exchange rates. Further measures were adopted over the following year or so (after approval of the Fund program), including a 13 percent import surcharge on a wide range of commodities.

66. The Fund staff did not support the introduction of these policies. It rightly pointed out (in the 2008 SBA document) that a comprehensive economic policy package would likely have a stronger effect on confidence—by avoiding a sharp overshoot of the exchange rate—than would the somewhat piecemeal capital flow restrictions adopted.[36] In fact, some of the measures were judged inconsistent with the Fund's Article VIII (such as the multiple currency practice of having an official rate deviating significantly from the market rate) and the authorities were required to withdraw them.

67. After the 2008 program went off track (for reasons unrelated to the controls), a new SBA was negotiated in early 2010. Many other first-order problems required action in order to help Ukraine recover from what became a severe recession (real GDP fell by 15 percent in 2009), including the resolution of failing banks and a correction of the fiscal imbalances to which the recapitalization of banks was contributing. But the Fund staff made the removal of many of the exchange controls a key part of the accompanying policy package under the general heading of "facilitating foreign exchange market operations." Indeed the controls, which were numerous and complex, were seen by the Fund staff as having distortionary effects on the economy.[37] One notable example was a requirement for banks to repatriate funds that they had previously been holding to hedge foreign exchange risks on their portfolio.[38] The restrictions are said to have been quite easy to circumvent, thus driving a wedge between law-abiding firms and the rest. De facto discrimination against foreign-owned banks in the auctions of foreign exchange was alleged.

[36] At the end of 2010, Standard and Poors' rating for Ukraine was still only B+.

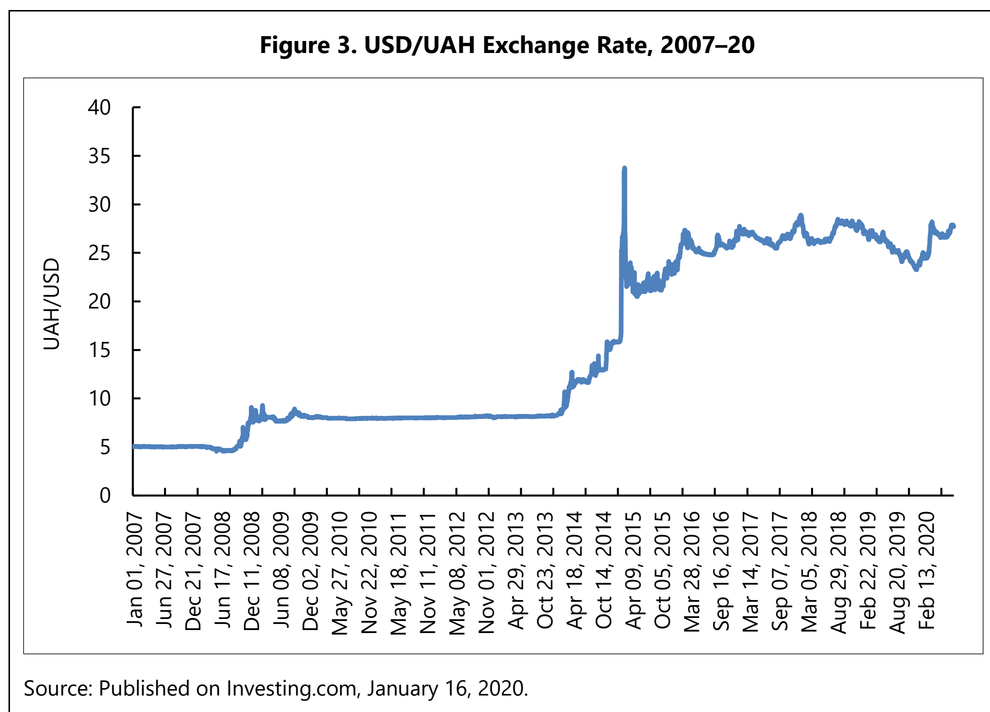
[37] The authorities' inclination to reach for controls as a first line of defense of exchange rate stability is illustrated by the *inflow* controls that they adopted during a period of returning confidence in 2011.

[38] This was the so-called "Section 109" issue, see IMF (2012c), Section VIII.

68. It should not be thought that the Fund staff was complacent in this phase (during which credit default swap spreads spiked to 1000 basis points) about the vulnerabilities of the Ukraine economy to a sudden stop. It was aware of the scale of gross external financing requirements, together with frail confidence in the domestic currency and weak institutions and policy credibility.

69. Though controls had not prevented an almost 40 percent devaluation in 2008, their intensification from late 2011, together with very high interest rates, may have helped the authorities in their effort to keep the new exchange rate close to USD1=UAH8 for almost five years between 2009 and 2013 (Figure 3). But if a cost of that was selective access to foreign exchange on an economically arbitrary basis, it was probably not a good bargain.[39] Fiscal dominance of monetary policy and wage increases meant that the exchange rate became increasingly overvalued; it was assessed by the Fund to be about 15 percent overvalued by late 2013. Despite the high interest rates, Ukraine's foreign exchange reserves were declining, with the prospect of a "first generation" currency crisis clearly present by then. The Fund did not support these controls, nor the goal of an exchange rate peg.

**Figure 3. USD/UAH Exchange Rate, 2007–20**




Source: Published on Investing.com, January 16, 2020.

[39] It would be hard to disagree with the conclusion of the Fund's ex post evaluation of the 2010 program, to the effect that operating the highly managed exchange rate regime for most of the past two decades included restrictions and regulatory constraints that introduced significant distortions; were not transparent; allowed for excessive discretion; and were difficult to reverse.

## B. Phase II

70. Indeed, in February 2014, in the midst of growing political uncertainty, the peg was abandoned, and the exchange rate quickly depreciated by about a third. However, worsening political and security factors dominated the economic situation over the following months, which saw a sharp rise in gas import prices, Russia's actions in Crimea, and secessionist movements in the East, the latter resulting in the loss of more than 20 percent of export revenues.

71. In the Memorandum of Economic and Financial Policies that it submitted with its request for a new Fund supported program in April 2014, the new government declared its intention to continue with the newly floating exchange rate and to start dismantling the exchange restrictions.

72. Already by August 2014, though, with escalation of conflict in the East, the need for a larger and longer program was evident. Negotiations on this were not completed until February 11, 2015. Before the agreed program could be submitted to the IMF Executive Board for its approval, the security situation took another downward plunge.

73. The first week of February 2015 saw a collapse in the exchange rate, with the hryvna falling from USD1=UAH16 to UAH24, later that month spiking down to UAH34 (see Figure 3). At this point, the Fund staff shared the authorities' view that the exchange rate had overshot. Nevertheless, the authorities' sudden decision to introduce draconian new exchange controls and other administrative restrictions (starting Monday, February 23), in what was described by *The Economist* that week as "a fruitless attempt to slow [the UAH] plunge" seems to have taken the staff by surprise.[40] The measure is not explicitly mentioned in the Fund staff report on Ukraine's request for a new arrangement under the Extended Fund Facility, which was finalized later that week; it was adopted several days after the Fund team had concluded its mission. Still, the staff came around to supporting the measure as necessary given the exchange rate overshoot, and issued a supplementary note to the Executive Board's consideration of the funding request. The staff agreed that, as a temporary response to Ukraine's tenuous financial situation, the measures were appropriate; it helped in their design, and judged that they were being implemented in a more transparent and evenhanded manner.

74. Belying *The Economist*'s pessimism, the exchange control measures of February 2015, along with other measures including a tighter monetary policy, helped the exchange rate bounce back, though only to levels never experienced before that month. The authorities now kept to their stated intention of allowing the exchange rate to float—which it has done, between about

[40] Though in previous months the staff had been providing advice on technical aspects of controls (including drawing on Iceland's experience with closing loopholes).

USD1=UAH20 and UAH29 in the five years since—with accumulation of foreign exchange reserves and a progressive and almost complete easing of exchange controls.

75. It might be considered somewhat ironic that, against the background of many years of the Fund urging the Ukrainian authorities to liberalize the foreign exchange market, the most conspicuous exchange policy measure in the decade being reviewed was the sharp tightening of controls in early 2015.[41] Unlike previous regimes, the new controls were more comprehensive and were enforced strictly. The widespread view that the introduction of the measures in 2015 was desirable—albeit as a last resort—reflects partly the severity of the crisis that Ukraine faced in 2014–15 and partly the fact that the exchange control measures were accompanied for the first time by persistent implementation of a coherent fiscal, monetary, energy price, and financial sector policy package by credible policy reformers.[42] Market participants also point to an increasing perception that tax evasion was being tackled and the rule of law being better observed, as contributing to stabilization.

76. By limiting the "race to the exit" by wealth holders, the 2015 controls helped to remove the extreme fluctuations of the exchange rate that would likely have caused losses to those exiting as well as exacerbating economic uncertainty more generally.[43] Whether, once confidence had sufficiently returned after the initial months, there was still much to be gained from maintaining the controls is not clear. The Fund staff was pleased to see exchange rate flexibility maintained as part of the overall package and satisfied with the conditions-based roadmap for the removal of the controls. The authorities sometimes found themselves more eager than the Fund staff to take some liberalizing steps, a situation echoed by soft language in the Fund's 2016 program review documents.

## V. THE IMF'S ADVICE

### A. Was the Fund in the Driving Seat?

77. Although IMF programs were involved in each case, the Fund was not the major contributor to the key decisions on timing, overall approach, and intensity of the capital flow measures that were introduced in the three countries. In Iceland the authorities, drawing on independent sources of advice, drove the initial emergency measures in 2008, though in this case the Fund quickly and strongly advised the refinement and formalization of the measures as a key

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[41] However, the context was quite different. In Phase I, the Fund had been cautioning against the use of controls to help support a de facto fixed exchange rate that, by 2013–14, was overvalued and causing larger macro imbalances. The use of controls in Phase II (in particular 2015) was to prevent exchange rate overshooting, to limit reserve losses when at critical levels, and to regain financial stability given deposit runs.

[42] The package included the long-advocated move to inflation targeting and a clear public statement by the—now independent—Central Bank (National Bank of Ukraine) on its foreign exchange intervention policy.

[43] A curious link between two of the countries discussed in this paper, Cyprus and Ukraine, lies in the fact that Cyprus is by far the largest single destination and source of Ukrainian foreign direct investment.

part of the stabilization program. In Cyprus, the need to reach compromise with the other Troika lending entities (EU Commission/European Stability Mechanism/European Central Bank) was a critical constraint, notably in the first abortive "horizontal" levy. In Ukraine, the draconian measures introduced in February 2015 came as a surprise to the Fund.

78. In all three cases, the design of the measures benefited significantly from important technical refinements stemming from Fund advice. The Fund staff was heavily involved in the design of capital account measures in all three countries, and then again was to the fore in helping design a roadmap for the progressive withdrawal of the measures. The staff was seen by the authorities in all three countries as a most useful sounding board and source of constructive advice on these matters.

79. When it came to liberalization, the national authorities remained largely in control of the timing, moving ahead of the Fund in Cyprus and Ukraine, and choosing a thoroughly homegrown approach to the package that allowed liberalization in Iceland.

80. The Fund staff did not neglect consideration of the alternatives to capital controls for moderating capital flows (e.g., monetary, fiscal, exchange rate, and macroprudential policies). While recognizing the need for controls to help stabilize the economy in the three key episodes, it also urged comprehensive policy reforms that would help make the progressive removal of capital controls possible and safe. Furthermore, it opposed controls where it felt other policies were preferable (for example, early on in the Ukraine case and the inflow measure in Iceland in 2016). Returning to a position of largely uncontrolled capital movements remained a goal throughout. Once it had endorsed the introduction of controls, though, the Fund staff tended to adopt a cautious, conditions-based, and phased approach to the process of liberalization—for example, pressing for sufficient foreign exchange reserve accumulation, fearing the disruption that might follow a premature liberalization that could unleash pent-up demand for foreign assets if investor confidence had not been sufficiently restored.

81. Possibly reflecting its long-standing lack of enthusiasm for capital account restrictions, the Fund was arguably somewhat slow to recognize the severity of the problems and the need for administrative measures to stem the outflows. Thus, even where it supported measures that were being introduced and reflected them in program design when providing financing, it had not fully recognized in advance that they would be necessary. This seems to have been the case in Iceland, recalling the experience with the Financial Sector Assessment Program just before the crisis broke, and in Ukraine, where the full extent of the security/geopolitical threat may not have been fully factored into the Fund's thinking in 2014.

82. In addition, some of the negotiations in which the Fund was involved were arguably concluded too slowly. In Iceland, the initial 2008 decisions were taken before the Fund was even invited (though in this case it was just a matter of days). In Ukraine, the 2014 negotiations took a long time, during which the situation deteriorated with outflows accelerating. In Cyprus, during the protracted pre-program discussions, both within the Troika and with the reluctant

government, the economy shrank and sizable outflows were financed by (partly government-

guaranteed) emergency liquidity assistance borrowings from the Central Bank of Cyprus, thereby shifting the burden from exiting depositors to the national budget and the remaining depositors.

## B. Clarity of Goals

83. It is not clear that the Fund always had a realistic and holistic view of the likely endgame with regard to capital controls in the different cases:

- In Ukraine in 2008–14, ineffective, leaky, and discriminatory controls operated against the background of incoherent monetary and fiscal policies and a de facto pegged exchange rate. They were opposed by the Fund, especially in the 2010 program, but both programs went off track. In contrast, more comprehensive and strictly enforced controls were endorsed by the Fund from 2015, taking into account the removal of the peg and the operation of more consistent macro policies. But were these controls really still needed after the first few months?

- The Iceland case was ultimately resolved with a substantial haircut on foreign claims. The Fund backed the controls from the outset, but there is no indication that the staff realized early on that, by trapping very large foreign holdings, the capital controls were creating the conditions which the authorities could, would, perhaps even should, subsequently exploit to leverage a haircut. Perhaps a quicker and cleaner solution to this overhang could have been found, had it been planned from the outset.

- In Cyprus, given the stance of the Troika partners, it was probably correct for the Fund to back a program that involved capital controls, but the fact remains that the program contained an unacknowledged inconsistency. If the bank recapitalization was sufficient, as it should have been, the European members of the Troika should have agreed with the Fund's hope that the ECB would finance further outflows while confidence was being restored, without the need for administrative controls. This would have been a more orderly way to limit the adverse effects on economic activity in Cyprus without material credit risk to the financiers.

## C. Usefulness of the Institutional View

84. The IV provided a framework but not a roadmap. Though it has no legal force, interviewees mentioned the IV as a constraint within which they operated, and did not point to it as a practical basis for choosing among available policy options.

85. When Iceland introduced inflow restrictions to stem incipient inflows in 2016, the Fund staff argued that the IV did not provide a justification for preemptive measures—a line of reasoning that did not resonate in a country whose 2008 crisis had been enabled by a lack of restraint on pre-crisis inflows.

86. In this application to Iceland's inflow measure, the IV has been employed as a narrow gate through which candidate restrictions must pass—capital flow management measures are a third line of defense to be employed only when other tools have failed. This is quite different from seeing such measures as a tool to be actively integrated with monetary, exchange rate, and macroprudential measures.

87. If the IV must thus be interpreted as indicating a lexicographical preference for other measures over capital controls, it will sit uneasily with advocates of a more integrated policy approach.

## D. Who Stands to Gain?

88. The public policy motivation for introducing controls on outflows of capital in a crisis of confidence is to protect macroeconomic and financial stability and to avoid, or at least limit, the downward spiral characteristic of financial crises that so often results in sharp output and employment losses and arbitrary changes in asset prices contributing to a balance sheet recession.

89. If the rush of creditors to the exits is unjustified by fundamentals, capital controls can save the economy from reaching a bad equilibrium, thereby protecting the fugitives from the adverse collective effect of their own actions. This seems to have been the case in Ukraine in February 2015.

90. But there may be other available policy adjustments that can restore investor confidence just as effectively and without the damaging side effects of a prolonged period of controls. Credible implementation of a coherent macro policy package in Ukraine in 2008–14, with a realistic degree of exchange rate flexibility, would have been much more effective than the policy mix that was actually adopted, as was seen in subsequent years.

91. If the loss of investor confidence is justified, and the causes not easily remedied, then capital controls may be just the prelude to some form of levy (as proved to be the case in Iceland); in this case early introduction of the controls can help spread the losses more widely by including parties who would have exited early. In Cyprus, failure to introduce controls in 2012 increased the percentage haircut on depositors who had remained loyal to their banks until the measures of March 2013.

92. The precise scope and operation of administrative controls can also result in arbitrary gains and losses and create scope for corruption. Assessing the extent to which this has happened during the operation of the cases under review is beyond the scope of this study. It is acknowledged by all respondents, however, that the Fund's technical advice helped considerably in closing loopholes that could potentially have been abused.

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