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GUIDANCE NOTE ON THE LIBERALIZATION AND MANAGEMENT OF CAPITAL FLOWS

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GUIDANCE NOTE ON THE LIBERALIZATION AND MANAGEMENT OF CAPITAL FLOWS

EXECUTIVE SUMMARY

This note provides operational guidance to staff on the use of the Fund's institutional view (IV) on the liberalization and management of capital flows. The IV establishes a framework for consistent policy advice and assessments of members' capital flow policies when relevant for surveillance. The IV does not alter the rights and obligations of members under the Fund's Articles of Agreement or other international agreements. The IV has no mandatory implications for the Fund's financing role.

The IV rests on the premise that capital flows are desirable as they can bring substantial benefits for countries, but they may also generate risks. Capital flow management measures (CFMs) or measures that are both CFMs and macroprudential measures (MPMs), i.e., CFM/MPMs, can be useful in certain circumstances but should not substitute for warranted macroeconomic adjustment. The IV aims to help countries reap the benefits of capital flows, while managing the associated risks in a way that preserves macroeconomic and financial stability and does not generate significant negative outward spillovers.

Staff should discuss capital flows and related policies in surveillance when these are macro-critical or when spillovers from those policies significantly influence the effective operation of the international monetary system. Staff reports should characterize measures which are designed to limit capital flows as CFMs or CFMs/MPMs and assess their appropriateness under the IV, except for CFMs subject to special treatment. The IV's use should reflect both country circumstances and evenhandedness.

This Guidance Note discusses application of the IV in a range of circumstances: (i) capital flow liberalization (including premature liberalization); (ii) management of capital inflows both in the context of capital inflow surges and preemptively (i.e., outside of surges); (iii) management of disruptive outflows; the role of source countries; (iv) the treatment of certain categories of measures; (v) and other operational considerations.

This note combines, elaborates, and clarifies all previous IV guidance, replacing the 2013 guidance note and the 2015 note on further operational considerations. It also provides guidance on the new elements introduced in the 2022 review of the IV.

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CONTENTS

Glossary ____ 4

INTRODUCTION ____ 5

OPERATIONAL GUIDANCE FOR FUND STAFF ____ 6

A. Use of The Institutional View ____ 6

B. Multilateral Coordination ____ 13

CAPITAL FLOW LIBERALIZATION ____ 14

A. Considerations to Assess Capital Flow Liberalization ____ 14

B. Premature Liberalization and Reimposition of CFMs ____ 18

MANAGING CAPITAL FLOWS ____ 20

A. Managing Capital Inflow Surges ____ 21

B. Managing Capital Inflows Preemptively ____ 27

C. Managing Disruptive Capital Outflows ____ 37

D. The Role of Source Countries ____ 44

SPECIAL TREATMENT OF CERTAIN CATEGORIES OF MEASURES ____ 45

A. Measures Adopted for Reasons of National or International Security ____ 45

B. Measures Based on Internationally Agreed Prudential Standards ____ 46

C. AML/CFT Measures ____ 49

D. Measures Arising from International Cooperation Standards Against Avoidance or Evasion of Taxes ____ 50

OPERATIONAL ISSUES 51

A. CFMs that are also Exchange Restrictions and/or Multiple Currency Practices (MCPs) 52

B. Other Operational Issues 55

BOXES

1. Guidance on Considering Capital Flows in Surveillance 11
2. Integrated Surveillance Decision: Aspects Related to Capital Flow 13
3. Some Examples of Multilateral Collaboration 14
4. Assessment of Housing Measures Under the IV 27
5. CFMs that are also Exchange Restrictions and/or Multiple Currency Practices (MCPs) 53

FIGURES

1. Stylized Representation of a Broad Liberalization Plan 17
2. Potential Indicators of Premature Liberalization 19
3. Managing Capital Inflow Surges 24
4. When Would a Pre-Emptive CFM/MPM Be Appropriate? 28
5. Managing Capital Outflows 40
6. Assessing Imminent Crisis Circumstances 43

TABLE

1. CFMs, Exchange Restrictions, and MCPs: Some Illustrative Examples 54

ANNEXES

I. Terminology: The Institutional View on the Liberalization and Management of Capital Flows 59

II. Liberalization: Thresholds, Pre-Conditions, Sequencing, Other Operational Considerations, and Examples 64

III. Pre-Emptive CFM/MPMs: Data Sources, and Other Operational Considerations 67

IV. Assessment of Housing Measures Under the IV 70

V. Capital Flows in Staff Reports: Some Examples 73

VI. Aligning the Assessment of Tax Measures Under the the IV with Internationally Established Legal Principles of Taxation 75

VII. Identifying Inflow Surges: A Toolkit 78

References 81

Glossary

AEs	Advanced Economies
AFTAC	OECD Advisory Task Force on the Code of Capital Movements
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BEPS	Base Erosion and Profit Shifting
BIS	Bank for International Settlements
CCyB	Countercyclical Capital Buffer
CFMs	Capital Flow Management Measures
CFM/MPMs	Capital Flow Management Measures and Macroprudential Measures
D-SIBs	Domestic Systemically Important Banks
EBA	External Balance Assessment
EMDEs	Emerging Market and Developing Economies
EMs	Emerging Markets
ESA	External Sector Assessment
ESRB	European Systemic Risk Board
FFA	Financial Flow Analytics
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FX	Foreign Exchange or Foreign Currency
FXI	Foreign Exchange Intervention
GFC	Global Financial Crisis
G-RAM	Global Risk Assessment Matrix
G-SIFIs	Global Systemically Important Financial Institutions
IMF	International Monetary Fund
IMS	International Monetary System
IPF	Integrated Policy Framework
ISD	Integrated Surveillance Decision
IV	Institutional View on the Liberalization and Management of Capital Flows
LCR	Liquidity Coverage Ratio
MCPs	Multiple Currency Practices
ML/TF	Money Laundering/Terrorism Financing
MPMs	Macroprudential Policy Measures
NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Cooperation and Development
PGM	Principles for Guidance of Members' Policies
ROSC	Report on Observance of Standards and Codes
SSB	Standard Setting Bodies
UFR	Use of Fund Resources
UN	United Nations
VEA	Vulnerability Exercise for Advanced Economies
VEE	Vulnerability Exercise for Emerging Markets

INTRODUCTION

1. This note provides operational guidance to staff on how to apply the Fund's institutional view on the liberalization and management of capital flows. The Institutional View on Capital Flows (IV), adopted in 2012, and reviewed in 2022, establishes a consistent framework for policy advice and, where relevant, assessments of members' capital flow policies in the context of surveillance. The IV does not alter members' rights and obligations under the Articles of Agreement or other international agreements.[1] It also does not have mandatory implications for the Fund's financing role[2] or capacity development (CD), although it can guide staff's advice in these activities. The IV provides guidelines for managing capital flows, by identifying circumstances when capital flow management measures (CFMs) and measures that are both CFMs and macroprudential policy measures (CFM/MPMs) may be useful. It also provides guidance for safe capital account liberalization, without presuming full liberalization to be an appropriate goal for all countries at all times and highlights the importance of international cooperation on capital flow policies. The IV is expected to continue evolving in light of research and lessons from its implementation.[3]

2. This note combines, elaborates, and clarifies all previous guidance for how to use the IV. It replaces the 2013 Guidance Note for the Liberalization and Management of Capital Flows and the 2015 note on Managing Capital Outflows-Further Operational Considerations. It also provides guidance on the new elements introduced in the 2022 Review of the Institutional View on Liberalization and Management of Capital Flows:[4]

- ***Policy Changes.*** These include the use of preemptive CFM/MPMs on inflows, and the special treatment of certain categories of measures.
- ***Elaboration of concepts.*** These include macro-criticality, capital inflow surges, imminent crises, and premature liberalization.

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[1] This includes multilateral international agreements such as the Organization of Economic Cooperation and Development (OECD)'s Code of Liberalization of Capital Movements, as well as regional agreements, such as those establishing currency unions, and bilateral and regional foreign investment and free trade agreements.

[2] The IV has no mandatory implications for the Fund's financing role. For example, CFMs maintained consistently with the IV would not on this basis be considered measures requested by the Fund pursuant to Article VI, Section 1. Nor would CFMs maintained, but assessed as inappropriate under the IV, be considered measures that the Fund could require members to eliminate as a condition for the use of Fund resources. The right of members to control capital movements under Article VI, Section 3 has been interpreted as generally precluding the Fund from requiring the removal of capital controls as a condition for access to the Fund's resources. A limited exception to this principle is the Fund's policy on non-accumulation, reduction or elimination of external payments arrears, including arrears evidencing capital restrictions.

[3] A review of experience with the IV in 2016 found that it remained broadly appropriate, while pointing to emerging issues warranting further research, clarification, or elaboration. The 2022 review of the IV introduced changes to the policy, informed by the insights from the staff's work on an Integrated Policy Framework (IPF) undertaken in recent years, the findings of the report by the Independent Evaluation Office (IEO) on IMF Advice on Capital Flows, other relevant research, and staff's experience in the implementation of the IV.

[4] The note also draws on the Fund's macroprudential policy framework established since the adoption of the IV (IMF 2013b, IMF 2014a, IMF 2017).

- ***Guidance on issues which have arisen in the process of implementation of the IV.*** These include the treatment of CFMs that are also exchange restrictions and/or multiple currency practices (MCPs), and other operational issues.

3. When discussing capital flows, staff should use terminology consistent with the IV. A broad range of policies in both source and recipient countries can influence capital flows. Such policies include macroeconomic and structural policies, supervisory and regulatory frameworks, and measures that are designed to limit capital flows. In the IV, the last-mentioned measures are referred to as CFMs.[5] Measures that are both CFMs and MPMs are referred to as CFM/MPMs. Annex 1 provides a discussion of terminology and examples, including residency-based and non-residency based CFMs. The assessment of whether a measure is designed to limit capital flows, when non-residency based, often needs to take into account country-specific circumstances, including the overall context in which the measure was introduced or adjusted. The usefulness and effectiveness of CFMs and CFM/MPMs depend on country-specific circumstances. Staff maintains a running roster of macro-critical policy measures assessed as CFMs or CFM/MPMs and referred to in published IMF staff reports as they have been introduced or adjusted since the adoption of the IV.[6]

4. The guidance note is organized as follows. Section II provides operational guidance for Fund staff. Section III discusses considerations for capital flow liberalization and when liberalization may be considered premature. Section IV discusses considerations for managing capital flows, including (i) management of capital inflows during surges; (ii) management of capital inflows preemptively (i.e., outside of inflow surges); (iii) management of disruptive capital outflows; and (iv) the role of source countries; Section V provides guidance on the treatment of certain special categories of measures, such as measures adopted for reasons of national or international security and measures based on certain internationally agreed prudential standards, anti-money laundering and combating the financing of terrorism (AML/CFT) frameworks, and international cooperation standards against the avoidance or evasion of taxes; and Section VI provides guidance on other operational issues.

OPERATIONAL GUIDANCE FOR FUND STAFF

A. Use of The Institutional View

5. The IV guides staff's policy advice and assessments of members' capital flow policies when relevant in surveillance. The IV does not alter the rights and obligations of members under the Fund's Articles of Agreement or other international agreements. The IV has no mandatory implications for the Fund's financing role. The IV can also inform advice in the context of capacity

[5] Definitions in the IV are intended for use by Fund staff in the context of assessments and policy advice and may not correspond directly to definitions used by other organizations or agreements. The terms "financial account" and "capital account" are used interchangeably, in line with the tradition in the capital flows literature.

[6] See IMF Taxonomy of Capital Flow Management Measures.

development.[7] Staff should consider capital flow issues in the context of bilateral and multilateral surveillance as outlined in paragraphs 6 and 8 respectively (the procedural guidance for considering capital flows in surveillance is provided in Box 1). The typical circumstances when the IV applies include:[8]

- ***Capital flow liberalization***. Instances when the authorities are contemplating further liberalization, cases of premature liberalization, or more generally situations when staff has a view whether liberalization would be useful considering the benefits of liberalization relative to the costs and risks.

- ***Managing capital flows.*** Cases of capital inflow surges, situations when certain financial sector vulnerabilities have built over time as a result of capital inflows, instances of disruptive outflows, as well as circumstances when capital flows generate actual or potential significant outward spillovers.

6. In the context of bilateral surveillance staff is required to cover a member's balance of payments (BOP) developments and capital flow policies as follows (Box 2).[9] Consistent with the Integrated Surveillance Decision (ISD), the Fund's assessment of a member's policies always includes an evaluation of the developments in the member's BOP, including the size and sustainability of capital flows. Furthermore, when capital flow policies have a significant impact on the present or prospective domestic or BOP stability, i.e., when they are macro-critical, staff reports should discuss these policies as well.[10]

7. This Guidance Note elaborates on the principles for determining macro-criticality of CFMs outlined in the 2022 IV Review.[11] In general, for a CFM to be assessed as macro-critical, staff must determine that it has a significant impact on the present or prospective domestic or BOP stability, which is referred to as a macro-critical impact.[12] Staff should first analyze the economy-wide significance of the sector subject to the CFM, the flows targeted by the CFM within the specific sector, and the expected impact of the measure on the targeted flows. Staff should then analyze the channels and economic variables through which domestic or BOP stability would be affected (e.g., international reserves, exchange rates, financial system stability, fiscal sustainability,

[7] See Guidance Note for Surveillance under Article IV Consultations (2022).

[8] Capital flows should also be included as part of the external sector assessment, along with indicators such as the current account balance and the exchange rate. See Guidance Note for Surveillance under Article IV Consultations (2022).

[9] See Modernizing the Legal Framework for Surveillance—An Integrated Surveillance Decision (July 17, 2012), and the Guidance Note for Surveillance under Article IV Consultations (2022), especially paragraphs 85–87.

[10] See Modernizing the Legal Framework for Surveillance – An Integrated Surveillance Decision (July 17, 2012), and the Guidance Note for Surveillance under Article IV Consultations (2022).

[11] See the discussion on macro-criticality in the 2022 Review of the Institutional View on Liberalization and Management of Capital Flows.

[12] For broader guidance on assessing macro-criticality in surveillance, see Guidance Note for Surveillance under Article IV Consultations (2022).

asset prices including house prices, or economic efficiency and growth) and determine whether the impact would be significant. For example, a CFM on a macro-critical sector may not be necessarily macro-critical, if the measure is expected to have only a small impact on the targeted flows or other relevant economic variables. In addition, several important considerations apply:

- ***Staff should assess both the current and prospective impact of a CFM on domestic or BOP stability when determining macro-criticality.*** A CFM may have a small effect on present capital flows but may be expected to have a significant impact on future capital flows, making its prospective impact macro-critical. In such instance, staff should assess whether the future flows have a reasonably high expectation of becoming large enough for the measure to have a macro-critical impact. In these cases, staff should focus on the following considerations:

    - ***Staff's view on future capital flows which may be affected by the measure.*** A current low level of capital flows that would be affected by a CFM should not necessarily imply lack of macro-criticality. If staff assesses that the targeted flows have declined compared to the past, but that there are reasonable expectations that the capital flows will return in the future (including, for example, due to the expected removal of previous policy actions which have depressed capital flows), staff can use the level of past capital flows to assess macro-criticality. In certain cases when staff expects an increase in capital flows in the targeted sector from its past levels due to other reasons (increase in financial sector development, for example), comparator countries with similar characteristics and circumstances may be used to determine future flows.

    - ***Important reforms or other measures either already underway or expected*** with a high degree of certainty to affect capital flows. For example, a planned reform in the financial sector, or a planned removal of a CFM which is expected to increase capital flows in the sector that the measure would target, should be taken into account when assessing macro-criticality. This is also the case when a previously imposed CFM already reduced the flows in the sector targeted by the new CFM. In certain cases, the previously introduced CFM and the new measure may be considered as a package (see bullet on classification and assessment of packages).

- ***The nature of certain measures may make their expected impact difficult to assess ex ante.*** A measure may inherently involve a degree of discretion in how it is applied that the range of possible impacts is too wide to determine a baseline. For example, some measures, like approval requirements, may allow officials to exercise wide judgment in its implementation. In these cases, staff should focus on the macro-criticality of the sector or the targeted flows.

- ***When CFMs are judged to be introduced as a package of measures, staff should assess the macro-criticality of the package as a whole.*** To determine whether a set of measures

constitutes a package[13] staff should be guided by whether at least one of the following criteria is satisfied: (i) similar objectives; or (ii) similar sector and/or geographical impact. The proximity in time may also be an indicator of the measures being a part of a package. The overall determination will require staff's judgement. A package of measures may also include measures at different government levels, e.g., subnational and national/federal governments. The final determination for whether a set of CFMs constitute a package, however, would require a measure of judgment. When a set of measures is judged to be a package, staff should be guided by the following principles:

- ***The macro-criticality assessment should focus on the full package of measures.*** If one of the measures is macro-critical, the package will be considered macro-critical. If none of the measures are macro-critical individually, staff will assess the overall impact of the package. Moreover, if some measures are tightened while others are loosened, staff will assess the overall impact.

- ***Staff reports should discuss changes to a measure or package of measures previously assessed as macro-critical even if the subsequent marginal changes are small and on their own would not be macro-critical.*** This applies irrespective of whether the original measure was assessed as a CFM under the IV or predates the IV.[14] Similarly, incremental changes to a measure previously not considered macro-critical may make the resulting measure or package of measures macro-critical. On the other hand, a removal of a measure, which was part of a macro-critical package of measures, may result in the package not being macro-critical anymore.

- ***When discussing a change to a measure in staff reports, the discussion should characterize the change as either a tightening or loosening***. When the measure is a part of a package of measures, the change should be characterized as tightening or loosening of the package. If several measures in a package are changed in opposite directions, staff should assess the overall impact of the changes to the package and characterize the overall change as either a tightening or loosening.[15]

- ***The assessment of macro-criticality for a CFM may change over time.*** For example, over time, capital flows may grow significantly in certain sectors, making them macro-critical, and potentially rendering a CFM targeting them macro-critical as well. Alternatively, sectors which were previously large recipients of capital flows may, over time, become less so for reasons

[13] Staff examples of measures which constituted a package of CFMs, include the introduction of outflow CFMs in Cyprus in 2013 (such as limit on individuals' FX payments abroad, and limits on FX cash when traveling) and Ukraine (2014). (See IMF Taxonomy of Capital Flow Management Measures).

[14] The IV only applies to measures which have been introduced after the approval of the IV in 2012, or measures which, even though were originally introduced prior to the IV, have been changed after 2012. However, measures which were removed or eased after 2012 may be covered under the capital flow liberalization section. Regarding measures which were introduced prior to 2012, but were enforced after 2012, see paragraph 84 sub-bullet (iii).

[15] In certain cases such characterization may not be feasible to do, in which case staff need not characterize the overall change as either a tightening or a loosening.

other than being subject to CFMs, and as a result, in certain cases a CFM targeting these sectors may no longer be macro-critical. In such cases, when staff believes that clear long-term changes in capital flows have taken place, staff may reassess the macro-criticality of a measure, and revise its appropriateness under the IV.

- ***Staff should discuss with the authorities the actual and expected impact of the measure and consider the authorities' views when making the assessment on macro-criticality.*** In case of differences in views on macro-criticality of the CFM between country authorities and staff, the differences should be reflected in the staff report.

8. Capital flows may also need to be discussed in the context of multilateral surveillance. As mandated by the ISD, if spillovers from a member's policies may significantly influence the effective operation of the international monetary system (IMS), for example by undermining global economic and financial stability, these policies need to be discussed with the member during the Article IV consultation.[16] In this context, staff could recommend alternative adjustments to members' policies that would be more conducive to IMS stability, but would still achieve the authorities' objectives, and the recommendations with respect to capital flows should be informed by the IV. In particular,

- ***Staff should assess whether policies and developments in a country have the potential to give rise to outward spillovers*** that are transmitted through capital flows and may undermine global economic and financial stability or otherwise significantly influence the effective operation of the IMS.[17] Staff may use the Fund's multilateral surveillance products to assess the extent of push factors and structural changes in global capital flows.

- ***Staff should discuss such spillovers with the authorities and examine if viable alternative policy actions could achieve the authorities' objectives while minimizing spillovers.***[18] However, in such cases, the authorities would not be obliged to act on staff recommendations if they are promoting their own domestic and BOP stability.

[16] Under the ISD, outward spillovers are deemed to "significantly influence" the effective operation of the international monetary system, if by themselves, or in combination with spillovers from other members' policies, or through their regional impact, they enter the macrofinancial policy considerations of members representing a significant portion of the global economy.

[17] Staff may also propose to discuss with the authorities, on a voluntary basis, outward spillovers that have important implications for other members but not for global systemic stability. This dialogue can be useful for several reasons. First, with greater financial interconnectedness, it is not always possible to ascertain ex ante whether the policies and developments in question may have globally significant effects. Second, even where the direct effects are limited, feedback loops may lead to indirect domestic and external stability implications for the member concerned (for example, the cross-border activity of financial institutions headquartered in the country in question may have significant implications for their stability and, therefore, for financial stability in the home country).

[18] For example, policies such as monetary, fiscal, capital flow management, and prudential policies may result in significant spillovers. Alternative policy options which achieve the authorities' objectives while minimizing spillovers could include careful communication and sequencing of policy changes and/or alternative combinations of monetary, fiscal, capital flow management, prudential, and structural policies.

Box 1. Guidance on Considering Capital Flows in Surveillance

Staff should inform the Fund's interdepartmental group on capital flows (LEG, MCM, RES, SPR) as early as possible of any policy measures that may potentially be a CFM or CFM/MPM, or changes to existing CFM or CFM/MPM for assessment under the IV. In addition, as noted in paragraphs 38 and 60, staff would conduct periodic evaluations, as appropriate, of existing measures.

Policy Note

Staff should highlight the following:

- Capital flow developments and policies that raise concerns regarding domestic and BOP stability (see paragraph 22 of the ISD for specific indicators), including a preliminary view as to whether there is likely an inflow surge, FX mismatches on external debt, or disruptive outflows, and challenges for macroeconomic and financial stability arising from such capital flows and stock vulnerabilities, including those related to external debt in local currency. For source countries, staff should highlight potential and actual outward spillovers (drawing on the G-RAM, vulnerability exercises, and multilateral surveillance products).
- Where relevant, how macroeconomic and other policies, have been adjusted regarding capital flows and related risks. This includes the authorities' announcement or implementation of new CFMs and CFM/MPMs, changes to existing ones, and measures to liberalize capital flows.
- For new, or recently changed, or reevaluated CFMs and CFM/MPMs, the policy note should discuss the measures, including the assessment, the circumstances under which the measure was assessed, and any relevant policy advice.
- Existing CFMs and CFM/MPMs (previously assessed under the IV) should be mentioned when they are relevant for the issues discussed in the SR, for example, whenever the policy note discusses the specific sectors or risks which they target. In other cases, the policy note can refer to discussions in previous Staff Reports, as appropriate.

During the Mission

Staff should discuss with the authorities:

- Developments in capital flows, size and sustainability, and impact on macroeconomic and financial stability as well as other risks, and staff's assessment.

If capital flows and related policies have implications for the member's current or prospective domestic and BOP stability (i.e., are macro-critical), or may affect the effective operation of the IMS, staff should discuss:

- The appropriateness and effects of the policy mix in response to capital flows (including whether warranted macroeconomic adjustments are being made), the types of policies being used, including macroeconomic and other policies (such as CFMs, MPMs, CFM/MPMs), and the stability of the financial system.
- Staff's assessment of any new, or changed, or reevaluated CFM or CFM/MPM, when the measure has been assessed under the IV by the interdepartmental group on capital flows, including any policy recommendations. If an assessment of a measure is ongoing, staff should inform the authorities, and discuss any relevant data or information for its assessment.
- Potential or actual outward spillovers if they may have significant implications for global stability; or if they arise when the country from which the spillover originates is not promoting its own (domestic or BOP) stability. (This consideration is related to the ISD and is outlined in Box 2) The G-RAM, VE, and other multilateral products may be useful for framing the discussion.

Box 1. Guidance on Considering Capital Flows in Surveillance (concluded)

In the case of proposed/implemented liberalization plans, staff should discuss:

- How the authorities' approach broadly compares with the "integrated approach" outlined in the IV, taking into account country circumstances, and the needed complementary reforms.
- The soundness of the financial sector and institutions, as staff already do but bearing in mind the need to handle capital flows and their associated potential volatility.
- Inward and outward spillover implications of the authorities' plans or measures.

Staff Report

Staff reports should discuss capital flows related policies when these significantly influence member's present or prospective domestic or BOP stability (i.e., are macro-critical), as well as if they generate spillovers that may significantly influence the effective operation of the IMS, while other spillovers may also be discussed if requested by or agreed with the authorities. In doing so, the assessment should be based on the IV and the discussion should cover the aspects noted above in the policy note consultation stage and the discussions with authorities. The level of detail would be at the discretion of mission chiefs and reviewers, but it should ensure that the relevant policy challenges are adequately covered, and that staff's view on appropriateness of measures which should be labelled as CFMs or CFM/MPMs as appropriate and clear policy recommendations are provided. In case of differences, the authorities' views should be reflected in the staff report. In assessing the adequacy of data for surveillance, staff should keep in mind data related to capital flows.

9. The IV has no mandatory implications for the Fund's financing role. In particular, members' rights under Article VI, Section 3 would continue to be interpreted as generally precluding the Fund from requiring the removal of capital controls as a condition for access to the Fund's resources.[19] For example, CFMs maintained consistently with the IV would not on this basis be considered measures "requested" by the Fund pursuant to Article VI, Section 1. Nor would CFMs maintained inconsistently with the IV be considered measures that the Fund could require members to eliminate as a condition for the use of Fund resources. However, an analysis under the IV could, where relevant, be taken into account as input for the assessment in a UFR context of whether a member's policies are appropriate to help the member resolve its balance of payments difficulties and regain external viability.[20]

10. The IV and the Integrated Policy Framework (IPF) are fully consistent with each other. The 2022 review of the IV has been informed by the insights from the staff's work on the IPF, and the IPF is fully consistent with the IV. The IPF aims to provide a systematic analytical approach to considering an appropriate policy mix for achieving macroeconomic and financial stability for countries experiencing shocks. It jointly considers monetary, exchange rate, MPMs, CFMs, CFM/MPMs, and fiscal policies, as well as their interactions. Key insights of the IPF are that the optimal policy mix in response to shocks depends on country characteristics, type of shocks, and initial conditions, and that optimal policies may include both ex ante (i.e., before a shock materializes) and ex post policies. Key country characteristics considered in the IPF include balance

[19] A limited exception to this principle is the Fund's policy on non-accumulation, reduction, or elimination of external payments arrears, including arrears evidencing capital restrictions.

[20] See 2012 IV Board Paper, para 61.

sheet mismatches, the depth of FX markets, monetary policy credibility, and the currency of trade invoicing, and other factors may also be relevant for the choice of optimal policy mix.

Box 2. Integrated Surveillance Decision: Aspects Related to Capital Flows[1]

The ISD establishes the policy framework for Fund's surveillance and explicitly addresses capital flows. It lays out the scope and modalities of surveillance and defines PGMs that provide guidance on members' exchange rate and domestic economic and financial policies. The PGMs call on members to: avoid manipulation of exchange rates to prevent adjustment or to gain unfair competitive advantage; intervene in the exchange market if necessary for countering disorderly market conditions; take into account in their intervention policies the interests of other members; avoid exchange rate policies that result in BOP instability; and seek to avoid domestic economic and financial policies that give rise to domestic instability. The ISD provides that, in assessing a member's policies, the Fund will always evaluate developments in the member's BOP, including the size and sustainability of capital flows. Capital flow management policies shall be covered when they significantly influence the member's present or prospective domestic or BOP stability, i.e., when they are macro-critical.

Certain developments may trigger the need for a thorough review and indicate the need for discussion with the member on whether the PGMs are being observed. The developments directly related to capital flows include:

- The introduction or substantial modification for BOP purposes of restrictions on, or incentives for, the inflow or outflow of capital
- The pursuit, for BOP purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows; and
- Large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

When a member's policies regarding capital flows, while not undermining the member's own domestic and BOP stability, lead to spillovers that may have a significant impact on global stability, staff should encourage the authorities to consider alternative policy options that minimize spillovers while continuing to promote the member's own stability.[2] This aspect of the ISD allows for a more balanced treatment of capital flows in both recipient and source countries, even though the source country authorities are not obligated to alter their policies, as long as they are promoting their stability. Volatile capital flows, the excessive build-up or depletion of reserves, and imbalances arising from excessive or insufficient global liquidity are among the developments that could affect the effective operation of the IMS.

[1] See *Modernizing the Legal Framework for Surveillance – An Integrated Surveillance Decision*.
[2] See *Guidance Note for Surveillance under Article IV Consultations*.

B. Multilateral Coordination

11. Staff are encouraged to promote multilateral coordination on the treatment of policies related to capital flows. The IV does not alter members' rights and obligations under other international agreements. However, staff could use it in their dialogue with members and international organizations to promote a more consistent approach towards the treatment of

policies related to capital flows across other international agreements,[21] by taking into account country-specific macroeconomic and financial stability considerations in determining the appropriate policy response and the pace and path of capital account liberalization. In certain cases, while a country's introduction of CFMs or CFM/MPMs may be considered appropriate under the IV, their introduction may conflict with the country's obligations under other international agreements. In these cases, although, the economic analysis of policy options available should still be guided by the IV it cannot be construed to advise violating international agreements of which the country is a party. This issue of potentially different treatment of capital flows and related measures under different frameworks may be addressed by bringing more consistency among existing bilateral and multilateral treaties. Staff, particularly in functional departments, are encouraged to develop ways of collaborating with other relevant international institutions, such as the Bank of International Settlements (BIS), the Financial Stability Board (FSB), and the Organization of Economic Cooperation and Development (OECD), for example by exchanging data and information, with due regard to the different mandates, purposes, and memberships of the IMF and the other institutions.

Box 3. Some Examples of Multilateral Collaboration

Collaboration with the BIS. The 2022 review of the IV established a special treatment for some prudential measures, including countercyclical capital buffers, liquidity coverage ratios, and net stable funding ratios, by refraining from assessing them for appropriateness under the IV if these conform with the Basel Framework. This will help avoid potential unintended tensions in the assessment of such measures under the Basel framework and the IV. Staff also participates in technical working groups in the BIS related to these issues.

Collaboration with the FSB. Staff participates in technical working groups at the FSB and Standard Setting Bodies (SSB) on issues related to nonbank financial institutions (NBFIs) and market-based intermediation of capital flows.

Collaboration with the OECD. Staff participates in the OECD's Advisory Task Force on the Code of Capital Movements (ATFC), where views and information on capital flow management policies are exchanged from the perspective of both the OECD Code of Capital Movements and the IMF's IV. The 2019 amendments to the OECD's Code of Capital Movements envisage that the OECD may liaise on the Fund's views "on any questions relating to the balance of payments and the state of the monetary reserves of an OECD Member" and on "any questions relating to the liberalization of capital movements." The Fund and the OECD, together with some central banks, also organizes joint workshops, to facilitate policy discussions on issues related to capital flows based on new analytical and empirical work by external researchers and those of the organizing institutions.

CAPITAL FLOW LIBERALIZATION

A. Considerations to Assess Capital Flow Liberalization[22]

[21] For an example of such agreements, see the OECD Code of Liberalization of Capital Movements. Staff may also use it in their dialogue with regional organizations, including currency unions (see the Consolidated version of the treaty on the functioning of the European Union, 2012).

[22] The IV uses the terms "capital flow liberalization", "financial account liberalization", and "capital account liberalization" interchangeably.

12. The IV provides principles to draw upon when staff advice covers capital flow liberalization. Capital flow liberalization should be covered in surveillance when the authorities are undertaking or considering liberalization steps or strategies, or when liberalization appears to have outpaced the economy's capacity to safely handle capital flows, referred to as premature liberalization. In addition, capital flow liberalization can be covered when in staff's view the benefits of further liberalization relative to the costs have risen.

13. This Guidance Note provides a working definition of capital flow liberalization. "Capital flow liberalization" refers to the removal of CFMs. The concept includes the underlying capital transaction as well as the related payment or transfer, and full liberalization includes unrestricted convertibility of local currency in international financial transactions. Liberalization does not rule out the temporary re-imposition of CFMs or CFM/MPMs under certain circumstances, or the imposition and maintenance of certain measures that are subject to special treatment under the IV (see Section V).

14. Staff's advice should be guided by the principle that liberalization is more beneficial and less risky if countries have reached certain levels or thresholds of financial and institutional development. Therefore, liberalization needs to be well planned, timed, and sequenced to ensure that its benefits outweigh the costs and to reduce the risks of potentially costly backtracking that may undermine the credibility of the liberalization plan. The IV also emphasizes that there is no presumption that full liberalization is an appropriate goal for all countries at all times.

15. Staff should assess benefits and costs when advising on capital flow liberalization. As countries develop, they require more advanced financial systems, which usually go hand in hand with greater cross-border capital flows. In addition, capital flows can facilitate the transfer of technology and management practices (particularly through foreign direct investment (FDI)), and financing of current account deficits for productive investment or for smoothing consumption. They also have indirect benefits, such as fostering financial sector development, macroeconomic policy discipline, and economic efficiency.[23] Benefits, such as enhanced investment and consumption smoothing, tend to be greater for countries whose financial and institutional development enables them to intermediate capital flows more safely. Staff could assess how freer capital flows could support a country's economic objectives, such as boosting growth-enhancing investment, lowering borrowing costs, providing funding to credit-constrained economic sectors, bringing in new technology, and lengthening debt maturities, improving liquidity in securities markets, or enhance macroeconomic policy discipline.

16. At the same time, staff should be mindful of potential risks associated with capital flows. These risks include heightened macroeconomic volatility, lower level of macroeconomic

[23] Background Note 1—Capital Flows and Capital Flow Management Measures—Benefits and Costs, for the 2022 Review of the IV Board Paper, provides further details of the benefits and costs of capital flows.

policy autonomy,[24] a buildup of systemic financial risks, and vulnerability to capital flow reversals, which are magnified when countries have yet to achieve sufficient financial and institutional development. A key point for staff is, therefore, to consider the adequacy of macroeconomic policies, macroeconomic and financial stability, structural policies, institutional quality, financial regulation and supervision, and macroprudential policy, to manage the risks associated with capital flows.[25]

17. Staff's advice on liberalization should provide for a systematic process and pace of liberalization, that is also consistent with each country's institutional and financial development. The "integrated approach"[26] to capital flow liberalization outlines such a process and pace and includes the following considerations: (i) the removal of CFMs in a manner that is properly timed and sequenced, taking into account other policies and conditions, notably macroeconomic, structural, and financial sector prudential policies; and (ii) the path toward and extent of liberalization needs to be tailored to countries' particular circumstances and objectives. For example, liberalization could take advantage of periods of lower external vulnerability. When assessing capital flow liberalization, issues to consider include the following:

- ***Thresholds.*** The benefits of capital flow liberalization are largest when countries have achieved certain levels ("thresholds") of financial and institutional development (Figure 1). The literature and country experiences do not, however, provide a uniform guide as to what levels of relevant variables are adequate for safe liberalization. Staff assessments of countries' readiness to move forward will, therefore, need to incorporate judgment based on country-specific circumstances, particularly on the soundness of financial systems, institutions, and fiscal, monetary, and exchange rate policies.[27] Exchange rate flexibility can help cushion the real economy against the effects of capital flow volatility. At the same time, a country could make progress toward greater capital flow liberalization before reaching all of the necessary thresholds for financial and institutional development, and indeed doing so may itself spur progress in these dimensions. But liberalization needs to be managed particularly cautiously in these circumstances as the risks are higher.

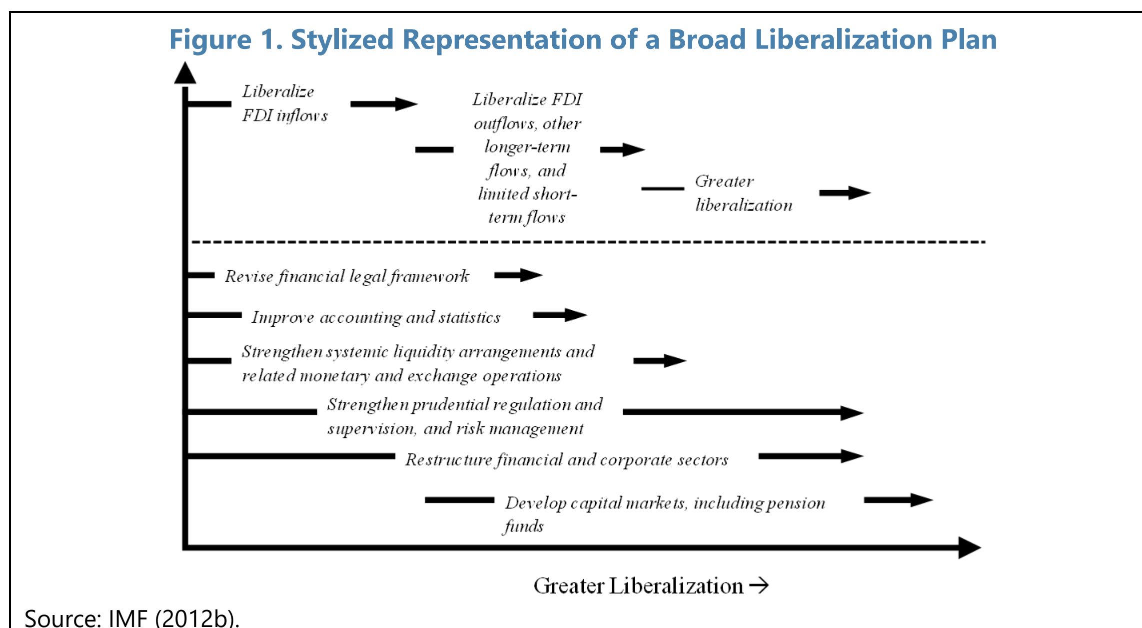
[24] Due to the "impossible trinity", more open capital account and larger capital flows must involve less autonomy with respect to either monetary policy or the exchange rate.

[25] Staff reports generally already discuss financial sector supervision and regulation, as well as macroprudential policy, which implicitly includes the ability to handle capital flows. These discussions are sometimes supported by FSSAs and ROSCs. See also Background Note 1—Capital Flows and Capital Flow Management Measures—Benefits and Costs, for the 2022 Review of the IV.

[26] For description of the integrated approach see Section II.B of the 2012 IV, and further background in Ishii et al., 2002.

[27] In considering country-specific circumstances, staff could note that small states and LICs often have more shallow and less liquid capital markets. They may also face additional challenges in building regulatory and supervision capacity.

Figure 1. Stylized Representation of a Broad Liberalization Plan



Source: IMF (2012b).

- ***Liberalization direction.*** Staff advice should not presume that full liberalization is an appropriate goal for all countries at all times. Instead, the appropriate degree of liberalization at any time would depend upon the country's circumstances and overall economic objectives. In particular, staff could discuss the rising benefits of capital flows relative to the risks in cases where countries have made significant progress with respect to the pre-conditions for liberalization, as several emerging economies with long-standing and extensive CFMs have done. The discussion could cover the strength of macroeconomic fundamentals (growth, price stability, foreign reserves); financial sector (balance sheets and financial markets); composition of external flows (such as a large share of equity and FDI in total flows; long-term vs. short-term debt flows); and trends in financial development, trade openness, and institutional quality.

- ***Liberalization process.*** When advising on the liberalization of capital flows,[28] staff should emphasize a systematic process, pace, and sequencing, consistent with the country's institutional and financial development along the lines of the "integrated approach." Teams should emphasize the need, and work with CD departments as relevant, for progressively deeper and broader supporting reforms to the financial and non-financial frameworks. Staff advice should also rely on recent financial and institutional assessments (for example, Financial Sector Assessment Programs (FSAPs), Reports on Observance of Standards and Codes (ROSCs)) and cross-country examples. Where detailed recommendations are warranted, area department teams should draw upon expertise from MCM, which has provided CD on capital flow liberalization in several countries over a number of years.

[28] This covers instances when the authorities are contemplating further liberalization, and more generally situations when staff considers that the benefits of further liberalization have risen compared to risks.

- ***Spillovers.*** Spillovers may have a significant impact on the effective operation of the IMS, particularly in the case of large, systemically important countries, and in such cases, staff should assess the potential outward spillovers of liberalization measures.

B. Premature Liberalization and Reimposition of CFMs

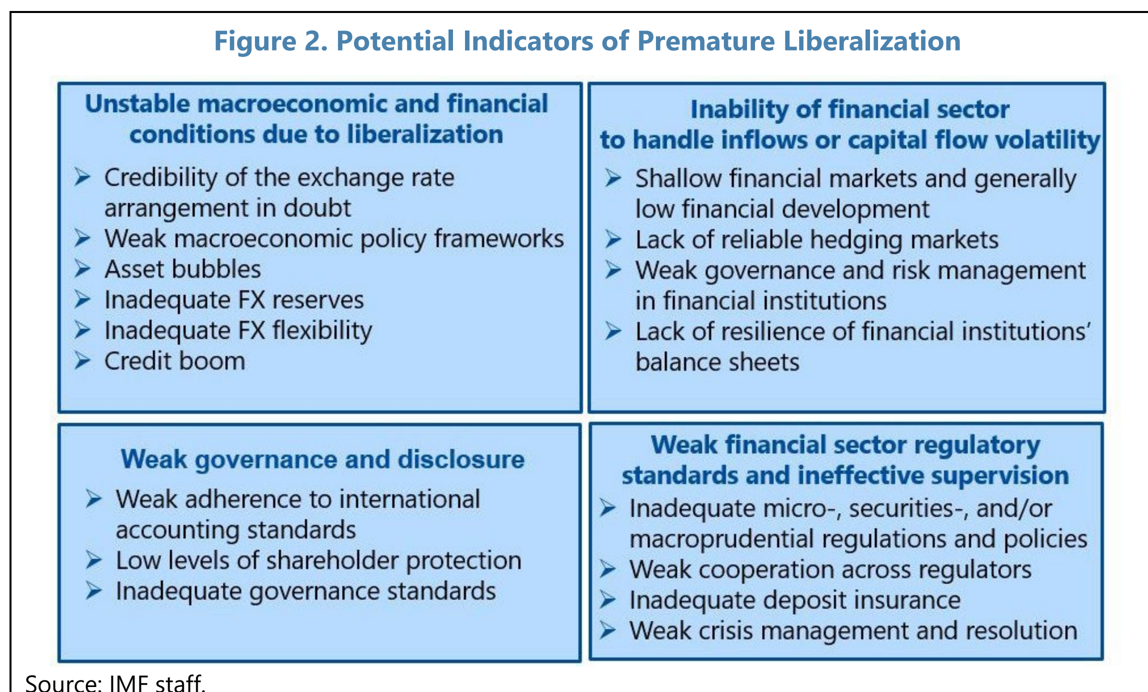
18. The IV can support the re-imposition of CFMs due to premature liberalization. A temporary re-imposition of CFMs can be consistent with an overall strategy of capital flow liberalization under certain circumstances. If staff assess that liberalization has been premature, i.e., it has outpaced the capacity of the economy to safely handle the resulting flows, the re-imposition of CFMs may be warranted until sufficient progress has been made with respect to the conditions that the integrated approach recommends.

19. Identifying instances of premature liberalization requires an assessment of whether the removal of CFMs has outpaced the capacity of the economy or financial system to safely handle the resulting flows. The integrated approach in the IV sets out certain conditions or thresholds (see Figure 1 and Annex 2) which should generally allow for safe liberalization of different types of flows. Premature liberalization occurs when those conditions are not met even if they may have appeared to do so at the time of liberalization and a country's capacity to handle the liberalized flows is seriously challenged. As this capacity depends on several features, the identification of premature liberalization needs to consider a wide range of macrofinancial indicators. Such an analysis should explore whether large changes have taken place in capital inflows or outflows following liberalization, and whether as a result, a severe deterioration in indicators of macrofinancial stability has emerged. It should look at the period shortly after the CFMs were removed, as well as, if needed, at subsequent periods when the newly open financial account (or specific segments of it) has become exposed to sizable flows or changes in the global financial cycle for the first time. This can be challenging, in part because some of the costs of greater financial account openness may take time to become apparent. Examples of premature liberalization include:

- ***Liberalization of short-term flows*** without having the necessary prudential, supervisory, and monitoring frameworks to manage the risks from these flows.

- ***A relaxation of outflow CFMs*** in response to a temporary increase in inflows. The resulting increase in outflows could be sustained or could accelerate even as the inflows subside, and without instituting the necessary supporting reforms, could create unstable macroeconomic and financial conditions that the economy has insufficient resilience to withstand.

Figure 2. Potential Indicators of Premature Liberalization



Source: IMF staff.

20. Figure 2 provides an overview of some of the indicators of premature liberalization. Usually, a country experiencing premature liberalization would have a number of these features resulting in lack of capacity to handle capital flow volatility following liberalization, or when the newly liberalized part of the financial account has been exposed to sizable flows or changes in the global financial cycle. The relative importance of these factors would depend on the degree of financial account openness as set out in a stylized manner in Figure 1. The conditions stated in Figure 2 indicate that the pre-condition for safe liberalization is not met (see Annex 2).

21. If liberalization is assessed to have been premature, it may be appropriate to reimpose CFMs until conditions for safe liberalization are in place. This reflects that a temporary reimposition of CFMs may be in line with moving toward greater liberalization, even though it is generally more desirable if such backtracking can be avoided. The re-imposition of CFMs may be implemented alongside the liberalization of other types of flows if the conditions for such liberalization are met. For example, where short-term debt inflows have been liberalized before long-term debt inflows, and where the necessary monetary, supervisory and macroprudential frameworks have not been fully developed, a temporary reimposition of CFMs on short-term flows combined with an easing of some CFMs on longer-term debt inflows may be appropriate under the IV. If CFMs are re-introduced, the least discriminatory measure that is effective should be preferred. In such cases, when staff has assessed liberalization as premature and CFMs were re-introduced, a subsequent assessment should consider the needed policy actions. The assessment should identify necessary improvements in the policy framework and financial and institutional development to remove the reimposed CFMs over time, while safely managing the so achieved degree of financial account openness. Staff's advice on the policy actions would be based on this assessment.

22. Progress in implementing policy actions to address the weaknesses that led to the reimposition of CFMs would be expected for the reimposed CFMs to remain appropriate. If a country has reimposed CFMs, staff will analyze the actions taken following the reimposition to guide the assessment of appropriateness of such reimposition, e.g., enhancing the effectiveness of financial supervision or increasing exchange rate flexibility. Lack of or insufficient/inadequate policy action to address weaknesses may suggest that the re-imposition of CFMs is no longer consistent with a safe liberalization strategy. In such cases, staff's advice should focus on the policy actions to address the weaknesses,

23. Premature liberalization does not include cases where capital flow episodes or systemic stock vulnerabilities temporarily overwhelm countries with generally adequate capacity to manage their openness. The IV recognizes that countries that have appropriately sequenced the liberalization and generally have adequate capacity to manage capital flows may nevertheless experience exceptionally large inflow surges or disruptive outflows or accumulate stock vulnerabilities (e.g., FX mismatches). Such developments may pose policy challenges and may warrant temporary use of CFMs and/or CFM/MPMs. For example, a country facing asset bubbles or a credit boom amid an inflow surge without meeting the other conditions stated in Figure 2 should not be considered as a premature liberalization case. In the case of premature liberalization, the lack of capacity to safely handle capital flows is likely to be more sustained arising from underlying weaknesses in institutional or financial development, than in the case of a country with generally strong fundamentals but one that is temporarily being overwhelmed with capital flow volatility. Therefore, in the case of premature liberalization, it would not be appropriate to for the reimposed CFMs to be loosened and re-tightened to manage capital flows, as the removal of the reimposed CFMs should be part of a safe liberalization strategy.

MANAGING CAPITAL FLOWS

24. This note provides operational guidance to staff on the IV's policy advice for managing capital flows. Managing large and volatile capital flows, or vulnerabilities that may have built up over time as a result of capital flows, will often pose a policy challenge for authorities, or have implications for domestic and BOP stability. When they do, staff reports will need to cover them and assess them sufficiently comprehensively and evenhandedly. Staff should use the IV in such cases to ensure consistent advice, while taking due account of country-specific circumstances. In discussing with authorities their policy responses to capital flows, it is useful to ascertain as directly as possible the objectives of specific measures (for example, whether they are targeted at macroeconomic risks, financial stability risks, or some other objectives), which can help frame the policy advice.

25. Under certain circumstances, capital inflows can give rise to macroeconomic and/or financial risks. These could arise from inflow surges leading to rapid currency appreciation, overheating, asset bubbles, credit booms, or other financial risks, or from the incremental buildup of financial vulnerabilities in the absence of an inflow surge. Some of those risks may materialize during subsequent reversals of inflows or outflow episodes. When capital flows give rise to macroeconomic

and systemic financial risks, macroeconomic and financial policies are a key part of the appropriate combination of policies for addressing these risks. For example, capital flows generally warrant adjustments in macroeconomic variables, including the real exchange rate, and policies need to facilitate these adjustments. In addition, improving structural policies and strengthening financial stability including by financial supervision and regulation, as well as institutional capacity, would help improve a country's ability to absorb and safely handle capital flows.

26. CFMs and CFM/MPMs may also be appropriate but they should not substitute for warranted adjustments in macroeconomic policies. This section discusses possible policy responses to address such risks and provides guidance on the circumstances in which the use of CFMs and CFM/MPMs may be appropriate to deal with capital inflows.

A. Managing Capital Inflow Surges

27. Surges in capital inflows often pose policy challenges. They can lead to macroeconomic and financial volatility, due to rapid currency appreciation, overheating, and build-ups in balance sheet and other financial vulnerabilities. Inflows surges may be followed by "sudden stops" or reversals of inflows, which can lead to macroeconomic and financial stress and, in some situations, crises. To pose such risks, surges do not necessarily need to be large from an economy-wide perspective, if they are sizeable in a particular sector with systemic linkages. This section provides guidance on: (i) identifying capital inflow surges; (ii) appropriate macroeconomic and financial sector policies to deal with inflow surges; and (iii) circumstances in which CFMs and/or CFM/MPMs may be helpful to manage the challenges arising from capital inflow surges.

28. The Guidance Note provides a working definition of capital inflow surges in line with the additional guidance provided in the 2022 Review of the IV. A surge can be understood as an increase in capital inflows exceeding their historical average over a specific time frame, which is relevant for the inflow surge episode. This includes both economy-wide surges, and surges in sectors with systemic linkages. Identifying a surge can be guided by quantitative indicators but also involves an element of judgment. Staff may use a stepwise procedure to assess whether an inflow surge is taking place and is giving rise to macroeconomic and/or financial stability challenges, as outlined in the 2022 Review of the IV, as well as the additional guidance to identify inflow surges and the challenges they can give rise to, by proposing a variety of quantitative methods to inform the assessment. These quantitative metrics are not intended to replace staff's judgment in assessing whether a surge is taking place and giving rise to associated challenges, nor to constitute an exhaustive list of possible metrics, but rather to provide more tools to assist staff in identifying an inflow surge.

29. Analytical tools should assist staff in assessing whether an inflow surge is taking place and is giving rise to macroeconomic and/or financial stability challenges. Staff can rely on a host of methodologies to obtain a signal on whether the economy (or sector) is experiencing a surge in the volume of capital inflows. It may also be useful to consider whether inflow surges are taking place in comparator economies. In addition, staff could analyze a range of macrofinancial

variables to assess the country's absorption capacity and whether the surge is giving rise to macroeconomic or financial stability challenges.

30. Quantitative methodologies useful to gauge capital inflow surges include:[29]

- ***Threshold Analysis.*** This method identifies surges as flows exceeding their historical patterns by looking at past distributions. The approach was pioneered by Reinhart and Reinhart (2008) by selecting a cut-off of 20th percentile for net capital flows (in percent of GDP). Ghosh et. al (2014) further extended and refined this method by defining a surge if it lies both in the top 30th percentile of the country's own distribution of net capital flows (expressed in percent of GDP) and in the top 30th percentile of the cross-country distribution of net capital flows (in percent of GDP). The reason for identifying surges based on the country-specific distribution of net capital flows as well as the broader cross-country criterion is to ensure that surges are not only "large" by the country's own experience but also by cross-country standards.[30]

- ***Trend Analysis.*** An alternative way to derive historical patterns from which to identify surges is by looking at deviations from a long-term trend using a Hodrick-Prescott (HP) filter. This methodology was used in IMF (2011a), where a surge in capital inflows is defined to occur when inflows in a given period significantly exceed their long run trend (by one standard deviation or more) and are large in absolute magnitude (exceeding 1.5 percent of annual GDP). The country-specific trend is calculated by applying a Hodrick-Prescott filter with a smoothing parameter (lambda) of 1600 for quarterly gross capital inflows data.[31] More recently, Hamilton (2018) proposed a new regression-based filter for detrending time series that produces a stationary cycle for a wide range of time series and suffers less from the end-of-sample bias than the HP filter.[32]

- ***Rolling window.*** This methodology considers a recent period as benchmark via the use of a rolling window. Forbes and Warnock (2012) popularized this methodology using quarterly data on gross capital flows and defining a surge as an annual increase in gross inflows that is more than one standard deviation above the five-year rolling average, and at least two standard deviations above the average in at least one quarter.

- ***Cluster Analysis.*** This methodology partitions inflows into k clusters with the nearest mean, obtained by minimizing the within-cluster sum of squared differences. This approach was first introduced in Ghosh et al. (2014) as a robustness check to the threshold analysis employed as

[29] This is not an exhaustive list of methodologies that can used by staff.

[30] Variations of the threshold approach have been also employed by Qureshi and Sugawara (2018) and the OECD (2018).

[31] IMF (2007a, 2010c) used similar approaches and criteria in identifying surges in capital inflows. Similarly, Cardarelli et al. (2010) define a surge when net private capital flows (in percent of GDP) to a country exceed its HP trend by one standard deviation or fall in the top quartile of the regional capital flows.

[32] Quast and Wolters (2022) further refine the Hamilton filter to obtain more reliable and economically meaningful real-time output gap estimates.

baseline to avoid imposing an ad hoc threshold to identify surges. This methodology applies the k-means clustering technique on each country's (standardized) net flow to GDP observations, and groups them into three clusters ((i) surges, (ii) normal flows, and (iii) outflows), such that the within-cluster sum of squared differences from the mean is minimized (while the between-cluster difference in means is maximized). As a result, each observation belongs to the cluster with the nearest mean, and clusters comprise observations that are statistically similar.

31. Staff may use a specially designed toolkit for identifying inflow surges based on the methodologies outlined in this guidance note and the IV Review. The toolkit allows staff to (i) identify gross and net inflow surges across a variety of quantitative approaches, (ii) conduct cross-country comparisons, and (iii) analyze a range of macrofinancial indicators to assess whether these surges can pose macroeconomic and/or financial stability challenges. Furthermore, it allows staff to identify such episodes in fourteen categories of cross border capital flows. The further delineation of net and gross capital flows into certain sectors or asset classes that the toolkit allows for can inform Fund staff on financial stability risks within different sectors that may have systemic linkages to the greater economy (see Annex 7 for detailed description of the toolkit). The toolkit should assist staff in assessing whether an inflow surge is taking place, but is not intended to replace staff's judgment.

32. Once a capital inflow surge has been identified, staff should assess the macroeconomic and/or financial stability risks arising from the surge. Staff should clearly lay out the key macroeconomic or financial stability risks already playing out or likely to occur because of the surge. These could include rapid currency appreciation, potentially leading to overvaluation; higher inflation due to overheating; and/or excessive credit growth and asset price bubbles, increasing systemic financial risks. Staff reports would already include staff's views with respect to overheating risks, macroeconomic policies, exchange rates, and reserves, and the financial sector. The assessment could draw upon these views to discuss the appropriate policy mix for responding to capital flows.

33. Staff should assess the appropriate policy mix for addressing the macroeconomic and financial stability risks, with due account of country-specific considerations. Appropriate macroeconomic policies to address the risks associated with a capital inflow surge could include (see Figure 3):

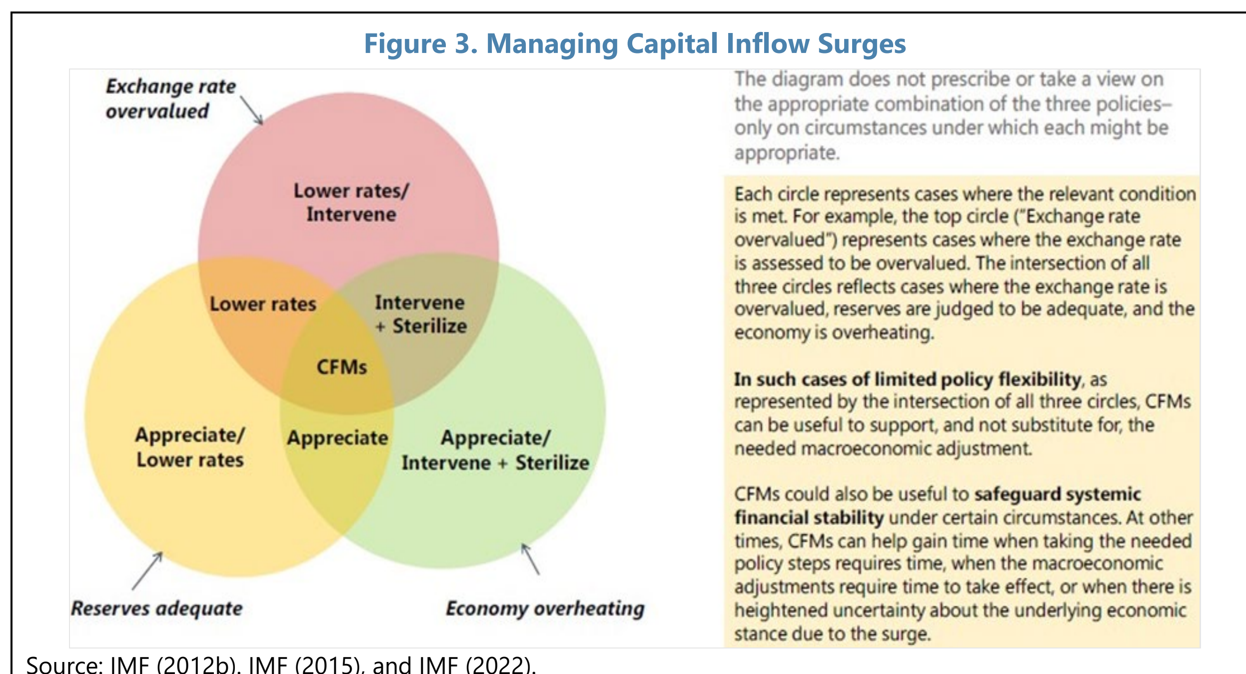
- Lowering interest rates in the absence of overheating or asset price pressures, through monetary easing and/or fiscal tightening;

- Allowing exchange rate appreciation if the currency is not overvalued;[33,34] and

- Building foreign reserves, if these are not more than adequate[35], through sterilized intervention.[36]

- In addition, when capital inflow surges contribute to financial stability risks, MPMs may be appropriate as well.[37]

Figure 3. Managing Capital Inflow Surges



Source: IMF (2012b). IMF (2015), and IMF (2022).

34. In some circumstances, CFMs and CFM/MPMs may be appropriate for supporting macroeconomic policy adjustment and safeguarding financial system stability. These would include the following:

- ***When the room is limited for adjusting macroeconomic policies*:** for example, if there are signs of overheating or asset bubbles, the exchange rate is overvalued, and reserves are more

[33] Staff should refer to the latest External Sector Assessment (ESA) which was included either in a staff report, the External Sector Report, or a policy note.

[34] This does not preclude the possibility that in certain cases, when macroeconomic and financial stability risks are limited, some moderate temporary overshooting relative to fundamentals may not necessarily call for a policy response.

[35] Staff should refer to the reserve adequacy assessment provided in the most recent staff report or policy note. For additional guidance, see "Guidance Note on the Assessment of Reserve Adequacy".

[36] This refers to sterilized intervention in order to maintain a distinction with monetary policy. The appropriate monetary policy response is noted in the first bullet.

[37] See the Fund's macroprudential policy framework (IMF 2014a, IMF 2017).

than adequate. These situations are illustrated in the intersection of the Venn diagram (see Figure 3).

- ***When an inflow surge raises risks of financial system instability*:** MPMs, which are designed to limit these inflows and their associated systemic risk (and therefore considered also to be CFMs, i.e., CFM/MPMs) may be useful provided that they accompany needed macroeconomic policy adjustment and financial regulations. When capital inflow surges contribute to financial stability risks, staff should draw on both the IV and the macroprudential policy framework developed by Fund staff.).

- ***When rapidly changing underlying conditions make the macroeconomic stance difficult to assess quickly, or when warranted policy adjustments take long to implement and take effect*:** CFMs can be temporarily useful to gain time to make such assessments or while the necessary policies are being implemented. For example, when fiscal consolidation is being undertaken toward a sustainable position consistent with macroeconomic stability, introducing CFMs could, in some circumstances, be useful until the consolidation starts to affect the real economy and interest rates. These circumstances require judgment by country teams, and staff need to be able to substantiate them clearly, including whether necessary policy adjustments are being undertaken.

35. In addition, there are further considerations when assessing appropriateness of CFMs during inflows surges. CFMs should not substitute for macroeconomic policies that are warranted for macroeconomic adjustment, domestic stability, and the effective operation of the IMS. For example, using CFMs to influence exchange rates in order to gain unfair competitive advantage would not be appropriate; it could also be inconsistent with countries' obligations not to manipulate the exchange rates under Article IV. Even when CFMs are desirable and appropriate, other considerations could also be weighed (see Background Note 1 in IMF 2022). One of the key considerations in this respect is the likely effectiveness of CFMs, which is a matter of judgment and would depend on country-specific policy frameworks and institutional settings. For example, in larger economies with more developed financial markets, controls may be less effective than in other settings. Also, CFMs may be precluded by a member's international commitments. Within the EU, for instance, full capital mobility is generally required.[38] For countries with well-established reputations for being open to capital flows, the reputational costs of CFMs may be relatively high and would need to be offset by commensurately higher benefits.

36. Staff should be guided by some broad principles from the IV in the design of CFMs. CFMs on inflows during a surge should be transparent, targeted, temporary, and preferably non-discriminatory. CFMs that target the flows resulting in instability as directly as possible may be the most effective and least costly when dealing with specific risks or sectoral surges. Broader measures may be more suitable for addressing overall macroeconomic concerns. When CFMs are adopted, they should generally be temporary, being phased out when capital inflow pressures abate

[38] In addition, staff should note that the definition of capital mobility may differ across international agreements.

(except in some circumstances, as discussed below). For assessing whether capital flow pressures have abated sufficiently, staff would need to draw on the analysis of surges as well as judgment. CFMs should preferably be non-discriminatory between residents and non-residents, with the least discriminatory measure that is effective being preferred. If, however, failure to discriminate between residents and non-residents would render the policy ineffective, this may justify using residency-based measures.[39] The design of measures needs to be continuously reviewed as their efficacy can erode over time owing to incentives for circumvention.

37. As noted above, when an inflow surge gives rise to financial stability risks, measures that are assessed as both CFMs and MPMs may be appropriate to safeguard financial stability. Capital inflow surges can contribute to systemic risk through several channels (IMF 2017). In such cases, staff should draw on both the IV and the policy framework for the use of MPMs developed by Fund staff (IMF 2013b, IMF 2014a, IMF 2017). Some key principles, which are consistent between the IV and macroprudential policy framework, are to avoid using CFM/MPMs as a substitute for necessary macroeconomic adjustment, use the policy instruments that are the most effective, efficient, direct, and the least distortive in addressing the policy objective, and to seek to treat residents and nonresidents in an evenhanded manner (see Annex 1).[40]

38. Staff should be guided by the following considerations on the removal of inflow CFMs and CFM/MPMs imposed during surges. When an inflow surge has abated, CFMs on those inflows could impose unnecessary costs or at best be ineffective. Staff should therefore assess their continued appropriateness, and generally recommend their phasing out as the surge abates, or scaling back to pre-surge settings, in cases when a long-standing inflow CFM was tightened.[41] However, some inflow CFM/MPMs imposed during surges may continue to be necessary for managing systemic financial risks, even after the inflow surge subsides. Their usefulness relative to their costs would need to be evaluated on an ongoing basis, including whether there are alternative ways to address the prudential concern that are not designed to limit capital flows. In particular, MPMs can increase the resilience of the financial sector, and contain vulnerabilities that may be building in the context of a surge, even when they are not designed to limit capital flows.[42] In particular, such evaluations will be appropriate when there are changes in the circumstances relevant for the measure's continued need, such as, for example, when prudential regulations are revised. Moreover, if the previous surge reveals that liberalization has outpaced the capacity of the economy to safely handle the resulting flows, further reforms to improve institutional and financial

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[39] For example, a limit on the net open FX position for commercial banks would be a non-discriminatory measure, while a limit on their FX borrowing from non-residents abroad would be considered a discriminatory one. For further examples, see Background Note 4 in the 2022 Review of the IV.

[40] See Box 1 in 2022 Review of the Institutional View on Liberalization and Management of Capital Flows.

[41] This includes CFMs which were introduced prior to the adoption of the IV in 2012 and tightened in response to an inflow surge, or measures which were re-introduced in cases of premature liberalization.

[42] For instance, MPMs like capital surcharges and leverage caps on banks or borrower-based tools can reduce the scope for capital inflows to generate procyclical dynamics between asset prices or exchange rates and credit. Similarly, MPMs can reduce the scope for capital outflows to result in financial stress by building buffers on the balance sheets of financial institutions and borrowers alike.

development may need to be implemented before CFMs can safely be lifted (see paragraph 20 on premature liberalization).

Box 4. Assessment of Housing Measures Under the IV

Housing demand from non-resident buyers has prompted a number of countries to put in place real estate sector measures to reduce such demand. As housing prices have increased after the global financial crisis, several countries, including advanced economies such as Australia, Canada, Hong Kong SAR, Macao SAR, New Zealand, and Singapore, have introduced measures to limit non-resident demand and regulate real estate markets. For example, countries have imposed measures such as stamp duties and other transaction taxes or restrictions on housing purchases, including measures that discriminate between residents and non-residents.[1]

As with any measure which may constitute a CFM, staff should be guided by the usual steps in the assessment. These include determining whether the measure is a CFM, or CFM/MPM, whether it is macro-critical (including whether it may be part of a package), and whether it is introduced during surges. In the case of housing measures, the following specific considerations may be useful to staff:

- When housing measures discriminate between residents and non-residents, they are identified as CFMs. This is because under the IV, measures limiting capital flows that discriminate between residents and non-residents are considered CFMs by virtue of their design (IMF, 2012 and IMF, 2017). When making this assessment staff should be mindful whether the discrimination is based on tax residency. Annex 6 provides useful guidance to this.
- Housing measures in certain cases may constitute CFM/MPMs. This is because the financial sector typically has significant exposure to the housing sector, and because housing assets are used as collateral for loan contracts, which can lead to a procyclical buildup of systemic financial risk, as housing prices rise. Determining whether the measure is introduced for financial stability purposes is also important since appropriateness and conditions for removal of the measure may depend on whether the measure is a "pure" CFM, or a CFM/MPM. Measures that aim at ensuring affordability are usually pure CFMs.
- In most cases, housing measures are macro-critical. The housing sector is often economically significant, and measures which have a significant impact on it, will generally be considered macro-critical. This may not be always the case, however, and macro-criticality would need to be assessed as discussed in paragraph 7. Housing measures may also constitute a package in some cases, for example, when they target the flows in the same sectors, or when similar measures were introduced in different regions of the country.

When assessing housing measures, staff may find it useful to refer to Annex IV. It provides additional guidance, examples, and data sources regarding the issues outlined above, and may be helpful to staff.

[1] For examples of such measures see Prohibition on the Purchase of Residential Property by Non-Canadians Act (justice.gc.ca) and Overseas Investment Amendment Bill 2017: Bills Digest 25-57 - New Zealand Parliament (www.parliament.nz)

B. Managing Capital Inflows Preemptively

39. Even in the absence of an inflow surge, stock vulnerabilities can be a source of systemic financial risks. External debt denominated in foreign currency may gradually build up in the financial, household, or corporate sectors in the absence of an inflow surge, or they may remain high in the aftermath of an inflow surge. If external FX debt is large and unhedged, it increases the

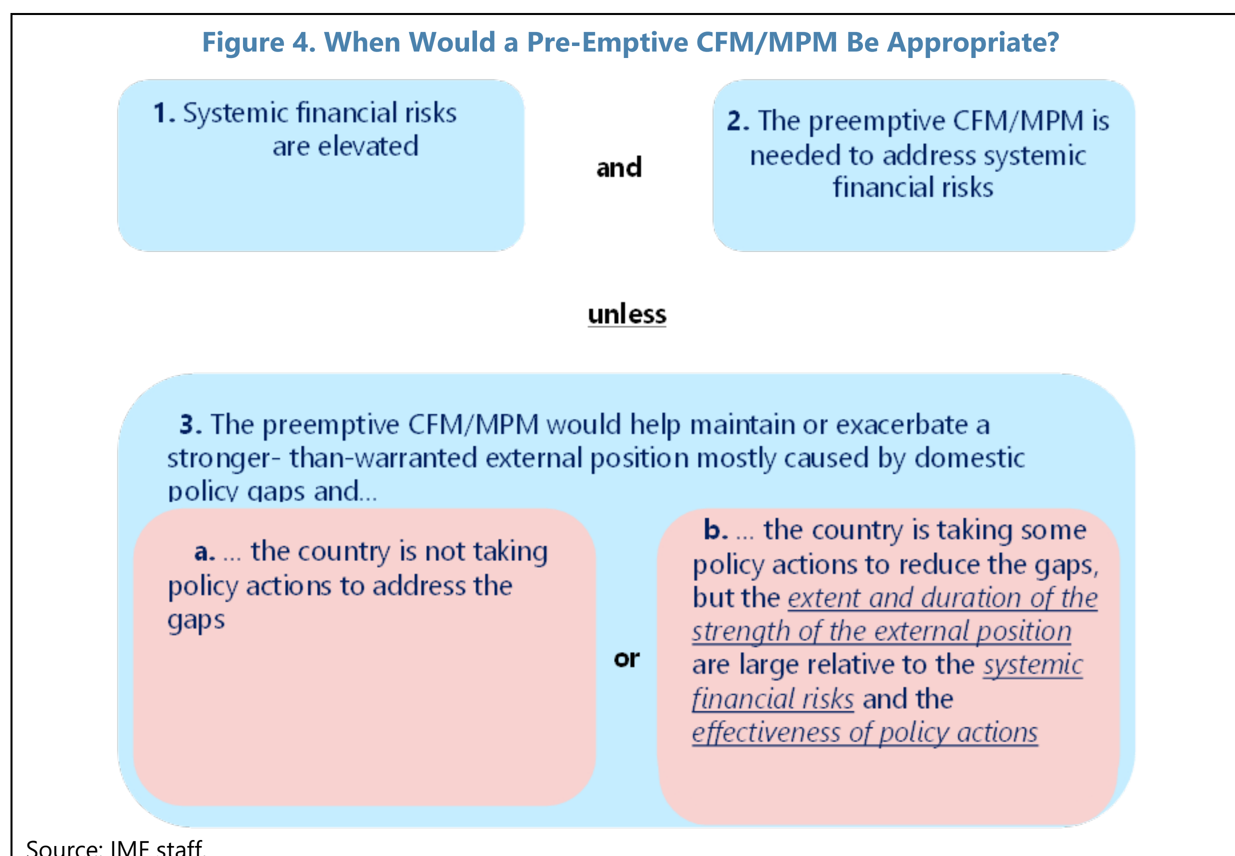
probability that capital flow reversals and associated currency depreciations generate costly balance sheet effects, systemic financial risks, and even a crisis. In some circumstances, systemic risks may also arise from the accumulation of external debt denominated in local currency.

40. Preemptive CFM/MPMs on inflows to reduce these risks may be appropriate in some circumstances (Figure 4). The IV considered two potential sources of systemic risks where a preemptive CFM/MPM may be appropriate: (i) FX mismatches due to external FX debt and (ii) local currency-denominated external debt. In assessing the appropriateness of a proposed or already-imposed preemptive CFM/MPM (i.e., a CFM/MPM imposed in the absence of a capital inflow surge), staff should focus on the following three main considerations:

- ***Are systemic financial risks elevated?*** Staff should assess potential systemic risks arising from (i) FX mismatches and (ii) local currency-denominated external debt. These are discussed in more detail below.

- ***Is the preemptive CFM/MPM needed to address these risks?*** The measure should not be used if MPMs, which are not designed to limit capital inflows, are sufficient to address the risks. In addition, the measure should not substitute for warranted macroeconomic policy adjustments, or for market development and structural policies that could reduce the underlying frictions.

Figure 4. When Would a Pre-Emptive CFM/MPM Be Appropriate?



Source: IMF staff.

- ***Would the preemptive CFM/MPM help maintain or exacerbate a stronger-than-warranted external position that is mostly caused by domestic policy gaps?*** The measure should not add to the set of domestic policies that are causing the external position to be stronger than the level implied by medium-term fundamentals and desirable policies. The discussion below outlines the criteria that can be used for making these judgments.

Assessment of Systemic Financial Risks Arising from FX Mismatches[43,44,45]

41. Preemptive CFM/MPMs on FX debt inflows are appropriate only if systemic financial risks are elevated due to FX mismatches. Staff should assess FX mismatches in the economy either at the balance sheet level or at the relevant remaining maturities which may expose the economy to systemic risks. The following two-step approach can be used: (i) assess the level of FX mismatches and establish whether they are high enough to warrant a systemic risk assessment; (ii) assess whether there are elevated systemic risks stemming from such FX mismatches. The assessment of whether FX mismatches are elevated would require staff's judgment and requires a holistic assessment of the available data and country-specific factors and should consider historical trends and peer country information, among others.

42. The first step comprises assessing the level of FX mismatches at the relevant remaining maturities using available datasets. To assess FX mismatches overall and at the relevant maturities, three components are needed: (i) the stock of FX liabilities; (ii) the denomination of assets and availability of hedges; and (iii) the maturity structure of the balance sheet (including FX liabilities, assets, and hedges). Ideally, and subject to data availability, multiple indicators should be used to assess each of these components. However, data gaps are likely to exist in most countries. Annex 3 lists some publicly available data sources and explains how they can be used to extract the required information and illustrates how these data can be used to assess FX mismatches for a hypothetical country.

43. When some data is unavailable, staff may use other country-specific information to assess FX mismatches. Data gaps may be severe for some countries and in these cases, quantitative and qualitative information regarding these debts and asset positions should be uncovered as much as possible to assess the level of FX mismatches. For example, country authorities contemplating preemptive CFM/MPMs may have access to additional information, e.g., unpublished data on FX mismatches, which they may be able to provide to staff. Similarly, they may have other relevant information, e.g., whether most borrowing is by FDI companies with parent guarantees, which can

[43] FX mismatch at any relevant remaining maturity is defined as the stock of FX liabilities which is not covered by liquid FX assets or FX hedges of the same maturity (either natural hedges, such as export revenue or remittances, or financial contracts in deep hedging markets). FX mismatches give rise to solvency risks that may arise from the impact of currency depreciation on the entire balance sheet and/or liquidity risks from short-term liabilities.

[44] Additional guidance is provided in Background Notes 2 and 3 of the 2022 Review of the IV.

[45] For certain cases within the IPF framework, the assessment of systemic risk is similar to the one presented here. See forthcoming note on Integrated Policy Framework: Principles for the Use of Foreign Exchange Interventions.

be considered hedged, or from parent companies, which may be considered more stable compared to borrowing from foreign wholesale markets or banks.

44. If FX mismatches at relevant maturities are judged to be high in Step 1 for at least one macro-critical sector, staff's assessment should proceed to Step 2. In cases where FX mismatches are in an intermediate range—neither high enough to clearly be assessed as elevated, nor low enough to clearly be considered as safe—staff should err on the side of caution and move to Step 2. It would be sufficient for the FX mismatches to be elevated for one macro-critical sector, and the analysis in Step 2 should focus on the identified sector(s).

45. The second step is for staff to assess whether the systemic financial risks arising from those FX mismatches are elevated. For any given level of FX mismatches, the associated systemic risks depend on the economy's financial structure, the type and strength of macrofinancial linkages, and the factors which may mitigate or amplify the domestic transmission of shocks through these linkages. Staff should use multiple sources of information[46] and tools to understand how shocks may interact with FX mismatches and other mitigating or amplifying factors, and trickle down through the financial system and interact with the macroeconomy. Some of the approaches are outlined below.

- ***Stress test*.** When possible, staff may use a granular stress test of the relevant sectors that allows for designing a possible adverse scenario and trace the transmission of shocks through the domestic financial and non-financial sectors. Stress tests may cover both liquidity and solvency risks and may be available from a past FSAP or can be done in the context of the Article IV surveillance if the necessary data are available. Annex 3 illustrates the principles to be used for solvency and liquidity stress tests and illustrates one example of a system-wide FX liquidity stress-test.

- ***Country authorities' analysis and data*.** In conducting the analysis in step 2, staff should discuss with the authorities any specific concerns they may have or additional data about the transmission of systemic risks owing to FX mismatches, which can help inform the design of the stress test and shape the overall analysis. For example, country authorities may have additional information on the composition of the foreign investor/creditor base, granular data on the financial network, unpublished information regarding non-financial corporates' balance sheets, unpublished central bank or financial supervisor stress tests, credit registries, and legal guidelines for the sequence of asset liquidation in adverse scenarios. Staff and the authorities may also be able to fill in gaps regarding the connection of the amplifying and mitigating variables to FX mismatches, for example, the overlap between the holders of domestic assets and the sectors which undertake FX borrowing, FX contingent liabilities in large corporates, and under what circumstances the government would be able or willing to draw down its FX buffers.

46. The systemic risk assessment can build on the existing risk assessments in bilateral surveillance. This analysis can complement stress tests but becomes more relevant where stress

[46] As part of the IPF workstream, Fund staff maintains IPF Metrics Database (see also Annex 3).

tests are not feasible. Risk assessments are routinely conducted as part of bilateral surveillance for all countries, using a variety of approaches which draw on the available data and country-specific qualitative information.[47] The assessment of the FX-related systemic risk should involve analyzing the following elements:

- ***Consequences of capital inflow reversal.*** The relevant consideration is whether a capital inflow reversal, due to a domestic or external shock, could lead to elevated systemic financial stress. This generally refers to the disruption in the provision of financial services caused by an impairment of the financial system with negative effects for the real economy.

- ***Amplifying and mitigating factors.*** Staff should analyze whether the variables judged to be amplifying or mitigating the risk of a costly capital flow reversal operate via transmission mechanisms which are closely connected to the FX mismatches identified in Step 1. Examples of such assessments include whether FX debt service is high as a percentage of export revenues; whether elevated housing or stock price valuations are associated with high leverage which would be unwound in the event of a reversal of FX debt inflows; whether the resilience of FX borrowers' balance sheets would allow them to withstand shocks and periods of financial distress; whether there are large FX contingent liabilities in adverse scenarios; whether FX hedging markets would continue operating smoothly in adverse scenarios, and whether the central bank or the government has access to FX buffers.

Assessment of Systemic Financial Risks Arising from Local Currency External Debt[48]

47. Preemptive CFM/MPMs on local currency debt inflows may be appropriate in narrow and exceptional circumstances. Several preconditions need to be satisfied before preemptive CFM/MPMs related to local currency external debt are considered. This is because a wider set of policy tools would generally be available to manage an abrupt reversal in local currency-denominated debt inflows. Such policy tools would include monetary and exchange rate policy, open market operations, asset purchases, local currency lender of last resort, and other liquidity facilities. For reversals in local currency-denominated debt inflows to generate systemic financial risks, such policies (and other risk mitigants) would need to be substantially impeded or unavailable.

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[47] These include, for instance, financial soundness indicators, SWIFT data, and analysis of the cyclical and structural dimension of vulnerabilities using tools such as conditional Value-at-Risk, Balance Sheet Analysis (BSA), network analysis, the Systemic Risk Tracker, the Growth-at-risk (GaR) framework, and the Global Bank Stress Test tool. See the Guidance Note for Surveillance under Article IV Consultations (2022), in particular Section IV B.

[48] The share of local currency external debt of emerging market economies has been rising in recent years, which enhances resilience but does not exclude them from shocks. Emerging markets economies have historically often been unable to borrow abroad in their domestic currency, a phenomenon termed "original sin" (Eichengreen and Hausmann (1999), Eichengreen et al. (2002) and Eichengreen et al. (2005)). However, vulnerabilities may still arise, as reflected in the Covid-19 selloff in local currency bond markets, where record bond fund outflows and sharp exchange rate appreciations went hand in hand with steep increases in local currency bond yields (Hofmann et al. (2020), Hördahl and Shim (2020)). Carsten and Shin (2019) refer to this continued vulnerability as the "original sin redux".

In particular, the following conditions should be expected to be jointly satisfied in the event of a disruptive capital flow reversal for preemptive CFM/MPMs on such flows to be considered:

(i) local currency debt and FX markets are sufficiently shallow so that an outflow by some foreign investors would be unlikely to be offset by other (domestic or foreign) investors;

(ii) a large depreciation is costly due to FX mismatches or other reasons (e.g., if it de-anchors inflation expectations), and these costs outweigh the benefits of depreciation, such as from the improvement of net exports;

(iii) domestic monetary policy is constrained, and FX reserves are low; and

(iv) other relevant ex post policy instruments to address capital flow reversals, particularly local currency lender-of-last-resort and liquidity facilities, are substantially impeded or unavailable.

If it is determined that conditions (i)–(iv) are jointly satisfied, staff should proceed to the risk assessment process following a two-step approach analogous to the one described in the case of FX mismatches. If they are not jointly satisfied, staff should assess the preemptive CFM/MPM as not appropriate under the IV.

48. In Step 1 of the risk assessment, staff should establish whether local currency leverage and maturity mismatches are elevated owing to local currency-denominated debt inflows. Data on local currency-denominated external debt stocks, assets, and maturity structure should be used to establish whether leverage and maturity mismatches are high enough in at least one macro-critical sector potentially including recipients and providers of cross-border funding, to proceed to Step 2. Judgment would be necessary, and in cases where leverage and maturity mismatches are neither high enough to clearly be assessed as elevated nor low enough to clearly be considered safe, staff should proceed to err on the side of caution and move to Step 2.

49. In Step 2, staff should assess the systemic risks related to local currency leverage and maturity mismatches in the sector(s) identified from Step 1:

- ***Stress tests.*** Ideally and subject to data availability, staff's approach should involve granular stress tests of the relevant sectors to assess both solvency and liquidity risks (such as those conducted in FSSAs) related to a rise in local currency yields and fall in local currency asset prices. The stress tests should build in the impairment of policy instruments during crises considered applicable for the specific country and which justified the beginning of the assessment process (such as the need for sharp increases in policy rates, or the inability of the central bank to provide liquidity support).

- ***Building on existing risk assessments.*** The risk assessment can also build as appropriate on existing risk assessments in Article IV reports. Staff should assess whether the systemic vulnerabilities arise from the local currency debt inflows, and whether crisis risks would be accentuated in the event of a reversal in these flows owing to FX mismatches or to other factors. For example, whether elevated housing or stock price valuations are associated with high

leverage due to local currency—denominated debt inflows and which, when unwound during a reversal with subsequent effects on local currency interest rates and asset prices, would lead to stress that could not be alleviated by central bank local currency liquidity support.

Assessing Whether the Preemptive CFM/MPM is Needed to Address Systemic Financial Risks

50. There are several conditions that should be satisfied for a preemptive CFM/MPM to be a needed measure to address the risks. In making this assessment, staff should focus on the following considerations: (i) the policy measure should be an CFM/MPM; (ii) MPMs alone are insufficient to address the risks; (iii) the measure should be well-targeted and calibrated effectively to minimize costs and distortions; (iv) the measure should not be used to substitute for warranted adjustments in macroeconomic policies; and (v) should not substitute for market development or structural policies that could reduce the underlying frictions, nor undermine such policies. In general, all these conditions would need to be met.

51. The policy measure should be an MPM in addition to being a CFM. The policy measure —both in the case of FX mismatches and local currency external debt vulnerabilities—should be primarily oriented to address the systemic financial risks stemming from capital inflows. In the case of systemic risks arising from FX mismatches, staff should determine whether the measure reduces risks arising from unhedged FX debt, for example by reducing the existing FX mismatches, preventing capital inflows from causing a further increase in FX mismatches from already-elevated levels, or increasing resilience to FX mismatches by requiring additional capital or liquidity for external borrowing in FX. In the case of systemic risks from local currency—denominated external debt stocks, the measure should lower the associated vulnerabilities by reducing such inflows. If the measure does not pursue a financial stability objective, it would not be an appropriate preemptive measure.

52. The preemptive CFM/MPM would be appropriate only if MPMs alone are not sufficient to address the risks. For example, while MPMs are typically able to contribute substantially to managing risks from FX borrowing (e.g., IMF, 2014b, and IMF, 2017), they may be unavailable or insufficient to address the specific sources of systemic risk. Thus, under these circumstances, staff may determine that using a pre-emptive CFM/MPM—either alone, or to reinforce other MPMs—may be needed as the least distortive way to address the risks effectively. In general, it is useful for staff to determine the sources of FX lending resulting in FX mismatches. For example, when the FX mismatches occur primarily due to local banks lending in FX to local firms and households, MPMs, which are not designed to limit capital flows, are typically able to manage risks from FX borrowing. However, if there is a significant cross-border borrowing in FX, a CFM/MPM that adds constraints on direct cross-border borrowing in FX can be necessary to address risks effectively (IMF 2014a).[49]

53. The preemptive CFM/MPM should be designed to address systemic risks by targeting them at source. In the case of FX mismatches, staff should first determine the magnitude and

[49] See also Background Note 3 in the 2022 Review of the IV.

source of FX mismatches across the relevant sectors (financial sector, non-financial corporate sector, and household sector) as well as the underlying financial transactions (e.g., type and maturity of financial instruments) that give rise to the risks. The measure should target debt inflows in the specific sector that give rise to the risk as closely as possible. Moreover, it should be calibrated in a manner that addresses risks effectively while minimizing costs and side effects. For example, if the coverage or calibration of the measure goes beyond what is necessary to address the financial stability risk at hand, and this could be avoided by using a better-calibrated tool, the measure would not be appropriate, and staff would recommend a better calibrated and designed measure. It should also be calibrated to address FX mismatches or local currency debt effectively without generating undesirably strong impacts on capital flows, domestic credit, output, or market functioning. Among the alternative instruments that could target the same sources of risks, the most efficient preemptive CFM/MPMs are preferred, i.e., those that minimize distortions and costs while still being effective.

54. The preemptive inflow CFM/MPM should not be used to substitute for warranted adjustments in macroeconomic policies. If monetary policy, exchange rates, or fiscal policy are at inappropriate settings, and if correcting them would eliminate or significantly reduce the specific systemic risk in question, staff should recommend adjusting these policies instead of using a preemptive CFM/MPM. To make this assessment, staff can follow a two-step process. First, determine whether macroeconomic policies are significantly away from desirable levels and whether an adjustment is warranted, by relying on the overall assessment of macroeconomic policies in the Article IV consultations. Second, assess whether the warranted adjustment in macroeconomic policies will significantly reduce or eliminate the specific systemic risk in question. In case staff assesses that warranted macroeconomic adjustment will significantly reduce the systemic financial risks, but immediate adjustment is unduly costly, or the policy adjustment may take time to produce effects, CFM/MPMs may be temporarily appropriate to maintain financial stability while the macroeconomic policy adjustments take place. However, such measures should be accompanied by a commitment to undertake and progress in delivering the warranted policy adjustments recommended in the context of Article IV consultations.

55. The preemptive CFM/MPM should not substitute for market development or structural policies that could reduce the underlying frictions, nor undermine such policies. The preemptive CFM/MPM should not undermine market development in a manner that exacerbates the underlying friction. For example, if the preemptive CFM/MPM is being used to reduce FX mismatches, it should not prevent the development of markets which could provide funding in local currency, such as local currency money, bond, equity, and hedging markets. Structural policies, such as local currency market development (IMF, 2021d) can be effective in addressing the frictions that call for the need to introduce preemptive CFM/MPMs and, unlike some CFM/MPMs, may not produce adverse side-effects. Since such policies can take time to be implemented and become effective, preemptive CFM/MPMs may be appropriate in the interim unless they undermine such efforts. If preemptive CFM/MPMs are used, staff should discuss ways to combine them with reforms to address the underlying frictions, which may include, for example, developing and deepening local currency bond markets, boosting the credibility of the macroeconomic policy framework, and

developing sound financial supervision and regulation.[50] When warranted, preemptive CFM/MPM can be used to accelerate the development of the necessary structural reforms, such as market development or institutional and regulatory reforms, to address the source of the vulnerability.

Assessing Whether the Preemptive CFM/MPM Helps Maintain or Exacerbate a Stronger-than-Warranted External Position that is Mostly Caused by Domestic Policy Gaps.[51]

56. The preemptive CFM/MPM should not help maintain or exacerbate a stronger-than-warranted external position, which is driven by domestic policy gaps. In assessing whether the preemptive CFM/MPM does so, staff should form a view on the following three areas:

- ***The strength of the external position and the contribution of domestic policies.*** Staff needs to establish whether the country's external position is stronger than warranted relative to the level implied by medium-term fundamentals and desirable policies according to the External Sector Assessment (ESA).[52] Staff should also establish whether any policy gaps underpinning the external imbalance are mostly domestic rather than foreign. In such cases, it raises the concern that the use of preemptive CFM/MPMs could add to the set of domestic policies generating the external imbalance. To determine that, staff should rely on the ESA, which would typically contain analysis of the contribution of several policy variables (those policy variables include both the country's own policies, and those of the rest of the world) to the strength of the external position.

- ***The expected effect of the preemptive CFM/MPM on the external position.*** In general, relative to the counterfactual of no CFM/MPM use, the inflow CFM/MPM would be expected to depreciate the currency and strengthen the external position, unless a case can be made that its impact on the currency would not be economically significant. To assess whether it does so and to what extent, staff should focus on whether the measure is narrowly targeted, its overall impact on capital inflows, as well as the ease of substitution of the assets targeted by the measure into other assets. For example, a narrowly targeted measure to reduce FX mismatches in the banking sector may lead to flows into local currency debt.[53]

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[50] The appropriate reforms for the specific country may draw on the menu of options in Annex III.

[51] The external sector assessments (ESAs) categorize countries' external positions as either "broadly in line," "moderately weaker (stronger)," "weaker (stronger)," or "substantially weaker (stronger)" than the level implied by medium-term fundamentals and desirable policies. In this section, the term "stronger-than-warranted external position" corresponds to the external positions being categorized in the ESA as either "moderately stronger," "stronger," or "substantially stronger."

[52] In general, staff should refer to the latest ESA which was included in a staff report. However, when available, staff may also use a more recent draft ESA, which was included in a Policy Note.

[53] Only macro-critical CFM/MPMs are assessed in bilateral surveillance. However, macro-criticality does not necessarily imply a significant effect on the exchange rate, as the measure could have a significant effect on other macroeconomic variables even if it does not have a significant effect on the exchange rate. The impact on the currency may depend on the ease of substitution of the assets targeted by the measure. The availability of alternative assets could depend on the existing capital flow management regime (e.g., existing CFMs and the effectiveness of their enforcement) and on the level of the country's financial development.

- ***Policy actions to address a stronger-than-warranted external position.*** If the country has a stronger-than-warranted external position caused by domestic policy gaps, staff should consider whether it is undertaking corrective policy actions to address them or is committed to undertake them. The absence of such actions or commitment would raise concerns that the use of the preemptive CFM/MPM could exacerbate the external imbalance.

Coming to an Overall Assessment of the Appropriateness of Preemptive CFM/MPMs

57. Staff's overall assessment of appropriateness requires first identifying elevated systemic financial risks and determining that the preemptive CFM/MPM is a needed policy instrument to address these risks. If those two conditions are met, staff should assess whether the preemptive CFM/MPM would help maintain or exacerbate a stronger than warranted external position. If that is the case, staff should assess the preemptive CFM/MPM as inappropriate in the following circumstances:

- If the country is not taking policy actions to address the domestic policy gaps leading to the stronger-than warranted external position.

- If the country is undertaking policy actions to address the relevant domestic policy gaps or is committed to undertake them, but the extent and duration of the strength of the external position are large relative to the severity of the systemic financial risks in question and the expected effectiveness of the policy actions to address the relevant domestic policy gaps.

Other Issues

58. Countries with fixed exchange rate regimes[54] may face tighter policy constraints that may strengthen the case for preemptive CFM/MPMs. During capital flow reversals, such countries would face tighter constraints in the use of monetary policy and/or in allowing for nominal exchange rate flexibility to achieve external adjustment than those with more flexible exchange rate regimes. In addition, their ability to provide local currency liquidity support may also be limited. These constraints may strengthen the case for preemptive CFM/MPMs, while bearing in mind that these measures should not substitute for warranted macroeconomic and structural adjustments or help maintain unsustainable currency pegs.

59. Policy advice on preemptive CFM/MPMs should take spillovers into account. Spillovers could arise from the effects of the preemptive CFM/MPM on the exchange rate and the external position or international financial flows, e.g., through contagion effects in international financial markets affecting expectations of market participants or capital flows to other countries.[55] The effects of the preemptive CFM/MPM on the external position are analyzed via the approach outlined

[54] As referenced in paragraph 1, when a country is in a currency union, the appropriate advice should also take into consideration the country's obligations towards the currency union.

[55] There should be no presumption that a preemptive CFM/MPM would have negative spillovers. Similarly, to other MPMs, a preemptive CFM/MPM may have positive spillovers by supporting domestic and global financial stability.

in paragraph 57, and hence, to the extent that it contributes to maintain or exacerbate a stronger-than-warranted external position, they enter the determination of whether the preemptive CFM/MPM is regarded as appropriate under the IV. If the use of the CFM/MPM is assessed as appropriate, the treatment of spillovers should follow the guidance set by the ISD, which mandates staff to discuss outward spillovers from members' policies if they significantly influence the effective operation of the IMS.[56] In such case, staff should examine whether alternative policy actions could achieve domestic objectives while minimizing negative spillovers. However, consistent with the ISD, if the policies promote the member's own domestic and BOP stability, the authorities would not be obliged to act on staff recommendations. Staff may also discuss with the authorities, on a voluntary basis, any outward spillovers that have important implications for other members but not for global stability.[57]

60. Staff should review the preemptive CFM/MPM periodically to assess whether its use continues to be appropriate. Periodic evaluations in Article IV consultations, as appropriate, should ensure that the conditions that were satisfied at the time of the introduction (and initial assessment of appropriateness) of the CFM/MPM continue to hold. The evaluations should follow up on new information regarding economic and policy developments since the introduction of the measure: e.g., whether (new) MPMs have become available to address the risk; whether the measure has become a substitute for warranted macroeconomic adjustments; whether there has been progress on reforms to diminish the need for the CFM/MPM; whether the measure has caused the exchange rate to depreciate significantly (beyond originally envisaged); whether the external position has become stronger than warranted following the introduction of the measure; and whether the authorities have taken measures to address the domestic policy gaps underpinning the strength of the external position. If any of the conditions required for the measure to be appropriate are no longer met, staff should recommend that the CFM/MPM be removed—immediately if it is feasible without jeopardizing macroeconomic or financial stability; or in a phased manner, with the appropriate speed of phasing depending on the feasible time path for the needed macroeconomic, financial, and structural policy adjustments.

C. Managing Disruptive Capital Outflows

61. Capital outflows which are large, sudden, or sustained can be disruptive and pose significant policy challenges. In such cases, when the authorities are faced with significant policy challenges, staff's advice should be tailored to the following circumstances (i) when there is no immediate threat of a crisis; (ii) imminent crisis circumstances; and (iii) crisis circumstances. In particular, when staff's assessment is that there is no immediate threat of a crisis, disruptive outflows can be handled through macroeconomic, financial, and structural policies. However, in imminent crisis or crisis circumstances, CFMs may be appropriate to help restore macroeconomic and financial sector stability. Staff's assessment of whether there are imminent crisis or crisis circumstances is

[56] Using CFM/MPMs to influence exchange rates in order to gain unfair competitive advantage would also be inconsistent with countries' exchange policies obligations under Article IV.

[57] See IMF (2013a), paragraph 7.

therefore important for the relevant policy advice, and this section provides guidance to staff on how to make such determination.

62. In the absence of imminent crisis risks, capital outflows should be handled through macroeconomic, financial sector, and structural policy adjustments. Some capital outflows are a natural consequence of openness, but outflows that are large, sudden, or sustained can pose significant policy challenges, including through their effects on exchange rates, external financing, and interest rates. When there is no immediate threat of a crisis, outflow risks are appropriately handled by macroeconomic, exchange rate, financial, and structural policies, thereby facilitating external adjustment and reducing outflow pressures. The macroeconomic policy response should address the domestic triggers and implications of outflows and foster orderly external adjustment, if warranted. The combination of policies would be based on macroeconomic conditions, taking into consideration financial stability risks, including balance sheet foreign exchange exposures, and any need for the adjustment of policies that may have contributed to outflows in the first place.

63. Countries may respond to capital outflows through a variety of policies. The appropriate policy mix to manage outflows would consider country-specific circumstances and depend on macroeconomic and financial sector conditions and specific risks, and the nature and size of the shock. Possible macroeconomic and financial sector policy responses to capital outflows may include:

- ***Allowing the exchange rate to be a shock absorber.*** Flexible exchange rates serve as an equilibrating mechanism in response to shocks. In the case of outflows, if the currency is not undervalued, some depreciation would be appropriate. A certain degree of exchange rate volatility is normal and may occur without generating disorderly conditions.

- ***Increasing interest rates.*** Higher interest rates could compensate market participants for the expected currency depreciation and discourage capital outflows, or even encourage capital inflows. Considerations should be made on whether the increase in interest rates is consistent with inflation developments and targets. Increasing rates would be appropriate if the monetary stance is too loose vis-à-vis the inflation outlook.

- ***Intervening in the foreign exchange market,*** provided that doing so would not cause reserves to fall to inadequate levels as determined by appropriate metrics. Foreign exchange interventions should be deployed to address disorderly market conditions or could also be deployed to address other inefficiencies.[58] For example, excessive movements in the exchange rate (e.g., changes that lead to balance-sheet effects, heightened counterparty risk, and domestic spillovers to other markets) can cause it to lose its role as a shock absorber and instead to amplify financial and macroeconomic disruptions. The use of intervention should weigh the costs on the credibility of the policy framework against its benefits in terms of dampening shocks. Sterilizing the intervention can help avoid any unwarranted tightening of

[58] See the note on Integrated Policy Framework: Principles for the Use of Foreign Exchange Interventions (forthcoming).

monetary policy. Unsterilized intervention can be appropriate in other circumstances, particularly if initial monetary conditions are too loose or the intervention is conducted under a fixed exchange rate regime. Clear communication can help emphasize the purpose of intervention or that it is temporary.

- ***Role for fiscal policy.*** Fiscal policy may need to be adjusted based on considerations of macroeconomic stability, financing constraints, or policy credibility. It should also be based on public debt sustainability and cyclical considerations, with the latter taking into consideration policy space and availability of financing. A broadly neutral fiscal stance that allows automatic stabilizers to work is generally appropriate, provided that fiscal sustainability and financing constraints are not binding. If, however, policy space or credibility has been eroded, or financing constraints are binding, steps to rebuild fiscal buffers may be needed to regain policy credibility and restore market confidence. In such cases, fiscal tightening that reduces imbalances could enhance policy credibility, lower risk premia, and thereby help address capital outflow pressures, and can also support financial sector policies outlined below.

- ***Financial sector policies.*** Liquidity provision may be required to support orderly financial conditions. Prudential measures can be appropriate to prevent de-capitalization of banks and avoid confidence problems or deposit runs. Policy action needs to be commensurate with specific risks, including whether they are associated with individual institutions or the whole financial system.[59] In this regard, a 'stop-loss' approach whereby authorities determine ex ante what conditions would trigger an intensification of policies would be a useful approach, which may also help with coordination among financial sector supervisors amid a fast-evolving situation. Teams should encourage supervisors to discuss and inform each other of relevant information and policy decisions.

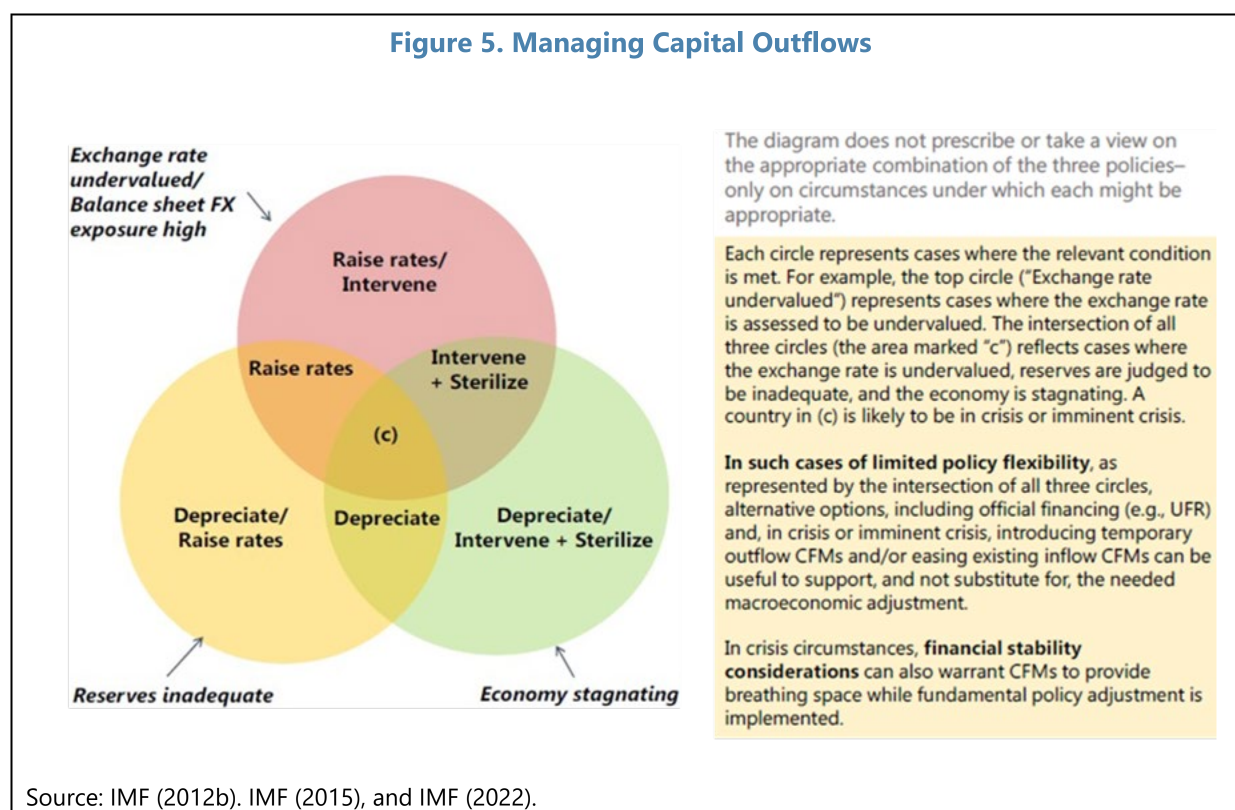
- ***Relaxing inflow CFMs*** that were introduced or tightened to address inflow surges may be useful in some circumstances, if the conditions for their safe removal are in place. In relaxing inflow CFMs that are also macroprudential measures, i.e., CFM/MPMs, the appropriate policy response would also depend on what actions best safeguard systemic financial stability.

64. In countries with fixed exchange rates, macroeconomic policies need to ensure consistency with the peg. In such countries, intervention is integral to the exchange rate arrangement, and accordingly more of the burden of adjustment has to be borne by macroeconomic and structural policies. Foreign exchange intervention to deal with outflows under a peg should typically be unsterilized. In cases in which a shock requires a significant real exchange rate adjustment, a realignment of the peg or crawling arrangement may be needed. Such realignment should consider the effects on the credibility of the peg. Intervention and realignment should not substitute for macroeconomic adjustment that is necessary to ensure consistency with the regime.

[59] IMF 2014a, IMF 2017, and Integrated Policy Framework: Principles for the Use of Foreign Exchange Interventions (forthcoming).

65. In imminent crisis or crisis circumstances, CFMs on outflows may be appropriate to help restore macroeconomic and financial stability. As shown in Figure 5, disruptive outflows can lead to such circumstances when the FX reserves are inadequate, the exchange rate is undervalued or balance sheet FX exposure is high, and the economy is stagnating. Imminent crisis circumstances can also lead to a disruption of the functioning of the financial markets, and/or to financial system stress, and may also constrain the ability of central banks to perform lender of last resort (LOLR) functions or/and emergency liquidity assistance (ELA) in FX. In some cases, outflows may trigger crisis circumstances, by leading to reserve depletion, currency collapse, severe financial system stress, and/or output losses, and policy flexibility to address them may be limited as represented by point (c) in the Venn diagram in Figure 5. In situations when a crisis may be imminent or when there are crisis circumstances, there could be a temporary role for the use of CFMs on outflows, to prevent a free fall of the exchange rate and depletion of international reserves and restore or maintain macroeconomic and financial stability while fundamental policy adjustments are implemented. In imminent crisis circumstances, CFMs may be desirable if they help to prevent a full-blown crisis. For example, outflow CFMs were introduced in Iceland during its crisis in 2008, and in Cyprus and Greece during the European debt crisis (in 2013 and 2015, respectively).

Figure 5. Managing Capital Outflows



Source: IMF (2012b). IMF (2015), and IMF (2022).

66. Outflow CFMs should not substitute for warranted policy adjustment. In crisis and imminent crisis circumstances, staff should ensure that if CFMs on outflows are used, they form part of a broader policy package and are not used as a substitute for warranted policy adjustment, such as fiscal and exchange rate adjustment in response to a classic BOP crisis. Like inflow CFMs, CFMs on outflows should be transparent, temporary, and seek to be non-discriminatory (although it is

recognized that residency-based measures may be hard to avoid in crisis-type situations). Unlike inflow CFMs, which are targeted, outflow CFMs generally need to be comprehensive in order to be effective. They need to be supported by a sound institutional and regulatory system and to be adjusted on an ongoing basis. The challenges associated with ensuring a smooth and timely exit in the future should be kept in mind (discussed below). The CFMs on outflows should avoid, whenever possible, leading to external payment arrears or default, particularly on sovereign debt, which can undermine relations with creditors and damage the international financial and payments system.[60]

67. Staff should be aware of some general considerations regarding the design and implementation of outflow CFMs. In general, outflow CFMs need to be sufficiently broad-based and comprehensive to address the main sources of capital flight and prevent any possible circumvention to be effective. The introduction of outflow CFMs—if selective rather than comprehensive—may trigger additional capital outflows and thus exacerbate ongoing outflow pressures. Poorly designed or implemented CFMs can exacerbate an economic crisis and impose a high economic cost, by creating delays for legitimate transactions and further encouraging outflows through loopholes and lax enforcement (Moretti et al., 2020). In addition, if outflow CFMs are used in imminent crisis and crisis circumstances, it is important that they are introduced swiftly after being announced, in order to prevent front running.

68. The determination of when crisis or imminent crisis circumstances exist is an important consideration for policy advice on outflow CFMs. Assessing crisis circumstances can be guided by quantitative indicators but also require a measure of judgment from staff, based also on country-specific conditions and authorities' views, rather than a mechanical approach. In general, currency collapse, debt sustainability pressures, corporate and financial stress, sharp interest rate increases, and severe output contractions are common features of crises.

69. To assess imminent crisis circumstances, while such an assessment can be challenging, staff can be guided by indicators of vulnerability, possible crisis triggers, and economic and financial distress. In the literature, crises are often seen as emerging from the confluence of an underlying vulnerability and a specific shock or "trigger" (e.g., Chamon et al. 2012). When evaluating whether a crisis is imminent, staff should consider whether the country has recently experienced a shock ("trigger") leading to mounting financial sector and economic distress, fueled by the country's underlying vulnerabilities. To identify imminent crisis circumstances, staff can be guided by the following analysis:

- ***Assess the country's underlying vulnerabilities.*** To this purpose, staff can draw from the Fund's risk assessment tools, which incorporate a variety of indicators identified in the literature as precursors of crises. Useful tools include the vulnerability exercise (VE), the debt sustainability analysis (DSA), and the external sector assessment (ESA), which would help identify risks to domestic and external stability.

[60] In the context of surveillance, policy advice on outflow CFMs should be consistent with Fund's surveillance policy and guidance.

- ***Identify possible crisis triggers.*** It would be useful to identify possible shocks (domestic or global) that may trigger a crisis and their probability of occurrence. This judgement may be guided by the global risk assessment matrix (G-RAM).

- ***Monitor high-frequency data for indications of mounting financial sector and economic distress.*** High-frequency financial data can help staff monitor financial pressures as they build and assess whether financial sector and economic distress may escalate into a full-blown crisis. Such data can also help gauge the degree to which market sentiment may be shifting. Some high frequency data that may provide useful indicators of building pressures include:

  - ***Exchange rate data,*** offering direct indication of external pressures.[61] Most countries experience rapid depreciation of the exchange rate ahead of a crisis. Exchange rate depreciations are also often rapid in the early phase of a crisis, and usually sustained over an extended period as the crisis deepens.

  - ***Official FX reserves data,*** especially when available on a daily or weekly frequency, can be very useful to complement the exchange rate data, as declines in official reserves also point to external pressures.

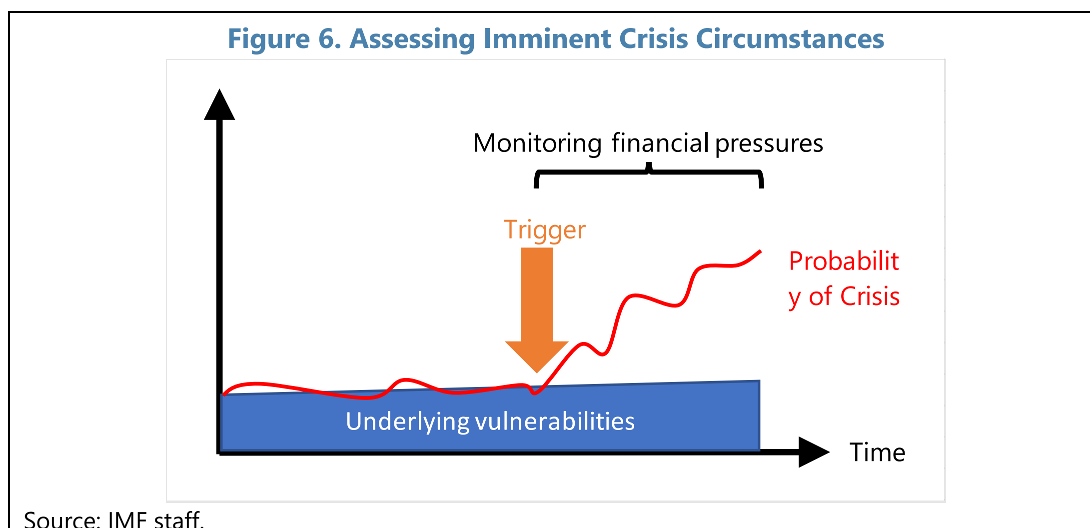
  - ***Asset price data, including yields on local currency bonds, spreads on foreign currency bonds, and stock market indices.*** In countries with significant fiscal sustainability risks or where such concerns may result from the sovereign-banking nexus, pressures on sovereign bond prices may provide important information on whether a country is approaching crisis conditions. In countries where the non-financial corporate sector is a concern, yields/spreads on corporate bonds may be useful sources, complemented by stock market data (which are not as widely available across countries).

  - ***High frequency portfolio flow data,*** which offer direct evidence of the magnitude of outflow pressures and provide a gauge of investor sentiment. Such data have become more widely available in recent years, with some 20+ countries now releasing monthly, weekly, or even daily data on non-resident transactions of portfolio securities. If available, high-frequency data on deposit outflows, and deposit dollarization may also be useful in assessing outflow pressures. [62]

[61] In some countries, while the official exchange rate data may not show pressures, this may be indicated by the parallel market exchange rate. Other indicators could also be queues to purchase FX, and external arrears.

[62] See Koepke and Paetzold (2020).

Figure 6. Assessing Imminent Crisis Circumstances



Source: IMF staff.

70. Staff should monitor the above-described indicators, even when the initial assessment is that there is no immediate threat of a crisis. Rapidly evolving conditions may quickly transform the economic circumstances into imminent-crisis situation.[63] In this regard, staff may focus on assessing any potential vulnerabilities and monitoring possible triggers.

71. Outflow CFMs should be phased out as macroeconomic and financial stability are restored. Outflow CFMs introduced in response to capital outflows in crisis or imminent crisis circumstances can have over time significant costs and adverse effects once those conditions have abated. Phasing out of these measures will help to mitigate adverse effects and enhance macroeconomic growth and financial development. Exiting from these measures requires careful considerations, and the exit strategy should be planned at the time of or soon after the implementation of the measures to ensure a smooth exit. For example, premature withdrawal of outflow CFMs could result in more outflows that lead to renewed macroeconomic and financial instability.[64] Therefore, exiting from outflow CFMs requires a set of operational considerations, with respect to both timing and strategy. The right time to lift outflow CFMs will depend on country specific circumstances—in particular, on conditions rather than on a calendar date. In general, outflow CFMs should be lifted when macroeconomic stability, particularly with respect to the exchange rate, debt sustainability, and financial stability are restored, market access is reestablished, and reserves climb above critical levels. The exit strategy or "roadmap" will need to carefully formulate several key aspects, including design and incentives, communication, and sequencing to deal with country-specific challenges. Examples of countries which have used such exit strategies include Cyprus, Greece, and Iceland.

[63] Recent experience with the rapid pace of bank runs, facilitated by digitalization, has highlighted the speed with which moderate distress may morph into near-crisis circumstances.

[64] In certain cases, this may lead to the re-introduction of outflow CFMs, due to their premature withdrawal, which can undermine the credibility of the authorities' policies.

D. The Role of Source Countries

72. The policies of countries from which capital flows originate (source countries) are relevant for global capital flow developments. Capital flows are influenced by both push (global) and pull (domestic) factors. Push factors include monetary policy in source countries and prudential policies in economies with large financial systems, while pull factors include policies and macroeconomic fundamentals in recipient countries.

73. Staff should discuss with source countries, where relevant for surveillance, the role of their policies in influencing capital flows to the rest of the world and ways to internalize any spillovers of such policies.

- ***Staff should discuss outward spillovers from country policies when significant.*** As mandated by the 2012 ISD, in those cases where spillovers from country policies significantly influence the effective operation of the (IMS), staff reports should include an assessment of outward spillovers, including spillovers from capital flows policies.[65] In such cases, staff should encourage policymakers in those countries to take into account how their policies affect others. In particular, source countries are encouraged to internalize the spillovers from their monetary, capital flow management, and prudential policies. For example, both the use of and exit from unconventional monetary policies (UMPs) in AEs may generate significant spillovers, and present policy challenges particularly for EMDEs. The use of CFMs may also generate significant spillovers, including by amplifying macroeconomic and financial stability risks in other countries, which may be the case in particular, when used by a large economy. The use of prudential policies, especially in countries with global systemically important financial institutions in their jurisdictions, may also generate spillovers. Even when spillovers are not considered significant, they can be discussed on a voluntary basis.

- ***Source country policies can help mitigate the multilateral risks associated with capital flows.*** Countries are neither expected, nor obliged, to adopt policies that are less effective in meeting their primary objectives, such as domestic and BOP stability. Nevertheless, in discussions with the authorities, staff is encouraged to examine possible options to reduce policies' outward spillovers that may adversely affect the IMS while maintaining their effectiveness. Examples of such policy options which minimize spillovers could include careful communication and sequencing of policy changes and/or alternative combinations of monetary, fiscal, capital flow management, prudential, and structural policies. Additionally, progress in global financial sector reforms and improvements in supervision and regulation, including for non-bank financial institutions, can also help reduce the riskiness of capital flows, by increasing financial sector resilience, improving the infrastructure for intermediating capital flows, and helping manage the associated risks.

[65] See Modernizing the Legal Framework for Surveillance—An Integrated Surveillance Decision (July 17, 2012), especially paragraph 20.

SPECIAL TREATMENT OF CERTAIN CATEGORIES OF MEASURES

A. Measures Adopted for Reasons of National or International Security

74. Countries may adopt CFMs for reasons of national or international security. In some cases, these measures may be introduced as part of a sanctions package. Due to their special nature, CFMs introduced solely for reasons of national or international security will not be assessed for appropriateness under the IV. This is consistent with the longstanding principle guiding the Fund's exercise of its jurisdiction over exchange measures imposed for security reasons (Decision 144), which recognizes that the Fund is not a suitable forum to discuss the political or military considerations that lead to the imposition of measures for reasons of national or international security.[66]

75. The treatment of CFMs introduced for reasons of national or international security will be guided by the following considerations:

- ***A determination of whether a measure is a CFM will be made regardless of the stated intent or motivation behind the adoption of the measure.*** Where staff finds that the measure is designed to limit capital flows, it will be considered a CFM. The security motivation of the measure will not be relevant for the determination of whether the measure is a CFM.

- ***Like other CFMs, security-based CFMs need to be discussed in surveillance if they are macro-critical or generate significant spillovers.*** In line with the ISD, such measures will be discussed in Article IV consultations if: (i) they significantly influence a member's present or prospective balance of payments or domestic stability (i.e., are "macro-critical"), or (ii) generate outward policy spillovers that may significantly influence the effective operation of the international monetary system,[67] for example by undermining global economic and financial stability.[68] Where staff assesses that security-based CFMs should be covered in surveillance as specified above, the Article IV staff report will discuss the macroeconomic implications of

[66] In 1952, it was recognized that the Fund does not "provide a suitable forum for discussion of the political and military considerations" underlying certain economic policies. The Fund has a long-standing approach to approve exchange restrictions adopted solely for reasons of national or international security set forth in Board decision No. 144. Under that framework, the Fund's practice has been to rely on members' representation that a measure has been adopted solely for reasons of national or international security, and for the Executive Board to grant approval of such exchange restrictions under Article VIII based on a non-objection procedure. While the Fund could challenge a member's representation, it has not done it in practice. In some cases, the economic impact of measures imposed for national security reasons has been discussed in the context of surveillance (e.g., Article IV for Ukraine 2016, Iran 2018, and Russia 2020).

[67] If the spillovers from the collective (relevant) policies of a group of countries are significant from a macroeconomic standpoint in staff's judgment, the spillovers should be discussed in the Article IV consultation staff report for each country imposing such measures.

[68] ISD at paras. 6 and 12.

security-based measures that are CFMs, which will cover the economic significance and (potential) macro-economic impact of such measures.

- ***However, these measures, if introduced solely for reasons of national and international security, should not be assessed for appropriateness under the IV.*** The staff report should note that measure has been introduced solely for reasons of national or international security and thus should not be assessed under the IV.

- ***Staff will not advise on removing or substituting measures that are determined to be CFMs introduced for reasons of national or international security.*** This is in line with the principle of the Fund not being an appropriate forum for discussion of political and military considerations behind such measures.

- ***Staff will rely on a member's representation as to whether the CFM is introduced solely for reasons of national or international security.*** Staff will rely on members' representation on the objective of the measure, irrespective of the reasons included in the relevant national legislation, thereby providing an evenhanded treatment to all CFMs that are introduced with a similar representation. Such a representation should be communicated to staff, and good practice would be for such communication to be in writing.[69]

- ***Measures that are not explicitly represented by the authorities as having been introduced solely for reasons of national or international security will be assessed under the general criteria under the IV.*** This will be the case even if the measures themselves are similar to those introduced by other members and have been represented as being motivated solely by reasons of national and international security.

- ***In cases where Executive Directors raise concerns about the member's justification for imposing the security-based CFMs discussed in the staff report, these may be included in the Summing Up and/or Chairman's Statement for the relevant Board meeting***. To this effect, the rules set forth in the Compendium of Executive Board Work Procedures[70] determining the content of a Summing Up will apply.

B. Measures Based on Internationally Agreed Prudential Standards

76. Certain prudential measures, which are implemented in line with internationally agreed prudential standards, may constitute CFM/MPMs but are accorded special treatment in the 2022 Review of the IV. The reason such prudential measures may fall under the IV is that they may discriminate based on residency and affect international financial transactions, and thereby be residency-based CFM/MPMs by virtue of their design. The 2022 Review of the IV mitigated the

[69] The communication could be provided by the country authorities or the office of the Executive Director for the member. The authorities should be encouraged to communicate any such representation before finalization of the staff report.

[70] See Compendium of Executive Board Work Procedures.

risk that such measures, which are implemented in accordance with the Basel Framework, in particular Basel III, and international agreements on the reciprocation of certain prudential measures—both of which the Fund has supported—might be assessed as inconsistent with the IV.

77. Hence, the following measures will be labelled as CFM/MPMs, but will not be assessed under the IV for their appropriateness, if implemented in accordance with the Basel framework:[71]

- ***A reciprocation of the countercyclical capital buffer (CCyB)***. This is a residency-based outflow CFM/MPM under the IV as it applies a CCyB requirement that is different from the one applied on domestic exposures to outward/cross-border bank exposures based on residency (the location of the exposure) in a jurisdiction that has activated its CCyB. The requirement may apply for exposures in one or more other countries.

- ***Capital surcharges on domestically or globally systemically important banks (D-SIBs or G-SIBs, respectively).*** Such measures typically constitute CFM/MPMs as one of the criteria for the selection of DSIBs and G-SIBs is their complexity, including the additional complexities from cross-border activity.

- ***The liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) in cases where their design relies on residency-based discrimination***, when such discrimination is allowed under the Basel framework. A residency-based discrimination could occur when the authorities apply a higher run-off rate for non-resident deposits to account for greater volatility of such funding (for example when the country has a history of volatile deposit funding from nonresidents) as can be allowed by the Basel framework. LCRs and NFSRs differentiated by currency would also follow the treatment of residency-based LCRs and NFSRs.

However, when such measures meet the criteria for coverage in surveillance for CFMs, they will be discussed as such in staff reports.

78. Similarly, the appropriateness under the IV of mutually agreed reciprocity arrangements will not be assessed for appropriateness, when they constitute outflow CFM/MPMs. An example is the regional mechanisms operated by the European Systemic Risk Board (ESRB) to expand reciprocity to all (outward) exposure-based measures (i.e., beyond the CCyB, and including all exposure-based tools) among EU member countries. Such measures typically constitute outflow CFM/MPMs as they discriminate based on residency. Such measures will be labeled as outflow CFM/MPMs, and if they meet the criterial for coverage in surveillance for CFM/MPMs, will be discussed in staff reports, but their appropriateness under the IV should not be assessed.

79. To determine if the special treatment applies to a particular measure under paragraphs 77 and 78 which the authorities claim to have been in line with the Basel

[71] The provision of this treatment applies to both Basel member countries, and non-Basel countries.

framework or mutually agreed reciprocity agreements the following steps should be followed:

- ***County teams should flag the measure to the interdepartmental group on capital flows,*** including the authorities' views and/or representations, collect relevant information on the measure, and note any concerns that the team may have.[72]
- ***The interdepartmental group would need to determine that the measure is both a CFM and an MPM (see Annex 1).*** When a measure was taken for reasons other than to secure financial stability, it would be assessed for appropriateness under the IV as any other CFMs. Only those measures whose main objective is to ensure financial stability will be considered further for the special treatment.
- ***The interdepartmental group should not do an in-depth analysis of whether the measure is implemented in line with the Basel framework or mutually agreed reciprocity arrangements, given the complexity of such determination.*** The assessment of implementation of the Basel Framework is a highly specialized and resource intensive task, performed by experts under the Regulatory Consistency Assessment Programme (RCAP) established by the Basel Committee on Banking Supervision (BCBS)[73] or within a Basel Core Principle (BCP) assessment conducted under the Fund's Financial Sector Assessment Program (FSAP).
- ***The interdepartmental group will only check if the specific measure and its parameters are provided for under the Basel framework, or the relevant reciprocity agreement.*** In this context, it would also consider whether, for instance, a measure seems to differ materially from that described in the Basel framework. In addition, if the measure is covered by the assessments as described above, staff should draw on them as well.
- ***If the interdepartmental group does not have any concerns with respect to whether the measure falls under provisions of paragraphs 31-35 of the Review of the IV on internationally agreed prudential measures it should not be assessed under the IV, and the reason for this should be noted in the relevant staff report.*** However, staff should be aware that a subsequent in-depth assessment performed by experts may reach a different conclusion regarding the implementation of the measure, in which case the treatment of the measure under the IV should be revised accordingly.[74]
- ***In contrast, in cases where the interdepartmental group has concerns, regarding the design, calibration or any other aspect of the measure it should consult with the relevant***

[72] This holds in general for measures that may constitute CFMs, but it is an important step in this context as well.

[73] See RCAP on consistency: jurisdictional assessments (bis.org)

[74] Staff may use the following standard language in staff reports: *"Staff has not assessed this measure for appropriateness under the IV, consistent with the special treatment under the IV for measures implemented in line with internationally agreed prudential standards."*

experts in MCM. Staff should obtain a view from the relevant experts in MCM before concluding that a prudential measure is not covered by the carve-out for internationally agreed prudential standards.

- ***If the measure is considered as not falling under the special treatment for internationally agreed prudential measures (or it is not a CFM/MPM)*** the measure should be assessed for appropriateness under the IV as any other CFM or CFM/MPM.

C. AML/CFT Measures

80. AML/CFT measures may constitute CFMs. The international AML/CFT standards[75] requires countries to adopt AML/CFT measures to prevent and stop illicit flows, including illicit cross-border capital flows. AML/CFT measures are required to be applied on an ongoing, risk-sensitive basis. Some of the measures (such as the obligation on financial intermediaries to perform enhanced due diligence measures on certain customers or transactions in light of the higher money laundering or terrorist financing risks that they present) may delay transactions, while others (such as the prohibition to deal with banks from a certain country) may prevent them altogether with a principal objective to manage ML/TF risks of illicit capital flows.[76] Such measures could be purposefully designed so as to discriminate based on residency or nationality,[77] which are among risk factors for illicit flows. Furthermore, AML/CFT measures are generally required on an ongoing (rather than temporary) basis, while CFMs are generally justified by temporary capital flow episodes. Considering these differences and the special purpose of the AML/CFT CFMs, the criteria applied to assess the appropriateness of CFMs under the IV are not well-suited for the assessment of AML/CFT measures.

- ***CFMs that are implemented in accordance with the international AML/CFT standards will not be assessed under the IV for their appropriateness.*** AML/CFT measures are considered to be implemented in accordance with the AML/CFT standards if they are aimed to mitigate ML/TF risks in a commensurate fashion. For example, enhanced due diligence measures that can delay or stop certain transactions (such as additional attention afforded to the beneficial owners and the source of funds) are commonly implemented to manage ML risks of cross-border flows from a country that has a high risk of drug trafficking or corruption. For such measures, staff needs to consider whether these are targeted at the risks and are based on a ML/TF risk assessment or whether the measures are called upon by the Financial Action Task Force (FATF).[78] An example

[75] For the purpose of this guidance note, international AML/CFT standards include the Financial Action Task Force (FATF)'s 40 Recommendations as well as its interpretative notes and glossary.

[76] See FATF Recommendation 19 on enhanced due diligence measures and counter measures towards higher-risk countries (FATF Recommendations 2012).

[77] This could, for example, be the case of customers who reside in a country that is under enhanced monitoring by the FATF because its AML/CFT framework was assessed and found to suffer from strategic deficiencies that impact its effectiveness.

[78] For countries identified as high-risk, the FATF calls on its members and urges all jurisdictions to apply enhanced due diligence, and, in the most serious cases, countermeasures to manage the ML/TF and proliferation financing risks. See High-risk and other monitored jurisdictions.

would be when a jurisdiction instructs its financial intermediaries to limit or prohibit wire transfers for, and consider ending business relationships with, customers from high-risk jurisdictions subject to a call for action by the FATF. These discussions would normally be expected to take place in the lead-up to, or as part of, the discussions of AML/CFT issues during the Article IV consultation or another engagement with the authorities. Like any other CFMs, CFMs arising from AML/CFT measures will be discussed in surveillance and covered in Article IV reports on a mandatory basis and labelled as a CFM if they are macro-critical or generate significant outward spillovers. The staff report should note that the measure has been introduced in accordance with the international AML/CFT standards and thus should not be assessed under the IV.

- ***If staff determines that the CFM is not implemented in accordance with the international AML/CFT standards, it should be treated like any other CFM and assessed under the IV criteria for appropriateness.***[79] Where staff determines that a CFM is not implemented to aim to address ML/TF risks or is not required under the international AML/CFT standards, the appropriateness of such measure should be assessed in accordance with the criteria established in the IV.[80] This could, for example, be the case if a member limits specific types of capital transactions (for example in the real estate sector or in the capital markets) by foreign nationals purportedly on the grounds of money laundering concerns (such as the laundering of proceeds of drug trafficking or tax evasion), but without supporting such a measure by a risk assessment or an assessment of its compliance with the international AML/CFT standards. Another example would be measures to limit capital transactions in the education or charitable sectors (e.g., investing in existing or new educational or religious establishments) by some foreign nationals or governments, purportedly on the grounds of terrorist financing concerns, and in the absence of an assessment or evidence pointing to the risk of misuse of these sectors for terrorist financing purposes. In these scenarios, staff should discuss the appropriateness of the measure under the IV.

D. Measures Arising from International Cooperation Standards Against Avoidance or Evasion of Taxes

81. Measures arising from international cooperation standards against the avoidance or evasion of taxes. The appropriateness of a "residency-based" CFM that is consistent with international cooperation standards against tax avoidance and evasion will not be assessed under

[79] Staff should consult with LEG-FIG to determine whether the measure is implemented in compliance with the AML/CFT standard.

[80] Staff should consult with experts from LEG in providing recommendations regarding such measures, to the extent that such measures were intended to address ML/TF risks or implement requirements under the international AML/CFT standards.

the IV.[81] However, if macro-critical, staff should note that the measure as a CFM, discuss it in the staff report, and note that it is not assessed under the IV.

- ***This special treatment only applies to tax measures based on and implemented in accordance with international cooperation standards against tax avoidance and evasion.*** Such standards include the existing minimum standards of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS), and established tax transparency standards on exchange of information.[82] Other recommended actions that were not agreed to by consensus in the international tax standard setting bodies (e.g., of the OECD and UN) are not covered. For example, other BEPS Actions that were not "minimum standards" within the adopted language of BEPS are not covered.[83]

- ***The circumstances under which tax measures constituting CFMs will not be assessed for appropriateness under the IV are limited to avoid the risk of misclassification[84].*** Tax measures only qualify for this special treatment when they are: (i) based on and implemented in accordance with the agreed international cooperation standards (which are typically peer reviewed); and (ii) designed to prevent the avoidance or evasion of taxes (which further narrows the range of tax measures eligible for this special treatment). Eligible tax measures need to arise from, and be consistent with, the relevant international standards, and, if defensive in nature, based on the identification of countries that fail established peer review processes with respect to the implementation of those international cooperation standards. This would cover, for example, the adoption of defensive tax measures against non-cooperative tax jurisdictions in the form of a "residency-based" CFM that applies a higher withholding tax rate on payments made to a specifically listed non-cooperative tax jurisdiction which has failed, based on a peer review process, to implement the agreed standards. The special treatment will not be available to other arrangements (e.g., bilateral or regional agreements) to limit capital flows agreed with the purpose of preventing tax avoidance and evasion but which go beyond the relevant standards.

OPERATIONAL ISSUES

[81] See 2022 Review of the IV, para 20.

[82] The following international cooperation standards are covered: BEPS Action 5—Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance; BEPS Action 6—Preventing the Granting of Treaty Benefits in Inappropriate Circumstances; BEPS Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting; BEPS Action 14—Making Dispute Resolution Mechanisms More Effective; Automatic exchange of information (AEOI) standard; and Exchange of Information on Request (EOIR) standard.

[83] Actions not covered include: BEPS Action 1 – Addressing the Tax Challenges of the Digital Economy; BEPS Action 2—Neutralizing the Effects of Hybrid Mismatch Arrangements; BEPS Action 3 – Designing Effective Controlled Foreign Company Rules; BEPS Action 4—Limiting Base Erosion Involving Interest Deductions and Other Financial Payments; BEPS Action 7—Preventing the Artificial Avoidance of Permanent Establishment Status; BEPS Actions 8–10—Aligning Transfer Pricing Outcomes with Value Creation; BEPS Action 11—Measuring and Monitoring BEPS; and BEPS Action 12—Mandatory Disclosure Rules.

[84] Country teams should inform the interdepartmental group of such measures, as well as any concerns they may have that the measure qualifies for this special treatment. In case of doubts whether the measure is implemented in accordance with the relevant standards, the interdepartmental group and the country team should consult with LEG.

A. CFMs that are also Exchange Restrictions and/or Multiple Currency Practices (MCPs)[85]

82. Under the IMF's Articles of Agreement, members are free to exercise controls over international capital movements, as long as these controls do not restrict payments and transfers for current international transactions.[86] In accordance with Article VIII, Section 2(a) and Section 3, all Fund members have an obligation not to introduce exchange restrictions or multiple currency practices (MCPs) unless approved by the Fund or subject to transitional arrangements under Article XIV.[87] The IV does not in any way alter members' obligations under Article VIII. If a policy measure constitutes both a CFM and an exchange restriction and/or an MCP, the respective Article VIII framework would generally take precedence as described in this section and Box 5.

83. Measures that are "designed to limit capital flows" (i.e. CFMs) may at the same time be exchange restrictions and /or MCPs The definition of "current transactions" under Article XXX(d) of the IMF`s Articles of Agreement captures some transactions that, from the economic perspective, are capital in nature and are registered in the capital and financial accounts of the balance of payments, namely: (i) payments of moderate amounts for amortization of loans or for depreciation of direct investments; (ii) normal short-term banking and credit facilities; and (iii) moderate remittances for family living expenses. As a result, measures that impact these types of transactions may be classified simultaneously as CFMs and exchange restrictions and/or MCPs. In addition, some measures may affect solely capital transactions (as per Article XXX(d)), being an MCP as well as a CFM. Finally, a measure may be broad enough so as to affect both capital transactions and transactions defined as "current" under the Articles. As a result, a measure may be classified as a CFM and MCP with respect to capital transactions and as an exchange restriction and/or MCP with respect to payments and transfers for current transactions (see Box 5). In advising members on CFMs, staff should be mindful that CFMs should generally be designed in such a way as not to give rise to exchange restrictions or MCPs for current transactions.[88] Measures that are both CFMs and exchange restrictions and/or MCPs will always be mentioned as exchange restrictions and/or MCPs in relevant staff reports in line with the requirements for coverage of jurisdictional issues in surveillance,[89] and will be identified in the report as being a CFM if the criteria for coverage of CFMs in surveillance are met.

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[85] The provisions of this section also apply to measures that are CFM/MPMs.

[86] See the IMF's Articles of Agreement, Article VI, Section 3.

[87] While Article XIV provides for a transitional regime whereby members upon joining the Fund may maintain exchange restrictions and multiple currency practices that exist when the member joins the Fund until such time it accepts the obligations of Article VIII, Sections 3, 4, and 5, all Fund members, irrespective of whether they maintain measures under Article XIV, are bound by Article VIII, Sections 2(a) and (3) in respect of new measures.

[88] See Review of the Fund's Policy on Multiple Currency Practices–Proposals for Reform, 2022, paragraph 32.

[89] See Guidance Note for Surveillance under Article IV Consultations (2022), paragraph 93, and the Guidance Note for the Fund's Policy on Multiple Currency Practices (2023).

Box 5. CFMs that are also Exchange Restrictions and/or Multiple Currency Practices (MCPs)

Exchange restrictions and MCPs (including those that are also CFMs) are subject to Board approval, except for MCPs applicable solely to capital transactions. Executive Board decisions set out criteria for the temporary approval of exchange restrictions maintained for balance of payments reasons and for the temporary approval of MCPs maintained for either balance of payments and primarily for non-balance of payments reasons.[1] Such approval criteria differ from the criteria to assess the appropriateness of CFMs under the IV. To avoid potentially inconsistent policy advice that may result from the application of the two frameworks to a measure which is at the same time a CFM and an exchange restriction and/or MCP, such measures will be treated as set out in the paragraphs below.

Measures that are CFMs and also exchange restrictions and/or MCPs due to the Articles definition of current transactions and are subject to Fund approval under Article VIII will not be assessed under the IV for appropriateness. Such measures will be assessed only under the relevant Article VIII approval criteria.

A measure may be broad enough so as to affect both capital transactions and transactions defined as "current" under the Articles. Such measure may be classified as a CFM with respect to capital transactions and as an exchange restriction and/or MCP with respect to payments and transfers for current transactions and will be treated as follows:

A measure which is an exchange restriction and also a CFM (but not an MCP) will be assessed under the IV for its appropriateness only for the part that is designed to limit capital flows and under the Article VIII approval policy for exchange restrictions for the part that affects current (as defined in the Articles) payments and transfers. For example, a ban on access to FX for certain current and capital transactions will be an exchange restriction to the extent it limits current payments/transfers, and a CFM as it also designed to limit capital flows/transactions.

A measure, which is an MCP and, which affects both current (as defined in the Articles) and capital transactions and also a CFM, will be assessed only under the MCP approval policy.[2] The appropriateness of such measure will not be assessed under the IV. An example of such measure may be a tax that gives rise to an MCP and applies to both current and capital transactions.

CFMs that are also MCPs and are applicable solely to capital transactions will be assessed only under the IV.[3] This is because the Executive Board[4] repeatedly decided not to assert jurisdiction under Article VIIII over the MCPs relating solely to capital transactions. Therefore, in cases where such MCPs are also CFMs and they are considered macro-critical, they are assessed only under the Fund's IV, and the issue of the overlap between the Article VIII framework and the IV does not arise.

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[1] See the Guidance Note for the Fund's Policy on Multiple Currency Practices (2023).

[2] See Review of the Fund's Policy on Multiple Currency Practices–Proposals for Reform, 2022, footnote 50.

[3] "Capital transactions" in this section refer to transactions that are registered in the capital and financial accounts of the balance of payments, except for those defined as "current" under Article XXX(d)) of the Fund's Articles of Agreement.

[4] See Decision No. 8648-(87/104).

Table 1. CFMs, Exchange Restrictions, and MCPs: Some Illustrative Examples

CFMs, Exchange Restrictions, and MCPs: Some Illustrative Examples[1]	Assessment under	
	Article VIII policy	IV for appropriateness
Measures that are both CFMs and exchange restrictions because they relate to transactions that are capital in nature but considered current under Fund's Articles	**Yes**	**No**
- Prohibition for payments of moderate amounts for amortization of external loans[2]		
- Limiting the amount of short-term trade credits to nonresidents that previously were freely allowed		
- Discretional central bank`s approval requirement for payments of moderate amounts for family living expenses.		
Measures that are both CFMs and MCPs because they relate to transactions that are capital in nature but considered as current under Fund`s Articles	**Yes**	**No**
- A tax that applies to the exchange rate used to sell FX for making payments of moderate amounts for amortization of external loans while other FX sales are free of such tax.[3]		
- Requiring to use more depreciated exchange rate for short-term trade credits to nonresidents.[4]		
CFMs that are also MCPs applicable solely to capital transactions	**No**	**Yes**
- A tax on FX conversions for certain capital transactions relative to the exchange rate prevailing for other capital transactions		
Measures that are both designed to limit capital transactions (CFMs) and affecting transactions defined as current under the Articles (exchange restrictions, but not MCPs)	**Yes (only for current transactions)**	**Yes (only for capital transactions)**
- A tax on outward transfers abroad related to both current and capital transactions		
- Absolute limits on transfers abroad for both current and capital transactions		
Measures that are both designed to limit capital transactions (CFMs) and affecting transactions defined as current under the Articles (MCPs)	**Yes**	**No**
- A special exchange rate imposed for transactions of certain market participants covering both capital and current transactions		

[1] Exchange restrictions and MCPs subject to Board approval under Article VIII are always mentioned in the Article IV staff reports/Informational annexes. CFMs, which do not constitute exchange restrictions and MCPs subject to Board approval under Article VIII, are only discussed when such measures meet the criteria for coverage in surveillance for CFMs.

[2] This is different from the case when a restriction is imposed on the repayment of external loans as a bullet (full) amount, where the latter is considered as a capital transaction.

[3] Assuming the amount of tax gives rise to the effective exchange rate that exceeds the exchange spreads permissible under the MCP policy.

[4] Assuming that the more depreciated exchange rate exceeds the exchange spreads permissible under the MCP policy.

B. Other Operational Issues

84. In some cases, CFMs may be part of a country's policy framework or regulations but are either not activated, have quantitative parameters set to zero, or are not enforced. Examples of such measures and their treatment under the IV are set forth below:

(i) *Measures which are part of a country's regulations and framework, but have never been activated.* This includes safeguard/contingency measures[90] whose introduction is conditional on the materialization of exceptional circumstances (e.g., in crisis situations). Some illustrative examples of this kind of measures are those in Croatia,[91] Iceland,[92] Kazakhstan,[93] Moldova,[94] North Macedonia,[95] Serbia,[96] Ukraine,[97] which have provisions on the temporary use of safeguard (protective) measures in their FX laws.[98] The EU has provisions in its policy framework allowing the imposition of such measures in certain circumstances,[99] while the OECD Codes of Liberalization have provisions allowing such measures temporarily for member countries in certain similar circumstances.[100]

(ii) *Measures that could be CFMs but have current quantitative parameters set at zero.* These include measures that have been active in the past with non-zero parameters, but whose parameters are currently set at zero, for example as in the case of Iceland.[101]

Measures described in (i) and (ii) will not be labeled as CFMs and will not be assessed for macro-criticality under the IV. However, if the measure is activated or implemented (in the case of (i)) or amended by setting non-zero quantitative parameters (in the case of (ii)), staff should assess

[90] Some members or international agreements refer to contingency measures as "safeguard" measures. In practice, they could be mentioned in the Staff Report if needed (e.g., when describing the changes in the regulatory framework).

[91] Chapter V: Safety Provisions, articles 47–48, Foreign Exchange Act, 2003.

[92] Chapter 3: Protective measures under extraordinary circumstances, Foreign Exchange Act, No. 70/2021.

[93] Chapter 6, Article 24: Special currency control regime, Currency regulation and currency control, Law of the Republic of Kazakhstan, 2018.

[94] Chapter VII, Article 56. Safeguard measures, Law on foreign exchange regulation, 2008.

[95] Chapter 7. Special Measures, articles 37–38, Law on Foreign Exchange Operations.

[96] Chapter VII. Safeguard measures, articles 42–43, Law on foreign exchange operations.

[97] Article 12. Remedies, Law of Ukraine on Currency and Currency Operations, 2018.

[98] The law may ensure a legal provision granting the power typically to the central bank to introduce "emergency" restrictive measures for a short period of time. Such an arrangement facilitates the prompt introduction of CFMs in exceptional circumstances.

[99] Articles 66 and 144, Consolidated version of the treaty on the functioning of the European Union, 2012.

[100] Article 7: Clauses of derogation, OECD Code of Liberalisation of Capital Movements, 2022.

[101] Chapter II Special Macroprudential measures, article 4, Special reserve requirement on foreign currency inflows, Foreign Exchange Act, No. 70/2021.

the measures under the IV, i.e., assessing if it is a CFM and macro-critical, and, if so, discussing appropriateness in staff reports.[102]

(iii) ***CFMs that are adopted but not enforced.*** Staff should assess unenforced measures if/when they become enforced or if the enforcement is tightened. For example, if a new regulation is introduced which will begin to enforce a CFM, staff should assess the measure in line with the IV.[103]

85. Measures on FX purchases and transactions between residents may be considered CFMs in certain circumstances.[104] The IV is primarily concerned with transactions between residents and nonresidents, i.e., balance of payments flows. However, in some cases, countries may restrict certain transactions among residents, for example by limiting deposit withdrawals and/or restricting FX purchases. When such measures between residents are put in place to arrest depreciation pressures in the context of capital outflows or a sudden stop, these measures would be deemed to have been designed to limit capital outflows, and as such will be considered CFMs and assessed under the IV. For example, in the context of capital outflows, countries may restrict certain transactions among residents to limit capital outflows. These policy actions are sometimes introduced in imminent crisis or crisis circumstances. For example, the authorities may introduce a ban or limit on cash withdrawals from local currency deposits and their conversion into FX, such as in Cyprus (2013), Greece (2015), and Ukraine (2015).

86. Assessing tax measures under the IV needs to take into consideration internationally established legal principles of taxation. Internationally accepted standards on taxation permit treating tax residents and non-residents differently.[105] For example, general tax measures that discriminate based on tax residency (for instance, income tax, withholding tax, and capital gains tax measures) are typically considered non-discriminatory because they seek to achieve an equivalent treatment between persons in "like circumstances," thereby seeking to create a level-playing field.[106]

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[102] Pre-IV measures, i.e., those that were introduced before the IV was adopted in November 2012, will be assessed if settings of the measures have been changed after 2012.

[103] Pre-IV measures that have not been enforced will be assessed if the authorities start enforcing them after 2012, or if the enforcement has been tightened. While the effect of such unenforced measures can be different from the effect of the absence of such measures altogether, in particular on investor decisions, staff is not expected to discuss the differences in implications.

[104] See para 65 in the 2022 Review of the IV.

[105] This is appropriate for general tax measures for two main reasons: (i) to ensure the effective collection of taxes (e.g., withholding tax is the internationally accepted means of collection against non-residents under general tax systems; whereas tax residents typically have substantial connections to the taxing jurisdiction often making withholding unnecessary); and (ii) to reflect key differences in the tax base between tax residents and non-residents (e.g., applicable tax rates often differ under general tax systems, with higher effective tax rates appropriate for non-residents because of structural and long standing tax base differences under which non-residents are taxed only on their income sourced within the taxing jurisdiction; whereas residents are taxed on their entire worldwide income).

[106] Tax residency is commonly defined under the domestic tax law of a country or state and determines a person's liability to tax in that country or state by reason of their domicile, physical presence, or any other criterion of a similar nature.

International legal frameworks such as tax treaties,[107] the WTO rules,[108] and the OECD Codes of Liberalization of Capital Movements and Current Invisible Operations[109] also recognize this distinction. In case non-general tax measures (such as stamp duties and property taxes) were to adopt the tax residence concept used in the general tax law, they would be considered non-discriminatory as well.

87. In assessing whether a given tax measure is a CFM, staff will review the applicable legal definition being used by the tax measure. Staff should determine whether the tax residency concept adopted conforms to international standards by avoiding discrimination because it has been designed to treat all persons—whether nationals or non-nationals—in "like circumstances" the same way (see Annex 6 for details).[110] General and non-general tax measures that solely discriminate based on tax residency conforming to international standards should not be automatically considered residency based CFMs under the IV. In these cases, further analysis will be required. Such analysis needs to consider the circumstances surrounding the introduction or tightening of such measures. If based on the analysis of such circumstances, the tax measures are found to be designed to limit capital flows, they will be assessed as "other CFMs".[111] Annex 6 provides guidance on when residency-based discrimination arises with respect to tax measures, and how to determine whether any differentiation based on tax residency conforms to international standards, and staff may also consult with both LEG and FAD on making such determination.

88. As discussed in the 2022 Review of the IV, some other topics, while important, are not covered under the IV. This is because additional work is needed to establish the analytical foundations and develop operational guidance. These topics include the use of CFMs for social or political objectives, the distributional effects of capital flow liberalization, the use of outflow CFMs

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[107] See the OECD and UN Model Tax Conventions. For example, Article 24 prohibits discrimination based on nationality but does not apply where a different tax treatment results from factors other than nationality, such as tax residence.

[108] See Chairman's Statement of 10 December 1993, issued at the conclusion of the negotiations of the GATS (https://docs.wto.org)

[109] See OECD Code of Liberalisation of Current Invisible Operations (page 23).

[110] While domestic tax residency definitions can vary in their specific design and drafting, a typical standard formulation for an individual person would be as follows (other non-discriminatory iterations can apply to non-individual taxpayers): An individual is resident in the local jurisdiction for a year of tax assessment if the individual: (i) resides in the local jurisdiction; (ii) is domiciled in the local jurisdiction unless the individual has a permanent place of abode outside that jurisdiction; or (iii) is present in the local jurisdiction for a period of, or periods amounting in aggregate to, 183 days in any 12-month period.

[111] The continued existence of tax rate discrimination in a non-general tax measure that need not differentiate on policy grounds would tend towards a finding that it was designed to limit capital flows and is therefore a CFM (even if not held to be a residency-based CFM that is discriminatory). For example, stamp duties are transaction taxes that can be collected and enforced without differentiation (e.g., stamping can be enforced against both residents and non-residents as the transaction being stamped invariably relates to physical property—often land—located in the taxing jurisdiction) and the tax base upon which the stamp duty is paid is the same for residents and non-residents (e.g., dutiable value of the property transferred by the transaction).

outside of (imminent) crisis circumstances, and the effects of digitalization and climate change on capital flows and related capital flow management issues.[112]

[112] See para 7 in the 2022 Review of the IV.

Annex I. Terminology: The Institutional View on the Liberalization and Management of Capital Flows

Capital Flow Management Measures (CFMs)

1. **For the purposes of the IV, the term capital flow management measures (CFMs) is used to refer to measures that are designed to limit capital flows.**[1] CFMs comprise:

- ***Residency-based CFMs***, which encompass a variety of measures (including taxes and regulations) affecting cross-border financial activity that discriminate on the basis of residency. These measures are also generally referred to as capital controls;[2] and

- ***Other CFMs***, which do not discriminate on the basis of residency, but are nonetheless designed to limit capital flows. These other CFMs typically include measures, such as some prudential measures, that differentiate transactions on the basis of currency as well as other measures (for example, minimum holding periods) that typically are applied to the non-financial sector.

2. **Based on this definition, if a measure is not considered to be designed to limit capital flows it would not fall under the CFM nomenclature.** These measures that are not designed to influence capital flows are neutral in their application in that they do not discriminate according to residency and do not, typically, differentiate by currency. Prudential measures such as capital-adequacy requirements, loan-to-value ratios, and limits on net open foreign exchange positions, that are not designed to limit capital flows but rather to ensure the resilience and soundness of the financial system are generally not CFMs. Macroeconomic policies, similarly, would not normally be CFMs and nor would structural and other policies that, while they may directly or indirectly inhibit capital flows, are not designed to limit capital flows.

3. **In practice, the classification of a particular measure as a CFM would require judgment as to whether the measure is, in fact, designed to limit capital flows.** The key consideration in making the determination whether a measure is designed to limit capital flows is whether the measure, by virtue of its design: (i) treats international capital transactions[3] (and/or associated payments or transfers) less favorably than domestic capital transactions (and/or associated payments or transfer), or (ii) applies only to international capital transactions (and/or associated payments or transfers) and either imposes or intensifies a limitation on such transactions (and/or associated payments or transfers). An example would be measures that discriminate between residents and non-residents with respect to international capital transactions which are always considered as CFMs. However, there may be cases where, even though the measure is not a CFM by

[1] This definition is provided in Annex 2 of the 2012 Institutional View Board paper.

[2] The term "capital controls" is used interchangeably with the term "capital restrictions".

[3] For purposes of determining whether a measure is a CFM under the IV, international capital transactions generally are capital transactions recorded in the capital and financial accounts of the balance of payments, i.e., transactions that are not current transactions.

virtue of its own design but is nevertheless judged to be designed to limit capital flows based on an evaluation of the context in which it was introduced and the totality of the country-specific circumstances. Such an evaluation could take into account, for example, whether the measure was adopted during a period of surges in inflows or disruptive outflows. The determination whether a measure is a CFM should be guided by the above considerations regardless of the stated intent or motivation behind the adoption of the measure (for example, to promote price or financial stability, social policy, or national security reasons).

4. To illustrate further, a measure could be designed to limit capital flows if any of the following are observed:

- ***It explicitly discriminates on the basis of residency*** (for example, restrictions on non-resident investments or residents' access to FX for portfolio investments abroad).

- ***It directly targets a cross-border capital flow*** (for example, a blanket tightening of domestic financial institutions' net open foreign exchange position when the on-shore foreign exchange interbank market is small relative to external sources of finance).

However, measures that are designed to deal with the financial sector risks of increased liquidity arising from capital flows, but not to limit the flows themselves, would not be considered CFMs.

Use of Terminology

5. For transparency and even-handedness, CFMs and MPMs should be identified as such in staff reports and other papers. (In some instances, staff reports have, for example, identified as "MPM" measures that are in fact "CFM" or "CFM/MPM.") If the classification is unclear, or the staff and authorities have different interpretations, the staff report can note the lack of clarity or difference in interpretation. At the same time, staff should focus in the discussions on the policy context and appropriateness of particular measures and avoid attaching any sense of stigma or preference to one term or other.

6. The terminology is intended for use only in the context of the institutional view and its application in the Fund's advice and assessments. The terminology is not intended to supplant terms used in other contexts, such as in other international, multilateral, or bilateral agreements. In addition to the CFM terminology, this intention applies also to concepts like capital flow liberalization. In the institutional view, "capital flow liberalization" is understood as the removal of CFMs, but the understanding can differ in other international frameworks. For example, the OECD concept of liberalization applies only to the elimination of measures that discriminate between residents and nonresidents, while the obligations with respect to capital flow liberalization in the Treaty on the Functioning of the European Union generally prohibit all restrictions on capital flows even if they do not discriminate based on residency (both among EU members and between

members and third countries).[4] Staff do not assess consistency of CFMs/MPMs measures with these other frameworks.

MPMs and CFMs

7. MPMs and CFMs are often perceived as similar, but their primary objectives do not always overlap. While CFMs aim to contain the scale or influence the composition of capital flows, MPMs are prudential tools that are primarily designed to limit systemic financial risk and maintain financial system stability irrespective of whether the origin of the risk is domestic or cross-border. For example, a tax on specific cross-border inflows is a CFM and may only indirectly affect financial stability.

8. In some instances, however, CFMs and MPMs can overlap. To the extent that capital flows are the source of systemic financial sector risks, the tools used to address those risks can be seen as both CFMs and MPMs. An example could be when capital inflows into the banking sector contribute to a boom in domestic credit and asset prices. A restriction on financial institutions' foreign borrowing, for example through a levy on their foreign exchange inflows or required reserves on financial institutions' external foreign exchange liabilities would aim to limit capital inflows, slow down domestic credit and asset price increases, and reduce liquidity and exchange rate risks (see also paragraph 2 of Annex 1 on net open foreign exchange position). In such cases, the measures are designed to limit capital inflows as well as reduce systemic financial risk and would be considered both CFMs and MPMs.

9. Staff maintains a running roster of macro-critical policy measures assessed as CFMs or CFM/MPMs and referred to in published IMF staff reports as they have been introduced or adjusted since the adoption of the IV.[5] The IMF Taxonomy of CFMs, updated annually, provides information about measures assessed by Fund staff as CFMs or CFM/MPMs (measures that are both CFMs and macroprudential measures) discussed in published IMF staff reports. The Taxonomy contains details of CFMs and CFM/MPMs, including their type and description, dates of their introduction and/or adjustments, and their latest status based on available information as of the cutoff date. It also includes direct quotations from relevant IMF staff reports reflecting policy advice provided under the IV.

[4] See OECD Code of Liberalization of Capital Movements and the Treaty on the Functioning of the European Union, in particular Article 63.

[5] See IMF Taxonomy of Capital Flow Management Measures.

Box AI.1. Definition of CFMs, MPMs, and CFM/MPMs

The Fund's policy framework distinguishes between CFMs, MPMs, and CFM/MPMs. CFMs are measures that are designed to limit capital flows, while MPMs are primarily prudential tools that are designed to limit systemic financial risks. Measures that are designed to limit such risks stemming from capital flows are classified as CFM/MPMs (IMF 2012b, 2013b, 2017). An interdepartmental group works with country teams to ensure consistent and evenhanded classification of measures, while also ensuring that the policy recommendations provided are adequately guided by the different frameworks.

The classification of measures requires a careful assessment of their design, objectives, and the circumstances under which they are introduced. It has been recognized that the delineation of CFMs from other policies and measures affecting capital flows can be challenging and would need to take into account the overall context and circumstances in which the measure was adopted. In addition to measures discriminating based on residency, non-discriminatory measures may also constitute CFMs if they are designed to limit capital flows based on the circumstances under which they were introduced or changed.

To determine whether a CFM is also an MPM, three conditions need to be fulfilled: (i) its primary objective is to safeguard financial stability; (ii) a source of systemic financial risks can be identified; and (iii), the CFM can reasonably be expected to mitigate such risks. Currency-based measures may in many instances be only MPMs, but in some cases also CFMs if they are designed to limit capital flows.

CFMs are not labeled as CFM/MPMs if their design or context suggest that their primary objective is not financial stability or that they are unlikely to limit systemic risks. For instance, if the authorities' stated objective is explicitly not financial stability, the CFM would not be classified as an MPM even though it could mitigate systemic risks. Conversely, measures that are stated to be taken for financial stability purposes may not be classified as MPMs if their transmission does not suggest that they can be expected to mitigate systemic risks but can be classified as CFMs if they are designed to limit capital flows based on the circumstances under which they were introduced or changed. For instance, if a measure has been imposed and its usage or design magnify rather than mitigate risk, this information would be an input into the assessment of the primary objective of the measure. CFMs that mainly operate through the exchange rate are given extra scrutiny and may not qualify as MPMs.

Source and Recipient Countries

10. The terms source countries and recipient countries are based on gross flows. For operational purposes, source countries can generally be understood as countries from which significant gross flows originate, while recipient countries are countries that receive gross flows on a scale that is substantial relative to the domestic economy. Push and pull factors accordingly originate from source and recipient countries, respectively.

Table AI.1. Selected Capital Flow Management Measures [1/]

	Measures designed to limit inflows	Relevant features
Brazil	2009 - Introduction of a 2 percent tax on portfolio equity and debt inflows.	Tax directly on inflows.
Indonesia	2011 - Imposition of (1) a six-month holding period on central bank bonds and (2) a limit on short-term foreign borrowing by banks to 30 percent of capital.	Directly targets a capital flow and will reduce demand for foreign capital
Korea	2011 - Restoration of a 14 percent withholding tax on interest income on nonresident purchases of treasury and monetary stabilization bonds (in addition to a 20 percent capital gains tax), leading to equal treatment of both foreign and domestic investors. Nonresident investors based in countries with double taxation treaties with Korea are subject to reduced rates based on these treaties and official investors are exempt.	Increased the tax rate for foreign investors with the stated intention of reducing capital inflows (even though it led to equal treatment).
Peru	2010 - Increase of fee on nonresident purchases of central bank paper to 400 basis points (from 10 basis points).	Discriminates on the basis of residency and is intended to limit capital flows.
	Measures designed to limit outflows	**Relevant features**
Argentina	2001 - Establishment of *Corralito*, which limited bank withdrawals and imposed restrictions on transfers and loans in foreign currency.	Direct restrictions on capital flows.
Iceland	2008 - Stop of convertibility of domestic currency accounts for capital transactions.	Direct restrictions on capital flows.
Malaysia	1998 - Imposition of 12-month waiting period for nonresidents to convert proceeds from the sale of Malaysian securities	Discriminates on the basis of residency to limit outflows.
Ukraine	2008 - Introduction of a 5-day waiting period for nonresidents to convert local currency proceeds from investment transaction to foreign currency.	Discriminates on the basis of residency to limit outflows.
Thailand	1997 - Imposition of limits on forward transactions and introduction of export surrender requirements.	Restricts foreign exchange transactions to limit capital outflows.

1/ The measures in this table are described as they were at their respective introduction.

Annex II. Liberalization: Thresholds, Pre-Conditions, Sequencing, Other Operational Considerations, and Examples

When assessing liberalization plans or developing staff's views on member countries' readiness for liberalization, staff should analyze whether they are consistent with safe liberalization that allows reaping the benefits of greater openness while managing the risks. Staff could take into consideration the following aspects:

1. The extent to which the preconditions for safe liberalization are in place.[1] Such preconditions include the following, and in examining them peer comparisons may also be helpful based on comparable economies with liberalized capital flows.

- *Stable macroeconomic and financial conditions supported by a strong macroeconomic policy framework.* A credible exchange rate arrangement supported by adequate reserves can reduce the risks related to increased capital flow volatility. A flexible exchange rate arrangement facilitates absorbing external shocks, as could a credible peg combined with fiscal and labor market flexibility. Low and stable inflation reduces the risk of capital inflow surges that can stem from carry trade and capital flight caused by depreciation expectations. Building and maintaining macroeconomic and financial sector buffers can also serve to reduce the risks. A sustainable fiscal position and manageable public sector and external debt reduce the likelihood of adverse macroeconomic effects of capital flow retrenchment, while providing room for private sector outflows. The absence of potential credit and asset price bubbles also reduces the financial stability risks.

- *Financial sector capacity to absorb inflows.* Active and deep domestic money and foreign exchange markets facilitate the absorption of capital flow volatility, as well as the implementation of an effective monetary policy. Development of equity and bond markets helps reduce the risk of residents' reliance on foreign assets and the corporate sector's resort to foreign funding, by providing alternative investment and funding opportunities. Moreover, the development of an adequate yield curve is necessary to ensure the availability of hedging instruments.

- *Ability of financial sector to deal with increased capital flow volatility*. Liberalizing and developing the financial sector and ensuring sound governance and risk management in financial institutions, helps to strengthen its ability to deal with capital flows. Evaluating the resilience of banks' balance sheets to larger capital flows generally requires attention to the following factors: (i) relatively high reliance on deposits, in particular from institutional investors who may

[1] These conditions need not be taken as given over time, and staff advice should aim to strengthen these conditions for managing capital flows safely and beneficially.

rebalance portfolios when outward capital transactions are liberalized; (ii) adequacy of net open foreign exchange position limits or exchange rate risk management practices; (iii) credit risk associated with exchange rate depreciation, due to a large share of foreign exchange-denominated loans or inflation-linked loans (especially in high exchange rate pass-through countries); (iv) high levels of NPLs.

- *High standards of governance and disclosure*. Adherence to international accounting, transparency and shareholder protection standards facilitates the liberalization of FDI and portfolio flows and allows proper pricing of stocks and securities. Adequate governance standards reduce the vulnerability of the financial and nonfinancial corporate sectors to risks related to greater openness.

- *Strong financial sector regulatory standards and effective supervisory framework*. Adequate micro and macroprudential regulations can significantly contribute to containing the risks of greater openness. Cooperation agreements with supervisory authorities of other countries, particularly countries that are important as sources or destinations of capital flows, can facilitate the detection and management of financial stability risks. An adequate deposit guarantee framework can help local banks retain residents' deposits. Proper crisis preparedness and resolution frameworks gain importance in a context of increased capital flow volatility and potential contagion. Adequate prudential regulations need to be in place on institutional investors' foreign investments before liberalizing capital outflows. Reforms also need to address the risk that operations through the informal financial sector can undermine the effectiveness of the prudential framework in the formal financial sector.

- *Strong policy track record.* A track record of implementing sound policies, which provides a credible basis for the necessary reforms underpinning liberalization, can facilitate managing its risks.

2. Rely on a range of available sources of relevant information. The macroeconomic assessment should be based on the analysis for bilateral and multilateral surveillance (see surveillance guidance note). Staff should also draw on examples of other similarly situated countries that have liberalized successfully.

3. Assess the risks that removal of the CFMs would pose to macroeconomic and financial stability. Staff should identify those CFMs that are effective and assess the risks their liberalization would pose to the economy and the financial sector. Subsequently, reforms can be designed to support liberalization by eliminating or reducing these risks.

4. Plan the sequencing of liberalizing reforms to match the achievement of preconditions and thresholds to reduce risks. Broadly, sequencing reforms in the integrated approach can be summarized as "long term before short term, FDI and other non-debt before debt, and inflows before outflows." In addition, the currency composition of financial assets can have implications for stability that may warrant caution. The sequence needs to be calibrated to country-specific circumstances and to entail a measure of flexibility and judgment, taking into account the dialogue

between the authorities and staff, the preconditions, and expertise from MCM and others. The following general approach to sequencing could provide a reference point to be adapted to each country:

- *Liberalize FDI inflows* and certain short-term bank-related flows needed to facilitate trade and financial transactions for clients of financial institutions (for example, trade finance and allowing banks to open accounts with correspondent banks abroad).

- *Liberalize FDI outflows and inflows* into traded securities (for example, listed bonds and equities). Liberalizing inflows into equities may present fewer complications than bonds, given equities' potential for both greater risk-sharing and market-deepening. Nevertheless, the development of bond markets could also benefit from foreign participation enlarging the investor base. Some countries have taken advantage of liberalizing inflows into traded securities to lengthen maturities (for example, initially allowing inflows only for long maturities). In this stage, prudential controls on banks' open positions will need to continue, especially to limit the large-scale use of short-term foreign currency borrowing to fund domestic currency lending, along with prudential rules on domestic lending in foreign exchange.

- *Progressively lift controls on outflows* and allow greater participation of foreign investors in other assets.

5. Evaluate whether the current stage of liberalization is appropriate, considering benefits and risks associated with the existing preconditions. If liberalization has outpaced the capacity of the economy to safely handle the resulting flows, the re-imposition of CFMs may be warranted until sufficient progress has been made with respect to the macroeconomic, financial, and governance policies and the level of market development that the integrated approach recommends. If CFMs are re-introduced, the least discriminatory measure that is effective should be preferred.

Some Examples of Liberalizing Capital Flows

- *China (2011 Article IV Consultation). Discusses sequencing of liberalization.* Key elements of discussion: staged approach to liberalization, including at the outset financial sector reforms and a focus on removing restrictions on more stable, long-term sources of financing such as FDI; full liberalization—including short-term flows—waiting until the bulk of financial sector reforms have been implemented; the risk that liberalizing interest rates could raise rates in a way that leads to potentially destabilizing capital inflows; and allowing the exchange rate to appreciate would help reduce these pressures.

- *Korea (2006 Article IV Consultation). Discusses role of financial development for handling capital flows.* Key elements of discussion: authorities' policies to further develop the financial sector, including the proposed removal of remaining restrictions on the capital account; and priority areas for further financial development, especially an active money market to provide a pricing mechanism for forward transactions in foreign exchange.

Annex III. Preemptive CFM/MPMs: Data Sources, and Other Operational Considerations

This annex provides additional guidance on data sources and operational considerations for assessing appropriateness of preemptive CFM/MPMs. Staff may find useful to refer to it.

1. In the assessment of the appropriateness of a preemptive CFM/MPMs, staff are typically asked to assess systemic risk, related to FX mismatches. The following data sources and approaches may be useful to staff:

- *Private sector FX debt stocks.* Ideally, to assess the liabilities component of FX mismatches, staff should analyze the stock of private sector FX debt, both economy-wide as well as at the sectoral level. In addition, data on the breakdown of FX debt stocks across households, non-financial corporations (NFCs), banks, and non-bank financial institutions (NBFIs) could be particularly useful in identifying additional vulnerabilities that would be discern from aggregate data alone. In general, such detailed data would not be available, however, the following sources may be useful:

  - *Data from public data sources.* Staff should check the available data from databases at the BIS, LBS, IDS, and IFS..

  - *Data from the authorities.* Staff should check if the authorities have such data and can share it with Fund staff. Authorities' data may cover only certain sectors, or in some cases staff may need to request data from several government institutions to get larger coverage. For example, the central bank may have access to such data for banks, and possibly for NFBIs, but may not for NFCs, or households. The data for NFCs may be available through other supervisory agencies (such as an agency overseeing listed companies), and the data for households may be available through surveys. In certain cases, the authorities' data may be provided on condition of confidentiality.

- *Private Sector FX assets and hedges.* The hedging could be of several forms: (I) natural; (ii) via holdings of liquid FX assets; or (iii) through financial contracts in deep hedging markets. The following approaches may be useful to staff:

  - *Natural hedges.* Staff can approximate natural hedges by using data on export revenues net of FX expenses for corporates, or data on remittances for households. However, natural hedges may provide coverage for only a limited segment of the economy, i.e., the export sector or households supported by remittances from abroad.

  - *Liquid FX assets.* Data on portfolio assets and other investment assets can be found in the IMF's Statistics Department's BOP/IIP database. In addition, staff may use the Balance Sheet Approach (BSA) data (including the currency and deposits subcomponent), which also has

data on short- and long-term maturities. In general, staff should assume that all maturities have significant liquid components.

  - *Hedging through non-deliverable instruments* (such as non-deliverable forwards (NDFs)). Such hedging only protects the buyer from losses due to exchange rate movements, i.e., protects from FX mismatches, but does not provide the FX liquidity needed at maturity, and does not hedge against maturity mismatch. NDFs are typically used in Asia, as well as Brazil and Russia. The BIS's Triennial Central Bank Survey provides the most comprehensive data, but it is only available on a triennial basis and for a limited number of currencies.

- *Maturity structure.* A breakdown of FX debt stocks and assets by maturity would allow staff to identify whether there is a mismatch between FX obligations falling due in the short term and the stock of liquid FX assets. The timing of FX income and the maturity structure of hedges can provide important information as to whether there is such mismatch with the maturity of FX obligations, and whether the financial hedges need to be rolled over, creating further FX maturity risks. Data gaps may be filled by complementing the available data with reasonable proxy for missing maturity data. To estimate the maturity structure of FX debt if such information is not available, staff can use as proxies those debt categories that are likely to comprise mostly short-term and FX debt, e.g., external interbank debt. On the asset side, available information could also be used to come up with a reasonable proxy for the ratio of FX to local currency debt in the short-term external debt series available in the IIP database.

2. In assessing systemic risk, staff may refer to the following principles to be used for solvency and liquidity stress tests:

- *A solvency stress test* can be used to assess how an adverse macroeconomic scenario, including a calibrated level of depreciation, may increase the defaults of private sector agents such as banks, corporates, and households owing to FX balance sheet mismatches, and how this in turn may affect the solvency of banks.

- *A liquidity stress test* attempts to understand how a withdrawal of FX funding or a drop in FX revenue interacts with FX maturity mismatches at the sectoral level to create systemic shortfalls including through amplification from an interaction between domestic sectors. Such an exercise would begin with a calibration of the size of the depreciation and the withdrawal of FX funding to the private sector, together with assumptions for the liquidation of each sector's FX assets and the operation of the FX hedging markets under stress. The stress test would enable the identification of the spillovers of FX shortfalls onto the rest of the economy, using available information on the structure of the financial system, the presence of elevated asset valuations, and the availability of policy support.

- *The objective of both kinds of stress tests* is to assess whether the key sectors can withstand the shock, to quantify the size of the domestic contagion, and to judge the degree of FX policy support that may be needed. The required policy support should be compared to the FX buffers

held by the central bank or government, including access to other FX liquidity sources (e.g., sovereign wealth funds, FX reserves, FX swap lines, and/or Fund arrangements).

Annex IV. Assessment of Housing Measures Under the IV

1. A housing measure which is designed to limit capital flows is considered a CFM. In particular, a measure restricting capital flows that discriminate between residents and non-residents, as is the case for many housing measures, constitutes a CFM under the IV. Such a measure may also be classified as a MPM, in addition to being a CFM, i.e., CFM/MPM, if (i) the authorities' primary objective with the measure is to limit systemic risk, (ii) a potential source of systemic risk can be identified, and (iii) a path of transmission of the measure can be identified along which the measure can reasonably be expected to contribute to a reduction in systemic risk (see Annex 1)[1]. Thus, when the authorities' primary concern is housing affordability—while relevant—this would not be a reason to qualify the measure as also an MPM, in addition to a CFM (i.e., as a CFM/MPM), for example measures taken in Australia and Canada.

2. Housing measures that are assessed as CFMs or CFM/MPMs must be evaluated for their appropriateness under the IV when they are macro-critical. In many cases for example, the housing market has important implications for the functioning of the financial sector, and housing services are also an important part of consumption, and thus measures imposed on the housing market would generally be considered macro-critical. However, in some cases the effect of a measure on the current and prospective domestic or BOP stability is very small, possibly as a result of the design of the measure, and thus the measure may not be macro-critical (see paragraph 7 for guidance on assessment of macro criticality of CFM or CFM/MPMs). However, if the current impact of the measure is small because prior measures on the real estate sector have already reduced the volume of nonresident inflows which would be expected to increase with their removal, then the new measure's prospective impact may render it macro-critical. Moreover, if the measure is determined to be part of a package of prior measures, then it may be considered macro-critical, if the overall package of measures is macro-critical.

3. Under the IV, CFMs and CFM/MPMs may be appropriate if they are introduced or tightened during a capital inflow surge, and in certain circumstances CFM/MPMs may also be appropriate if introduced or tightened preemptively, i.e., in the absence of an inflow surge. A capital inflow surge does not necessarily need to be large from an economy-wide perspective for CFMs or CFM/MPMs to be appropriate. A surge that is sizeable in a particular sector with systemic linkages may pose financial stability risks or contribute to macroeconomic imbalances even if the surge is not large in relation to the economy as a whole. Thus, an inflow surge in the housing market, while not necessarily significant compared to total capital inflows, can lead to macroeconomic instability and/or financial sector stability risks. Thus, CFMs or CFM/MPMs on the housing sector may be considered appropriate according to the IV, provided that they are designed

[1] For instance, nonresident inflows can fuel demand for housing, which pushes up house prices when supply is slow to react. Higher prices may necessitate more borrowing and increase the share of lower quality credit in banks' portfolio. In addition, or alternatively, non-residents' demand for housing can adversely affect banks' credit quality. This may be the case in particular, if banks have less visibility on the nonresidents' credit worthiness, or if the recourse to nonresidents' assets is more challenging than for the residents.

to address the financial or macroeconomic stability risks arising from a capital inflow surge into the housing sector.[2]

4. Access to data on nonresident demand is necessary to evaluate the presence of a capital inflow surge. To assess the appropriateness of a housing CFM or CFM/MPM, staff should evaluate the existence of an inflow surge and its effect on housing markets and household credit, or macroeconomic imbalances. The 2022 Review of the IV provides additional guidance on assessing inflow surges (see Annex 7 for description of the inflow surge toolkit).[3] Useful data to determine the relevance and the trend of nonresident demand include both the number and the value of housing transactions separated by resident and nonresident buyers. The housing transaction data is an important source because nonresident investors may not necessarily resort to domestic banks to finance their house purchases and thus housing loan data, which is typically available to the authorities, may not provide the full extent of nonresident demand. In addition, it can be useful to assess if the demand focuses on just a specific segment of the housing market or whether it is more broad-based. Evidence on the effect of nonresident purchases is also useful for the assessment. In this analysis, however, it is important that demand in a particular sector can also affect other housing prices and that nonresidents may be the "marginal investors" who end up having an important impact on the level of prices overall, even if their share in the total number of transactions is less important. When the CFM or the CFM/MPM has already been introduced, staff should analyze the period before the implementation of the measure, when assessing surges, since the measure is likely to have had an impact on capital flows since. The assessment of a surge can be further useful in the evaluation of whether nonresident demand fuels additional indebtedness by the domestic households and increases in financial stability risks.

5. Under the IV, for CFMs or CFM/MPMs to be appropriate, they should not substitute for warranted macroeconomic adjustment. Since many housing measures—such as stamp duties—may have a very limited impact on overall capital flows and may not impact substantially the external position, in many cases they are not used to substitute for warranted macroeconomic adjustment. Nevertheless, there might still be cases where such measures might be used to substitute for warranted adjustment, for instance inappropriate monetary policy leading to high housing prices or structural reforms related to housing supply or taxes.

6. The 2022 review of the IV did not alter the evaluation of housing measures introduced during surges, and hence past practice is a useful guide for the evaluation of new measures. In recent years, a number of housing CFMs and CFM/MPMs have been assessed to be appropriate under the IV. The assessments identified a surge into the real estate market and a systemic risk stemming from those flows (in the case of CFM/MPMs, for instance, in Hong Kong SAR and Macao SAR). The assessments also concluded that these measures have not been found to substitute for warranted macroeconomic adjustment, as the authorities were conducting appropriate

[2] Under the IV, as noted in para 40, in certain circumstances, CFM/MPMs, introduced or tightened preemptively, may be appropriate. However, in general, preemptive housing CFM/MPMs do not satisfy the necessary conditions, and thus would be inappropriate under the IV.

[3] See Section IV in this Guidance Note and Table 2 in the IMF (2022a).

macroeconomic policies at the time.[4] However, in a few cases, the imposition or tightening of inflow CFMs or CFM/MPMs on housing have been found inappropriate under the IV, for example, due the lack of an inflow surge.

7. The IV requires that inflow CFMs be removed once the surge abates, while CFM/MPMs introduced during surges may continue until the financial risks subside, but their usefulness relative to their costs needs to be evaluated on an ongoing basis. As a result, some of the housing CFM/MPMs have remained in place for an extended period of time (e.g., Hong Kong SAR stamp duties), and the periodic evaluations of those measures has not yet resulted in recommending their removal given the presence of systemic risk. However, in other cases staff has recommended phasing out the measures, mainly on the grounds that they could be replaced by less discriminatory measures that could be expected to achieve the same objectives. For example, in the case of Canada, staff pointed out that a broader tax regime applied to all investors' speculative activity (not just nonresident buyers) would be feasible and desirable to reduce the discriminatory feature of the CFMs.[5,6]

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[4] This holds for most CFMs in Australia and CFM/MPMs in Hong Kong and Macao SAR.

[5] For instance, a nondiscriminatory tax on vacant housing (Canada), a broader land tax (Australia) or broader non-discriminatory housing agenda (New Zealand).

[6] See Canada Article IV (2020), para 56.

Annex V. Capital Flows in Staff Reports: Some Examples

Examples of staff reports discussing the managing capital inflows during surges

- *Australia (2017 Article IV Consultation). Discusses appropriate policy mix, including CFMs.* Key elements of discussion: Drivers of supply and demand in the housing market, including a capital inflow surge; supply-side measures to increase housing supply; prudential measures to address financial risk originating in the housing sector; appropriateness of CFMs given macroeconomic policy adjustment was not warranted and prudential tools were insufficient to address the inflow surge; the desirability of replacing CFMs with non-discriminatory measures when available and removal as the inflow surge abates.

- *Brazil (2012* and *2013* Article IV Consultations*). Discusses appropriate policy mix, including CFMs.* Key elements of discussion: drivers of inflows and outflows, as well as pressures from inflows on the already-overvalued real; fiscal policy tightness as part of policy mix conducive to a reduction in net capital inflows; usefulness of CFMs (the IOF tax on portfolio inflows) as part of the policy toolkit; costs of CFMs and the need to address the underlying causes of Brazil's structurally high interest rates—a key pull factor; and importance of increasing the financial sector's absorptive capacity. The discussion covers the appropriateness of easing the IOF as conditions improve.

- *Liberia (2016–2019).* Surrender requirement on remittance flows. Most surrendered proceeds auctioned back to the markets. Assessed as an appropriate temporary measure that was then discontinued as conditions allowed.

- *South Africa (2011 Article IV Consultation)*. Discusses appropriate policy mix, relying on macroeconomic policies. Key elements of discussion: the authorities' responses to capital inflow episodes, including exchange rate appreciation while building international reserves, accommodative monetary policy, and further liberalizing capital outflows; medium-term scope to build up reserves further and to tighten fiscal policy to create more room for monetary policy to manage the impact of capital flows; the case for CFMs in the near-term given little short-term policy space and overvalued rand, and the conclusion that their use was not warranted owing to their potential costs and low effectiveness.

Examples of staff reports discussing the managing disruptive capital outflows

- *Iceland (2008 SBA Request, 2012 Second Post-Program Monitoring Report)*. Discusses appropriate policy mix to manage disruptive outflows, including role of CFMs. Key elements of discussion: need for tighter monetary policy and maintenance of recently introduced exchange controls to prevent an exit of large non-resident krona holdings and preserve exchange rate stability after collapse of oversized banking sector left private sector debt at over 450 percent of GDP by end-2008. Need for liberalization strategy to lift these controls to be appropriately sequenced and paced to avoid disorderly capital outflows that would put the krona under pressure.

- *Kazakhstan (2022 Article IV Consultation)*. Discusses appropriate policy mix to manage disruptive outflows, including CFMs. Key elements of the discussion: need for tighter monetary policy to curb inflation, fiscal consolidation, and the role of financial sector policy.

Annex VI. Aligning the Assessment of Tax Measures Under the IV with Internationally Established Legal Principles of Taxation

1. **The assessment of tax measures under the IV poses a special challenge because internationally accepted standards on taxation generally permit treating tax residents and non-residents differently.** Hence, this Annex provides guidance on how to assess a range of tax measures (e.g., general and non-general tax measures) under the IV to clarify when residency-based discrimination arises, and how to determine whether the differentiation in a tax measure between residents and non-residents based on tax residency conforms to international standards. Given the technical nature of the issues related to national and international legal frameworks for taxation, country teams are encouraged to bring issues on potential tax related CFMs to the attention of the Legal Department at an early stage.

2. **Tax residency is commonly defined under the domestic tax law of a country or state.** It determines a person's liability to tax in a country or state by reason of their domicile, physical presence, or any other criterion of a similar nature. Therefore, the relevant legal definition being used by the relevant tax measure will need to be reviewed to determine whether the tax residency concept adopted conforms to international standards which avoid discrimination because they are designed to treat all persons—whether nationals or non-nationals—in "like circumstances" the same way. Domestic tax residency definitions can vary in their specific design and drafting, however, a typical standard formulation for an individual person[1] would be as follows: An individual is resident in the local jurisdiction for a year of tax assessment if the individual: (i) resides in the local jurisdiction; (ii) is domiciled in the local jurisdiction unless the individual has a permanent place of abode outside that jurisdiction; or (iii) is present in the local jurisdiction for a period of, or periods amounting in aggregate to, 183 days in any 12-month period.

3. **A finding of "residency-based" discrimination will not arise with respect to tax measures based solely on tax residency conforming to international standards.** This will be the case where the tax residency concept adopts the above features based on physical residence, legal domicile or the number of days physically present in a jurisdiction (e.g., 183 days or more). A finding of "residency-based" discrimination will continue to apply to domestic tax law measures that are designed based on citizenship, nationality, or immigration status. An example would be applying a different tax treatment to foreign nationals.

4. **The determination that general tax measures (e.g., income tax, withholding tax, and capital gains tax) do not contain "residency-based" discrimination should follow when those measures are enacted within a complying general tax law framework.** This is because any such general tax law framework should have an existing tax residency definition that meets international

[1] Tax residency tests are also typically adopted for other non-individual taxpayers (e.g., such as corporations, trusts and partnerships), and are designed and drafted to similarly avoid discrimination and reflect the specific circumstances of those entities.

standards—otherwise the country's whole general income tax system that hinges on that definition would be susceptible to breaching applicable public international law frameworks.[2]

5. In contrast, drawing a conclusion that non-general tax measures (e.g., stamp duty or property tax measures) do contain "residency-based" discrimination should follow when a distinction is made between residents and non-residents based on citizenship, nationality, or immigration status. Stamp duty measures do not typically use an international standard definition of tax residency (e.g., as adopted for general tax measures) because of their different design, policy, collection, and enforcement objectives.

6. However, if a non-general tax measure was to adopt a tax residency concept that meets international standards, then that measure would be treated similarly to general tax measures. The key point for staff assessment is that general and non-general tax measures that solely discriminate based on tax residency conforming to international standards will not be automatically considered a residency-based CFM under the IV because of their presumed discriminatory design. Rather they will be assessed as "other CFMs" only when they are found to be designed to limit capital flows.[3] A finding as to whether a tax measure that does not discriminate based on residency constitutes a CFM requires—consistent with established policy—a comprehensive evaluation of the totality of the country-specific circumstances surrounding its introduction (or its adjustment, in the case of an existing measure), regardless of the stated intent or motivation behind the adoption of the measure.

7. There is no general carve-out or automatic exemption for tax measures when assessing whether such measures are CFMs. Tax measures found not to be "residency-based" measures could still be assessed to be CFMs,[4] for both:

- general tax measures, where, based on the totality of the country-specific circumstances, they are also found to be designed to limit capital flows; or
- non-general tax measures (such as stamp duty or property tax measures), where they impose a higher tax rate on non-residents compared to residents because the tax rate discrimination could still point to, if the totality of the country-specific circumstances support this conclusion, a deliberate design to limit capital flows.

8. More complex assessment situations arise when "hybrid" measures are being assessed. In this regard, some recent property tax measures (including those levied at a state/provincial

[2] Staff will only review the relevant tax residency definition being used by a particular tax measure under assessment and will not consider whether other aspects of the general tax law framework comply with international standards.

[3] However, the continued existence of tax rate discrimination in a non-general tax measure that need not differentiate on policy grounds would tend towards a finding that it was designed to limit capital flows and is therefore a CFM (even if not held to be a residency-based CFM that is discriminatory).

[4] Tax measures which do not have tax rate discrimination based on residency may also constitute CFMs, if determined that they are designed to limit capital flows—a hypothetical example would be a tax on FX conversions (see Table AI.1).

government level) have adopted the complying tax residence concept used in the general tax law (often, in contrast, administered at a central/federal government level).[5] These measures practically demonstrate that in some circumstances a line will need to be drawn on whether the differentiation between residents and non-residents in cross-cutting measures goes beyond internationally accepted standards. Any such tax measure would go beyond those standards where the measure does not adopt the existing tax residency definition in the general tax law, whether in form (e.g., by making a specific cross-reference to the complying general law tax residency definition) or in substance (e.g., by adopting its own standalone definition but reproduced from—or equivalent to—the general tax law definition of tax residency meeting international standards). A practical way to guide the making of this determination would be to answer the following question: "If the particular non-general tax measure being assessed under the IV was within the scope of tax treaties, would it breach the Non-Discrimination Article?"[6] If the answer is "no", then there is unlikely to be "residency-based" discrimination under international standards of taxation.

[5] For example, the Canadian measure in the form of the speculation and vacancy tax (SVT) in British Columbia (being, a provincial tax of a non-general nature) introduced the specific concept of "untaxed worldwide earner" (based on tax residency for general tax purposes) to ensure that the tax residency feature overrode (i.e., took priority over) any pure immigration-based discrimination. It was assessed as "other" CFM because it was considered, based on the totality of circumstances, to be designed to limit capital flows, but was not assessed to be a "residency-based" CFM. Further details in relation to the relevant Canadian SVT can be found here: [Tax rates for the speculation and vacancy tax - Province of British Columbia (gov.bc.ca).]

[6] Article 24 of both the OECD and UN Model Tax Conventions prohibits discrimination based on nationality but does not apply where a different tax treatment results from acceptable tax residency concepts.

Annex VII. Identifying Inflow Surges: A Toolkit

1. **This annex provides an introduction to a toolkit for identifying capital inflow surges as per the methodologies outlined in this note.** The toolkit allows staff to (i) identify gross and net inflow surges across a variety of quantitative approaches, (ii) conduct cross-country comparisons, and (iii) analyze a range of macrofinancial indicators to assess whether these surges can pose macroeconomic and/or financial stability challenges. The toolkit is not intended to replace staff's judgment in assessing whether a surge is taking place and giving rise to associated challenges, nor to constitute an exhaustive list of possible methodologies or metrics, but rather to provide more tools to assist staff in identifying an inflow surge.

2. **The 2022 Review of the IV identified fourteen categories of cross-border capital inflows**. This includes net/gross flows in foreign direct investment, portfolio equity, portfolio debt, and other flows (with other flows further disaggregated to the extent possible, into official versus nonofficial flows). Differentiating between net and gross capital flows can provide context to a country's specific economic circumstance. Additionally, the further delineation of net and gross capital flows into certain sectors or asset classes as well can inform Fund staff on financial stability risks within different sectors that may have systemic linkages to the overall economy.

3. **The toolkit provides users with an updated panel dataset on international capital flows by country at both annual and quarterly frequencies, from 1970 to the latest available year and from 1970 Q1 to the latest available quarter respectively**. The panel is unbalanced as exact time coverage varies by country. This dataset stems from a replication of the Financial Flows Analytics (FFA) dataset which was updated by RES until 2022. The underlying data of the FFA dataset draws upon the IMF's Balance of Payments Statistics, BPM version 6. This capital flow data is complemented by 19 macro, structural, and global financial variables that can provide further context to a country's capacity to manage inflow surges. Retrieval of both capital flow and macrofinancial data relies on database management tools found in the Software Center and available to Fund staff. Additionally, computation of capital inflow surges based on the five methodologies identified in the 2022 Review of the IV is automated via Stata.

4. **The toolkit will enable staff to conduct the assessment with higher-frequency capital flows data too.** In addition, as annual and quarterly data are only available with a lag (and some countries do report monthly data), the toolkit will enable staff to conduct the assessment with higher-frequency capital flows data, as well as alternative sectoral information beyond the fourteen inflows identified in the 2022 Review of the IV. This will allow for both (i) more timely assessment of surges and (ii) alternative approaches of evaluating surges to reflect country-specific circumstances.

5. **The end result of this assessment of capital inflow surges is an output of three heatmaps in the form of Panels A-C presented in the Revised IV**. Together they provide (i) a historical time series of all surge episodes within a country for the specified period of analysis (Panel A), (ii) a historical time series of all surge episodes within a country alongside within comparator countries for the specified period of analysis (Panel B), and (iii) an array of macroeconomic, financial

market, and structural data to assess a country's absorption capacity of surge episodes when those variables are exceeding their historical trends or levels (Panel C).

6. In addition to the dataset on capital flows, the toolkit contains supplemental material to guide users. In particular, the toolkit contains: (i) a panel dataset of GDP, as most of the methodologies employed scale flows by GDP; (ii) the set of Stata routines needed to reproduce panels A, B and C after the user specifies the country to analyze (and comparison countries for Panel B); the period and data frequency of analysis; and (iii) supplemental material in the form of readme files that accompany the Stata codes, and methodology notes with further technical details of each of the methods employed and the further technical details of the updated FFA dataset.

Figure AVII.1. Indicators to Guide the Assessment of Capital Inflow Surges

Panel A: Heatmap of Capital Flows by Different Types of Flows

Country A	Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10	Q11	Q12	Q13	Q14
Gross Inflows Surges														
Total Inflows	0	0	0	1	1	3	5	5	5	4	0	0	0	0
Nonofficial Inflows	0	0	0	1	1	4	5	5	5	3	1	1	0	0
Portfolio Inflows	0	0	0	0	0	0	2	2	2	2	1	0	0	0
Portfolio Debt Inflows	0	0	0	0	0	0	2	2	2	2	0	0	0	0
Portfolio Equity Inflows	2	2	2	1	1	1	2	4	5	3	4	1	0	0
Other Inflows	0	0	0	0	4	5	5	4	3	2	1	1	0	0
Other Inflows to Banks	0	0	0	0	0	5	5	4	4	0	0	0	0	0
Net Inflows Surges														
Total Inflows	0	0	0	1	1	1	5	5	5	5	1	1	0	0
Nonofficial Inflows	0	0	0	0	0	1	5	5	5	5	1	0	0	0
Portfolio Inflows	0	0	0	0	0	0	2	3	3	2	1	0	0	0
Portfolio Debt Inflows	0	0	0	0	0	1	2	2	2	2	0	0	0	0
Portfolio Equity Inflows	2	1	1	0	1	1	1	4	5	3	4	1	0	0
Other Inflows	0	0	0	0	3	5	5	3	1	1	1	2	0	0
Other inflows to Banks	0	0	0	0	0	4	4	3	0	0	0	0	0	0

Panel B: Comparisons to Peers

Net Total Inflows

Time	Country A	Country B	Country C	Country D	Country E	Country F
Q1	0	3	1	0	4	1
Q2	0	3	3	0	4	2
Q3	0	2	0	0	3	4
Q4	0	2	0	0	3	5
Q5	0	1	0	0	2	4
Q6	1	0	0	0	2	4
Q7	1	0	2	0	3	3
Q8	1	0	4	3	2	3
Q9	5	1	4	5	2	3
Q10	5	1	5	4	2	3
Q11	5	0	5	5	2	2
Q12	5	0	5	4	3	2
Q13	1	0	5	2	3	2
Q14	1	0	3	0	2	2
Q15	0	0	0	0	2	1

Gross Total Inflows

Time	Country A	Country B	Country C	Country D	Country E	Country F
Q1	0	1	1	2	2	2
Q2	0	3	1	2	4	2
Q3	0	3	0	1	4	4
Q4	0	3	0	2	4	4
Q5	0	3	0	1	5	4
Q6	1	2	0	1	3	4
Q7	1	3	4	2	4	3
Q8	3	3	4	4	3	4
Q9	5	4	4	5	2	4
Q10	5	4	5	5	3	3
Q11	5	3	5	5	2	2
Q12	4	3	5	5	3	2
Q13	0	3	4	3	2	2
Q14	0	2	2	3	0	3
Q15	0	0	0	0	0	2

Panel C: Heatmap of Macro and Financial Conditions

Country A	Year 1 Q1	Q2	Q3	Q4	Year 2 Q1	Q2	Q3	Q4	Year 3 Q1	Q2	Q3	Q4
Domestic												
Macro												
Real GDP growth												
CPI inflation												
Current account/GDP												
NIIP/GDP												
Financial												
Nominal USD exchange rate												
REER												
Credit-to-GDP ratio												
3-month treasury bill rate/Money market rate												
Share price index												
Real house price index												
Structural												
Crisis	0	0	0	0	0	0	0	0	0	0	0	0
Capital account openness	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Institutional quality	54.4	54.4	54.4	54.4	54.4	54.4	54.4	54.4	56.0	56.0	56.0	56.0
Overall financial development	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Financial institutions	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.7	0.6	0.6	0.6	0.6
Financial markets	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.5
Global												
VIX												
US 3-month Treasury												
Commodity price												

Source: The 2022 Review of the Institutional View.

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