



# ISSUES IN BRIEF

## The IMF's New View on Financial Globalization: A Critical Assessment



**Kevin P. Gallagher** is Associate Professor of International Relations at Boston University and director of the Global Economic Governance Initiative at BU's Pardee Center, where he co-chairs the Pardee Center Task Force on Regulating Global Capital Flows. He is also coordinator of BU's Global Development Policy Program. His research and writing focuses on the developmental impacts of trade and investment. The analysis in this brief is his own and does not necessarily reflect the views of other members of the Pardee Center Task Force.

### Kevin P. Gallagher

After two years of research, rethinking, and debate, the International Monetary Fund (IMF) has endorsed a new "institutional view" on capital account liberalization and the management of capital flows. This new view, which received an IMF Executive board-level endorsement, will give official guidance to IMF surveillance and reporting efforts.

In 2011 the Pardee Center Task Force on Regulating Global Capital flows recommended that the goal for emerging market and developing nations should be to ensure that surges and sudden stops of external capital flows do not jeopardize national development priorities. Therefore, the Task Force noted, nations should have the policy space to deploy a package of measures that mitigates the risks and optimizes the benefits of external capital flows in a counter-cyclical manner. To that end, the Task Force recommended a set of "rules of thumb" for nations seeking to regulate capital flows for long-run development (see Box 2).

The IMF's new view is a major step forward for an institution that once advocated mandatory capital account liberalization worldwide, thanks in large part to the insistence of emerging market and developing country IMF members and some innovative economists within the Fund. However, those voices did not totally prevail and taken as a whole, the new view is still out of step with country experience and current economic thinking in important respects. The major steps forward are:

- The IMF now recognizes that capital flows carry risks and that the liberalization of capital flows before nations reach a certain threshold of financial and institutional development can accentuate those risks.
- The IMF now acknowledges that under certain circumstances, cross-border capital flows should be regulated to avoid the worst effects of capital flow surges and sudden stops.
- The IMF rightly says that nations that are the source of excessive capital flows should pay more attention to the potentially negative spillover effects of their macroeconomic policies.
- The IMF boldly notes that its new view on capital flow management may be at odds with other international commitments, such as in trade and investment treaties, that restrict the ability to regulate cross-border finance.

However, the IMF's view on these matters suffers from at least five shortcomings that will be discussed in greater detail in this policy brief:

- Despite econometric evidence and country experience to the contrary, the IMF still sees capital account liberalization as the end goal for macro economic policy.
- The conditions under which the IMF approves the regulations on capital flows are overly narrow and not consistent with economic theory, analysis and country experience.
- The IMF still puts the majority of the burden on emerging market and developing countries, and does not balance such an approach with solid analysis and recommendations regarding how source countries should regulate capital flows.
- The IMF pays little attention as to how nations should design, monitor, and enforce capital account regulations.
- The IMF view gives little guidance regarding how nations should cooperate on regulating capital flows or how nations should respond to the conflicting sets of recommendations and rules they receive from the IMF versus other international commitments.

This brief will discuss the main features of the new IMF view on capital flows and expand on some of the shortcomings identified above.

## The IMFs 'New' View on Capital Flows

In the 1990s the IMF embarked on an initiative to provide an explicit mandate for capital account liberalization and to gain jurisdiction over members' capital account policies. What a difference a few crises makes. In December of 2012, the IMF released an Executive-board endorsed new 'institutional view' on the management of cross-border financial flows (IMF 2012b). The new view on capital flows is part of a broader set of changes that the IMF has put forth on macroeconomic policy in the wake of the financial crisis (Grabel 2011).

The IMF remains wedded to the eventual liberalization of a country's capital account, but it now recognizes that the idea of free transfers of investments rests on much weaker ground than does the case for free trade. The IMF now sees that nations need to cross a certain institutional threshold first, one that many emerging market and developing countries have not yet reached. What is more, the IMF now acknowledges that there are risks as well as benefits to cross-border financial flows. Capital flows are particularly prone to sharp inflow surges followed by sudden stops that can cause a great deal of financial instability. The new IMF view says nations could even use 'capital controls,' reframed as "Capital Flow Management Measures (CFMs)," on previously deregulated portions of their capital account if done alongside other macroeconomic policies such as: interest rate and fiscal policy management, the accumulation of foreign exchange reserves, and macro-prudential financial regulations. Even under such circumstances, capital controls should generally not discriminate on the basis of currency<sup>1</sup>.

The IMF reiterates its support of capital account liberalization as a long-run goal, but qualifies that support. The IMF now states that capital account liberalization is only optimal after a nation has reached a certain threshold of financial and economic development and that liberalization should be sequenced, gradual, and not the same for all countries at all times. Indeed, it offers a sequenced, stepwise process for the liberalization of capital flows for its members.

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<sup>1</sup> Measures have been called a variety of terms (see Epstein et al 2008). "Capital controls" "capital flow management measures (CFMs)" "capital account regulations (CARs)" and "capital management techniques (CMTs)" are used interchangeably throughout this brief.

IMF's view is that capital controls can be part of the liberalization and sequencing. The IMF's guidelines on inflows recommend that countries deploy capital controls only as a last resort — that is, after such measures as building up reserves, letting currencies appreciate, and cutting budget deficits. The Fund recommends that controls not be discriminatory among residents. And it also recommends guidelines for the use of controls on capital outflows, arguing that by and large they should not be used but can be considered in crisis or near crisis conditions (IMF 2012a, b).

This new IMF is not brand new however. It elevates and clarifies the general view held since the early 2000s. In 2005 the IMF's Independent Evaluation Office (IEO) conducted an assessment of the IMF's views on capital account liberalization which concluded that the IMF “takes a more consistently cautious and nuanced approach to encouraging capital account convertibility; and acknowledges the usefulness of capital controls under certain conditions, particularly controls on inflows.” (IEO 2005, 7).

In general then, the IMF's institutional view is only incrementally different from the view identified by the 2005 IEO report, but the new view goes into much greater detail about the nature of capital account liberalization and the specific conditions for the use of capital controls (or CFMs). And, while incremental, the substantive changes break significant ground. In particular the IMF view has significantly broadened with respect to the multi-lateral aspects of regulating financial flows—recognizing the role of source country spillovers and the lack of consistency between the guidelines and trade and investment treaties.

## Shortcomings of the IMF View

The IMF's new view is a significant step in the right direction, but it is still out of step with country experience and economic thinking in many respects. In general, the IMF view continues to insist on eventual capital market liberalization despite the lack of evidence supporting it, is too narrow concerning the sanctioned use of CFMs on inflows and outflows, and misses some of the logic in the new economics of capital controls with respect to the multi-lateral aspects of regulating cross-border finance.

Box 1 outlines the main shortcomings of the IMF's institutional view on regulating capital flows. The IMF continues to advocate for the eventual liberalization of the capital account despite the fact that the literature overwhelmingly finds no strong correlation between capital account liberalization, growth, and financial stability — especially in EMDs. Indeed, former IMF economists Olivier Jeanne and Arvind Subramanian have recently conducted a “meta-regression” on the literature and conclude that “the international community should not seek to promote totally free trade in assets — even over the long run — because (as we show in this book) free capital mobility seems to have little benefit in terms of long-run growth and because there is a good case to be made for prudential and non-distortive capital controls” (Jeanne et al. 2012, 5).

The IMF view of managing inflows of capital is also limited. The IMF view stresses that priority should be given to letting the exchange rate appreciate, to accumulating reserves, and to tightening fiscal policy in order to reduce the amount of capital flowing into an emerging market, and that CFMs could be used as a complement to or after such efforts. There is no substantive economic basis for this claim. New research in economic theory shows that capital controls can be the optimal policy for internalizing the externalities associated with risky capital flows (Korinek 2011). Second, econometric analysis by the IMF, NBER and others have all shown that capital account regulations have been effective in meeting many of their stated goals. Indeed, the IMF's own research showed that those nations that deployed controls were among the least hard hit by the global financial crisis; these studies did not differentiate the

## Box 1: The IMF's "Institutional View" on Capital Flows: A Critical Analysis

### Capital Account Liberalization

- IMF continues to recommend capital market liberalization (CML) even though the literature continues to show no clear evidence that CML is correlated with growth in emerging market and developing countries

### Managing Capital Inflows

- IMF's tentative endorsement of capital controls after other measures rests on weak and contradictory economic evidence. Aspects that the IMF fails to address include:
  - CFMs may be necessary for exchange rate management
  - Very difficult to calculate under/overvaluation
  - Reserve accumulation may be costly and difficult
  - Fiscal tightening subjects domestic policy to global finance
  - Paradox of good fundamentals
- CARs (or CFMs) need to be permanent features of a counter-cyclical stability policy, and may be necessary for exchange rate management and growth policy.

### Managing Capital Outflows

- Outflow measures may be necessary for source countries to cooperate on both ends of the problem.
- Outflow measures can often deter inflows.
- CARs on outflows may need to be part of counter-cyclical financial policy.
- May be used for exchange rate management and growth tool.

### Multi-lateral Aspects

- Need to be more specific on those measures that source countries should deploy for global management of capital flows.
- Trade and investment treaties make it difficult for nations to regulate capital flows at either end (i.e., inflows or outflow).
- Economics of spillovers from CARs on inflows need further thinking and testing.
- Forum for international cooperation is needed.

sequence of use for different measures nor did they distinguish whether such measures were market-based and temporary (see Magud et al. 2011, Ostry et al. 2010).

Regulating capital flows can be an alternative to reserve accumulation. Accumulating reserves can be costly to emerging market and developing countries in terms of the opportunity cost of investment and sterilization, and some Central Banks may not always have the capacity to sterilize without adverse effects (Gallagher and Shrestha 2012; Rodrik 2008; Aizenman 2013). Moreover, the accumulation of reserves by developing countries also resulted in global costs in the form the global imbalances that played a role in the global financial crisis (Eichengreen 2007).

Tightening fiscal policy also may not be optimal or doable in the short-term and capital account regulations can buy time for such an adjustment. First, it has been argued that it is undemocratic for fiscal policy to be managed for the benefit of global investors over local needs. Second, and more pragmatically, adjustments to fiscal policy are often long, drawn out processes that require legislation (see the U.S. debates in 2011 and 2012 for instance). The fiscal balance cannot be changed overnight but a Central Bank or Finance Ministry can indeed put in CARs overnight to either buy time for (or put up with) a slow moving fiscal cycle.

Finally, it is not always clear that a nation should wait for the exchange rate to float to a certain level before utilizing CARs. As Gabor (2011) points out, exchange rate over/under valuation is fairly difficult to adequately measure, especially *ex-ante*. Also, it should be

recognized that some nations see a need for a competitive exchange rate as part of an export-led development strategy (Rapetti et al. 2012; Rodrik 2008).

The IMF's stress that such measures be temporary and not discriminatory also misses some of the point. In order for CARs to be part of a counter-cyclical macroeconomic policy, a nation has to have permanent authority to use measures as inflows and outflows occur. And by their very nature, CARs are discriminatory among residents and non-residents. The IMF's recommendations thus counter their own findings about the kinds of measures that worked. In econometric analyses that show a significant impact of capital controls on limiting exchange rate volatility, changing the composition of inflows, and allowing monetary policy to be more autonomous, there is no such hierarchy of when a nation uses controls, what form they took, and how long they lasted.

On outflows the IMF ignores its own research that shows measures on capital outflows can be useful in preventing excessive inflows of capital. In addition, many countries in transition to more openness or in the process of development may need to deploy measures to curtail outflows in order to steer credit toward productive development (Epstein 2012; Lewis 1954, Ocampo 2012). Instead, the IMF only sanctions measures on outflows in the middle of a financial crisis. Focus on outflows is particularly important for the poorest countries. Least developed countries often do not experience massive inflow surges but do experience massive outflows (UNCTAD 2012).

The IMF's concern about the spillover effects of the prudential use of capital controls is unfounded. Korinek (2012) has shown that regulating capital flows in an efficient manner may cause increases or decreases of capital in neighboring countries that may not necessarily be "negative" spillovers in the economic sense. By design, an optimal tax on inflows lowers demand for inflows and thus interest rates may drop and cause more inflows in neighboring countries. This is the invisible hand at work. Those inflows to neighboring countries may not be negative—it really depends on the stock and composition of investment, the deepness of its capital markets, its current account balance, and its level of regulation. And, even if a nation chooses not to put in place regulations, the cost of a negative spillover may be far outweighed by the benefit of not being the recipient of contagion in the form of crisis.

The IMF is right to point out that source country policies "have likely affected the volume and volatility of capital flows to both advanced and emerging market economies" (IMF 2012b, 22). However, the IMF view lacks the level of specificity and scrutiny to source country policies as there is for emerging markets in the new view. Whereas the new view scrutinizes the exact types of capital account regulations in emerging markets, it does not equally examine which types of monetary and regulatory policy trigger the most risky capital flows from developed to developing countries.

The IMF is aware of the fact that it may recommend capital controls to nations that do not have the policy space to deploy CFMs because they would be deemed actionable under a trade agreement or investment treaty. The IMF final report says:

*"As noted, the Fund's proposed institutional view would not (and legally could not) alter members' rights and obligations under other international agreements. Rather, conformity with obligations under other agreements would continue to be determined solely by the existing provisions of those agreements. Thus, for example, even where the proposed Fund institutional view recognizes the use of inflow or outflow CFMs as an appropriate policy response, these measures could still violate a member's obligations under other international agreements if those agreements do not have temporary safeguard provisions compatible with the Fund's approach (IMF, 2012b, 42)."*

The Pardee Center Task Force convened a "compatibility review" between capital account regulations and the trading system in 2012 that confirms that many trade and investment treaties lack the appropriate safeguards (Gallagher and Stanley, 2012). At the World Trade Organization

## Box 2: Rules of Thumb for the Use of Capital Account Regulations in Developing Countries

Capital Account Regulations (CARs) should be seen as an essential part of the macroeconomic policy toolkit and not seen as measures of last resort.

CARs should be considered differently in nations where the capital account is still largely closed versus those nations where CARs are prudential regulations to manage an open capital account.

Price-based CARs have the advantage of being more market neutral, but quantity-based CARs may be more effective, especially in nations with relatively closed capital accounts, weaker central banks, or when incentives to bring in capital are very large.

CARs should not only be relegated to regulations on capital inflows. Capital outflow restrictions may be among the most significant deterrents of undesirable inflows and can serve other uses as well.

CARs can be seen as alternatives to foreign exchange reserve accumulation, particularly to reduce the costs of reserve accumulation.

CARs should not be seen as solely temporary measures, but should be thought of as permanent mechanisms to be used in a counter-cyclical way to smooth booms and busts. Their permanence will strengthen institutional capacity to implement them effectively.

Investors can increasingly circumvent CARs through mis-invoicing trade flows, derivative operations, or foreign direct investments that are in fact debt flows.

Therefore, CARs should be seen as dynamic, requiring a significant degree of market monitoring and ‘fine-tuning’ as investors adapt and circumvent regulation.

It may be useful for effective CARs to distinguish between residents and non-residents.

The full burden of managing capital flows should not be on emerging market and developing countries, but the ‘source’ countries of capital flows should also play a role in capital flow management, including supporting the effectiveness of those regulations put in place by recipient countries.

Neither industrialized nations nor international institutions should limit the ability of nations to deploy CARs whether through trade and investment treaties or through loan conditionality.

Industrialized nations should examine more fully the global spillover effects of their own monetary policies and evaluate measures to reduce excessive outflows of short-term capital that can be undesirable both for them and emerging countries.

The stigma attached to CARs should be removed, so nations have ample confidence that they will not be rebuked for taking action. The IMF could play a valuable role in taking away the stigma of CARs, as well as doing comparative analysis of which CARs are most effective.

Source: Gallagher et al, 2011

(WTO) nations that have made commitments to liberalize trade in cross-border financial services are not permitted to regulate capital flows. Although the WTO has more appropriate safeguards than many regional and bilateral agreements, there is considerable debate whether those safeguards amply allow nations to regulate capital flows, especially on inflows. In the case of regional and bilateral agreements, especially those of the United States, all forms of capital must flow “freely and without delay” among trade and investment partners, with no exception.

The IMF suggests that its new institutional view could help guide future trade treaties and that the IMF could serve as a forum for such discussions. It is important that the IMF recognizes that many nations will lack the policy space to implement new policy advice from the IMF. However, given that the IMF view is overly narrow, it is imperative that future safeguards for trade and investment treaties not simply defer to the IMF on capital account regulations. While the IMF has legal authority on current transactions, this new view does not grant the IMF authority over the capital account.

## Regulating Capital Flows for Development: An Alternative View

It is important to note that the new IMF view is not a legally binding set of guidelines in any form. IMF member nations are still free to regulate their capital accounts as they see fit. Article VI of the IMF Articles of Agreement still stands: “Members may exercise such controls as are necessary to regulate international capital movements.” The IMF is making strides in the right direction, but the lead will have to continue to come from the example of many emerging markets. Developing countries remain the best judges of their own economies and should look at the new IMF advice on financial globalization with great scrutiny.

The Pardee Center Task Force’s “rules of thumb” in Box 2 may serve as a more comprehensive and flexible set of guideposts for emerging market and developing countries hoping to achieve financial stability for inclusive growth and sustainable development. ●

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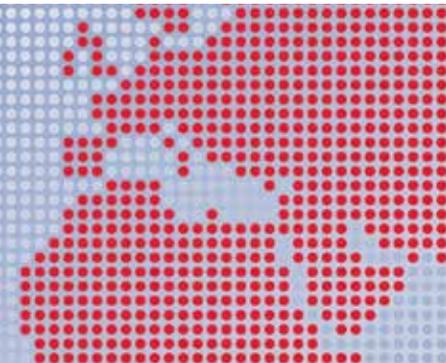
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