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ADVICE TO EMERGING MARKET ECONOMIES[13]

CONTEXT

The policy responses to capital flow volatility after the adoption of UMP differed significantly across EMs. Among our case studies, Brazil, China, and India were active users of CFMs and intervened extensively in FX markets; Korea and the ASEAN countries relied heavily on MPPs together with intervention; Mexico and South Africa relied largely on exchange rate flexibility and avoided CFMs; and Turkey adopted a heterodox monetary policy framework. A few countries considered applying for the FCL to bolster international reserves and shield themselves further from liquidity shocks, but only Mexico (from the set of EM case studies included in this evaluation) ended up obtaining approval for the FCL.

Brazil, China, and India employed a variety of measures to deal with the effects of capital flow volatility on exchange rates and domestic financial conditions. These countries were also vocal in raising concerns about spillovers from UMP, particularly QE in the United States from 2010 on.

- Brazil reintroduced a tax on foreign financial investments in October 2009, which was increased and broadened in coverage as inflows remained strong following the Fed's launch of QE2. It also used both spot and forward intervention to combat large real exchange rate swings and MPPs—including differential capital requirements and regulations on maturity and LTV ratios—to curb credit growth.

- When China experienced large capital inflows over 2009–13, the authorities were more accepting of "leakages," while keeping formal restrictions on outflows and intervening to dampen renminbi appreciation. After the "taper tantrum" and in the context of volatile market conditions in 2015, when concerns pivoted to capital outflows, China reinforced existing CFMs and imposed some additional measures—such as rules concerning cash withdrawal by Chinese citizens and a 20 percent unremunerated reserve requirement on forward FX sales—while using accumulated reserves to lean against FX market pressures.

- When capital inflows surged in 2009, India turned to FX intervention and selective CFMs to manage capital flow volatility. Once the situation stabilized, the central bank took a hands-off approach to intervention and liberalized restrictions on foreign portfolio investment. In 2013, however, after the "taper tantrum," it again resorted to CFMs—including less orthodox steps like subsidized FX swaps to attract non-resident inflows—in addition to orthodox adjustment measures like monetary tightening and fiscal adjustment.

A distinctive part of the policy response in Korea and the ASEAN5 over the 2010–13 period was the extensive use of MPPs alongside CFMs, building on experience in using such policies in the previous decade. MPPs included caps on LTV ratios for real estate lending, which were

[13] This chapter draws on Mohan (2019), Darius and Loungani (2019), Borensztein (2019), Darius (2019), and Kalemli-Ozcan (2019).

actively used by several of these economies faced with overheating housing markets. CFMs included minimum holding periods for central bank bills and withholding taxes for nonresident investors. After the "taper tantrum" in 2013, many of these countries used MPPs to counter the threat of outflows. Since 2013, the challenge has again been mainly to deal with inflows, though volumes have generally receded and some countries have gone through periods of outflows in the context of spikes in global risk aversion.

Mexico and South Africa relied on exchange rate adjustment with limited FX intervention. The Mexican peso was largely freely floating at the start of the GFC, though the central bank implemented different mechanisms of FX intervention until early 2016. Outside of this rule (and another relating to auctioning of oil company revenues), Mexico did not intervene, though it built up liquidity buffers through the FCL. In South Africa, appreciation of the rand in 2010 following a surge in inflows prompted opportunistic FX purchases to increase official reserves, but the intervention was less aggressive than in other EMs. By the time of the "taper tantrum," capital flows had reversed and the authorities allowed the rand to depreciate.

Turkey used a heterodox monetary policy framework from 2010 to mid-2018 to manage financial stability risks and maintain price stability. The framework combined MPPs such as differentiated reserve requirement and a reserve options mechanism (giving banks the incentive to alter the currency composition of their reserves in line with changes in the costs of borrowing in foreign currency) with an asymmetric interest rate corridor. The Turkish approach was aimed at allowing monetary policy to be set in a way consistent with growth objectives while containing inflation and limiting FX market pressure. In mid-2018, the central bank returned to a more orthodox approach in the face of sustained market pressures.

IMF ADVICE

Following the GFC, the IMF was increasingly open to the use of CFMs by countries in the face of volatile capital flows. Even before the adoption of the IV, staff were sympathetic to the use of temporary CFMs in the face of the significant volatility in cross-border flows, more so than before the GFC.[14] After the IV was approved, Fund staff were more systematic in discussing the role of CFMs, including in countries that preferred not to use such policy instruments.

- The Fund largely approved of Brazil's proactive and heterodox actions, albeit expressing concerns that measures could eventually become ineffective or risky. At the same time, Fund staff cautioned against heavy use of intervention, pointing to potential losses by the central bank. When Brazil started to intervene heavily in forward markets, staff analysis concluded that intervention in derivative markets was indeed effective in affecting the spot rate.
- In India, when capital inflows surged in 2009, IMF staff stressed that rupee appreciation should be the first response to capital inflows, but in 2010 recognized that intervention and some CFMs also could be helpful, albeit as "last resort" tools. In 2013, when India took less orthodox steps in response to concerns about net outflows, the IMF did not object, although it did not provide a public statement of support for the measures taken until the 2014 Article IV by when the situation had already turned for the better (IMF, 2014a).

The Fund supported the active use of MPPs by several Asian economies after the GFC, but recently has been less welcoming of some measures labeled as CFMs. For instance, in 2012–13 staff supported the introduction of stricter prudential controls in Indonesia, Korea, and Malaysia. They also noted that real estate prices had stabilized due to the authorities' effective MPPs. Staff also highlighted the success of LTV limits in the Philippines. However, the Fund was less supportive of some measures taken recently—such as measures to encourage the on-shore

[14] Prior to the GFC, the Fund generally encouraged capital account liberalization, albeit typically in a pragmatic, sequenced approach, and warned against CFMs as being distorting and only temporarily effective (IEO, 2015).

ringgit market in Malaysia and FX hedging requirements in Indonesia—which were labeled as CFMs.

The IMF supported the decision by the Mexican and South African authorities to use flexible exchange rates as the main policy lever. Staff agreed with the authorities that the role for CFMs was quite limited, in view of the commitment to already open capital markets. The Fund consistently supported the flexible exchange rate regime as an important shock absorber in dealing with capital flow volatility. The provision of the FCL to Mexico in 2009 and its subsequent multiple extensions reflected the IMF's confidence in Mexico's policy framework. In the case of South Africa, the Fund consistently urged the authorities to increase the level of international reserves, which were below the optimal level based on the IMF's reserve adequacy metrics and the levels held by peer EM economies. Staff suggested that reserve accumulation could be achieved through opportunistic FX purchases at times of large capital inflows and, as done by Mexico and Turkey, through preannounced small regular FX purchases that would not interfere with the floating exchange rate regime.

For China, IMF advice was framed in the context of the country's longer-term strategic commitment to a more market-determined exchange rate, more open capital markets, and deeper domestic financial markets. The Fund was quite intensively engaged in helping China's authorities advance towards these goals—particularly in the period leading up to inclusion of the renminbi in the Special Drawing Right (SDR) basket in 2015—while also responding to the short-term pressures created by swings in capital flows. IMF contributions included specific advice on designing monetary policy approaches as domestic markets deepened, and on developing deeper and more sophisticated FX and money markets. Support was provided through numerous channels including the resident representative office, technical assistance, and the convening of an annual research seminar together with the People's Bank of China (PBoC), as well as the regular Article IV consultations.

The IMF initially provided cautious support for Turkey's heterodox framework but became more critical when inflation and current account outcomes proved to be unsatisfactory. Staff initially characterized the heterodox framework as "innovative" and noted that it has been taken in the face of "unprecedented monetary easing in advanced economies." Subsequently, with continued pressures on inflation, rapid credit growth, and a large current account deficit, Fund staff started to modulate their position and urged in 2012 that "these new measures should be continuously reassessed in light of experience" and that "a return to a more conventional framework would be required should the inflation target remain elusive or inflation expectations stay high." Over time, staff became more forceful in advocating a change in policies, noting that the inflation target of 5 percent had not been met and urging a more conventional approach to manage inflation expectations.

ASSESSMENT

Article IV consultations are generally regarded by officials as a useful source of advice on monetary policy and dealing with capital flows. Authorities in all EM countries studied here valued the Article IV consultations as a regular and thorough discussion of their choices across a wide spectrum of policies with a trusted partner. There were virtually no instances where authorities felt they had received wrong advice from the Fund on a major issue over the past decade.

That said, IMF advice could be enriched by greater depth in discussions of monetary policy issues and greater focus on relevant cross-country experience.

First, the Fund provided most value to central banks when its advice was based on deep expertise. Examples where the Fund had been particularly helpful were the technical assistance provided to India on macro-modeling prior to the introduction of inflation targeting and the extensive technical support for China's financial and exchange market reforms. More generally, however, there was a sense that the Fund staff has been more comfortable with high-level conversations than with operational guidance or in-depth discussions on specific issues. In both Brazil and Mexico, for instance, the view expressed was that staff advice, although sound on general economic grounds, did not bring much insight into market dynamics or offer practical guidance on the implementation of FX intervention. Similarly, in India, it was felt that Fund advice on monetary issues was somewhat "formulaic" rather than helpful in advising on, say, CFMs that would work at a particular moment. In the case of Turkey, officials felt that they could have received more technical advice from the

Fund in developing their heterodox policy framework. As with the smaller AE central banks, many senior officials said that they relied more on counterparts in other central banks (particularly in regional networks) or at the BIS, which was seen as being more pragmatic and having greater depth of monetary expertise.

Second, the authorities would appreciate greater discussion of global developments and of cross-country experience relevant to their policy choices. The joint IMF-PBoC annual conferences were seen as an effective avenue through which such discussions were facilitated in the case of China and were regarded as a good use of the IMF's convening power to share cross-country experiences. An initiative by the South Africa mission chief to organize meetings of EM officials and IMF mission chiefs on the margins of the Bank-Fund meetings was also mentioned as an example of good practice.

The development of the IV on Capital Flows was welcomed by most officials as a sign of the Fund's willingness to depart from "orthodoxy." Officials were generally pleased with the Fund's willingness to be more open to the use of CFMs. Although the shift had materialized only after many of the countries had introduced such policies, officials were pleased that the Fund had shown support for some of the measures they had been using. The work on MPPs, both conceptual and the compilation of cross-country experience, was particularly appreciated.

However, the application of the IV has not turned out to virtually any country's full satisfaction. At one end of the spectrum of views, Mexican officials were concerned that the IV could be read as an "open blessing" to CFMs, even though the formulation of the IV is careful about accompanying policies and circumstances that warrant the use of capital controls. At the other end, ASEAN officials felt that the restrictions placed on the use of CFMs were so limiting that it did not really expand the choice set of policies that could be used by countries with the Fund's blessing. They would prefer an approach that recognized that CFMs could play a role pre-emptively as part of a broad toolkit of measures, not just as last in a hierarchy of policies (ASEAN, 2018). There was also a concern expressed quite broadly, echoing officials in the smaller AEs, that the IV was applied too rigidly by the Fund, with insufficient flexibility to respond to country circumstances. There was also a concern expressed by Indian officials that the IMF was still too cautious in publicly endorsing innovative measures that deviated from orthodoxy.