Evaluation Report

The IMF's Approach to Capital Account Liberalization

2005

International Monetary Fund

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The following symbols have been used throughout this report:

– between years or months (e.g. 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g. 2003/04) to indicate a fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

Some of the documents cited and referenced in this report were not available to the public at the time of publication of this report. Under the current policy on public access to the IMF's archives, some of these documents will become available five years after their issuance. They may be referenced as EBS/YY/NN and SM/YY/NN, where EBS and SM indicate the series and YY indicates the year of issue. Certain other documents are to become available ten or twenty years after their issuance depending on the series.

Foreword

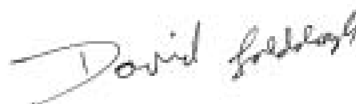
This report reviews the IMF's approach to capital account liberalization and related issues, drawing on evidence from a sample of emerging market economies over the period 1990–2004. The role of the IMF in capital account liberalization has been a topic of major controversy. An independent evaluation of the IMF's advice on capital account issues is therefore both timely and appropriate.

The evaluation seeks to contribute to transparency by documenting what in practice has been the IMF's approach to capital account liberalization and related issues and to identify areas where the IMF's instruments and operating methods might be improved, in order to deal with capital account issues more effectively. The report deals not only with capital account liberalization per se but also with capital flow management issues, including particularly the temporary use of capital controls.

Capital account liberalization is an area where there is little professional consensus, making it difficult to evaluate the IMF's policy advice against some universal set of criteria. Moreover, the IMF Articles of Agreement give the IMF only limited jurisdiction over the capital account, with the result that the IMF had no formal policy on most capital account issues during the period under review. For these reasons, the evaluation assesses the IMF's *actual approach* to these issues, identifying what policy advice the IMF gave in the context of a specific country at a specific point in time.

The report begins by reviewing the IMF's general operational approach and analysis as they evolved from the early 1990s into the early 2000s. It then assesses the IMF's country work in terms of (1) its role in capital account liberalization during 1990–2002, (2) its policy advice to member countries on managing capital flows during the same period, and (3) its ongoing work on capital account issues in a group of emerging market economies during 2003–04. The report concludes by offering two broad recommendations. First, as noted in the original terms of reference, the evaluation does not seek to make a judgment on whether the Articles of Agreement should be amended to give the IMF an explicit mandate and jurisdiction on capital account issues, since this is an issue that goes well beyond the scope of the evaluation evidence. However, the report does conclude that greater clarity on the IMF's approach to capital account issues is needed and makes a number of suggestions as to how this might be achieved. Second, the report supports greater attention by the IMF's analysis and surveillance to the supply-side factors of international capital flows, a process that is already under way.

The report was discussed by the IMF Executive Board on May 11, 2005. In keeping with established practice, the report is being published as submitted to the Board, except for minor factual corrections. This volume also includes the response of IMF management and staff to the evaluation, the IEO response, and the Summing Up of the Board discussion.



David Goldsbrough
Acting Director
Independent Evaluation Office

The report was prepared by a team headed by Shinji Takagi and including Jeffrey Allen Chelsky, Edna Armendariz, Misa Takebe, and Halim Kucur. It also benefited from substantive contributions from Rawi Abdelal, Masahiro Kawai, David Peretz, Jai Won Ryou, and participants in a workshop held at the Institute for International Economics—William Cline, Morris Goldstein, Michael Mussa, Edwin Truman, and John Williamson. Administrative support by Annette Canizares, Arun Bhatnagar, and Maria S. Gutierrez, and editorial work by Ian McDonald and Esha Ray are gratefully acknowledged. The report was approved by David Goldsbrough, Acting Director of the IEO.

Abbreviations and Acronyms

ADR	American Depository Receipt
AREAER	*Annual Report on Exchange Arrangements and Exchange Restrictions* (IMF)
BIBF	Bangkok International Banking Facility
CAC	Collective action clause
EFF	Extended Fund Facility (IMF)
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism (European Monetary System)
EU	European Union
FDI	Foreign direct investment
FSAP	Financial Sector Assessment Program (IMF and World Bank)
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GFSR	*Global Financial Stability Report* (IMF)
ICM	International Capital Markets Department (IMF)
ICMR	*International Capital Markets Report* (IMF)
IEO	Independent Evaluation Office (IMF)
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LEG	Legal Department (IMF)
LIBOR	London interbank offered rate
LOI	Letter of Intent (IMF)
MAE	Monetary and Exchange Affairs Department (IMF)[1]
MFD	Monetary and Financial Systems Department (IMF)
OECD	Organization for Economic Cooperation and Development
PDR	Policy Development and Review Department (IMF)
RES	Research Department (IMF)
SDR	Special drawing right (IMF)
SDRM	Sovereign Debt Restructuring Mechanism
SBA	Stand-By Arrangement (IMF)
TA	Technical assistance
UNCTAD	United Nations Conference on Trade and Development
URR	Unremunerated reserve requirement
WEO	*World Economic Outlook* (IMF)
WTO	World Trade Organization

[1]Effective May 1, 2003, name was changed to Monetary and Financial Systems Department.

The IMF's Approach to Capital Account Liberalization

Executive Summary

Against the background of highly volatile international capital flows and the associated financial instability experienced by a number of major emerging market economies in recent years, the role of the IMF in capital account liberalization has been a topic of major controversy. The IMF's role is particularly controversial because capital account liberalization is an area where there is little professional consensus. Moreover, although current account liberalization is among the IMF's official purposes outlined in its Articles of Agreement, the IMF has no explicit mandate to promote capital account liberalization. Indeed, the Articles give the IMF only limited jurisdiction over issues related to the capital account. Nevertheless, the IMF has given greater attention to capital account issues in recent decades, in light of the increasing importance of international capital flows for member countries' macroeconomic management. In view of these facts, an independent assessment of how the IMF has addressed capital account issues seems warranted.

The evaluation seeks to (1) contribute to transparency by documenting what in practice has been the IMF's approach to capital account liberalization and related issues; and (2) identify areas, if any, where the IMF's instruments and operating methods might be improved, in order to deal with capital account issues more effectively. The issues addressed in the evaluation cover not only capital account liberalization but also capital flow management issues, including particularly the temporary use of capital controls. The evaluation, however, does not address the question of whether liberal capital accounts are intrinsically beneficial—on which the broader academic literature has not been able to provide a definitive answer—or whether the Articles of Agreement should be amended to give the IMF an explicit mandate and jurisdiction on capital account issues. Many aspects of these issues are not amenable to evidence from the evaluation. However, the evaluation does shed some light on the consequence of the lack of explicit mandate and jurisdiction on the IMF's work on capital account issues.

The report begins by reviewing the IMF's general operational approach and analysis as they evolved from the early 1990s into the early 2000s. It then assesses the IMF's country work in terms of (1) its role in capital account liberalization during 1990–2002, (2) its policy advice to member countries on managing capital flows during the same period, and (3) its ongoing work on capital account issues (where outstanding issues are identified for 2003–04). The report concludes by offering two broad recommendations.

The IMF's General Operational Approach and Analysis

Despite the ambiguity left by the Articles of Agreement about its role in capital account issues, the IMF responded to the changing international environment by paying increasing attention to issues related to the capital account. Concurrent with the initiatives to amend the Articles to give the IMF an explicit mandate for capital account liberalization and jurisdiction over members' capital account policies, the IMF expanded the scope of its operational work in the area. It encouraged the staff to give greater emphasis to capital account issues in Article IV consultations and technical assistance and to promote capital account liberalization more actively.

In multilateral surveillance, the IMF's analysis prior to the mid-1990s tended to emphasize the benefits to developing countries of greater access to international capital flows and to pay comparatively less attention to the potential risks of capital flow volatility. More recently, however, the IMF has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the more fundamental causes and implications of their boom-and-bust cycles. Still, the focus of the analysis remains on what emerging market countries should do to cope with the volatility of capital flows (for example, in the areas of macroeconomic and exchange rate policy, strengthened financial sectors, and greater transparency). Although the IMF has addressed the moral hazard aspect of boom-and-bust cycles by encouraging greater exchange rate flexibility in recipient countries and attempting to limit ac-

cess to IMF resources during a crisis, it has not been at the forefront of the debate on what, if anything, can be done to reduce the cyclicality of capital movements through regulatory measures targeted at institutional investors in the source countries.

From the beginning of the 1990s, the IMF's management, staff, and Executive Board were aware of the potential risks of premature capital account liberalization and there is no evidence to suggest that they promoted capital account liberalization indiscriminately. They also acknowledged the need for a sound financial system in order to minimize the risks of liberalization. Such awareness, however, largely remained at the conceptual level and did not lead to operational advice on preconditions, pace, and sequencing until later in the 1990s. At the same time, a subtle change was taking place within the institution. As preliminary evidence emerged on the apparent effectiveness of Chile's capital controls in the mid-1990s, some in the IMF began to take a favorable view of the use of capital controls as a temporary measure to deal with large capital inflows.

In the event, the proposed amendment of the Articles put forward in the late 1990s failed to garner sufficient support, leaving ambiguity about the role of the IMF. In the meantime, something of a consensus—the so-called "integrated" approach—has emerged within the IMF that places capital account liberalization as part of a comprehensive program of economic reforms in the macroeconomic policy framework, the domestic financial system, and prudential regulations. While few would disagree with the prudence and judiciousness of the new approach, it has proved to be difficult to apply as an operational guide to sequencing because it emphasizes all of the potential interlinkages but does not provide clear criteria for identifying a hierarchy of risks. Moreover, these views remain unofficial, as they have not been explicitly endorsed by the Executive Board.

The IMF's Country Work

The evaluation assesses the IMF's country work in terms of the following criteria: (1) Was there any difference between the IMF's general policy pronouncements and the advice it gave to individual countries? (2) Was the IMF's policy advice operational and based on solid evidence? (3) How did the IMF's advice change over time, and did this change keep pace with available evidence? (4) Did the IMF give similar advice to countries in similar situations? and (5) Was the policy advice on the capital account set in a broader assessment of the authorities' macroeconomic policies and institutional framework?

Capital account liberalization

During the 1990s, the IMF clearly encouraged capital account liberalization, but the evaluation suggests that, in all the countries that liberalized the capital account, partially or almost fully, the process was for the most part driven by the country authorities' own economic and political agendas. In none of the program cases examined did the IMF require capital account liberalization as formal conditionality (which is understood to mean prior actions, performance criteria, or structural benchmarks), although aspects of it were often included in the authorities' overall policy package presented to the IMF. This is consistent with the interpretation of the Articles of Agreement, which states that the IMF, as a condition for the use of its resources, cannot require a member to remove controls on capital movements. In the first half of the 1990s, in encouraging capital account liberalization, the IMF seldom raised the issue of pace and sequencing. The staff occasionally expressed concern over financial sector weakness or macroeconomic instability, but this did not translate into concrete operational advice. From around 1994, and more noticeably following the East Asian crisis, the IMF began increasingly to give emphasis to the need to satisfy certain preconditions; in general, the IMF's approach in its country work was quite pragmatic, especially in this later period, and often accepted the authorities' own views on the appropriate pace and sequencing of liberalization.

Managing capital inflows

As countries experienced large capital inflows and associated macroeconomic challenges in the 1990s, the issue of how to manage large capital inflows became a routine subject of discussion between the IMF and the country authorities. The staff's policy advice was largely in line with the policy conclusions typically derived from the scholarly literature on open economy macroeconomics. To deal with large capital inflows, it advocated tightening fiscal policy and greater exchange rate flexibility. The staff's position on sterilization emphasized its quasi-fiscal costs and longer-term ineffectiveness but was, to a remarkable extent, supportive of the country authorities' policy choices, whatever they may have been. In a few instances, the staff also recommended further trade liberalization, liberalization of capital outflows, and tightening of prudential regulation as measures to deal with large capital inflows. These and other structural measures, however, received relatively little attention in the IMF's policy advice, although in recent years increasing attention has been given to strengthening the financial sector regulatory framework, primarily in the context of the Financial

Sector Assessment Program (FSAP). Given the IMF's focus and comparative advantage, this was probably appropriate.

Temporary use of capital controls

Use of capital controls has been a controversial subject, not only within the IMF but also in the academic and official policymaking communities. It is possible here to make a broad characterization that the IMF staff was in principle opposed to the use of such instruments, either on inflows or outflows. Its view was that they were not very effective, especially in the long run, and could not be a substitute for the required adjustments in macroeconomic and exchange rate policies. Even so, from the earliest days, the IMF staff displayed a remarkable degree of sympathy with some countries in the use of capital controls. In a few cases, both before and after the crises of 1997–98, it even suggested that market-based controls could be introduced as a prudential measure. As a general rule, the IMF staff, in line with the evolution of the institution's view, became much more accommodating of the use of capital controls over time, albeit as a temporary, second-best instrument.

Ongoing country dialogue on capital account issues

In ongoing country work, as documented for the period of 2003–04, IMF staff has been quite accommodating of the authorities' policy choices when they have involved a gradual approach to capital account liberalization or temporary use of controls. In terms of capital account liberalization, the staff has sometimes been more cautious than the authorities (as in Russia in 2003) when their preferred policy has been to liberalize the capital account quickly. In most cases, the staff has taken a medium-term perspective and has emphasized the importance of meeting certain preconditions, the most important of which are fiscal consolidation, a sound financial system, and the adoption of a floating exchange rate (usually with inflation targeting).

In terms of advice on temporary use of capital controls, IMF staff seldom challenged the authorities' decision and has even supported market-based controls in some cases. There was a slight difference in emphasis across countries. In a few countries (as in Russia in 2004), the staff expressed forcefully the view that capital controls, no matter how useful they might be in the short run, could not be expected to be effective over time and should not be used as a substitute for appropriate adjustment in macroeconomic policies. In others (as in Colombia), the use of controls introduced by the authorities did not figure prominently in policy discussions. In still other cases (as in Croatia), the staff recommended a market-based control, albeit as a last resort measure.

Overall Assessment

Throughout the 1990s, the IMF undoubtedly encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader when it wished to do so, especially before the East Asian crisis. However, there is no evidence to suggest that it exerted significant leverage to push countries to move faster than they were willing to go. The process of liberalization was often driven by the authorities' own economic and political agendas, including accession to the Organization for Economic Cooperation and Development (OECD) or the European Union (EU) and commitments under bilateral or regional trade agreements. In encouraging capital account liberalization, the IMF pointed out the risks inherent in an open capital account as well as the need for a sound financial system, even from the beginning. The problem was that these risks were insufficiently highlighted, and the recognition of the risks and preconditions did not translate into operational advice on pace and sequencing until later in the 1990s (and even thereafter the policy advice has often been of limited practical applicability).

In multilateral surveillance, the IMF's analysis emphasized the benefits to developing countries of greater access to international capital flows, while paying comparatively less attention to the risks inherent in their volatility. As a consequence, its policy advice was directed more toward emerging market recipients of capital flows, and focused on how to manage large capital inflows and boom-and-bust cycles; little policy advice was offered, in the context of multilateral surveillance, on how source countries might help to reduce the volatility of capital flows on the supply side. In more recent years, the IMF's analysis of such supply-side factors has intensified. Even so, the focus of policy advice—beyond the analysis of macroeconomic policies covering large current account imbalances—remains on the recipient countries.

In country work there was apparent inconsistency in the IMF's advice on capital account issues. Sequencing was mentioned in some countries but not in others; advice on managing capital inflows was in line with standard policy prescriptions, but the intensity differed across countries or across time (with no clear rationale provided for the difference); and a range of views was expressed on use of capital controls (though greater convergence toward accommodation was observed over time). Policy advice must of necessity be tailored

to country-specific circumstances, so uniformity cannot be the only criterion for judging the quality of the IMF's advice. Country documents, however, provide only an insufficient analytical basis for making a definitive judgment on how the staff's policy advice was linked to its assessment of the macroeconomic and institutional environments in which it was given. While one can explain why certain types of advice were offered in some individual cases, no generalization is possible about the consistency of the IMF's overall policy advice. Even so, it appears that the apparent inconsistency to a large extent reflected reliance on the discretion of individual IMF staff members, and not necessarily the consistent application of the same principles to different circumstances.

The evaluation suggests that the IMF has learned over time on capital account issues. This seems to have affected the work of the IMF through two channels. First, the IMF's general approach did respond—albeit gradually—to new developments or new evidence. Second, independent of how the general approach changed, some of the learning became more quickly reflected in the IMF's country work through its impact on individual staff members. The lack of a formal IMF position on capital account liberalization and the associated partial disconnect between general operational guidelines and country work had different consequences. On the one hand, this gave individual staff members freedom to use their own professional and intellectual judgment in dealing with specific country issues. On the other hand, the disconnect reflected the inherent ambiguity of this aspect of the IMF's work and led to some lack of consistency in country work, as noted above.

In more recent years, somewhat greater consistency and clarity has been brought to bear on the IMF's approach to capital account issues. For the most part, the new paradigm upholds the role of country ownership in determining pace and sequencing; takes a more consistently cautious and nuanced approach to encouraging capital account convertibility; and acknowledges the usefulness of capital controls under certain conditions, particularly controls on inflows. But these are still unofficial views, no matter how widely they may be shared within the institution. While the majority of staff members now appear to accept this new paradigm, some continue to feel uneasiness with the lack of a clear position by the institution.

Recommendations

The evaluation suggests two main areas in which the IMF can improve its work on capital account issues.

Recommendation 1. There is a need for more clarity on the IMF's approach to capital account issues. The evaluation is not focused on the arguments for and against amending the Articles of Agreement, but it does suggest that the ambiguity about the role of the IMF with regard to capital account issues has led to some lack of consistency in the work of the IMF across countries. This may reflect the lack of clarity in the Articles, but with or without a change in the Articles it should be possible to improve the consistency of the IMF's country work in other ways. For example:

- *The place of capital account issues in IMF surveillance could be clarified*. It is generally understood that while under current arrangements the IMF has neither explicit mandate nor jurisdiction on capital account issues, it has a responsibility to exercise surveillance over certain aspects of members' capital account policies. However, much ambiguity remains on the scope of IMF surveillance in this area. The clearest statement of the basis for surveillance of capital account issues is embodied in the 1977 Executive Board decision calling for surveillance to consider certain capital account restrictions introduced for balance of payments purposes, but the qualification limiting the scope to balance of payments reasons is too restrictive to cover the range of capital account issues that surface in the IMF's country work. On the other hand, the broader statement of the IMF's surveillance responsibility, found in the preamble to Article IV, is too wide to serve as an operational guide to surveillance on capital account issues. There would be value if the Executive Board were formally to clarify the scope of IMF surveillance on capital account issues. Such a clarification would recognize that capital account policy is intimately connected with exchange rate policy, as part of an overall macroeconomic policy package, and that in many countries capital flows are more important in this respect than current flows; capital controls can be used to manipulate exchange rates or to delay needed external adjustment; and a country's capital account policy creates externalities for other countries. Capital account policy is therefore of central importance to surveillance.
- *The IMF could sharpen its advice on capital account issues, based on solid analysis of the particular situation and risks facing specific countries*. Given the limited evidence that exists in the literature on the benefits or costs of capital account liberalization in the abstract, the IMF's approach to any capital account issue must necessarily be based on an analysis of each case.

For example, if a capital control is involved, the IMF must ask in the context of a specific country what objectives the control is designed to achieve; if it is accomplishing them; and whether there are more effective or less distortionary ways of achieving the same objectives. Such assessments need to be set in an overall consideration of the macroeconomic policy framework and whether controls are being used as a substitute for, or to seek to delay, necessary changes in such policies. The evaluation indicates that this is already done in some, but not all, cases. If a capital control measure is judged useful to stem capital flight under certain circumstances, the IMF should ask what supporting policies are needed to make it more effective or less distortionary (for example, setting up a system of monitoring external transactions). In terms of providing advice on capital account liberalization, just to spell out all the risks inherent in opening the capital account is of limited usefulness to countries seeking IMF advice. To assist the authorities decide when and how to open the capital account, the IMF should provide some quantitative gauge of the benefits, costs, and risks (and, indeed, practicality) of moving at different speeds. Admittedly, this is not an easy task. Drawing on the well-established literature on welfare economics, the IMF must ask such questions as: What distortions are being created when one market is liberalized but not another? What is the nature of risks being borne by residents when capital account transactions are liberalized only for nonresidents? And what are the costs to the economy (in terms of investment flows) of allowing equity inflows but not debt inflows?

- *The Executive Board could issue a statement clarifying the common elements of agreement on capital account liberalization.* At present, there remains considerable uncertainty among many staff members on what policy advice to provide to individual countries. This has led to hesitancy on the part of some within the staff to raise capital account issues with country authorities. The Executive Board could provide clear guidance to staff on what the IMF's official position is. This is not to say that the Executive Board must come up with a definitive statement on all aspects of pace and sequencing. Given the lack of full consensus, one should not expect such a definitive view from the Board. However, Board guidance on what are the minimum common elements on which there is broad, if not universal, agreement would be useful to the staff and member countries. Although the details are for the Board to decide, such a statement might include some or all of the following elements: (1) that in a first-best world there would be no need for controls over capital movements (though financial markets may not always operate accordingly); (2) that controls should not be used as a substitute for adjusting macroeconomic or structural policies; (3) a broad (as opposed to unnecessarily complex) framework of sequencing based on the consensus in the literature on the order of economic reforms; (4) the importance of taking country-specific circumstances into account; and (5) that risks can never be totally eliminated, so they should not be used as a reason for permanently delaying liberalization.

Recommendation 2. The IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and what can be done to minimize the volatility of capital movements. The IMF's policy advice on managing capital flows has so far focused to a considerable extent on what recipient countries should do. While this is important, it is not the whole story. As discussed in the evaluation report, the IMF's recent analyses have given greater attention to supply-side factors, including the dynamics of boom-and-bust cycles in emerging market financing. The IMF has also established an International Capital Markets Department (ICM) as part of an effort to better understand global financial markets; it participates actively in the work of the Financial Stability Forum, which was established to monitor potential vulnerabilities in global financial markets; and it has proposed a Sovereign Debt Restructuring Mechanism (SDRM), encouraged the use of collective action clauses (CACs), and has attempted to place limitations on countries' access to IMF resources in a crisis, in an effort to reduce the perceived moral hazard that may have led capital markets to pay insufficient attention to the risks of investing in developing countries and contributed to the boom-and-bust cycles of capital movements. These are important and welcome initiatives, but the IMF has not yet fully addressed issues of what, if anything, can be done to minimize the volatility of capital flows by operating on the supply side—as yet, little attention seems to be paid to supply-side risks and potential mitigating actions in the industrial countries that are home to the major global financial markets. The IMF could usefully provide more input into advanced country financial supervision and other financial market policy issues globally. Are current global supervision guidelines designed to help create stability? What if any action could be taken on the supply side to reduce cyclicality and herd behavior? Admittedly, this is a diffi-

cult topic on which little professional consensus exists. Yet, this is an area where a significant debate has taken place in the academic and policymaking communities and to which the IMF could contribute further. Indeed, one of the broad themes identified as potential priorities for the IMF's research program over the medium term—on institutions and contractual mechanisms that can help protect countries from external volatility—goes some way in this direction, but should not focus only on policies in countries that are recipients of capital inflows.

Chapter

1

Introduction

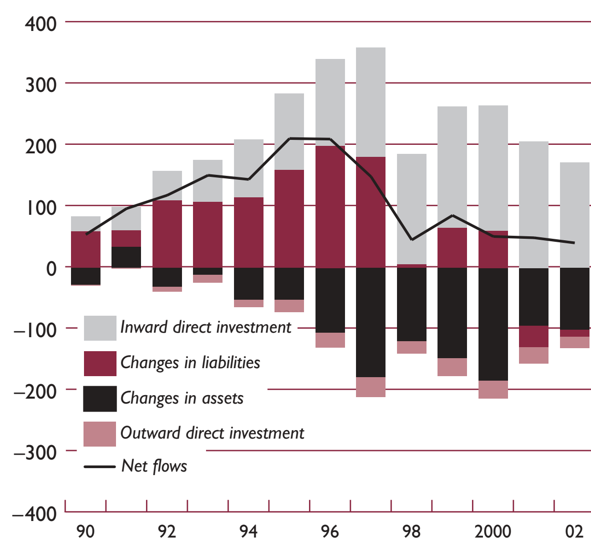
The 1990s witnessed a large swing in global private capital flows (Figure 1.1). Net private flows to developing countries, for example, grew from less than $100 billion in 1990 to well over $200 billion in 1995. The subsequent years, however, saw an equally substantial reversal of these inflows, which caused several emerging market economies to experience severe capital account crises. The volume of private capital flows to developing countries remained subdued through the early 2000s.

Against this background, there has been a major debate over the actual and potential role of the IMF in encouraging countries to open their capital accounts[1] and any possible associated increase in their vulnerability to crisis. Within the broader debate over the increasing importance of international capital flows in the world economy,[2] some have alleged that the IMF, in concert with some major shareholder governments, had encouraged member countries to liberalize their capital accounts prematurely without ensuring that adequate institutions and prudential regulations were in place.[3] Others argue that rapid liberalization, with insufficient attention to sequencing and establishing the appropriate preconditions, has been responsible for much of the financial instability and economic distress experienced by many emerging market countries.[4]

The role of the IMF has been particularly controversial because capital account liberalization is an area where there is little professional consensus (see Box 1.1). In this context, Eichengreen (2001) has noted that the views favoring liberalization emerged with a surprising degree of certitude in advance of (and in the absence of) definitive evidence. The IMF's role has been controversial for another reason: Although current account liberalization is among the IMF's official purposes outlined in its Articles of Agreement, it has no explicit mandate to promote capital account liberalization. Indeed, the Articles give the IMF only limited jurisdiction over the capital account (see Chapter 2, "The Legal Basis," for details). Nevertheless, the IMF has given greater attention to capital account issues in recent decades, given

Figure 1.1. Private Capital Flows to Developing Countries[1]

(In billions of U.S. dollars)



Source: IMF database.

[1]Portfolio investment flows, other private investment flows, and foreign direct investment to all developing countries, Israel, and Korea. Excludes government borrowing.

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[1]Since the fifth edition of the IMF's *Balance of Payments Manual* was published in 1993, the term used for statistical purposes has been the "capital and financial account." However, this report follows the established practice, both within the IMF and in the academic literature, of using the term "capital account" to describe the subset of the balance of payments that covers all noncurrent international transactions.

[2]The broad international interest in capital account issues that existed during the 1990s can be seen, for example, in the coverage given by successive issues of the UNCTAD's *Trade and Development Report* (see, in particular, Chapter 5 of the 1999 report).

[3]While such a policy was often referred to as part of the "Washington consensus," full capital account liberalization was in fact not one of the 10 policy reforms that Williamson (1990) considered as forming the Washington consensus. The presumed consensus was not on liberalization of capital flows in general, but rather more specifically on that of foreign direct investment.

[4]Academic proponents of these views are Desai (2003), Stiglitz (2000, 2002, and 2004), Wade (1998–99), and Wade and Veneroso (1998).

Box 1.1. The Debate on the Benefits of Capital Account Liberalization

The theoretical rationale for capital account liberalization is based primarily on the argument that free capital mobility promotes an efficient global allocation of savings and a better diversification of risk, hence greater economic growth and welfare (Fischer, 1998). An opposing view has held that there is considerable information asymmetry in international financial markets, so that free capital mobility—especially when significant domestic distortions exist—does not necessarily lead to an optimal allocation of resources (Stiglitz, 2000 and 2004). Between these two opposing positions is the view that, while there are benefits to be gained from liberalization, the magnitude of the gains is relatively small.[1] While the idea that free capital mobility enhances economic welfare is an appealing concept to many economists, there has been surprisingly little empirical evidence to date to either support or refute conclusively such a view.

Recent empirical work has addressed this issue from the standpoint of the effect of capital liberalization on economic growth (see Edison and others, 2002, for a survey). Unfortunately, the debate remains inconclusive because such empirical studies inherently involve a joint test of the effect of liberalization on growth and the particular method of quantifying the degree of liberalization or effectiveness of capital controls. This problem is common to all empirical studies in this area.[2] As it turns out, empirical results are sensitive not only to the quantitative measure of capital controls but also to the choice of sample and methodology. For example, while Quinn (1997) finds a positive association between capital account liberalization and economic growth, Grilli and Milesi-Ferretti (1995) and Rodrik (1998) fail to find any such relationship. This ambiguity may reflect the role of institutions (for example, the rule of law), macroeconomic stability, and other factors in determining the effect of liberalization on growth (Arteta and others, 2001; Eichengreen and Leblang, 2002).[3] On the other hand, studies that have more narrowly focused on stock market liberalization have found a positive impact on growth (for example, Henry, 2003).

[1]For example, Gourinchas and Jeanne (2004) use a calibrated neoclassical model to show that, for a typical developing country, the welfare gains from switching from financial autarky to perfect capital mobility is about 1 percent permanent increase in domestic consumption.

[2]Another common problem is the endogeneity of capital controls, which makes it difficult to disentangle the effect of capital controls per se from that of the macroeconomic and international environments within which they are introduced.

[3]Prasad and others (2003) also consider the effects of financial integration on consumption smoothing and find little evidence to indicate the benefits of liberalization. See Stiglitz (2004) for commentaries on this work.

the increasing importance of international capital flows for macroeconomic stability and exchange rate management in many countries. In view of these facts, an independent assessment of how the IMF has addressed capital account issues seems warranted.

The Scope of the Evaluation

The evaluation seeks to (1) contribute to transparency by documenting what in practice has been the IMF's approach to capital account liberalization and related issues; and (2) identify areas, if any, where the IMF's instruments and operating methods might be improved, in order to deal with capital account issues more effectively.[5] The issues addressed in the evaluation cover not only capital account liberalization but also capital flow management issues, including particularly the temporary use of capital controls. We evaluate the IMF's actual *approach* to these issues, not necessarily its *official policy*. Indeed, as will become clear, it is difficult to argue that the IMF had a firm formal policy on the issues we address—at least not during the period covered by the evaluation. In evaluating the IMF's approach, we rely primarily on country-based analysis. We will try to identify, for example, what policy advice the IMF gave in the context of a specific country at a specific point in time. Although context is important, the focus remains on the role of the IMF. We make no judgment on the underlying policies adopted by country authorities.

Given the lack of consensus in the academic and official policymaking communities, there is no universal set of criteria against which the IMF's approach to capital account issues can be assessed. Rather, we take a pragmatic approach to evaluation by asking the following questions about the IMF's policy advice:

(1) Was there any difference between the IMF's general policy pronouncements and the advice it gave to individual countries?

(2) Was the IMF's policy advice operational? Was it based on solid evidence?

(3) How did the IMF's advice change over time? Did this change keep pace with available evi-

[5]The IMF's instruments include surveillance, technical assistance, and IMF-supported programs.

Box 1.2. Effectiveness of Market-Based Capital Controls: Evidence from Chile

From around 1996, there began to emerge a substantial body of empirical research on the effectiveness of Chile's capital inflow control, which was introduced in 1991 in the form of an unremunerated reserve requirement (URR). We discuss available evidence to provide background to subsequent discussions on the policy advice given by the IMF on such controls.

This measure required a designated share of certain capital inflows to be deposited with the central bank at zero interest for a designated period of time (see Box 2.2 for details of how the system worked). Although different studies came to different conclusions, by 1999, the sense of the literature—though evidence was often weak—was that (1) the URR allowed domestic interest rates to be somewhat higher; (2) it lengthened the maturity of capital inflows; (3) it had only limited effectiveness, if any, in reducing the volume of total inflows; and (4) it had little or no effect on the real exchange rate (see Nadal-De Simone and Sorsa (1999) and Gallego and others (2002) for a review of the literature).

Most of these studies, however, contain serious methodological problems, making it difficult to accept any conclusion with confidence. For example, most used net inflows as the dependent variable, but government actions (including outflows liberalization, debt prepayment, and debt conversion programs) reduced the net inflows independently of the URR by increasing the outflows. Along with the liberalization of capital outflows, there were also changes in the administrative regulation of capital inflows. Likewise, the operation of the URR itself changed over time, as the authorities tried to close loopholes and increase effectiveness by widening its coverage and raising its rate. The exclusion of certain short-term flows (such as trade credits) may also have biased the results of many of the studies, given the substitutability that existed between transactions subject to the URR and those that were not. For these and other reasons, Nadal-De Simone and Sorsa (1999) concluded that it was "premature to point at the Chilean experience as supportive of the effectiveness of controls on capital inflows."

Some of these methodological problems have been addressed in a more recent study by Gallego and others (2002). The study extends previous research by considering the endogeneity of the URR (the central bank may tighten the URR in response to changes in the strength of capital inflows), the effect of administrative controls on capital flows, and using a much longer sample period covering 1989–2000. A significant contribution of the study is its consideration of the URR's "effective cost," which incorporates both "tax effectiveness" and "cost" and essentially measures how binding the URR was. The findings of this study broadly support the conclusions of previous work: (1) the URR temporarily allowed domestic interest rates to increase relative to international rates;[1] (2) it had no significant effect on the real exchange rate; (3) it significantly reduced the volume of capital inflows, though the effect diminished over time; and (4) it unambiguously changed the composition of capital inflows in favor of longer maturities. The less ambiguous effect of the URR on total inflows is new, but is supported by the findings of other recent research (see, for example, Le Fort and Lehman, 2003; Ffrench-Davis and Tapia, 2004).

[1]This, however, was achieved probably at the expense of increasing the cost of capital to smaller domestic firms with limited access to international capital markets (Forbes, 2003; Gallego and Hernandez, 2003).

dence—that is, did the IMF learn as new evidence emerged (see, for example, Box 1.2)?

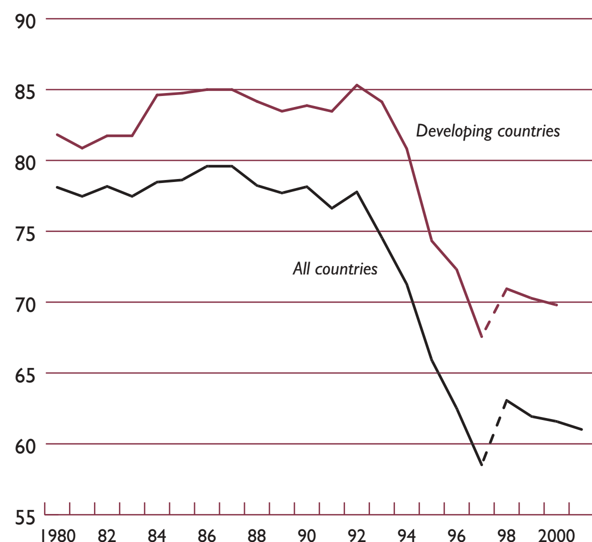
(4) Did the IMF give similar advice to countries in similar situations?

(5) Was the policy advice on the capital account set in a broader assessment of the authorities' macroeconomic policies and institutional framework?

In asking the last two questions, in particular, we are not seeking to assess the IMF's policy advice in individual countries against a specific yardstick of "appropriateness," since, as already noted, there is no such agreed measuring rod in many circumstances. Rather, the aim is to collect evidence related to two common (and, to some extent, contradictory) criticisms of the IMF's approach, namely that (1) it adopted a "one size fits all" approach in its policy advice, and (2) it was "inconsistent" by giving different policy advice to countries in broadly similar situations. In making such judgments, we faced a number of limitations—most notably that the rationale for particular policy advice was not always spelled out in the relevant staff reports.

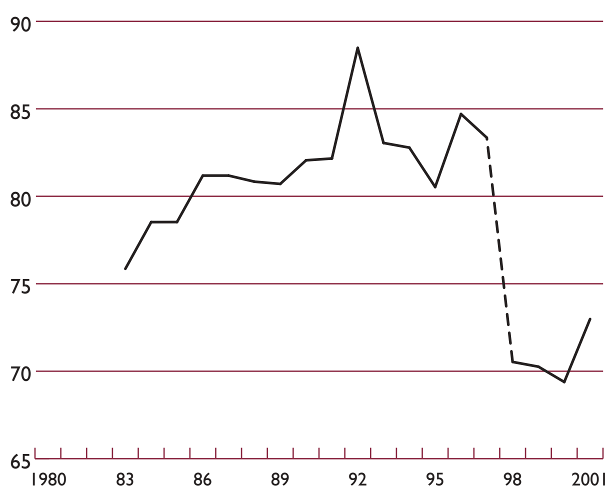
The evaluation does not address the question of whether capital account liberalization leads to faster growth (or generates other benefits)—an issue on which the wider body of research evidence has not reached definitive conclusions—or whether the IMF Articles of Agreement should be amended to give the IMF an explicit mandate for capital account liberalization and jurisdiction on member countries' capital account policies. Many aspects of these issues are not susceptible to evidence from the evaluation. In the case of the second issue, however, the evaluation does shed some light on whether ambiguities about the IMF's institutional role with regard to capital account matters has affected its country work in this area.

Figure 1.2. Countries with Capital Controls[1]
(In percent of total IMF membership)



Source: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*.
[1]Based on a one (controlled) or zero (not controlled) classification (covering all capital account transactions), as provided by the *AREAER*. There was a definitional change from 1997 to 1998.

Figure 1.3. Countries with Capital Controls[1,2]
(In percent of total developing IMF membership; GDP-weighted)



Source: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*.
[1]Based on a one (controlled) or zero (not controlled) classification (covering all capital account transactions), as provided by the *AREAER*. There was a definitional change from 1997 to 1998. GDP shares are based on 1990–2000 averages.
[2]The line would shift downward by about 5 percentage points if China and India were excluded.

Most of the country-based analysis will use a sample of emerging market economies, for which private capital flows have been important. This selection of countries is justified by the fact that emerging market economies received almost all of the private capital flows to developing countries in the 1990s and arguably required the close attention of the IMF. The largest 25 recipients, for example, accounted for as much as 90 percent of total cross-border investments during 1990–2002.[6] Moreover, it is primarily for the possible role played in these countries that the IMF has been criticized.

It should be clearly stated at the outset that the choice of emerging market economies may serve to make the IMF's role in capital account liberalization appear less significant than it actually was. From 1992 to 1997, for example, there was a significant reduction in the number of IMF member countries with capital controls, and much of this reduction was accounted for by low-income countries, including those in sub-Saharan Africa (Figure 1.2).[7] It is possible that the IMF had a more direct role in encouraging capital account liberalization in some of these lower-income countries that relied on IMF financing.[8] On the other hand, if the number of countries is weighted by GDP, there was a sharp rise in capital account restrictiveness in the early 1990s (reflecting the fact that a number of former socialist economies joined the IMF); for the period as a whole there was little change in the degree of capital account openness among the IMF's developing country membership (Figure 1.3). This means that the sample, in which there is a greater representation of larger or higher-income developing countries, may well be biased toward those that tended to maintain some capital account restrictions (see below for the list of countries included in the sample).

The evaluation will pay particular attention to country experiences with capital account liberalization (in terms of speed, sequencing, and preconditions) and policy responses to capital flows, including the temporary use of capital controls, and the

[6]This figure does not include foreign direct investments. The countries in the sample used in this report account for about 40 percent of this total during 1990–97 (reflecting the exclusion of Argentina, Brazil, Indonesia, and Korea), but the share increases to over 50 percent during 1998–2002.

[7]Judgment about the presence or absence of capital controls in each country is based on a one (controlled) or zero (not controlled) classification provided by the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (*AREAER*). It should be noted that this binary classification does not take account of either the intensity or the number of controls.

[8]A recent econometric study by Joyce and Noy (2005) shows that an extended IMF-supported program was statistically significant in explaining a country's decision to remove capital controls in the 1990s, suggesting that low-income countries often liberalized the capital account in the context of IMF financial support.

IMF's role and advice in these areas. In discussing controls on capital outflows introduced in the context of a capital account crisis, it must be stressed that the focus will remain on issues specific to the capital account, and we will not consider broader crisis management issues (including, for example, private sector involvement and debt restructuring). Likewise, no attempt will be made to establish, in the context of a specific country, causality between capital account liberalization and a subsequent capital account crisis, although vulnerabilities to crisis created by a particular policy toward capital account liberalization may be noted.

In discussing capital account openness in specific countries, the evaluation will focus on de jure (as opposed to de facto) controls on capital transactions as defined by the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (*AREAER*). Clearly, when one investigates the economic impact of capital account liberalization, one must define capital account openness in a way that has an operational content. Edison and Warnock (2003), for example, suggest such an operational measure that takes account not only of the existence but also of the intensity of capital controls.[9] In this report, we are not asking questions about the economic impact of a particular control measure. Instead, we are more interested in knowing, for example, what the IMF said about removing or introducing a particular control measure. We are, therefore, focusing on de jure controls.

Sources of Evidence

The evaluation roughly covers the period 1990–2004 and uses two types of documentation. First, it will use Executive Board papers and minutes of discussions on systemic themes, including *World Economic Outlook* (*WEO*) and *International Capital Markets Report* (*ICMR*) or *Global Financial Stability Report* (*GFSR*) exercises,[10] Occasional Papers, Working Papers, and various issues of the *IMF Survey* (for management speeches). The evidence gathered from these sources will be used to consider how the IMF viewed capital account issues over time, including whether it had a consistent approach and how effectively it adapted this approach in light of experience.

Second, the evaluation uses the IMF's country documents, including staff reports for Article IV consultations and program reviews, internal briefing papers and back-to-office reports for staff missions, staff memorandums and notes prepared for particular country issues, the minutes of relevant Board discussions, and technical assistance reports. This evidence is drawn from four overlapping groups of countries:

- Countries for which only staff reports (and, in some cases, summings up of Board discussions) are used for the period 1990–2002. There are 15 countries in this category: Bulgaria, China, Croatia, Estonia, Israel, Lebanon, Peru, the Philippines, Poland, Romania, Russia, the Slovak Republic, Slovenia, South Africa, and Ukraine.
- Countries for which, in addition to staff reports, confidential internal documents are used for the period 1990–2002. There are 12 countries in this category: Colombia, Chile, the Czech Republic, Hungary, India, Latvia, Lithuania, Malaysia, Mexico, Thailand, Tunisia, and República Bolivariana de Venezuela.[11]

These first and second groups of countries, numbering 27, constitute the main sample upon which country analysis for 1990–2002 is primarily based (see below for the selection criteria).

- Countries that have requested technical assistance from the IMF on aspects of capital account liberalization, for which technical assistance reports are analyzed. There are 15 countries in this category: Belarus, China, Colombia, the Czech Republic, Hungary, India, the Islamic Republic of Iran, Kazakhstan, Latvia, Lesotho, Peru, Poland, Russia, Tanzania, and Tunisia.
- Countries with ongoing capital account issues for which confidential internal documents are used for the period 2003–04.[12] There are 14 countries: Bulgaria, China, Colombia, Croatia, India, the Islamic Republic of Iran, Kazakhstan, Libya, Morocco, Romania, Russia, South Africa, Tunisia, and Venezuela.[13]

The 27 countries in the first and second groups are chosen on the basis of the size of portfolio capital flows (absolute or relative to GDP) during 1991–2002 (see Appendix 4), our own qualitative

[9]See also Prasad and others (2003, pp. 6–8), for a discussion of the difference between "the existence of de jure restrictions on capital flows" and "de facto financial integration in terms of realized capital flows."

[10]In 2002, the *Global Financial Stability Report* replaced the *International Capital Markets Report*.

[11]Brief field visits were made to receive the views of officials and other experts in several of these countries: Chile, Colombia, the Czech Republic, Hungary, India, Latvia, Mexico, and Tunisia. A list of interviewees is provided in Appendix 6.

[12]These countries have been identified on the basis of a questionnaire sent to recent mission chiefs and interviews with IMF staff. The list of countries is not meant to be exhaustive.

[13]Additional information on ongoing issues was obtained from interviews with senior IMF staff.

Box 1.3. Capital Account Liberalization in Indonesia and Korea

The role of capital account liberalization in the East Asian crisis of 1997 has been a major topic of discussion. An earlier IEO report (IEO, 2003) discusses the effectiveness of the IMF's precrisis surveillance in identifying financial sector vulnerabilities created by capital account liberalization in Indonesia and Korea. Drawing on this report, we briefly review the IMF's role in these two countries. The broad message is that IMF surveillance failed to assess fully the underlying risks but that it did not play a major role in formulating the particular capital account liberalization strategy adopted by the authorities.

Indonesia

Indonesia had removed most controls on capital outflows by the late 1980s, and is often cited as an example of a country that had liberalized its capital account before the current account. Indonesia, however, retained controls on various categories of capital flows throughout the 1990s. Almost all the liberalization measures taken from the late 1980s to the mid-1990s were related to the liberalization of direct investment inflows. Rapid capital inflows that began in 1990 took place against the background of financial sector liberalization and domestic capital market development. At the time of the crisis in 1997, a considerable number of controls remained on many types of capital account transactions.[1] In response to the large capital inflows, the IMF staff advocated tight fiscal and monetary policies, greater exchange rate flexibility, accelerated structural and banking sector reforms, and even faster external debt repayment. The IMF did not push a particular path or pace of capital account liberalization. However, it underemphasized the risks of short-term capital inflows that were vulnerable to a sudden shift in sentiment, and did not fully appreciate the weakness of the banking sector and the vulnerability created by the country's buildup of external debt.

Korea

In Korea, it was in the context of OECD accession that, in 1994, a Foreign Exchange System Reform Plan was announced to achieve full capital account convertibility in five years, in three stages (Kim and others, 2001; Cho, 2001). The process began first with the liberalization of capital outflows, followed by a gradual easing of restrictions on foreign investment in the domestic stock market and short-term trade-related borrowing. Notwithstanding these measures, however, Korea's approach to capital account liberalization remained cautious. At the time of its OECD accession in 1996, Korea retained a number of reservations to the Code of Liberalization of Capital Movements, particularly regarding the liberalization of long-term capital inflows.[2] The IMF staff was aware of the weak banking system but did not sufficiently appreciate the vulnerabilities created by the buildup of short-term external borrowing by weak, poorly regulated financial institutions. Its view on Korea's particular choice of sequencing was that the speed of liberalization should be accelerated. The IEO report states that staff papers and Board discussions on Korea were "concerned primarily with the speed of liberalization (typically recommending a faster process)" and that "[issues] of sequencing and supervision were inadequately addressed in the surveillance process." Further liberalization of the capital account proceeded in the context of a program supported under the 1997 Stand-By Arrangement.

[1]These included nonresident purchases of Indonesian shares; the sale or issue of money market instruments abroad by residents; the granting of commercial credits by nonresidents to residents; purchases of land by nonresidents; bank borrowing from abroad; and bank lending to nonresidents (Johnston and others, 1997).

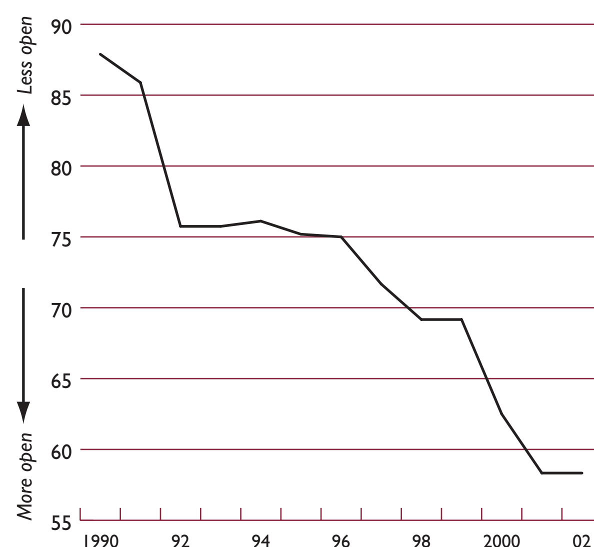
[2]As a result, at the time of the 1997 crisis, controls of one type or another remained on such capital account transactions as: issues of foreign-currency-denominated securities by residents; purchases of local securities by nonresidents; purchases of money market instruments by nonresidents; external borrowing by banks; inward direct investments; and even some trade credits (Johnston and others,1997; Kim and others, 2001).

judgment of the degree of capital account openness in 1990, and the changes introduced during the 1990s. The list includes: (1) countries that significantly liberalized the capital account during the 1990s; (2) countries that either still maintain or have until very recently maintained significant controls on capital account transactions; and (3) countries that introduced measures to restrict capital account transactions over the period. The second group of countries was selected from this larger group for more in-depth examinations, based on our own judgment of the learning potential—the important criteria informing this judgment were diversity of experience and outcome—in order to make sure that we cover varied experiences with, and different stages of, capital account liberalization. Argentina, Brazil, Indonesia, and Korea were all important recipients of international private capital inflows during much of the 1990s but are not included in the sample, because the IEO's earlier evaluations (IEO, 2003 and 2004) have already examined their relationships with the IMF (Box 1.3). This smaller sample, for example, allows us to take a closer look at the role of the IMF in countries that substantially eased restrictions on cap-

ital transactions during the early 1990s, the nature of IMF advice for countries that took a gradual approach to capital account liberalization, and the IMF's views in the context of specific country experiences with capital controls.

In order to aid the evaluation, we have created an index of de jure capital account openness that utilizes a more detailed classification of capital account transactions than the simple 1/0 system. In particular, following Miniane (2004), we assign 1 (or 0) to each of the 10 categories of capital account transactions as reported in the *AREAER* when a restriction is present (absent), and express the sum in percentage terms. This index has been calculated for the 12 core countries to which we give closer attention (see Appendix 5).[14] It turns out that 7 of these countries maintained moderate to extensive restrictions on capital account transactions almost consistently during 1990–2002; 2 countries had a largely open capital account; another 2 countries eased restrictions significantly in the late 1990s or early 2000s; and 1 gradually reduced restrictions over the period. As a result, when we look at the average index of capital account openness for these countries, we find that the index remained relatively high throughout the period, but observe a gradual decline in restrictiveness (Figure 1.4).

Figure 1.4. Average Capital Account Openness in 12 Sample Countries
(In percent)



Source: IEO estimates based on MFD data. See Appendix 5.

Organization of the Report

The rest of the report is organized as follows. Chapter 2 "General Policy and Analysis" reviews the legal basis for the IMF's work on capital account issues, intellectual and operational developments within the IMF in this area from the early 1990s to the early 2000s, and how the issues were viewed in the IMF's multilateral surveillance work. The following two chapters present an analysis of the IMF's approach to capital account liberalization based on work in individual countries. Chapter 3 "Advice to Member Countries" assesses the IMF's specific advice to member countries during 1990–2002 on capital account liberalization, macroeconomic and structural policies to manage large capital inflows, and the temporary use of capital controls. Chapter 4 "Ongoing Country Dialogue on Capital Account Issues" provides an overview and assessment of the IMF's latest country work on capital account issues. Chapter 5 "Major Findings and Recommendations" summarizes major findings and suggests two broad recommendations to help improve the IMF's operations in the area of capital account issues.

The main body of the report is followed by six appendixes. Appendix 1 "A More Detailed Assessment of Some Country Cases" provides a more in-depth analysis of how the IMF viewed capital account issues over time in the context of four countries with diverse experiences: the Czech Republic, Colombia, Tunisia, and Venezuela. Appendix 2 provides an overview of relevant staff research on capital account topics during 1990–2004. Appendix 3 reviews the IMF's public communications on capital account issues, focusing on management speeches and other public statements. Appendix 4 summarizes quantitative indicators of capital flows in the main sample of 27 countries. Appendix 5 depicts the indices of capital account openness for the 12 core countries. Finally, Appendix 6 provides a list of people interviewed by the evaluation team.

[14]IMF (1999, pp. 83–96) offers a methodology of calculating an index of capital account restrictions based on even more detailed transaction categories and ranks 41 industrial, developing, and transition economies for 1996. See also Johnston and Tamirisa (1998). Because of data limitation, however, we instead follow—with some modifications—the methodology of Miniane (2004), who extends the indices to the pre-1996 period but for a smaller set of 34 countries and based on 10 categories of capital account transactions.

CHAPTER 2 General Policy and Analysis

This chapter discusses the legal basis for the IMF's work on capital account issues, intellectual and operational developments within the IMF relating to its policies in this area, and how capital account issues were viewed by staff and the Executive Board in the context of multilateral surveillance exercises. In reviewing the IMF's general policies and analyses, we discuss, but only briefly, the background to the debate in the 1990s on whether or not the IMF's authority in this area should be expanded and the associated initiatives taken by IMF management to amend the IMF Articles of Agreement. Although the consequences of such an amendment would have been significant for the IMF's formal role, the focus of this report remains on what the IMF actually did or said in the course of its operational work.

The Legal Basis

The IMF's approach to capital account issues, including capital account liberalization in particular, has been a controversial topic, in part because there exists little consensus on what the role of the IMF in this area should be. To give a sense of issues involved, we first discuss what the IMF Articles of Agreement say, including the distinction between "purpose" (or "mandate") and "jurisdiction," as well as between current and capital account transactions. We then discuss the evolving role of the IMF in capital account issues, as it was interpreted by the Executive Board, and the context in which the evolution took place.

Mandate versus jurisdiction

Within the IMF, the term "mandate" has been used, in place of the legal term "purpose," to refer to the objectives which the IMF must pursue in its operations and activities;[1] "jurisdiction," on the other hand, refers to the IMF's legal authority to assess and enforce member countries' compliance with obligations specified under the Articles.[2] Article I of the IMF's Articles of Agreement sets out the "purposes" of the IMF and, in effect, defines the institution's mandate, including:

- To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems;
- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy;
- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation; and
- To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

Consistent with the IMF's mandate to facilitate the expansion and balanced growth of international trade, the members of the IMF bestowed upon the institution jurisdiction over restrictions on the making of payments and transfers for *current* international transactions. Article VIII ("General Obligations of Members") stipulated that, without the approval of the IMF, members could not (except under "transitional arrangements" defined in Article XIV, Section 2 or with respect to "scarce currency" provisions under Article VII) impose restrictions on the making of payments or transfers for current international

[1]"Mandate" is not a legal term used in the Articles of Agreement, but it assumed currency in place of "purpose" as used in the Articles. These two terms are often used interchangeably within the IMF, because an institution's mandate is essentially the purposes for which it was founded or which were subsequently assigned to it.

[2]How "jurisdiction" is defined here is consistent with the usage of the word as it pertains to the IMF's responsibilities vis-à-vis the making of payments and transfers associated with current account transactions.

transactions, such as purchases of imports. At the same time, the IMF was *not* given jurisdiction over the underlying current account transactions for which the payment was required.[3]

It should be noted that current international transactions as defined in the Articles are broader than the standard statistical definition of current transactions and include some categories that are normally considered to be capital transactions and capital transfers. In particular, Article XXX defines payments for current transactions as "payments which are not for the purpose of transferring capital." It then explicitly mentions restrictions on "normal short-term banking and credit facilities" and "payments of moderate amount for amortization of loans or for depreciation of direct investments" as being subject to IMF jurisdiction.

The IMF and the capital account

The evolution of the IMF's involvement with the capital account was different. The Articles of Agreement did not provide the IMF with a clear mandate to encourage capital account convertibility. The exclusion of most capital transactions (and the associated making of payments and transfers) from IMF jurisdiction was deliberate (de Vries, 1969, p. 224). Both of the main architects of the Bretton Woods institutions, John Maynard Keynes and Harry Dexter White, argued that countries should be protected from the disruptive impact of speculative international capital movements and that a world of unrestricted capital movements was not compatible with either a stable exchange rate system or a liberal international trading system.[4] These views reflected the consensus, held at the time the Articles were being drafted, that "the large short-term capital flows of the 1920s and 1930s had led to disaster" by threatening exchange rate stability and making it difficult to achieve monetary and fiscal stability (James, 1996, pp. 37–38). Bloomfield (1946) characterized this consensus as a "highly respectable doctrine, in academic and banking circles alike" and having "been officially crystallized in the Bretton Woods Fund Agreement."

Consequently, unlike restrictions on the current account, capital controls were seen to be a necessary and useful instrument of economic management, particularly for giving governments autonomy from financial markets and discouraging "speculative" capital and "hot money."[5] Thus, Article VI, Section 1 allowed the IMF to request a member to exercise controls to prevent the use of the IMF's general resources to finance a large or sustained outflow of capital, and stated that failure to do so could result in the member being declared ineligible to use the IMF's general resources. Section 3 of the same article recognized the right of members to "exercise such controls as are necessary to regulate international capital movements," as long as it were done in a manner that did not restrict current international payments or transfers. This provision was reaffirmed in a subsequent decision of the IMF Executive Board, approving a report of its Committee on Interpretation, which provided that: "Subject to the provisions of Article VI, Section 3 concerning payments for current transactions . . . members are free to adopt a policy of regulating capital movements for any reason, due regard being paid to the general purposes of the Fund. . . . They may, for that purpose, exercise such controls as are necessary . . . without approval of the Fund."[6]

Over the subsequent decades, however, two important developments took place, which changed the environment envisaged in the Articles. First, starting in the late 1950s, an increasing number of countries have removed restrictions on the making of payments and transfers for current transactions and accepted the obligations under Article VIII, Sections 2, 3, and 4 of the IMF Articles. The effectiveness of capital controls depends to some extent on the ability to control or at least monitor current account transactions, because (1) some current transactions can substitute for capital account transactions that are otherwise restricted and (2) current transactions can create scope for disguised capital transactions through leads and lags or under- and over-invoicing. The removal of restrictions on current payments and transfers has to

[3]There are several reasons for the distinction that emerged between current transactions and the making of payments and transfers for those transactions. Jurisdiction over the underlying current transactions was to have resided with a proposed International Trade Organization. However, opposition to this approach from key constituencies led instead to reliance upon the much less ambitious General Agreement on Tariffs and Trade (GATT). For a more in-depth discussion of the political context underlying decisions on current account convertibility and jurisdiction, see James (1996).

[4]Helleiner (1994, pp. 33–38) discusses how the views of Keynes and White influenced the provisions of the Articles of Agreement regarding capital account issues. Keynes argued that international capital movements should be allowed only "for legitimate purposes" and that there must be "a means . . . of controlling short-term speculative movements or flights of currency." White, for his part, argued that "the task . . . is not to prohibit instruments of control but to develop those measures of control . . . as will be the most effective in obtaining the objectives of worldwide sustained prosperity" (as quoted in Horsefield, 1969, pp. 32, 64). See Boughton (2002) for a detailed analysis of the views of Keynes and White, who differed in their assessments of why controls on capital movements were necessary.

[5]Such a view, shared by both Keynes and White, had been initially advanced by League of Nations economists in the 1930s (see Nurkse, 1944).

[6]Executive Board Decision No. 541-(56/39), July 25, 1956.

some extent diminished the effectiveness of any remaining capital controls. More recently, the expansion of financial market innovation, including the development of new and more complex financial instruments, has made it even more difficult to enforce capital controls effectively. These were important factors accelerating moves toward liberalization among industrial countries in the 1970s and 1980s.

Second, de facto capital account liberalization proceeded in the context of such multilateral agreements as the OECD Code of Liberalization of Capital Movements (1961)[7] and the European Communities Directives on Capital Account Liberalization (1986–88). The WTO's General Agreement on Trade in Services (GATS) also served to ease restrictions on trade in financial services and, as a consequence, facilitated associated capital movements among a wider group of countries. The increased freedom of capital movements, particularly among industrial countries, generated large cross-border capital flows globally, with implications for macroeconomic stability and exchange rate management in many countries. These were some of the developments that put into question the ability of the IMF to deal with these issues effectively and highlighted the potential role the IMF could play in ensuring orderly liberalization.

The role of the IMF in capital account issues

An important milestone in this process was the Second Amendment of the IMF's Articles of Agreement, which was put in place in the wake of the collapse of the Bretton Woods system of pegged exchange rates. At that time, a new Article IV, inter alia, provided for surveillance by the IMF over the exchange rate policies of members and established certain obligations of members with respect to exchange rate stability. The preamble to Article IV (Section 1) states that "the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries."[8] In enumerating specific obligations of members, Article IV, Section 1 required each member to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

Under the new framework, the Executive Board adopted a decision setting out principles and procedures for surveillance over members' exchange rate policies (the 1977 Surveillance Decision).[9] These principles noted the importance of restrictions on capital movements and included, among the developments that might indicate the need for discussion with a member, "the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital," "the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows," and "unsustainable flows of private capital."[10] However, while unambiguously noting the importance of the capital account for the purposes of IMF surveillance, the 1977 Surveillance Decision implied neither the encouragement nor discouragement of capital account convertibility.

In the latter half of the 1990s, the IMF reassessed its mandate and jurisdiction over capital account transactions and considered the possibility of amending the IMF's Articles of Agreement (Box 2.1).[11] In the event, the proposed amendment of the Articles failed to materialize. As it stands, Article IV ("General Obligations of Members") and the associated 1977 Surveillance Decision of the IMF Executive Board, as amended in April 1995, define the role of the IMF in surveillance with respect to capital account issues. It is now generally understood that while the IMF does not have the authority to assess or enforce a standard of capital account convertibility among the general membership, it has a responsibility to exercise surveillance over capital account policies, albeit as part of its larger responsibility to exercise firm surveillance over exchange rate policies. It is also understood that the IMF can use technical assistance for capital account issues. Ambiguity remains, however, because the Articles do not prescribe a member's specific obligation with respect to capital account policies and technical assistance is not an activity explicitly mandated by the Articles.

General Operational Approach

Most of the intellectual and operational developments of the 1990s related to capital account issues

[7]See Thiel (2003) for a discussion of the role of the OECD Code in encouraging capital account liberalization in recent accession countries.

[8]The IMF's Legal Department, however, has emphasized that this refers to a "purpose of the international monetary system," and not necessarily of the IMF.

[9]Executive Board Decision No. 5392-(77/63), April 29, 1977.

[10]The last item "unsustainable flows of private capital" was added in the 1995 amendment.

[11]As part of this debate, the distinction between restrictions on the making of payments and transfers for capital transactions and the underlying capital transactions did not figure as prominently as with the current account. This was largely because—for many capital account transactions (e.g., long-term loans)—it was often difficult to distinguish operationally between the underlying transaction and its associated payments and transfers.

Box 2.1. The Proposal to Amend the Articles of Agreement[1]

In the latter half of the 1990s, IMF management proposed and actively promoted an amendment to the Articles of Agreement that would have transformed the IMF's formal role in capital account liberalization and capital account issues in general. The idea for an amendment had been raised within the IMF for some time, at least since 1994, but it was in 1996 that the agenda to amend the Articles received priority in the work program of the IMF. During 1996 and 1997, the Executive Board made intensive deliberations of the issues involved, to which IMF staff contributed significant intellectual inputs. At the level of the Board of Governors, the Interim Committee gave both encouragement and specific directives from time to time. The support of the Interim Committee reached its height in September 1997, when, at its annual meeting in Hong Kong SAR, the Committee issued a communiqué outlining the logic of its support for an amendment and requesting the Executive Board to "accord high priority" to submitting "a draft amendment to the Board of Governors."

As the debate evolved, there emerged general agreement that the proposed amendment must involve two fundamental and distinct changes. First, the IMF was to be endowed with a new purpose: to promote the liberalization of capital flows. Article I was to be amended to include the encouragement of the liberalization of capital movements and the elimination of restrictions on capital account transactions. Second, the IMF was to assume jurisdiction over restrictions in the capital account. Jurisdiction would have established as a general rule that member countries would be prohibited from imposing restrictions on certain types of international capital movements without the approval of the IMF. The amendment would also have resulted in a revision of Article VI, which recognizes the right of members to "exercise such controls as are necessary to regulate international capital movements" as long as they do not restrict current international payments or transfers.

In addition to the enthusiasm expressed by IMF management, the vast majority—albeit not all—of industrial countries favored the formalization of IMF authority on the regulation of international capital flows. Their authorities recognized that they lived in a world "very different from that faced by the Fund's founding fathers," characterized by floating exchange rates and large capital movements among the major countries. Many developing countries, however, were more guarded, considering that capital controls could be useful in some circumstances to deal with exchange rate pressure.[2] Their apprehension was not fully erased by the proposed provision for transitional arrangements (comparable to Article XIV for current transactions) and the language emphasizing the IMF's role to ensure "orderly" liberalization. Consensus in favor of an amendment eluded the Executive Board, which continued to discuss the possibilities for achieving more widespread support for an amendment. In the event, in the summer of 1997, most Executive Directors agreed that inward direct investment, often sensitive politically, would have to be excluded from the IMF's expanded jurisdiction.

The East Asian crisis, contagion from which was spreading through Asia and beyond at the time of the Interim Committee's Hong Kong SAR meeting in 1997, changed the dynamics of the debate in a fundamental way. Because the crisis was unexpected and severe, the risks of capital account liberalization began to weigh on the minds of policymakers who had previously emphasized the benefits. In addition, opposition began to emerge from some influential members of the U.S. Congress, who felt reservations about giving more authority to the IMF when it was seeking an augmentation of its quota. Although IMF management never officially abandoned the idea, by the spring of 1999 it was clear that sufficient support was not forthcoming to amend the Articles, at least as it was drafted and proposed.

[1]This is based on a comprehensive analysis of this episode, as provided by Abdelal (2005).

[2]Concluding Remarks by the Acting Chairman, Executive Board Seminar on "Issues and Developments in the International Exchange and Payments System," November 16, 1994.

took place within the context of the management initiatives to amend the Articles of Agreement to expand the IMF's mandate and jurisdiction. From 1995 to 1999, staff prepared a number of policy papers for Executive Board discussion, providing an analysis of legal and other conceptual issues involved in amending the Articles.[12] As noted at the beginning of this chapter, however, this section focuses on those developments that shed light on the IMF's actual operational work. In fact, the IMF's views and operational work on capital account issues evolved, responding to new evidence or new developments (see Table 2.1). We review this evolution in this section, which forms an important part of the basis upon which the IMF's country work will be assessed in the following chapter.

[12]The last of the series of formal Board papers discussing approaches to amending the Articles was prepared in September 1999 by the Legal Department, "The Role of the Fund in the Liberalization of Capital Movements—Further Considerations on a Two-Tiered Approach," SM/99/220, September 3, 1999. The paper was never discussed by the Executive Board.

Table 2.1. Notable Events Affecting Capital Account Issues, 1991–2004

Date	Events
June 1991	An unremunerated reserve requirement (URR) introduced in Chile.
September 1993	Chilean-style controls introduced in Colombia.
October 1994	"Madrid Declaration" issued by the Interim Committee, encouraging countries to remove impediments to the free flow of capital.
December 1994	Mexican peso comes under pressure and is allowed to float.
July 1995	Executive Board's first operational guidance on capital account liberalization issued to IMF staff.
December 1995	Staff operational note on capital account liberalization issued by the Policy Development and Review Department (PDR) and the Monetary and Exchange Affairs Department (MAE).
1995–96	OECD accession for the Czech Republic, Hungary, and Korea.
1996–97	Empirical evidence on the effectiveness of Chilean URR begins to appear.
1996–99	Executive Board deliberations on amending the Articles of Agreement.
March 1997	A supplement to the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* published, with an expanded coverage of capital account regulations.
July 1997	Thai baht comes under pressure and is allowed to float.
September 1997	The Interim Committee meeting in Hong Kong SAR issued a communiqué supporting an amendment of the Articles.
November–December 1997	Executive Board approves Stand-By Arrangements for Indonesia and Korea.
August 1998	Russian default and devaluation.
September 1998	Capital outflow controls introduced in Malaysia.
January 1999	Brazilian devaluation.
May 1999	Financial Sector Assessment Program (FSAP) launched.
July 2001	New "integrated" approach to capital account liberalization discussed in an Executive Board seminar.
May 2004	EU accession for eight transition economies, including the Czech Republic, Hungary, and Latvia.

Expanding role of the IMF

From the late 1980s, the IMF began to give greater attention to capital account issues as part of its surveillance work. Records show that the Executive Board regularly, and with increasing frequency, held meetings to discuss international capital flows.[13] These early efforts, however, tended to be a *positive* analysis of what motivated international capital flows and what the consequences would be, rather than an attempt to make a *normative* case for a particular capital account policy. They also included a review of measures taken by a number of developing countries to access international capital markets, particularly in the aftermath of the debt-servicing difficulties they had experienced in the 1980s, and often emphasized the importance of sound macroeconomic policies in attracting capital inflows.

In the early 1990s, in an environment in which nearly all industrial countries had removed virtually all capital controls, staff prepared policy papers that were clearly advocating the benefits of capital account liberalization, to which many Executive Directors gave broad endorsement.[14] While some of these papers raised questions of IMF jurisdiction and the need to formalize the IMF's role, it was not until the mid-1990s that these jurisdictional issues received the formal attention of the Executive Board.

Clearer support for capital account liberalization emerged in the context of the so-called "Madrid Declaration on Cooperation to Strengthen Global Expansion," adopted by the Interim Committee of the IMF's Board of Governors at its October 1994 meeting. In this meeting, Governors approved a statement welcoming the "growing trend toward currency convert-

[13]For example, the Board met during 1989–90 to discuss a number of policy papers prepared by staff, including: "Policies to Promote Private Capital Inflows in Fund-Supported Adjustment Programs," EBS/89/117; "Study on the Measurement of International Capital Flows," EBAP/89/269; "The Determinants and Systemic Consequences of International Capital Flows," SM/90/128; and "Capital Market Financing for Developing Countries—Recent Developments," SM/90/174.

[14]Some of these papers and the Executive Board's reactions to them are reviewed in Monetary and Exchange Affairs Department, "Issues and Developments in the International Exchange and Payment System," SM/94/202, August 1994.

ibility and [encouraging] member countries to remove impediments to the free flow of capital."[15] Following the Madrid Declaration, in July 1995, the Executive Board gave its first operational guidance to the staff, when it met to review the recent experience of the IMF's membership with capital account liberalization.[16] Here, Directors gave general support to the idea that capital account issues should be covered more fully in Article IV consultations and that surveillance and technical assistance work be strengthened to encourage and support capital account liberalization. These views were broadly endorsed by the Interim Committee in its October 1995 communiqué.

It was around this time that IMF management and staff began to give greater attention to capital account issues in the actual operational work of the IMF. A series of notes were prepared during 1995, providing operational guidelines for area department staff. Of these, a set of notes prepared by the Policy Development Review Department (PDR) and the Research Department (RES) in October 1995 discussed how to incorporate large unexpected capital inflows into program design, particularly when disinflation was an important program objective; and how to identify the causes of large capital inflows and determine appropriate policy responses. For example, the PDR note stated that programs should include the quasi-fiscal costs of sterilization within fiscal performance criteria and medium-term projections. The RES note suggested that the mix of instruments to deal with large capital inflows would depend on the institutional structure of the country and the history of policies, adding that "temporary capital controls" might be necessary if the use of conventional macroeconomic tools was restricted or their effectiveness limited.[17]

These were followed, in December 1995, by a "staff operational note" prepared by the Directors of PDR and the Monetary and Exchange Affairs Department (MAE) and circulated to area departments, outlining "the next steps to be followed by the staff in adapting Fund practices to elicit greater emphasis on capital account issues, and to promote more actively capital account liberalization."[18] The note requested help and cooperation from area department staff in two areas: (1) to give greater attention to capital account developments in mission and technical assistance work; and (2) to assist in the collection of detailed information on capital account regulations for a pilot group of major emerging market economies. While the note's guidance to the staff was clearly to encourage capital account liberalization, it also included a qualification: "Liberalization of capital account transactions should generally be undertaken consistent with progress in macroeconomic stabilization and structural reforms . . . in certain circumstances, the use of capital controls to deter or slow such inflows may provide some temporary breathing room for the authorities, while more fundamental policy adjustments are being prepared."

Over 1996–97, a significant improvement was made in the IMF's capability to collect more detailed information on the regulatory framework of external capital account transactions. Initial work involved adaptation of the well-established codes developed by the OECD; the expanded data on capital controls classified measures into 20 broad categories (10 each for inflows and outflows). In December 1995, a questionnaire was sent to a pilot group of 31 member countries, which was subsequently compiled as a supplement to the 1996 *AREAER*. With the successful completion of the pilot project, the coverage was extended to all IMF member countries, and August 1997 saw the publication of the 1997 *AREAER* with the expanded coverage of capital account regulations for all countries. Subsequently, in 1998, the expanded data set allowed MAE to develop indices of exchange and capital controls capable of providing a quantitative measure of the restrictiveness of a member's exchange and capital control regime that is comparable across countries.[19]

Pace and sequencing of capital account liberalization

The speed with which a controlled regime can (or should) be liberalized depends on various factors, including risks, distortions, and institutional capacity.[20] Developing effective regulatory frameworks takes time, but a lengthy process may create wrong incentives and distortions. There are also political

[15]Similar support was evident in the Interim Committee communiqué of 1996 in which the members "encouraged the Fund, in promoting liberalization in a global market setting, to pay increased attention to capital account issues and the soundness of financial systems."

[16]"Capital Account Convertibility—Review of Experience and Implications for Fund Policy," SM/95/164. The Board discussion was held on July 28, 1995. See EBM/95/73. The paper was subsequently issued as an Occasional Paper (Quirk and others, 1995).

[17]These notes were circulated to the staff under a management memorandum dated October 25, 1995.

[18]"Strengthening Discussions and Information on Capital Account Convertibility—Next Steps." Cover memorandum, dated December 13, 1995.

[19]See, for example, Johnston and Tamirisa (1998), IMF (1999), and Miniane (2004).

[20]Lack of administrative capacity may argue either for or against faster reform, because there is no presumption that the resource requirements of implementing a quick reform are either smaller or larger than those of managing a long transition process or administering capital controls. For a discussion of issues related to the speed of reform, including the choice between a gradualist and a big-bang approach, see Nsouli and others (2002).

considerations. A big-bang approach may be appropriate if a prolonged transition is likely to create resistance from vested interests or if different elements of the existing system are so dependent upon each other that a piecemeal reform is not possible without creating significant distortions. A gradualist approach, on the other hand, may be more appropriate if it takes time to build political consensus or if a slower process is more conducive to minimizing the adjustment costs.

Much of the scholarly literature in economics advocated the big-bang approach in the context of transition economies in the early 1990s, arguing that the lack of credibility in the reform made it more appropriate to act quickly (Funke, 1993). In extending the big-bang approach to nontransition contexts, many experts, including some at the IMF, argued that the best route to an efficient financial sector was to liberalize the capital account quickly, as it would allow market discipline to operate on the banking system (Guitián, 1996).[21] Others in the IMF used the ineffectiveness of capital controls as the argument for faster capital account liberalization, given their distortionary effects. For example, Mathieson and Rojas-Suarez (1993) stated: "Analyses of the sequencing of structural reforms and stabilization policies for developing economies have traditionally argued that capital controls . . . are necessary to prevent capital flows that would undermine the reform program. These policy recommendations, however, stand in sharp contrast to a growing body of empirical evidence that suggests that capital controls have often been evaded."

Following the East Asian crisis, however, "sequencing" emerged as an operational concept in the IMF's approach to capital account liberalization. The IMF staff emphasizes that "sequencing" as used in IMF terminology is an operational concept, involving specific measures of institutional building, which is distinct from "order" as used in the literature on economic reform.[22] A policy paper discussed by the Executive Board in July 1998 stated: "The Asian country experiences confirm that it is necessary to approach capital account liberalization as an integral part of more comprehensive programs of economic reform, coordinated with appropriate macroeconomic and exchange rate policies, and including policies to strengthen financial markets and institutions. The question is not so much one of the capital liberalization having been too fast, since some of the countries in Asia have followed a very gradualist approach. Rather, it is more to do with the appropriate sequencing of the reforms and, more specifically, what supporting measures need to be taken."[23]

At the same time, the greater recognition of the need for sound financial systems led, in May 1999, to the establishment of a Financial Sector Assessment Program (FSAP), which was to be administered jointly by the IMF and the World Bank. The FSAP was meant to fill an identified gap in the international financial architecture in support of crisis prevention, based on a judgment that existing approaches at the IMF under Article IV consultations were not sufficient for effective financial sector surveillance. Although participation is voluntary, over 80 member countries have so far subjected their financial systems to assessment under the FSAP.[24] Because the FSAP's key objective is an early detection of financial sector vulnerabilities, the staff has used its assessments as a basis for dialogue with the authorities of countries considering further capital account liberalization; technical assistance on capital account liberalization has also been given in conjunction with FSAP assessments.

Analytical work by staff on sequencing culminated in a policy paper, which was discussed in an Executive Board seminar in July 2001 and subsequently issued as an Occasional Paper (Ishii and others, 2002). The paper stresses the importance of an "integrated" approach, which considers capital account liberalization as part of a more comprehensive program of economic reform and coordinates it with appropriate macroeconomic and exchange rate policies as well as policies to strengthen the financial system. It analyzes different risks that might be posed to financial and macroeconomic stability by capital account liberalization. In drawing operational principles, it relies on the (both successful and not so successful) experiences of nine countries: Austria, Hungary, Korea, Mexico, Paraguay, South Africa, Sweden, Turkey, and the United Kingdom.[25] The op-

[21]Guitián (1996) was initially presented in a conference held in 1992. In a broader context, the "discipline effect" of international markets has been argued by some to operate on macroeconomic policymaking more generally. See, for example, Tytell and Wei (2004), who suggest that "financial globalization" may have encouraged low-inflation monetary policies but not necessarily low-budget deficits.

[22]The early contributions in this literature were based on the "Southern Cone" experience of Argentina, Chile, and Uruguay in the late 1970s, and emphasized the importance of achieving macroeconomic stabilization, financial liberalization, and trade liberalization before opening the capital account (McKinnon, 1982; Edwards, 1984).

[23]Monetary and Exchange Affairs Department, "Developments and Issues in the International Exchange and Payments System—Background Studies," SM/98/172, Supplement 2, July 8, 1998.

[24]A separate IEO evaluation of the FSAP process is under way. The terms of reference for this evaluation can be found at www.imf.org/ieo.

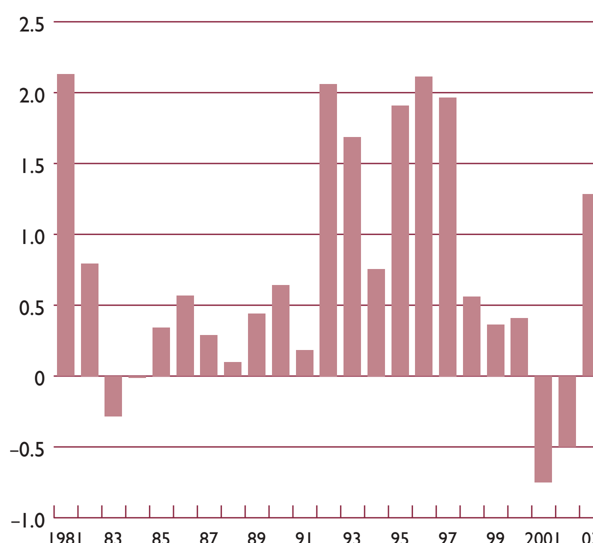
[25]For example, the paper notes that capital controls in South Africa and a cautious approach and early implementation of structural reforms in Hungary, respectively, may have limited the vulnerabilities of these countries to contagion from Russia.

erational principles stress the importance of safeguarding financial sector stability and maintaining consistent exchange rate and macroeconomic policies (see Box 4.3).

At the Executive Board seminar, Directors expressed a range of views on the paper. While some thought that the approach was appropriate, others expressed the view that some of the suggested policy measures could be implemented simultaneously and that countries might want to "use windows of opportunity" to move ahead quickly with capital account liberalization. The Acting Chairman noted that speed was not the issue—"what matters is the relationship between capital account liberalization and other policies, and that liberalization is sustainable." Although there was a broad endorsement of the general approach proposed, the views expressed in a seminar—unlike those in a formal Board meeting—were informal, and no formal decision was taken. Consequently, the paper has not removed the ambiguity that exists on the IMF's formal policy advice on capital account liberalization.

Figure 2.1. Net Capital Inflows to Developing Countries[1]

(In percent of total developing country GDP)



Source: IMF database.

[1]Changes in private foreign liabilities, including equity portfolio. Excludes government borrowing.

Multilateral Surveillance

Multilateral surveillance is an activity of the IMF that, among other things, identifies major risks and vulnerabilities that may affect economic policymaking in member countries through global and regional linkages. As the key outputs of multilateral surveillance exercises—the *WEO* and the *ICMR/GFSR*—are widely disseminated, they also serve as a channel by which the IMF communicates its views to the public.[26] In this section, we review how capital account issues were viewed by the IMF staff and the Executive Board in the context of multilateral surveillance exercises.

Developments in advanced economies—"push" factors

In discussing the IMF's policy advice on capital account liberalization and management of capital flows, one must first address the fundamental question of what determines the volume of global capital flows to emerging and developing countries—the so-called "push" factors that largely originate in advanced economies. In fact, it is well known that global capital flows have been characterized by "boom-and-bust" cycles (Figure 2.1), and it is appropriate to ask at the outset what the IMF's multilateral surveillance was saying about the causes of these cycles and the consequent policy implications for both advanced and emerging market countries.

Although a fuller discussion of this issue goes well beyond the scope of this evaluation,[27] it is useful to place the evaluation of the IMF's multilateral surveillance of "supply-side" factors within the following stylized characterization of the two polar ends of the debate:

- Some observers would argue that the fundamental cause of "excessive" capital inflows to emerging markets followed by sudden outflows lies in weaknesses in both macroeconomic policy (especially exchange rate policy) and in the framework governing financial institutions in emerging markets. According to this view, some of the solutions are to adjust macroeconomic policy settings and to strengthen institutional frameworks (for example, through the various "standards and codes" initiatives). These observers then note that solutions along these lines are under way (through more flexible exchange

[26]In 2002, the *International Capital Markets Report* (*ICMR*) changed its name to the *Global Financial Stability Report* (*GFSR*), but we refer to each report by the title used at the time it was prepared. The *World Economic Outlook* (*WEO*) and *ICMR/GFSR* reports, prepared by the staff in the context of multilateral surveillance, are released to the public, with the disclaimer that the views expressed therein are those of the staff, and not necessarily those of the Executive Board.

[27]A forthcoming IEO evaluation of the IMF's multilateral surveillance is expected to address some of these issues in greater depth.

rate policies and the strengthening of financial sector and transparency frameworks in emerging markets).

- An alternative and perhaps more pessimistic view would be that the unstable nature of these flows has more to do with the fundamentals of how financial markets operate that are much more difficult to resolve (for example, environments of suboptimal information that cause investors to herd; and "informational cascades" or other market imperfections that lead to market myopia). Proponents of these views point to evidence suggesting that the incidence of crises has not declined, and may even have increased over the long run (Eichengreen and Bordo, 2002; Persaud, 2001). These commentators usually emphasize the importance of "supply-side reforms" in advanced economy financial markets as part of the solution—although there are obvious questions about the extent to which official policies can, or should, seek to reduce volatility in these markets.[28]

Most observers would agree that both strands of the debate are important. For the purposes of this evaluation, the question is what the contribution of the IMF has been to the discussion on these issues, in terms of both analyses and policy advice.[29]

A review of multilateral surveillance documents suggests that the IMF paid relatively little attention to the push factors of global capital flows in the early 1990s but has given this topic increased attention in more recent years. This does not mean that the staff was initially unaware of the importance of developments in advanced economies in determining global capital flows. The early analysis, however, did not raise these issues in terms that stressed potential risks to emerging market economies. It appears that the IMF held a rather "fundamentalist" view of international capital flows. For example, the 1992 *ICMR* stated: "International capital flows continued to reflect the current account imbalances of industrial and developing countries and the international diversification of investment portfolios." The staff tended to view any regulatory development that would increase developing countries' access to international capital markets as beneficial.[30]

The prevailing idea that any measure that increases capital flows into emerging market economies is good must be understood within the context of the period. During much of the 1980s, a number of developing countries had lost access to international capital markets. Moreover, with the beginning of transition in former socialist economies, a widely held view stressed the need for greater global saving, and policy advice to advanced economies tended to be framed in these terms. For example, the October 1991 *WEO* noted the shortage of world saving and called for industrial countries to consolidate their fiscal policies. The May 1995 *WEO* continued to note the need to boost world saving: "World capital flows and financial conditions are largely determined by the industrial countries and the trend toward public dissaving is also heavily an industrial country problem. These are the countries where fiscal consolidation can help boost world saving the most."

As a result, multilateral surveillance at this time, while aware of the potential swings in capital flows, did not devote much attention to analyzing the potential risks to emerging market economies of capital flow volatility. The 1994 *ICMR*, for example, noted how hedge funds and other highly leveraged speculators had increased their exposure to emerging markets, particularly in Latin America, but concluded that these institutional investors were "often subject to limitations—ranging from government regulations to self-imposed prudential restrictions—on their holdings of paper from developing country issuers" though, given the still low level of exposure, the limits were not yet binding. The October 1994 *WEO* noted a strong inverse relationship between developments in long-term interest rates in the major countries and stock prices in emerging markets,[31] but included very little discussion of how these developments in advanced economies posed policy challenges to emerging market economies.

The IMF staff expressed the view that the benefits of greater integration brought about by portfolio diversification outweighed the risks. The October

[28]See, for example, Ocampo and Chiappe (2003) for a proposal to introduce a countercyclical element into the regulation of financial intermediation and capital flows. See also Griffith-Jones (1998), Williamson (2002), and Griffith-Jones and Ocampo (2003). Metcalfe and Persaud (2003) emphasize the "fundamental" causes of boom-bust cycles, but are skeptical about solutions that give a central role to improved information flows in crisis prevention. Such questions also apply to the debate over greater disclosure by hedge funds and other institutional investors.

[29]To the extent that crises are inevitable, more systemic crisis resolution procedures are also needed. In this context, the IMF has been involved in discussions on various mechanisms, including collective action clauses and a Sovereign Debt Restructuring Mechanism. See also Buiter and Sibert (1999) for the idea of an automatic debt rollover mechanism. We will not discuss these crisis resolution issues here.

[30]For example, the 1992 *ICMR* mentioned the June 1991 decision by the Japanese authorities to ease the credit rating standards for public placement of bonds in the Samurai market and the regulatory changes in the United States to reduce the transactions costs and liquidity problems facing developing country issues in U.S. capital markets as positive developments that "have facilitated, or have the potential to promote, developing country access to international bond markets."

[31]The *WEO* then added a footnote: "There is no strong evidence that recent capital flows are caused by speculative bubbles."

1995 *WEO*, for example, remained optimistic: "The increased openness of developing countries and their greater integration into the world economy do not necessarily mean greater vulnerability to external conditions. Paradoxically, increased openness and greater integration may reduce vulnerability because of stronger growth momentum in individual developing countries and in the developing countries as a group. . . . In addition, the impact on developing countries of changes in the demand for their exports may be partially offset by countercyclical changes in capital flows, as has been the case recently, implying a dampening of overall cyclical impulse from the industrial countries." Thus, the staff tended not to view any developments in industrial countries that might affect capital flows to be an important risk factor for emerging markets.

In the latter part of the 1990s, and certainly following the East Asian crisis, there was a fundamental change in the way multilateral surveillance viewed capital flow issues. It now began to pay greater attention to the linkage between industrial country developments and their capital flow and risk implications for emerging market economies. In 1998 and 1999, both the *WEO* and *ICMR* reports discussed how an underestimation of risks by international investors and low interest rates in industrial countries had contributed to large capital flows to emerging market economies. In this context, the October 1998 *WEO* suggested that it would be wrong "to attribute financial crises exclusively to policy shortcomings in the crisis countries," and called on investors and regulators in creditor countries to "recognize the inherently fragile and volatile nature of capital flows by better pricing risks." The Executive Board, in discussing the May 1999 *WEO*, "pointed to the need to improve the regulatory oversight, on the supply side, of the highly leveraged activities of financial institutions."[32]

The staff's analysis of risk factors inherent in financial integration has become increasingly sophisticated in more recent years. For example, the 2001 *ICMR*s analyzed the relationship between financial market returns in mature markets and those in developing countries, and its impact on global capital flows to emerging markets; it also discussed the cross-border behavior of investors and how it might affect aggregate private capital flows to emerging markets. The 2003 issues of *GFSR* included an analysis of the "feast or famine" dynamics in emerging debt markets (March issue) and the "boom-and-bust pattern and volatility" of capital flows (September issue). However, the policy prescriptions drawn from this analysis have emphasized, not the actions to be taken by creditor countries, but the actions to be taken by emerging market economies, including the need for greater transparency in data and policies, the need to develop local markets and, as expressed by the Executive Board in March 2004, the need to implement sound macroeconomic policies consistently.[33]

In making this observation, we are *not* implying that there was a set of policies for improving the functioning of the "supply-side" mechanism that the IMF should have been advocating or that there were clear answers to what was an "appropriate" level of volatility. Clearly, there was no such consensus. Nor are we suggesting that the IMF has done nothing to reduce the cyclicality of international capital movements on the supply side. In fact, the IMF has addressed this issue from the standpoint of minimizing moral hazard in investor behavior, by encouraging greater exchange rate flexibility in recipient countries and limiting access to IMF financing during a crisis. The proposal for a Sovereign Debt Restructuring Mechanism (SDRM) and the encouragement of collective action clauses (CACs) can be considered not only as the IMF's search for a crisis resolution measure but also as part of its efforts to minimize the moral hazard aspect of capital flow volatility on the supply side. But it is worth noting that the IMF's contributions to the broader debate on what, if anything, can be done by advanced countries to minimize the cyclicality of international capital flows (for example, through regulatory measures directed at institutional investors) have been much more limited.[34]

Gradual versus rapid liberalization

The documents prepared by the IMF staff in the context of multilateral surveillance during 1990–2003 consistently favored capital account liberaliza-

[32]From 1999 to 2000, the question of how to regulate highly leveraged institutions received considerable attention in the official community, and a number of reports were prepared by various bodies, including the International Organization of Securities Commissions (IOSCO) and the U.S. President's Working Group on Financial Markets. The IMF made its own contribution to the debate through its work on the Financial Stability Forum's Working Group on Highly Leveraged Institutions. See Financial Stability Forum (2000).

[33]In a recent note on the IMF's medium-term strategy circulated to the Executive Board, the staff suggested that its research program should include issues related to institutions and contractual mechanisms that can help protect countries from external volatility. See Caballero (2003) for an example of a "hedging and insurance instrument" to protect a country from volatility arising from commodity price fluctuations. While these ideas are welcome, the focus remains on the recipient countries.

[34]In this context, in July 2003, the IMF staff provided the Basel Committee with comments on the proposed New Basel Capital Accord (Basel II), noting that the use of ratings in setting capital charges could increase market volatility and procyclicality.

Box 2.2. Mexico: Capital Account Liberalization and the Crisis of 1994–95

From the late 1980s to the early 1990s, Mexico liberalized its capital account as part of a larger program of economic stabilization and reform. In 1989, the authorities eliminated major restrictions on FDI, allowed foreign investors to purchase nonvoting shares in the Mexican equity market, and allowed Mexican firms to issue stocks in foreign markets; at the end of 1990, they allowed nonresidents to purchase domestic government bonds; in 1993, they took additional measures to internationalize the stock market and to liberalize FDI. Although the stabilization and reform process took place under an IMF-supported program, the initiatives for capital account liberalization came from the Mexican authorities themselves within the context of negotiations for the prospective North American Free Trade Agreement (which started in 1990). By the time Mexico began to negotiate for OECD accession, it had already achieved almost complete capital account convertibility.

As early as 1989, Mexico's efforts to liberalize the foreign investment regime received a strong endorsement of the IMF Executive Board. On the other hand, potential vulnerabilities created by financial liberalization (1988–89) and what turned out to be an ill-timed privatization of banks (1991–92), when prudential regulation was weak, did not receive adequate attention in the IMF's assessment of Mexico's capital account liberalization strategy. On the contrary, at a Board meeting in 1991, "Directors expressed satisfaction with the progress achieved so far in the reprivatization of the commercial banks and the strengthening of the domestic financial system." When Mexico received large capital inflows between 1989 and 1993, relatively limited discussion took place between the IMF and the Mexican authorities on how to manage the surge in inflows. IMF staff, however, did communicate to the authorities its concern over the large current account deficit financed by short-term capital flows and the rapid increase in external borrowing.[1] Executive Directors expressed similar concern over this period. At the discussion of the 1993 Article IV consultation, for example, Directors expressed the hope that there would be a shift in external financing toward a greater share of direct investment.

The Mexican crisis of 1994–95 had only an incremental impact on the IMF's thinking of capital account liberalization, though it certainly influenced the views of some individuals within the institution. A number of internal and external experts interviewed explained this as reflecting the predominant view held at the time that the crisis had largely resulted from inconsistency between a pegged exchange rate and the pursuit of discretionary monetary policy, and not necessarily from wrong sequencing in capital account liberalization. Even so, some in the IMF did become aware of the danger of rapid liberalization when the prudential supervision of banks was weak. In fact, in discussing an internal assessment of IMF surveillance in Mexico in April 1995, Executive Directors suggested that "management should also invite the Executive Board and the staff to engage more decisively in capital account surveillance and discussion—a domain where the culture of the Fund must no doubt still evolve."

[1]In August 1991, the authorities imposed liquidity requirements on short-term external borrowing by commercial banks, which were extended in April 1992 to cover all foreign currency liabilities at a uniform rate of 15 percent.

tion. The staff in the early years emphasized efficiency gains and the need to attract foreign investment as the predominant reasons for capital account liberalization; the 1993 *ICMR* mentioned the stabilizing role of capital account liberalization that would come from a broader investor base; and in the discussion of the 1994 *ICMR*, Executive Directors stressed the discipline effect of capital flow volatility on macroeconomic and structural policies. In later years, the IMF staff also noted additional factors, such as the need for better risk diversification, greater consumption smoothing, and an improvement in the domestic financial system.

In the early years, the staff generally favored rapid liberalization on the grounds that capital controls were not effective. The staff was aware of the idea of sequencing, however. The October 1992 *WEO*, for example, stated that countries with an "uncompetitive" banking system should not liberalize the capital account until domestic financial liberalization was complete. Yet, the same report advocated "a comprehensive and rapid progress on all fronts." Management and the Executive Board generally supported these views. At the discussion of the May 1994 *WEO*, the Managing Director observed that "[in] its surveillance under Article IV, the Fund was making a great effort to convince countries of the broader benefits of capital account convertibility." Undoubtedly referring to a potential amendment of the Articles, he expressed hope that capital account convertibility would be part of the IMF's "refreshed mandate."

The Mexican crisis had impact on the thinking of some staff (and Board) members (see Box 2.2). The idea of sequencing became more prominent in staff analysis, although the evolution of the institution's stance on capital account liberalization would continue for some time, at least until the East Asian crisis. The *WEO* began more systematically to call for gradualism and sequencing in capital account liber-

alization, citing macroeconomic stability and financial sector soundness as preconditions, a position supported by several Executive Directors, including some representing major industrial countries. The October 1995 *WEO* recommended that countries in the early phases of convertibility should liberalize foreign direct investment (FDI) and trade-related flows before short-term flows. The 1997 issues stressed the need for gradualism in the context of sufficient exchange rate flexibility, sound macroeconomic policies, and a strong banking sector. The Director of RES stated at one of the Executive Board meetings that a flexible exchange rate system was not a prerequisite for capital account liberalization but stressed the importance of having appropriate prudential supervision of the financial sector prior to moving to capital account liberalization.

By 1999, the evolution in the institution's thinking was almost complete, and the voices of caution had become more dominant. In view of the weak evidence provided by the *WEO* to link capital account liberalization with economic growth, an industrial country Executive Director made a statement in the second *WEO* discussion of 2001 questioning the wisdom of undertaking costly and risky reforms to liberalize the capital account in the expectation of "modest and uncertain" benefits, while a developing country Director added that the prerequisites for capital account liberalization did not exist in most of the developing countries.

Although the staff position became more cautious, it remained in favor of capital account liberalization as a long-term goal. The October 1998 *WEO*, for example, stated that countries should pursue a well-sequenced and prudent capital account liberalization instead of "turning the clock back," in view of their need for external resources and the gains to be made from portfolio diversification. The *WEO* then suggested that countries should sustain structural reforms to reduce information asymmetries or market failures in order to reduce resource misallocations and excessive capital flow volatility. Likewise, in 2001, the *WEO* suggested that those countries with significantly open capital markets should strengthen and improve their institutions while others that were not fully involved in global capital markets should pursue capital account liberalization as the ultimate goal, though at the pace of their own choosing.

Temporary use of capital controls

IMF staff in its multilateral surveillance work consistently argued for tight fiscal policy and greater exchange rate flexibility as the best tools to deal with large capital inflows. At the same time, the staff expressed doubt at the effectiveness of sterilization, given its quasi-fiscal costs and its impact on the level of interest rates. However, neither the staff nor Executive Directors had much to say about conventional macroeconomic tools of capital flow management. At the 1995 *ICMR* discussion, an Executive Director representing a major industrial country expressed concern over the lack of "clear policy guidelines" on managing capital inflows "from a monetary policy standpoint."

Throughout the period, both the staff and Executive Directors said much more about the temporary use of capital controls. The staff expressed a generally negative position on the use of capital controls as a tool to manage capital flows. In the early years, the staff was heavily focused on the long-term costs of such a policy. As empirical evidence on the effect of Chile's inflow controls (particularly in lengthening maturities) emerged, however, the staff began to take a less hostile attitude in its multilateral surveillance work toward the temporary use of market-based controls (Box 2.3). It remained opposed to the use of administrative controls, particularly on capital outflows.

During the first two years of the 1990s, the *ICMR*s drew a lesson from developments in Europe (including the Exchange Rate Mechanism (ERM) crisis) that stressed the undesirability of capital controls and the need to strengthen the supervisory and regulatory systems. The staff in the April 1993 *ICMR* observed that "countries faced with massive and unrelenting capital market pressures often conclude that it is less costly over the long run either to realign the parity or to resort to temporary floating than to impose capital controls." The staff seemed to recognize the short-term benefits of capital controls, but a senior staff member stated at the May 1993 Board discussion that capital controls were like "killing the goose that laid the golden egg," especially for those highly indebted countries trying to attract foreign investment. The staff's preferred policy, as expressed in the 1993 *ICMR*, was to "foster a gradual expansion of the investor base and provide sufficient resilience in the face of transient shifts in the availability and terms of international financing" through macroeconomic stabilization and structural reform and by improving transparency and information disclosure. Until about 1994, Executive Directors generally expressed broad agreement with these views of the staff, although a few Directors were of the view that temporary controls could be useful in managing large short-term inflows.

A subtle change was in the making in 1994. While the *WEO* continued to advocate greater exchange rate flexibility and tight fiscal policy as a way of dealing with large capital inflows, it also took a more accommodating stance on the temporary tightening of restrictions. The turnaround was more evident after 1995. The August 1995 *ICMR*

Box 2.3. Chile: The IMF's Views on the Use of Market-Based Controls on Inflows

Responding to a surge in capital inflows, in 1991, the Chilean authorities introduced a 20 percent unremunerated reserve requirement (URR) on all foreign loans, except for trade credits, while relaxing the minimum stay requirements for foreign investment. The URR was a noninterest-bearing deposit in foreign currency to be lodged with the central bank for a specified period of time (one year from May 1992), in an amount proportional to the value of the capital inflow.[1] As experience was gained, the authorities introduced modifications to tighten the URR over time.[2] With capital flows to emerging market economies abating, they reduced the rate of the URR to 10 percent in June 1998 and further to zero percent in September 1998. In 2001, the authorities removed all remaining restrictions on the capital account, including the URR (see Box 1.2 for a review of the effectiveness of the Chilean URR).

The IMF staff's position on the URR changed over time. Initially, it did not oppose the use of the URR. The briefing paper for the 1992 Article IV consultation, for example, argued that the URR, along with the recent revaluation of the Chilean peso, could help counteract the effect of capital inflows on spending. The staff report for the 1994 Article IV consultation, in July, noted a "significant reduction in short-term private capital inflows" as a result of the URR. Later in the year, however, the staff's position turned more negative. In November 1994, the staff strongly advised the authorities against any measure to tighten the URR. The briefing paper for the 1995 Article IV consultation stated that capital controls increased the cost of capital, entailed allocative inefficiency, and would be increasingly evaded over time, and argued for an orderly relaxation of these controls, beginning with an elimination of the one-year stay requirement and prior authorization requirement for capital inflows. During the 1996 consultation, the staff reiterated its view that the URR had not been effective in reducing capital inflows despite the tightening and that it should be eliminated.

As empirical evidence began to emerge, however, the IMF's position was somewhat moderated. Internal documents during 1997–98 indicate that the staff was aware of some positive effects of the URR, particularly in lengthening the maturity of inflows, but it continued to argue against relying excessively on the URR as a substitute for greater fiscal discipline. The views of Executive Directors expressed at successive Board meetings remained mixed throughout the period. In general, more and more Directors over time saw the virtues of the URR in lengthening the maturity of capital inflows, increasing the share of non-debt-creating flows, and thereby reducing the volatility of capital inflows. However, there were always some Directors who argued that the effectiveness of the URR in discouraging short-term capital inflows tended to diminish over time and cautioned against reliance on such a measure.

[1]The deposit requirement could be met by the payment of an up-front fee, equal to the financial cost of the URR (initially calculated at the London interbank offered rate (LIBOR)).

[2]For example, in 1992, the authorities extended the coverage to foreign currency deposits in commercial banks in January, raised the rate of the URR to 30 percent in May (except for direct external borrowing by firms), and applied this rate for all transactions in August. Subsequently, they further extended the coverage to secondary American Depository Receipts (ADRs) in July 1995 and to FDI of a potentially speculative nature in May 1996.

suggested that a mix of several tools (such as tight fiscal policy, foreign exchange market intervention, and temporary prudential controls) should be carefully specified, depending on a country's circumstances; it also stressed the need to strengthen the banking system against financial risks and to limit foreign exchange exposure. When the report was discussed, some Executive Directors expressed support for the temporary use of capital controls.

In the *WEO* discussion of May 1997, the Director of RES clarified the staff position: "staff was not endorsing the use of capital controls; and some of the countries had resorted to controls that were undesirable." During a Board discussion in October 1997, the RES Director stated that "staff encouraged countries that faced capital inflow problems to consider liberalizing capital outflows as part of their overall stabilization strategy." Even after the East Asian crisis, the *WEO* continued to express the view that, while controls to limit short-term inflows could be helpful in specific circumstances (as in the case of India), controls entailed longer-term costs and that open capital markets yielded substantial benefits; it further argued that use of capital controls during crises was not very effective and could "distract the governments from their prime task of strengthening the financial and macroeconomic environment."

In subsequent years, there was little discussion of temporary use of capital controls in multilateral surveillance work, reflecting the sharp decline in global capital flows to emerging market countries. When the subject was discussed, the staff's position remained nuanced. For example, when discussing Malaysia's administrative controls on capital outflows, the October 1999 *WEO* emphasized the progress the country had made in financial and corporate sector restructuring, strengthening the regulation and supervision of financial markets, and implementing corporate governance reforms. It then concluded: "Any negative impact of the capital con-

trols may have been offset by the increase in confidence from the acceleration of structural reforms and by generally sound macroeconomic management." The staff—and Executive Directors—had a more favorable view of market-based controls, but still justified them as a temporary measure and under special circumstances; they considered sustainable macroeconomic policies to be preferred.

Assessment

Despite the ambiguity left by the Articles of Agreements about its role in capital account issues, the IMF in the early 1990s responded to the changing international environment, characterized by large cross-border capital movements, by paying greater attention to issues related to the capital account. The early efforts tended to be an analysis of factors influencing international capital movements. From the mid-1990s, however, the IMF through its staff analyses began to advocate capital account liberalization. Concurrent with the initiatives to amend the Articles to give the IMF an explicit mandate for capital account liberalization and jurisdiction on members' capital account transactions, the IMF expanded the scope of its operational work in the area, encouraging the staff to give greater emphasis to capital account issues in Article IV consultations and technical assistance and to promote capital account liberalization more actively. At the same time, a significant improvement was made in the capacity of the IMF to collect information on members' regulations of capital account transactions.

In the early 1990s, the IMF's multilateral surveillance work generally considered any measure that would promote capital flows to developing countries to be a favorable development. This was understandable in the context of the period when a number of developing countries were just beginning to regain access to international capital markets; this was also a period in which many held the view that, with the beginning of transition in former socialist economies, there was a shortage of global saving. As a consequence, during this period, the IMF staff paid comparatively less attention to potential risks of capital flow volatility. In more recent years, particularly after the East Asian crisis, the staff has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the fundamental causes and implications of their boom-and-bust cycles. The focus of the analysis, however, remained on what emerging market countries should do to cope with the volatility of capital flows, rather than what, if anything, advanced economies could do to reduce the cyclicality of such capital movements.

From the beginning of the 1990s, the IMF's management, staff, and Executive Board were all aware of the potential risks of capital account liberalization and never promoted capital account liberalization indiscriminately. They also recognized the need for a sound financial system in order to minimize the risks and maximize the benefits. Such awareness, however, largely remained at the conceptual level and did not translate into practical advice on preconditions, pace, and sequencing until later in the 1990s. Lacking the operational content, such talk of risks failed to mitigate the impact of the clear voice emanating from the IMF advocating capital account liberalization. Below the surface, however, a subtle change was taking place within the institution. As preliminary evidence emerged on the apparent effectiveness of Chile's capital control in the mid-1990s, some in the IMF, including within management and the Executive Board, began to take a more accommodating stance on the use of capital controls at least as a temporary measure to deal with large capital inflows.

In the event, the proposed amendment of the Articles failed to materialize, leaving ambiguity about the role of the IMF in capital account issues. In the meantime, something of a consensus has emerged within the IMF that emphasizes the need to meet certain preconditions for capital account liberalization and hence the importance of carefully determining appropriate pace and sequencing in light of countries' institutional capacity (the so-called "integrated" approach). The use of temporary capital controls also has become a more respected practice within the IMF, at least under certain conditions. These shared views, however, are unofficial as they have not been explicitly endorsed by the Executive Board, and ambiguity remains about the IMF's work in capital account issues. In the following chapter, we turn to the question of how this ambiguity has been dealt with in the context of a specific country and see if the lack of a formal policy has affected the quality and consistency of the IMF's advice.

CHAPTER

3 Advice to Member Countries, 1990–2002

This chapter reviews the IMF's advice (or views expressed) to member countries on capital account issues, particularly capital account liberalization and managing capital flows. It first discusses the role of the IMF in capital account liberalization during 1990–2002 in the full sample of emerging market economies, paying particular attention to how its views, as expressed in country work, evolved over time. It then shifts to the IMF's advice on managing capital flows in the context of bilateral surveillance, covering macroeconomic and structural policies to deal with large capital inflows and, in a separate section, the temporary use of capital controls to deal with both inflows and outflows.

Capital Account Liberalization

Out of the 27 countries examined, the evaluation identified 18 countries for which the IMF staff provided advice or otherwise expressed a view on capital account liberalization in staff reports during 1990–2002 (Table 3.1).[1] The table summarizes the evaluation team's best judgments on whether or not the staff's view or advice made a reference to the need for proper sequencing. For each country, when the staff report for a particular year makes no mention of sequencing, it is indicated by 1; when mention is made of sequencing, it is indicated by 2.

The nine countries not listed in the table include six countries that either had a relatively open capital account or liberalized the capital account at the beginning of 1990 (or before becoming members of the IMF): Estonia, Latvia, Lithuania, Malaysia, Mexico, and Venezuela. In most of these countries, the IMF had endorsed the authorities' overall capital account liberalization strategies. In the case of Mexico and Venezuela, this endorsement was given in the context of IMF-supported programs;[2] in the Baltic states of Estonia, Latvia, and Lithuania, the IMF endorsed the liberal regimes already in place when they joined the IMF in 1992 or in subsequent policy dialogue. The absence of Colombia and Malaysia from the list may be conspicuous, as they substantially opened the capital account in the early to mid-1990s. Surprisingly, no discussion of capital account liberalization can be found in staff reports for these countries (Malaysia's capital controls are discussed in the section "Temporary Use of Capital Controls" of this chapter).[3]

Some countries had a very open capital account but are still included in the table, when remaining restrictions were a subject of discussion. For example, Thailand, which had a very liberal capital account regime in 1990 with respect to inflows, retained some restrictions on outflows, and the IMF staff expressed its views on the liberalization of outflow controls (as well as on capital inflow promotion measures). Likewise, Chile abolished or eased most administrative controls on inflows from the late 1980s to 1991, so the IMF staff's subsequent views on Chile mostly concerned the liberalization of outflow controls (Chile's capital inflow controls are discussed in the section "Temporary Use of Capital Controls" of this chapter).

[1]It is not always straightforward to make this judgment. For example, in some cases reference may be made to the "liberalization of the trade and exchange system," in which case one cannot be sure if capital account liberalization is included. In other cases, liberalization of capital transactions can mean either an overall opening of the previously closed capital account or a removal of temporary capital controls (the latter case is treated separately later in this chapter). More fundamentally, the absence of an explicit reference to capital account liberalization in staff reports may not mean that the staff expressed no view to the authorities in policy dialogue. In the case of program countries, we assumed that the staff favored liberalization if a capital account opening measure was included in the authorities' policy statements even if no mention was made in the staff reports. The selection of countries in Table 3.1 represents the IEO's best judgments.

[2]Mexico launched a major program of economic liberalization in the late 1980s, which the IMF subsequently supported with an arrangement under the Extended Fund Facility; and Venezuela lifted most capital account restrictions in January 1990 under an IMF-supported program.

[3]For Colombia, the staff report for the 1992 Article IV consultation endorsed the liberalization measures taken by the authorities during the previous years.

Table 3.1. The Nature of the IMF's Advice on Capital Account Liberalization in Selected Countries[1]

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Bulgaria	. . .	. . .	. . .	. . .	. . .	. . .	. . .	1	2	2	2	. . .	. . .
Chile[2]	. . .	1	1	1	1	. . .	1	. . .	. . .	. . .	2	. . .	. . .
China	. . .	. . .	. . .	1	. . .	. . .	2	2	. . .	2	. . .	. . .	. . .
Croatia	. . .	. . .	. . .	. . .	. . .	. . .	. . .	1	. . .	. . .	. . .	2	. . .
Czech Republic	. . .	. . .	. . .	1	2	2	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Hungary	. . .	1	. . .	1	. . .	. . .	2	. . .	2	. . .	. . .	. . .	. . .
India	. . .	2	. . .	. . .	. . .	2	2	2	2	. . .	. . .	. . .	. . .
Israel	2	1	. . .	. . .	1	. . .	. . .	. . .	. . .	. . .	2	1	. . .
Peru	1	1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Philippines	. . .	1	1	. . .	. . .	. . .	. . .	. . .	1	. . .	. . .	. . .	. . .
Poland	. . .	1	. . .	. . .	. . .	. . .	. . .	. . .	2	. . .	1	1	. . .
Romania	. . .	. . .	. . .	1	. . .	1	. . .	. . .	2	. . .	. . .	. . .	. . .
Russia	. . .	. . .	1	. . .	. . .	. . .	. . .	. . .	. . .	2	. . .	. . .	2
Slovak Republic	. . .	. . .	. . .	. . .	. . .	. . .	. . .	2	. . .	. . .	. . .	. . .	. . .
Slovenia	. . .	. . .	. . .	1	. . .	. . .	. . .	2	2	. . .	. . .	. . .	. . .
South Africa[3]	. . .	. . .	2	. . .	. . .	2	2	2	. . .	. . .	2	2	. . .
Thailand[4]	. . .	1	1	. . .	. . .	. . .	2	. . .	. . .	. . .	. . .	. . .	. . .
Tunisia	. . .	. . .	. . .	. . .	2	2	1	1	2	2	2	2	2

Source: IEO judgments based on IMF staff reports, supplemented by internal documents where necessary.

[1]The IMF's advice for a particular year is assessed when capital account liberalization was part of that year's discussion with country authorities. "1" indicates that no explicit mention is made of sequencing, and "2" indicates that mention is made. A shaded area corresponds to a period in which there was an IMF-supported program.

[2]The advice refers mostly to the liberalization of outflows after 1991.

[3]In the case of South Africa, in addition to the financial sector, documents also explicitly spelled out country-specific risks whenever capital account liberalization was raised.

[4]The advice refers mostly to the liberalization of outflows.

We first discuss the role of the IMF in capital account liberalization in terms of program conditionality and technical assistance. We then divide the period 1990–2002 into three subperiods, (1) the early 1990s, (2) following the Mexican crisis; and (3) following the East Asian crisis. For each period, we discuss how the IMF viewed capital account liberalization within the context of a specific country and see how its views might have changed over time.

Program conditionality and technical assistance

Of the 18 countries to which the IMF staff provided advice on capital account liberalization, 13 countries had an IMF-supported program at one time or another. In none of these countries did the IMF require capital account liberalization as formal conditionality for the use of its resources, where formal conditionality is understood to include prior actions, performance criteria, or structural benchmarks. In addition to the country documents for these countries, the evaluation also examined PDR's comprehensive database on conditionalities for all programs, which confirms the almost complete absence of formal conditionality on capital account liberalization. This is consistent with the established interpretation of the Articles of Agreement, as given by the IMF's Legal Department (LEG), which states that the IMF, as a condition for the use of its resources, cannot "require a member to remove controls on capital movements."[4]

The Articles, however, are interpreted to allow the IMF to require as conditionality certain actions related to the capital account that are relevant to the mandate of the IMF, notably elimination of payment arrears (which typically arise from capital controls) and imposition of limits on external borrowing (which may implicitly require capital controls). Moreover, programs may also support capital account liberalization as part of country authorities' overall package of economic policies. In fact, a number of IMF-supported programs with some of the sample countries included references to aspects of capital account liberalization in the letters of intent (LOIs) or accompanying policy memorandums. LOIs are statements of the authorities' policy intention and do not constitute conditionality that links compliance with disbursements of funds.

[4]See Legal Department, "Capital Movements—Legal Aspects of Fund Jurisdiction Under the Articles," SM/97/32, Supplement 3, February 21, 1997. Records on structural conditionality indicate, however, that the 2001 program with Lesotho included completion of "the first stage of capital account liberalization" as a structural benchmark. The IEO cannot ascertain why, given the standard LEG interpretation, this particular measure was deemed appropriate to be included as formal conditionality.

For example, Hungary's 1991 LOI for an extended arrangement expressed the authorities' commitment to promote FDI by encouraging foreign participation in the banking sector and in the privatization process. Likewise, Russia's 1992 LOI for the first credit tranche included the authorities' intention to issue necessary foreign exchange regulations covering both capital and current transactions and to extend the same convertibility to nonresidents as soon as the monetary arrangements in the ruble area had been settled. The LOI for Croatia's 1997 request for an extended arrangement was more explicit in stating the authorities' intention to "put the liberalization of capital account transactions on its policy agenda, including restrictions that relate to outward portfolio and direct investment."[5]

For the most part, available evidence suggests that the process of capital account liberalization was determined by country authorities' economic and political agendas. In some cases, the process was driven by prospective OECD or EU accession and, in later years, commitments under bilateral or regional trade agreements. In other cases, such as Latvia (Box 3.1), it was driven by the countries' desire to attract foreign investment. The IMF's deference to country ownership is particularly evident in countries that chose a gradualist approach to capital account liberalization, such as Hungary or India; in these cases, we found no evidence that the IMF pushed for a faster pace in program negotiations or other policy discussions.

The IMF also provided technical assistance on issues that are broadly related to capital account liberalization. The documents we examined for 15 countries included advice on such issues as the development of indirect monetary policy instruments, establishment or development of a foreign exchange market, and drafting of a foreign exchange law. A Board paper prepared by the staff in 1995 noted that, while "the IMF's treatment of the issue of capital account convertibility [had] been on a case-by-case basis in the context of its surveillance and use of IMF resources activities, an effort to facilitate capital liberalization [had] been applied more generally through the medium of technical assistance to develop foreign exchange markets" (Quirk and others, 1995).

In technical assistance discussions, the staff in the early years tended to be more encouraging toward capital account liberalization. The back-to-office report for a 1995 technical assistance mission to the Czech Republic, for example, stated that the mission "argued strongly" in favor of a "more decisive program of liberalization." A 1995 technical assistance report for China concluded that an effective way to enhance the efficiency of the foreign exchange market was to eliminate restrictions that prohibited foreign banks from operating in the domestic market. Even in India, where the staff supported the country's gradualist approach in its surveillance work, a 1995 technical assistance report on foreign exchange market development noted the need for a broad strategy for capital account liberalization as a precondition for developing a dynamic market. Little advice was given, however, on the specifics of sequencing capital account liberalization until later in the 1990s.

In the late 1990s, the nature of the IMF's technical assistance seemed to change in two important respects. First, it began to emphasize the notion of sequencing. For example, in a December 1997 seminar held in China, the staff stressed the need to coordinate capital account liberalization measures with concurrent measures to strengthen financial markets and institutions and to sequence properly the liberalization measures in FDI, portfolio inflows, and outward investments. Second, technical assistance also became more accommodating of use of capital controls, especially for prudential purposes. In January 1999, for example, the technical assistance mission to Russia argued that countries that had opened up their capital account typically had in place regulations restricting certain transactions between residents and nonresidents, and recommended that the ability of nonresidents to access credit in the domestic market be restricted, especially where such borrowing could be leveraged to speculate against the ruble.

Surveillance in the early 1990s

In the early 1990s, the IMF viewed capital account liberalization favorably in its country work. The countries that liberalized the capital account may have done so on their own, but the IMF approvingly accepted their liberalization plans. In Israel, the IMF even advised the authorities to accelerate the pace of liberalization. For example, the staff report for the 1991 Article IV consultation with Israel stated: "The removal of foreign exchange controls should be speeded up to encourage capital inflows and improve allocation." In Thailand, in 1992 the staff "urged" the authorities to remove the remaining restrictions on capital outflows.

The IMF staff, in its discussions with country authorities, stressed the benefits of an open capital account, including greater resource flows to supplement domestic savings (as in Poland in 1991), better resource allocations (Israel in 1991), lower interest

[5]Korea's economic program supported under the 1997 Stand-By Arrangement included three measures to liberalize the capital account: (1) greater foreign participation in the domestic financial sector; (2) opening of the equity, money, and corporate bond markets; and (3) elimination of foreign borrowing by corporations. These measures were also included, not as formal conditionality, but in the memorandum attached to the LOI.

Box 3.1. Latvia

In 1991, independence for Latvia meant an immediate dismantling of all the capital controls that existed in the former Soviet Union. Independence also meant a reorientation of trade away from the Soviet bloc, which brought about a deterioration in the terms of trade and a shortage of energy and raw materials. In the early 1990s, coupled with the impact of a severe drought affecting agriculture, the economic outlook for Latvia was bleak. From 1992 to 1993, industrial output collapsed and unemployment soared, threatening to undermine the broad political support for economic reforms. Under these circumstances, the Latvian authorities chose not to replace the Soviet-era capital controls with new ones and, in November 1991, enacted a liberal foreign investment law in order to establish a legal framework for attracting foreign direct and portfolio investment. Effectively, capital account liberalization was completed overnight and preceded domestic financial liberalization, the establishment of a central bank, and the introduction of a national currency.[1]

Although the IMF had no formal role to play in Latvia's decision to open the capital account,[2] it supported the authorities' outward-looking, market-oriented reforms through financing and technical assistance.[3] The IMF's position on Latvia's capital account policy is evident in program documents. For example, in August 1992, the LOI for a Stand-By Arrangement stated that "[the] current stipulations in the foreign investment law allowing liberal repatriation of capital and transfers of shares in the event of liquidation [would] be maintained." Differences of view between the IMF staff and the Latvian authorities concerned the use of exchange rate policy to deal with capital inflows. When Latvia received large capital inflows, the staff's consistent view was to encourage greater exchange rate flexibility. A briefing paper of January 1995 was typical, by arguing that it would be better for any real appreciation of the lats to be achieved through a nominal appreciation than through higher monetary growth. The authorities on their part viewed nominal exchange rate stability as critical to price stability in a small, highly open economy such as Latvia, and insisted on maintaining the de facto peg to the SDR, which they had introduced in early 1994.

Latvia experienced a major banking crisis in the first half of 1995, which involved a closure of several prominent banks, including the largest one. This was in fact the culmination of a crisis that had been brewing for some time. In 1994, the licenses of several commercial banks were suspended. When several major banks failed to submit audited reports in March 1995, this turned into a major crisis of confidence in the banking sector. In May, the announcement by the government to take over the largest bank (accounting for 30 percent of total deposits) precipitated capital flight amounting to 10 percent of total foreign exchange reserves, exerting downward pressure on the exchange rate. Through decisive intervention in the banking sector and demonstrated commitment to the fixed exchange rate policy, however, the crisis was resolved relatively quickly and capital inflows resumed in the latter part of the year. A number of Latvian experts consulted by the evaluation team have expressed the view that the banking crisis of 1995 had little to do with capital account liberalization per se but resulted from the weak regulatory system that had allowed too many banks to be established without the necessary internal control procedures or sufficient capital and allowed them to adopt unsound lending practices.[4] Fortunately, Latvia's financial and foreign exchange markets lacked the depth and breadth to allow major international players to speculate against the currency.

[1]In May 1992, the authorities introduced the Latvian ruble initially as a supplement to the Russian ruble (to deal with a cash shortage), before the formal introduction of the national currency *lats* in March 1993.

[2]Latvia signed the IMF Articles of Agreement in May 1992.

[3]From 1992 to 1995, MAE provided extensive technical assistance on foreign exchange operations, central bank operations, and banking supervision.

[4]Some experts have even suggested that banks were engaged in activities bordering on criminal behavior. When the largest bank was suspended, most of the assets had been stripped, leaving a negative net worth of around 8 percent of GDP.

rates (Slovenia in 1993), and greater price stability (Russia in the early 1990s). The 1992 staff report on Russia noted that the anti-inflationary policies crucially depended on accelerating the pace of institutional and structural reforms, including opening the economy to foreign capital. For Israel (in 1994), the staff listed Israel's strong financial market and stable currency as reasons for moving forward with capital account liberalization. The staff occasionally pointed out the problems posed by a weak banking system, lack of exchange rate flexibility, or weak fiscal policy, but the awareness of these problems did not translate into operational advice on the pace and sequencing of capital account liberalization (for example, Poland in 1991; and the Czech Republic in 1993).

The staff's views of the offshore Bangkok International Banking Facility (BIBF) were typical. The BIBF was established in March 1993, with the goal of developing Thailand into a regional financial center. Various tax incentives were granted to BIBF banks, including a lower corporate income tax rate and several outright exemptions. The IMF staff took

little note of this, however, and made no comments on its implications for capital inflows in documents prepared around this time. The staff report for the 1993 Article IV consultation saw the BIBF, not in terms of its implications for capital inflows, but more in terms of the benefits it would provide in improving competition and technical skills in the financial sector. Even after the composition of capital inflows shifted to shorter-term maturities in 1994, the staff paid little attention to the vulnerabilities being created by the BIBF. For example, the briefing paper for the 1994 Article IV consultation noted the staff's intention to discuss with the authorities the progress they had made in developing the BIBF and the measures to be taken to "complete the process of financial market deregulation."

This does not mean that the IMF staff was unaware of the risks of rapid liberalization, and the staff seems to have explicitly supported a cautious pace in some cases. When the Indian government requested a Stand-By Arrangement (SBA) in 1991, for example, the staff supported the authorities' intention, as spelled out in the LOI, to liberalize the capital account slowly by first removing restrictions on FDI and equity inflows. In South Africa, the IMF agreed with the cautious attitude of the authorities toward capital account liberalization, albeit for a country-specific reason involving the climate of political uncertainty. Despite these specific instances, however, our review of country documents indicates that the IMF generally supported rapid capital account liberalization in the early 1990s and offered little practical advice on pace and sequencing.

Following the Mexican crisis

The Mexican crisis did not seem to have a significant impact on the broader institutional thinking of the IMF on capital account liberalization. As noted in Chapter 2, the "staff operational note," instructing area department staff to encourage countries to liberalize the capital account, was issued in December 1995, after the Mexican crisis. This may reflect the fact that this crisis was largely seen as one that had resulted from the country's choice of an inappropriate exchange rate regime under the circumstances; correctly or incorrectly, it was not necessarily seen to have resulted from rapid capital account liberalization. Nevertheless, internal documents suggest that the Mexican crisis did cause the staff's policy dialogue with some countries to become more cautious, questioning the wisdom of rapid capital account liberalization, particularly on outflows and short-term reversible inflows.

From 1995 to 1997, for example, some country teams argued that the liberalization of outflows or short-term flows could trigger capital flight (as in the Czech Republic in 1995), exacerbate unstable capital inflows (in Hungary in 1996), or make it more likely to reintroduce capital controls (in India in 1996). The idea of preconditions, familiar in the academic literature (and which was appearing in the staff's analytical work), also became more evident in the IMF's country work during this period. In the staff report for the 1996 Article IV consultation with the Slovak Republic (issued in 1997), the staff cautioned against further liberalization because of the country's large current account deficit. The staff was also aware of banking sector weakness (as in China in 1997), lack of exchange rate flexibility (in Hungary in 1996), and underdeveloped domestic financial markets (in the Slovak Republic in 1997), and urged the authorities to undertake reforms in these areas. In India, the staff in 1996 specifically advised against lifting restrictions on purchases of government bonds by nonresidents until fiscal consolidation was achieved.[6] In South Africa, the staff based its support for gradualism on vulnerabilities arising from the central bank's large net open position in the forward exchange market.[7]

Even in those cases where the staff did not provide operational advice to slow down the pace of liberalization, it clearly gave greater attention to the potential vulnerabilities associated with large capital inflows and the need for a strong financial system. In Thailand, for example, the briefing paper for the 1995 Article IV consultation indicated the staff's intention to discuss with the authorities the policy implications of the recent increase in short-term capital inflows, underscoring the importance of close banking supervision and the need to maintain adequate capital ratios for financial institutions. The staff report for the 1996 Article IV consultation paid attention to the currency and maturity mismatches being created through the BIBF. It expressed concerns over the "rapid growth of foreign currency lending to local firms, which is only partly hedged, suggesting that foreign exchange risk needs to be closely monitored."

Of course, these instances of cautious attitude and support for gradualism in the IMF's country work must be placed in context. As noted, the Mexican crisis did not have a major institutional impact on the overall philosophical orientation of the IMF. The

[6]As early as 1995, IMF staff had stressed that financial sector reform, fiscal discipline, and development of indirect monetary policy instruments would be necessary before capital account convertibility could be achieved in India. In 1997, these ideas led to a draft note on the pace and sequencing of capital account liberalization, which the staff submitted to the Indian authorities. The note explicitly listed preconditions for capital account liberalization, including fiscal consolidation, banking sector reform, and exchange rate flexibility.

[7]In 1995, South Africa lifted most controls on capital movements by nonresidents but retained restrictions for residents.

staff continued to encourage liberalization in such countries as Romania (1995) and Chile (1996). An earlier IEO report (IEO, 2003) documents that, during this period, the IMF also encouraged the Korean authorities to remove remaining restrictions on long-term capital flows, with insufficient attention to sequencing and supervision (see also Box 1.3). In the case of Russia, the staff encouraged the opening of the public debt market to nonresidents, though arguably this was related more to the question of how to finance fiscal deficits than to that of capital account liberalization per se. These sentiments were shared by some on the Executive Board. When the staff report for the 1997 Article IV consultation with India was discussed, some Executive Directors criticized the staff for its support of India's gradualist approach to capital account liberalization and argued that the benefits from further rapid liberalization would outweigh any risks.[8]

Following the East Asian crisis

The evolution of the IMF's thinking on capital account liberalization was a gradual process, and it is not correct to point out a single event as triggering a fundamental shift. Even so, there is no denying that the East Asian crisis had a major impact. From around 1998, one sees the IMF staff giving greater attention than previously to the risk of rapid liberalization when preconditions were not met. During this period, expressions of caution toward capital account liberalization or views accommodating of capital controls were no longer isolated cases. In a wide range of cases, the staff now saw virtue in limited capital account openness as a means of protection from contagion (as in Slovenia in 1998, Romania in 1998, India in 1998, and China in 1999) or as a way of providing breathing space for necessary reforms (Russia in 2002). The staff report for the 1999 Article IV consultation with China stated that the capital controls had helped the country reduce external vulnerability, while the staff report for the 1998 consultation with Slovenia noted that the country's cautious approach to capital account liberalization had helped avoid serious contagion from the emerging market crises of the recent years.

At the same time, the staff began to pay greater attention to the sources of capital flow volatility, and the need to address these as a precondition for full capital account liberalization. The staff in its country work suggested financial system weakness (in Bulgaria in 1999, Croatia in 2001, and Russia in 2002) and the lack of market-determined interest rates (Slovenia in 1998) as among the factors contributing to capital flow volatility. The staff report for the 2001 consultation with Russia (issued in 2002) expressed support for cautious liberalization "in light of the global uncertainties and potential risks from premature liberalization with an underdeveloped domestic financial system." For countries that requested advice on capital account liberalization, the IMF suggested that, as preconditions for liberalization, they should increase exchange rate flexibility (or introduce a floating exchange rate system with inflation targeting, if feasible), undertake banking sector reform, and strengthen financial sector regulation possibly in the context of the FSAP. At the same time, for those countries that had broadly met the preconditions, the IMF staff at least implicitly endorsed their move toward full capital account liberalization (as in the cases of Chile, Hungary, Israel, Poland, and South Africa).[9]

Macroeconomic and Structural Policies to Manage Capital Inflows

The 1990s saw a surge in capital flows to emerging market economies. In part, this reflected global "push" factors. But at the same time, policies pursued by these countries to liberalize the capital account were also an important "pull" factor contributing to the pickup in capital inflows (see Calvo and others, 1996). As countries experienced the large capital inflows and associated macroeconomic challenges, the question of how to manage such inflows became a routine subject of discussion between the IMF and country authorities. The evaluation found that the staff expressed views on capital inflow issues in 16 of the 27 countries in the broader sample that experienced large capital inflows (see Table 3.2). This section reviews how, in response to the large capital inflows, the IMF advised or otherwise expressed its views to the country authorities in these 16 countries in terms of macroeconomic and structural policies.

Macroeconomic policies

There is a large literature that discusses policy options available to countries desiring to manage large capital inflows (for example, Goldstein, 1995). Depending on the nature of the inflows, the options often considered include sterilization through open

[8]All Directors recognized, however, that progress on domestic financial sector reform and fiscal consolidation would help reduce these risks.

[9]The staff's policy advice in South Africa throughout this period was to tailor the further capital account liberalization to the strengthening of the balance of payments position, as reflected in the elimination of the net open forward foreign exchange position.

Table 3.2. The IMF's Advice on Managing Large Capital Inflows, 1990–2002[1]

		Policy Measures Advocated by the IMF						
	Years[2]	Tighten fiscal policy	Greater exchange rate flexibility	Sterilization	Further trade liberalization	Liberalization of capital outflows	Tightening of prudential regulation	Imposition of capital controls
Chile	1990–97	Yes	Yes	Yes[3]	Yes	Yes		
Colombia	1991–97	Yes		Yes	Yes			
Czech Republic	1994–96	Yes		Yes		Yes		
	1999–2001	Yes	Yes	Yes				
Estonia	1996–97	Yes		Yes[4]				
	2000–01	Yes		Yes[4]				Yes
Hungary	1995–2000	Yes	Yes	Yes		Yes		
India	1994	Yes	Yes	Yes	Yes	Yes	Yes	
	2002		Yes	Yes[3]	Yes			
Latvia	1993–97		Yes	Yes[4]				
Malaysia	1991–96	Yes	Yes	Yes				
Mexico	1990–93		Yes[5]	Yes[3]			Yes	
Peru	1992–98	Yes	Yes	Yes[3]				Yes
Philippines	1994–97		Yes	Yes				
Poland	1995–98	Yes	Yes					
Russia[6]	1995, 1997		Yes	Yes				
Slovak Republic	1995–2001	Yes					Yes	
Slovenia	1995–97	Yes	Yes	Yes[3]		Yes		
Thailand	1990–96	Yes	Yes	Yes	Yes	Yes	Yes	

Source: IEO judgments based on IMF staff reports.
[1] "Yes" indicates that IMF staff advised the policy measure concerned in one or more years.
[2] These years represent a period of substantial inflows.
[3] No explicit advice was given, but the IMF staff did not oppose the use of sterilization by country authorities.
[4] Tighter monetary policy.
[5] Support given to the crawling peg.
[6] In Russia, significant capital outflows were recorded in 1996.

market sales of domestic securities, increases in reserve requirements, fiscal tightening, and greater nominal exchange rate flexibility. Further trade liberalization, removal of restrictions on capital outflows, and tightening of controls on capital inflows are also considered. The consensus, however, seems to be that none of these policies is a panacea, as each may involve significant costs or otherwise bring about other policy challenges.[10] There is thus a difficult trade-off between the potential short-term costs of large capital inflows and the side effects of the policies to deal with them.

The 16 countries reviewed here used a combination of various policy instruments at different times to deal with the capital inflows, and the IMF provided advice or expressed views on them. As early as 1993, the IMF staff (Schadler and others, 1993) stated that the conventional policy prescription included fiscal tightening and real appreciation (preferably through nominal appreciation) but argued against sterilization (which would keep domestic interest rates high and therefore encourage more

[10] For example, sterilization has quasi-fiscal costs (as higher-yielding domestic securities are typically exchanged for lower-yielding industrial country securities) and may lose effectiveness as substitutability of assets increases; high reserve requirements affect the allocation of credit adversely by reducing financial intermediation; exchange rate flexibility may lead to a large real exchange rate appreciation; elimination of restrictions on capital outflows can send a positive signal to the markets, thus encouraging further capital inflows; and fiscal policy lacks short-run flexibility. Given the quasi-fiscal costs, moreover, there is a conflict between use of sterilization and fiscal tightening.

inflows) and use of capital controls (which were judged to be either ineffectual or distortionary).[11] Broadly, a review of country experiences suggests that the IMF's policy advice and views did not deviate much from this conventional wisdom. However, there were different emphases across time and across countries.

Fiscal policy

The IMF staff's most frequent advice was to tighten fiscal policy, preferably through a cut in public expenditure. Fiscal tightening was expected to reduce pressure on the exchange rate not only through lower domestic absorption but also by limiting the increase in the relative price of nontradables.[12] On the other hand, fiscal tightening could promote capital inflows by signaling the authorities' commitment to prudent macroeconomic management and thereby cause the exchange rate to appreciate, especially over the medium term.

The advice to tighten fiscal policy was given constantly throughout the period of large capital inflows in five countries: Chile, Colombia, Estonia, India, and Peru. The cases of Chile, Colombia, and India are of particular interest because the IMF provided this advice in connection with its advice on the use of capital controls. In Chile, the staff on some occasions discussed with the authorities the possibility of relaxing capital controls pari passu with fiscal restraint. In Colombia, in 1995 and 1997, the staff suggested that fiscal tightening could create conditions for a relaxation of the controls. Likewise, in India, the staff argued that fiscal tightening, complemented by further trade and capital outflow liberalization, would make it unnecessary to resort to administrative controls.

In seven other cases (the Czech Republic, Hungary, Malaysia, Poland, the Slovak Republic, Slovenia, and Thailand), the staff advised fiscal tightening, but only occasionally or with apparently less intensity. In Poland, for example, the advice was given only in 1995.[13] In Slovenia, it was offered as a contingency measure to be used in the event large capital inflows reemerged. The fiscal policy advice offered in the Slovak Republic was similar: in 2001, the staff suggested that the authorities should "stand ready to rebalance the policy mix toward a tighter fiscal stance if persistent upward pressure on the exchange rate posed a challenge to macroeconomic management."

In most of these countries, when support for fiscal tightening was expressed, the policy was perceived largely as an auxiliary measure. For example, the staff report for the 1994 Article IV consultation with Malaysia stated: "While fiscal policy can be expected to make a contribution, attaining the needed degree of restraint will ultimately fall largely on the side of monetary and exchange rate policy." Likewise, the staff report for the 1992 Article IV consultation with Thailand, after arguing that tighter monetary policy should be attempted through sterilization, suggested: "Sterilization would become increasingly difficult to sustain over time, and fiscal policy would have to be tightened."

In the remaining countries (Latvia, Mexico, the Philippines, and Russia), the IMF staff did not advise the authorities to tighten fiscal policy in response to large capital inflows. This is not to say that fiscal policy was not discussed in policy dialogue between the IMF staff and the authorities. To the contrary, in all these countries, fiscal policy was a major topic of discussion. However, discussion on fiscal policy took place as part of the authorities' overall macroeconomic strategy, and not necessarily in terms of managing capital inflows. For example, the Philippines was already committed to achieving fiscal consolidation by 1997 through structural fiscal reforms under an IMF-supported program and, in this context, there was probably little need to make a separate case for further fiscal tightening.

Country-specific factors must have been an important part of the observed cross-country differences in the intensity with which the IMF staff advised a tightening of fiscal policy. The staff's consistent advice of fiscal tightening in Estonia, for example, may be related to the fact that fiscal policy was the primary macroeconomic policy instrument available under the currency board arrangement. On the other hand, the less-intensive advice in Thailand may be explained by the assessment, as expressed during the 1994 Article IV consultation, that there was "little room for fiscal policy to contribute to restraining demand as the fiscal consolidation of the late 1980s involved sizable cuts in expenditure." Fiscal tightening was apparently not advocated strongly in Latvia because the staff viewed the capital inflows as resulting from increased confidence, and not from "high real interest rates caused by the combination of lax fiscal policy and tight credit policy."[14]

[11]Schadler and others (1993) reviewed experiences with surges in capital inflows in Chile, Colombia, Egypt, Mexico, Spain, and Thailand, focusing on what the policymakers did rather than how the IMF provided advice or expressed views.

[12]This assumes that government consumption is more intensive in the use of nontradable goods.

[13]Fiscal tightening was advised in subsequent years, but not in the context of managing capital inflows.

[14]Briefing paper for the first review under the SBA, January 16, 1996.

Table 3.3. Fiscal and Other Macroeconomic Indicators in Selected Countries with Large Capital Inflows, 1990–2002
(In percent of GDP; percent a year)

	Years[1]	Average Net Private Capital Flows[2]	Initital Fiscal Balance	Average Fiscal Balance	Average Improvement in Fiscal Position[3]	Average Primary Balance	Initial Public Debt[4]	Average Inflation	Average Current Balance
Countries for which fiscal tightening was advised with greater intensity									
Chile	1990–94	7.4	3.2	–0.3	–3.5	1.3	42.8	17.5	–2.4
	1995–97	7.4		2.1	–1.1	3.2		7.2	–3.5
Colombia[5]	1991–94	1.5	–0.1	–0.4	–0.3	1.4	n.a.	25.7	–0.4
	1995–96[6]	–1.3		–2.0	–1.8	–0.2		20.8	–4.9
	1997	1.1		–3.2	–3.1	–1.1		18.5	–5.4
Estonia	1996–97	14.0	–1.8	0.1	1.9	0.6	7.5	17.1	–10.0
	2000–01	7.8	–0.6	–0.1	0.5	0.2	2.8	4.9	–5.6
India	1994	3.2	–7.6	–7.6	n.a.	–2.5	73.3	10.2	–0.5
	2002	3.1	–9.7	–9.7	n.a.	–3.4	80.8	4.3	1.4
Peru	1992–94	6.3	–3.9	–3.5	0.4	0.6	80.2	48.6	–6.1
	1995–98	6.9		–1.3	2.6	1.1		9.6	–6.8
Countries for which fiscal tightening was advised with less intensity									
Czech Republic	1994–96	10.1	–1.8	–1.3	0.5	–0.2	16.2	9.3	–3.6
	1999–2001	6.9	–3.1	–3.1	0.1	–2.1	13.4	3.6	–4.2
Hungary	1995–97[6]	2.8	–6.2	–4.6	1.5	4.7	84.3	23.4	–4.6
	1998–2000	11.0		–3.8	2.3	3.2	60.6	11.4	–7.9
Malaysia[7]	1991–96	8.4	–0.9	1.3	2.1	n.a.	73.3	3.9	–6.4
Poland	1995–98	5.7	–2.8	–3.0	–0.2	0.5	50.8	18.6	–2.3
Slovak Republic	1995–98	10.1	0.3	–3.1	–3.4	–0.9	21.6	7.1	–6.7
	1999–2001	5.8		–5.9	–6.3	–2.9		10.0	–5.6
Slovenia[8]	1995–97	2.3	0.0	–0.3	–0.3	0.9	17.8	10.6	0.1
Thailand	1990–93	10.6	4.4	3.4	–1.0	n.a.	18.4	4.8	–6.6
	1994–96	10.5		2.3	–2.1	n.a.		5.6	–7.1
Countries for which no or little advice on fiscal tightening was given									
Latvia	1993–97	8.6	0.6	–1.7	–2.3	–0.7	11.2[9]	39.2	0.1
Mexico	1990–93	5.1	–2.8	–0.1	2.6	5.1	50.2	18.6	–5.0
Philippines	1994–97	9.8	–1.7	–1.1	0.6	n.a.	72.5	7.8	–4.2
Russia	1995, 1997	1.8	–6.5	–7.5	–1.0	–3.1	n.a.	106.4	0.4

Sources: IMF databases; and IEO estimates.
[1]Unless noted otherwise, these years cover a period of large capital inflows.
[2]Foreign direct investment, private portfolio investment flows, and other private investment flows.
[3]Average balance less initial balance.
[4]For most countries, gross debt of central or general governments; for Estonia, net debt; for Latvia, Peru, and Thailand, total debt of consolidated central governments (obtained from the IMF's Government Finance Statistics database).
[5]In calculating average net private capital flows, 1991 is excluded. Net capital inflows in 1993 amounted to 4.2 percent of GDP.
[6]Net private capital outflows were recorded in 1996–97.
[7]Net private capital outflows were recorded in 1994. For 1991–93, net private capital inflows amounted to 12.4 percent of GDP.
[8]Net private capital outflows were recorded in 1996.
[9]For 1994.

While we can try to explain the IMF's policy advice in some of these individual instances, a more systematic assessment of its overall advice on fiscal policy is more difficult. When we assess fiscal policy advice against the strength of capital inflows, inflation, and various fiscal indicators, we find little systematic relationship: advice was given in some countries but not in others; and the same advice was given in countries with different fiscal positions (Table 3.3). Neither do we find any systematic relationship between initial fiscal positions, changes in the fiscal position, and the strength of IMF advice on fiscal tightening (Figure 3.1). One wonders, for example, why the IMF staff gave the same advice of strong fiscal adjustment to both Chile and Colombia, when Chile was already following a tight fiscal policy and Colombia was not.[15]

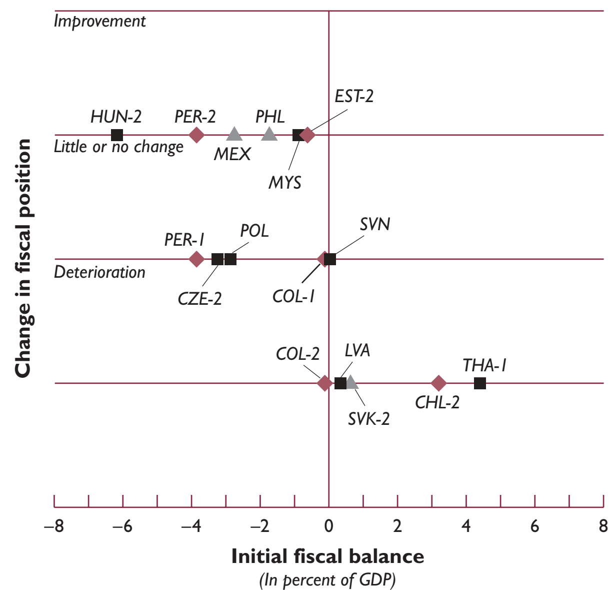
Exchange rate policy

The IMF staff also frequently advised countries receiving large capital inflows to increase exchange rate flexibility. In an environment in which the institution was moving (at the time) toward a "two-corner" solution view of sustainable exchange rate policy under high capital mobility, this advice appears to be all tending toward one of the corners only. It should be remembered, however, that none of the countries to which this advice was given had a de jure peg, let alone a currency board arrangement. It was in this context that the IMF advised the authorities to allow the exchange rate to appreciate in response to large capital inflows or to allow greater scope for depreciation in order to discourage speculative inflows.

In 4 of the 16 countries (Hungary, India, the Philippines, and Poland), this advice was given constantly throughout the period of large capital inflows (see Table 3.2). In Poland, in 1997, the staff stressed that "allowing more flexibility within the exchange rate band would be an effective instrument to contain inflows, as increased uncertainty would deter speculative movements." A similar line of argument was offered in the same year (as well as in other years) to Hungary: "From a medium-term perspective, the shift toward a more flexible exchange rate regime would also help contain speculative capital inflows in the context of increased financial liberalization."

[15]The difference in fiscal performance between Chile and Colombia was much greater than suggested by Table 3.3. The IMF staff in a recent paper characterizes Chile's fiscal performance during the 1990s as by far the best among Latin American countries (Singh and others, 2005). Unlike most other Latin American countries, Chile's fiscal policy was not procyclical and its debt-to-GDP ratio steadily declined.

Figure 3.1. Fiscal Performance and the IMF's Fiscal Policy Advice in Selected Countries 1990–2002[1,2]



Source: The IEO's judgment based on Table 3.3.

[1]Fiscal performance is classified into three broad categories: improvement, little or no change, or deterioration. The abbreviations are as follows: CHL-2 = Chile (1995–97); COL-1 = Colombia (1991–94); COL-2 = Colombia (1995–96); CZE-2 = Czech Republic (1999–2001); EST-2 = Estonia (2000–01); HUN-2 = Hungary (1998–2000); LVA = Latvia (1993–97); MYS = Malaysia (1991–96); MEX = Mexico (1990–93); PER-1 = Peru (1992–94); PER-2 = (1995–98); PHL = Philippines (1994–97); POL = Poland (1995–98); SVK-2 = Slovak Republic (1999–2001); SVN = Slovenia(1995–97); THA-1 = Thailand (1990–93).

[2]"◆" indicates a country in which the advice of fiscal tightening was given with greater intensity; "■" indicates a country in which the advice was given with less intensity; and "▲" indicates a country in which no or little advice of fiscal tightening was given.

In 9 countries (Chile, the Czech Republic, Latvia, Malaysia, Mexico, Peru, Russia, Slovenia, and Thailand), the staff supported greater exchange rate flexibility, but with varying degrees of intensity over time. In the Czech Republic, for example, the staff's advice was to increase the flexibility of the managed float when there was a surge in capital inflows in 2000, but similar advice was not given during the earlier surge of 1994–96 when the exchange rate was pegged.[16] Likewise, in Thailand, the staff stressed the need for greater exchange rate flexibility in the

[16]In fact, the staff report for the 1995 Article IV consultation with the Czech Republic stated that "the main aim of the policy response to the capital inflows should be to limit further real appreciation of the koruna, through avoidance of a nominal appreciation and a deceleration of price and wage increases." A number of Executive Directors, however, disagreed with the staff position and called for a more flexible exchange arrangement and for a nominal appreciation of the koruna.

mid-1990s (when the composition of inflows became more short term), but not in the early 1990s. In Mexico, the staff did not explicitly offer advice, but supported the country's crawling peg regime (while implicitly expressing preference for a wide band or faster crawl). In Latvia, the staff in principle supported the country's peg to the SDR as a nominal anchor, but suggested greater flexibility if the inflows were to become exceptionally large.[17]

In the rest of the countries (that is, Colombia, Estonia, and the Slovak Republic), the advice of greater exchange rate flexibility was not offered. Clearly in the case of Estonia, the country's choice of a currency board arrangement argued against such advice. In the Slovak Republic, the staff during the 1997 Article IV consultation discussed with the authorities the need to "consider making more active use of flexibility within the band" as a way of deterring contagion from the East Asian crisis, but not as a way of managing large capital inflows.

Several considerations seemed to influence the IMF's policy advice on exchange flexibility in specific instances. In some cases, competitiveness considerations were paramount. In Thailand, for example, in 1991–92 the staff believed that exchange rate appreciation was not advisable because of the large and growing current account deficit. A similar reason was given for not recommending greater exchange rate flexibility in the Czech Republic during much of the 1990s. The staff report for the 1995 Article IV consultation was typical in arguing that appreciation was not warranted, "given the apparent slowdown in the growth of exports in recent months, the sharp increase in imports, and the loss of most of the gains in competitiveness from the initial depreciation."

Another factor determining the staff's advice was its perception of the degree of actual exchange rate flexibility. In Peru, for example, the staff generally considered the exchange rate arrangement to be flexible (though at times highly managed), so the advice for greater flexibility, as offered more frequently after 1995, focused on how to manage the existing policy. Likewise, in Chile, the staff in 1993 apparently thought that substantial flexibility had been introduced to the exchange rate in 1992 when the Chilean authorities adopted a basket of currencies to determine the reference exchange rate and widened the band. By 1994 or 1995, however, the staff no longer considered Chile's crawling peg to be flexible enough. In 1995, it thus advised the authorities to abandon the exchange rate band in favor of a managed float and subsequently became much more emphatic about the need for greater exchange rate flexibility.

The staff's advice for Malaysia changed from year to year, as its perception of actual flexibility changed. In general, the staff considered Malaysia's exchange rate policy to be flexible. Thus, it supported "the authorities' intention to accept, if necessary, a moderate appreciation of the ringgit" (1991 Article IV consultation) or expressed caution against "substantial further upward movement" of the exchange rate "in view of the speed and extent of the recent appreciation" (1992 Article IV consultation), depending on the particular circumstance. But when the authorities began to intervene heavily to support the exchange rate in late 1993 despite the large capital inflows, the staff noted during the 1994 Article IV consultation: "Movements in the exchange rate should reflect underlying market conditions. As developments in late 1993 well illustrate, efforts to force an exchange rate policy that is not in line with underlying fundamentals are bound not to succeed for long and, ultimately, are more likely to complicate the conduct of monetary policy." At this point, the staff strongly argued for greater exchange rate flexibility.

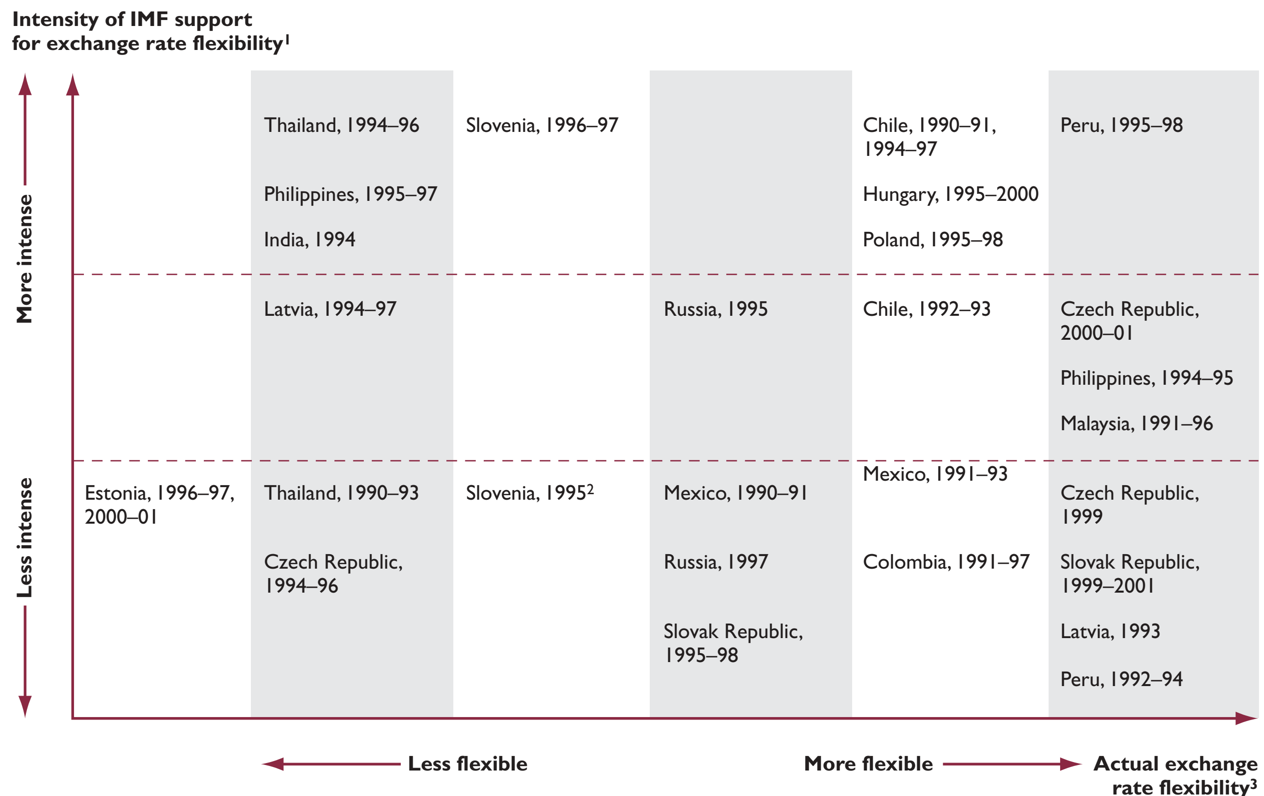
As in the case of fiscal policy, the review of these cases does not support the criticism of a "one size fits all" approach to the IMF's policy advice. However, although we can explain the IMF's advice in some individual instances, a more systematic assessment of the factors underlying its overall advice on exchange rate flexibility is much more difficult. Figure 3.2, which depicts the relationship between the intensity of policy advice on exchange rate flexibility and the degree of actual flexibility, clearly shows that actual flexibility was not a dominant determinant of IMF advice. At the same time, the figure also suggests that at least part of this diversity in policy advice may be a reflection of the evolution of the IMF's views on appropriate exchange rate policy for emerging market economies. It appears that the IMF staff placed somewhat more emphasis on exchange rate flexibility in the latter part of the period than had been the case earlier.

Sterilization

The IMF staff expressed its views on sterilization in all countries. In general, the staff took a stance that accommodated the policy choices of the authorities, but in two countries (Poland and the Slovak

[17]From early 1994, Latvia had a de facto peg to the SDR, which the authorities considered to be critical as a nominal anchor. It appears that the IMF staff viewed the de facto nature of the SDR peg as providing room for flexibility. In reality, the authorities' commitment to the peg was quite firm, although they wanted to maintain some uncertainty in the minds of market participants by not announcing it formally. A briefing paper of October 1994 stated the mission's intention to urge the authorities to reclassify the exchange rate regime from "independently floating" to "pegged to the SDR" or "other managed floating," while a management comment in February 1995 asked why the Latvian authorities did not want to "go to a currency board."

Figure 3.2. IMF Support for Exchange Rate Flexibility in Selected Countries, 1990–2002



Source: The IEO's judgment based on IMF documents.
[1]As given in the context of managing large capital inflows.
[2]Slovenia briefly adopted a managed float during the last two quarters of 1995.
[3]According to MFD classification.

Republic) the staff opposed the use of sterilization. In Estonia and Latvia, support was given to sterilization in the broader sense of the word, in the form of tight monetary policy. For example, the staff report for Latvia's Stand-By request in early 1995 stated: "The staff . . . argued for more active liquidity management, preferably through the use of treasury bills, in order to encourage the development of a government securities market." In many cases, the staff advised tight fiscal policy or greater exchange rate flexibility to complement the use of sterilization. In view of inflation risks, the staff advised sterilization (and tight monetary policy) in such countries as India (1994), the Philippines (1995), and Hungary (1996). In several countries, including Latvia, as noted above, the staff encouraged the authorities to develop secondary markets for government bonds in order to increase the effectiveness of sterilization.

In the context of the policy advice offered, the staff's view differed from those of the Czech and Thai authorities on the use of sterilization, but on different sides of the argument. Both countries experienced a surge in private capital inflows under a pegged exchange rate system in 1995. In the Czech Republic, the staff argued that there was room for sterilization,[18] while the authorities were reluctant to do so aggressively because of its presumed costs and ineffectiveness. In Thailand (where fiscal policy was tight), on the other hand, the staff favored greater exchange rate flexibility, while the authorities viewed sterilization as superior.

Staff was aware of the limitations of sterilization and accordingly qualified its advice by emphasizing its quasi-fiscal costs and the risk that such operations might increase the level of interest rates in a self-defeating manner. In Thailand, for example, the staff noted in 1994 that "maintaining the desired monetary stance may well require large-scale sterilization

[18]An accompanying selected background study showed that between 35 percent and 65 percent of domestic monetary operations could be offset by external capital inflows.

which could be very costly." In Malaysia, in 1993, the staff argued: "Large-scale mopping-up operations, in addition to their quasi-fiscal costs, may also induce further inflows." In the Slovak Republic, in 2000, the staff noted that the authorities were "more sanguine" about the effectiveness of sterilized intervention to deal with short-term capital inflows but agreed that it would not be effective to deal with "the larger, FDI-related inflows" being projected in connection with EU accession. Sterilization, however, remained a frequently used policy measure to deal with large capital inflows well into the late 1990s and early 2000s, including in Slovenia (1997),[19] Latvia (1998), the Czech Republic (1999), the Slovak Republic (2000), and India (2002).

Structural policies

Structural reform constitutes an important topic of policy dialogue between the IMF and member countries. As such, the documents examined indicate that a wide range of structural reform issues were discussed between the IMF staff and country authorities in all sample countries over the entire period. Of the many issues covered, some had obvious relevance to capital account liberalization, including privatization (which may affect policies toward inward foreign direct investment) and bank supervision (which has been increasingly recognized as a critical precondition for liberalization). However, the documents identify only a limited number of structural measures as discussed or proposed for the specific purpose of managing large capital inflows. The more important of these are noted below.

Further trade liberalization. Further trade liberalization, as a supporting policy to cope with the effects of large capital inflows, was advised in at least four countries: Chile, Colombia, India, and Thailand. In Chile, the advice offered in 1997 involved a reduction in the uniform import tariff. In Colombia, the advice was to liberalize the trade regime to increase competitiveness, while the staff suggested in India that trade liberalization should be accelerated through the elimination of import restrictions on consumer goods.

Liberalization of capital outflows. Elimination of restrictions on capital outflows was suggested as a complementary measure to offset the large capital inflows in at least six countries: Chile, the Czech Republic, Hungary, India, Slovenia, and Thailand. In the Czech Republic, the advice was given in 1994 but, as noted earlier, was reversed in 1995 when the staff recognized that such a measure was premature as it would make the country more vulnerable to speculative capital movements. The advice to Thailand was given in 1992 and again in 1996 (this time by suggesting that pension funds be allowed to invest in foreign assets). The advice was given to Slovenia in 1997 and to Hungary in 2000.

Tightening of prudential regulation. Prudential regulation received much attention from the IMF staff, but generally as part of broader surveillance of the financial sector. In four countries (India, Mexico, the Slovak Republic, and Thailand), however, the IMF staff advised a tightening of prudential regulations as a way of dealing with the large capital inflows (the advice in two countries took the form of endorsing what the authorities had already done). In Mexico, in August 1991 the authorities imposed liquidity requirements on short-term external borrowing by banks, which a number of Executive Directors welcomed; at the end of 1993, the staff explored the possibility of further tightening the rules on foreign borrowing by commercial banks. In Thailand, the staff in 1992 recommended that the authorities require appropriate provisioning by commercial banks for the guarantee they provided for foreign borrowing. In India, the authorities tightened prudential regulations on portfolio investment in 1994, a measure the staff subsequently endorsed. In the Slovak Republic, on the other hand, the staff took the initiative to suggest tightening foreign exposure regulations for commercial banks during 1999–2000.

In some countries, additional measures were mentioned. For example, in the Czech Republic, banking sector reform (including privatization) was advised in 1995 as a measure to reduce the high cost of intermediation (hence the high level of interest rates that were attracting foreign capital inflows). In Colombia, accelerated labor market reform was suggested on several occasions as necessary to maintain competitiveness in the face of upward exchange rate pressure created by the large capital inflows. In Chile, structural fiscal reform (in the form of a tax on nonrenewable natural resources) was proposed in 1997 as a way to moderate foreign investment flows in the mining sector. In India, the IMF staff in 1994 proposed the elimination of a floor on bank lending rates in order to reduce incentives for speculative capital inflows by reducing the level of interest rates.

There may well be other instances where the IMF staff or country authorities recognized structural reforms as a component of the broader strategy to manage large capital inflows (for example, through their effect on efficiency and competitiveness). Financial market development, sometimes encouraged as part of advice on sterilization (see "Sterilization" above), may be one such instance. The difficulty in identifying these cases, however, is that, as structural reform

[19] At the time of the 1995 Article IV consultation, the Slovenian authorities stated that the costs of sterilization had reached 1 percent of GDP in late 1994 and therefore suspended "proactive sterilization." Large-scale intervention resumed in late 1996.

is usually set in a long-term, country-specific framework, it is often not mentioned as part of a response to large capital inflows even when a particular structural measure could serve such a purpose. Nevertheless, it is probably fair to say that structural policies received much less attention than conventional macroeconomic policies, as measures to deal with large capital inflows. Given the IMF's focus and comparative advantage, this was probably appropriate, especially since the structural area that has received considerable, and increasing, attention from the IMF—strengthening the regulatory framework for the financial sector—is most closely linked to capital account sequencing.

Imposition of capital controls

Rather surprisingly, the IMF staff in the latter part of the 1990s advised the authorities of two countries (Estonia and Peru) to impose capital controls to deal with speculative capital inflows.[20] In neither of these countries, however, did the authorities accept the IMF advice. In Estonia, the staff stated in 2000 that the authorities' ability to offset the impact of capital inflows was limited unless they were willing to introduce temporary capital controls or raise reserve requirements, which were already very high. Previously, in 1996 and 1997, the authorities had been more amenable to introducing such a capital control measure if necessary (and a system of reserve requirements on foreign interbank liabilities was introduced in mid-1997). In 2000, however, they objected to such a measure because it was precluded by an agreement with the EU. In Peru, the staff was concerned with the rapid credit expansion, which was increasingly funded by short-term foreign currency liabilities. In 1997–98, the staff proposed to the Peruvian authorities that the coverage of marginal reserve requirements on foreign currency deposits be extended to external borrowing, while lowering the rate.[21]

Temporary Use of Capital Controls

The evaluation reviewed the relevant IMF documents for 10 countries involving 12 cases of temporary controls on either capital inflows or outflows during 1990–2002, with a view to trying to judge whether the differences in approach, if any, reflected a consistent set of underlying principles (Table 3.4).[22] Of the 12 cases reviewed here, 8 concerned capital inflow controls, and the other 4 capital outflow controls. We review below each of these cases.

Inflow controls

Of the eight cases of capital inflow controls, the IMF staff did not initially object to the introduction of controls in five of them (Chile, Colombia, the Philippines, Slovenia, and Thailand); however, in three of these (Chile, Colombia, and the Philippines), the staff changed its views over time. In the remaining three countries (the Czech Republic, Hungary, and Malaysia), the staff initially opposed the introduction of controls, though it became more accepting of them over time in two cases (i.e., the Czech Republic and Hungary). We explain below the context in which the IMF staff expressed its views on capital inflow controls by dividing the countries into those for which the staff's initial reaction was positive and those for which it was negative.

Cases of positive initial staff response

The IMF staff initially supported the unremunerated reserve requirement (URR) introduced by Chile in 1991 and Colombia in 1993, as we discuss more fully elsewhere in the report (see Box 2.3 for Chile; Appendix 1, the section "Colombia: Market-Based Controls on Inflows"). Likewise, the staff was supportive of inflow controls introduced by the Philippines, Slovenia, and Thailand.

In January 2000, the Philippine authorities introduced a 90-day minimum holding period on nonresident deposits. At the time of a program review in July 2000, the staff considered this to be a relatively minor measure designed to limit speculative capital flows and it supported the authorities' intention not to introduce additional controls. In late 2000, when the authorities tightened the reporting and compliance rules for capital account transactions,[23] the staff argued that the benefits of these measures needed to be weighted against the costs, while acknowledging

[20]The control measures suggested by the IMF could also be interpreted as having a prudential element. However, these are "restrictions" as the term is generally applied in the IMF, because their impact discriminates against international (as opposed to domestic) transactions.

[21]In 1993—based on an earlier technical assistance (TA) report by MAE—a briefing paper had indicated the staff's intention to explore ways of tightening credit policy through an increase in marginal reserve requirements on U.S. dollar deposits (then at 50 percent). In 1995, the staff took a position against capital controls except as a last resort measure.

[22]The list of countries in Table 3.4 is not meant to be exhaustive. For example, according to a Board document, 29 countries either introduced new controls or tightened existing ones during 1993–97 alone. See Monetary and Exchange Affairs Department, "Developments and Issues in the International Exchange and Payments System," SM/98/172, July 7, 1998.

[23]These measures included the prohibition of "engineered swaps" (operations to exploit weaker regulation and lower taxation for foreign exchange deposits relative to peso deposits), stricter reporting requirements for all foreign exchange transactions, and the requirement that bank-affiliated foreign exchange corporations be subject to the same rules as the banks themselves.

Table 3.4. The IMF's Position on Temporary Use of Capital Controls, 1991–2001

	Period	Position When Controls Were Introduced	Did the Position Change?
Controls on inflows			
Chile	1991–98	Supportive	Yes
Colombia	1993–2000	Supportive	Yes
Malaysia	1994	Not supportive	No
Czech Republic	1995	Not supportive	Yes
Slovenia	1995–99	Supportive	No
Thailand	1995–97	Supportive	No
Hungary	1996, 1999	Not supportive	Yes
Philippines	2000	Supportive	Yes
Controls on outflows			
Venezuela	1994–96	Not supportive	No
Thailand	1997–98	Partly supportive	Yes
Malaysia	1997–2001	Not supportive	Yes
Russia	1998–2000	Partly supportive	No

Source: IEO judgments based on IMF documents.

that these measures would improve monitoring and help close the regulatory loopholes. At the same time, the staff expressed regret that these measures had resulted in less freedom of capital movements, and welcomed the authorities' assurance that they were not the start of a tighter regime of controls.

In Slovenia, in 1995, the authorities introduced an unremunerated reserve requirement on non-trade-related loans with a maturity of up to five years. This measure was tightened during 1996 and remained in effect until September 1999. The staff initially endorsed the measure as a prudent response to the uncertainties of capital flows, but very little was said in the subsequent staff reports.[24] Slovenia had a reasonably sound fiscal policy (with virtual balance in 1994–95 and a deficit of only 1 percent of GDP in 1997) and, in 1994, active sterilization had been terminated because of its huge fiscal costs. The staff's tacit approval of the capital control measure can be understood in this context.

Thailand introduced market-based control measures in 1995 and 1996.[25] The briefing paper for the 1996 Article IV consultation indicates that the staff viewed the use of temporary controls on short-term instruments as ineffective, but did not "rule them out ex ante provided they were used as a complement to, not a substitute for, the macroeconomic measures proposed." The staff report for the 1996 Article IV consultation stated the mission's view that these measures would likely have some impact on foreign borrowing by banks, but they would not be expected to have impact on nonbank sources of credit, or hence on the overall level of inflows. The Executive Board supported the staff's view.

Cases of negative initial staff response

As noted in greater detail in Appendix 1, when capital control issues became a topic of discussion in early 1995 in the Czech Republic, the staff objected to use of capital controls by saying that experience in many countries had proved them to be ineffective. In mid-1995, however, the staff became more sympathetic to the authorities' use of capital controls, if financial stability was threatened or if use of other policy instruments was prevented by political constraints. This support for the capital controls was expressed while, as noted, the staff was not in favor of greater exchange rate flexibility.

When the Hungarian authorities considered introducing capital controls in 1996, the staff expressed the view that the controls as proposed would easily be circumvented. When a reserve requirement on nonresident bank deposits was introduced in early 1999,[26] however, the staff was sup-

[24]In 1998, the staff expressed views sympathetic to the temporary use of capital controls on short-term banking flows as a way of preserving domestic monetary policy autonomy in the transition period to participation in the European Economic and Monetary Union (EMU), provided that they were market based.

[25]In 1995, a 7 percent reserve requirement was introduced on nonresident baht accounts with a maturity of less than one year and on finance companies' short-term foreign borrowing. In 1996, the 7 percent requirement was extended to short-term baht borrowing by nonresidents and short-term foreign borrowing by commercial and BIBF banks.

[26]The reserve requirement was to be set below market rate. In the event, the rate was set at zero percent, and was never activated.

portive, saying that it could help the country respond to a possible resumption of large capital inflows. Unlike the case of the Czech Republic, however, the staff throughout the period was strongly in favor of greater exchange rate flexibility.

In Malaysia, a set of administrative controls was imposed in early 1994 on short-term capital inflows. These included prohibiting residents from selling short-term monetary instruments to nonresidents and a ban on forward transactions (on the bid side) and non-trade-related swaps by commercial banks with foreign customers.[27] The briefing paper for the 1994 Article IV consultation stated that the authorities should phase out these controls and allow the ringgit to appreciate. In 1995, the staff welcomed the authorities' decision to lift most of these controls.

Outflow controls

With respect to the use of outflow controls, the evaluation reviewed the related IMF documents for four countries that introduced them during 1990–2002: Venezuela (1994), Thailand (1997), Malaysia (1997), and Russia (1998). The documents suggest that the IMF's position differed across countries and over time (Table 3.4, bottom panel).

As explained more fully in Appendix 1, in June 1994, Venezuela introduced comprehensive price and exchange controls, covering current transactions and capital outflows. From the beginning, the staff consistently argued for an elimination of all exchange controls, saying that the "complete elimination of controls need not lead to a renewal of capital outflows" if supported by tight macroeconomic policies.[28] In March 1996, in view of the weak banking system, the staff proposed "a two-stage approach" involving the immediate elimination of exchange controls on current and nonportfolio capital transactions, accompanied by a public commitment to liberalize portfolio investment gradually.[29]

When Thailand introduced capital controls on outflows in May–June 1997 (see Box 3.2 for details),[30] the staff argued that it was essential to use the capital controls as a breathing space in which to implement a comprehensive macroeconomic policy package but, following the outbreak of an all-out crisis in July 1997, it argued for their immediate elimination. The staff's view remained negative when the Thai authorities attempted to tighten the existing controls in October 1999.[31] When the authorities intensified the enforcement of the existing controls in 2000,[32] the staff argued that the controls had been more effective in reducing offshore baht liquidity than in limiting exchange rate depreciation and that any tightening of the controls would likely impede trade and hedging activities.

The Malaysian authorities introduced capital control measures twice in connection with the East Asian crisis of 1997–98, first in August 1997 and then in September 1998 (see Box 3.2 for details on the second set of measures). When the first set of measures was introduced,[33] the mission expressed its strong disagreement and recommended that they be removed as soon as possible. A briefing paper of January 1998 expressed the staff's intention to urge the authorities to remove the swap limits imposed in the previous summer. When the second set of measures was introduced in September 1998, the IMF staff initially advocated a more flexible exchange rate and the simultaneous removal of most of the capital controls that had just been introduced. When the administrative controls were replaced by a system of exit levy for portfolio investment in February 1999, the staff recommended prudential risk-based management of cross-border transactions while continuing to favor the immediate removal of the exit levy.

The Russian authorities introduced capital outflow controls in August 1998, while simultaneously defaulting on domestic-currency-denominated government bonds. The controls included the suspension of conversion operations through nonresident accounts for those who had participated in the restructuring of government bonds,[34] and repatriation of ruble balances by other nonresidents—these measures effectively suspended capital transfers abroad by nonresidents (though some were *current* transfers as defined

[27]In August 1994, the authorities eliminated most of these control measures.

[28]Briefing paper for the 1994 Article IV consultation, October 28, 1994.

[29]In mid-April, the authorities abolished all exchange controls, on both current and capital transactions, in the context of an IMF-supported program.

[30]Most of the exchange restrictions and capital control measures introduced were relaxed in January 1998.

[31]This involved a clarification that the existing nonresident borrowing limit of 50 million baht for each customer (with no underlying real transaction) applied on a consolidated basis to subsidiaries as well.

[32]Stricter reporting requirements were applied to banks, and fines were imposed on banks found violating baht lending limits to nonresidents without an underlying real transaction.

[33]Limits were imposed on ringgit offer-side swap transactions (those that are not related to trade) by banks with nonresidents, except for hedging for trade-related transactions and genuine portfolio and FDI flows.

[34]A noninterest-bearing transit account was created for the ruble proceeds from government bond transactions.

Box 3.2. Outflow Controls in Thailand (1997) and Malaysia (1998)

Thailand

In May–June 1997, the Thai authorities introduced temporary selective capital controls on outflows by prohibiting the lending and sale of baht to nonresidents and requiring that any purchase before maturity of baht-denominated securities, or purchase of equities, from nonresidents be made in foreign currency. The measures were aimed at limiting the speculation of nonresidents against the baht by delinking the onshore and offshore markets.[1]

The IMF staff initially argued that these measures could not substitute for more fundamental adjustment measures and suggested that the breathing space provided by the control measures should be used to implement further fiscal consolidation, greater exchange rate flexibility, and financial sector reforms—a view endorsed by the Executive Board. Executive Directors, however, cautioned against use of permanent controls because they would risk undermining the confidence of long-term investors. A staff memorandum of June 1997 noted that, although the new measures had been effective in the short run, they had done "long-term damage" and led to a reduction in capital inflows.

Following the floating of the baht in July, the mission took the position that the capital controls should be eliminated as early as confidence was restored. The August 1997 LOI for an SBA indicated the authorities' commitment to eliminate the restrictions on purchases and sales of baht by nonresidents as well as sales of debt securities and equities for baht, once the currency was stable. Over the subsequent months, the IMF staff argued for an early elimination of the restrictions for baht sales to nonresidents (first review) and suggested that the unification of the onshore and offshore exchange markets remained a priority (second review in January 1998). In the event, at the end of January 1998, the authorities relaxed most of the control measures introduced in 1997.[2]

Malaysia

In September 1998, the Malaysian authorities introduced temporary capital outflow controls, while pegging the exchange rate to the U.S. dollar.[3] The measures were designed to restore a degree of monetary independence and included, among others, the introduction of a one-year holding period for the repatriation of portfolio investment. In February 1999, the one-year holding period was replaced by a graduated system of exit levy (in which principal and profits were allowed to be repatriated by paying an exit tax, the amount of which was determined by the duration of the investment). In September 1999, the exit levy was abolished, except for profits from portfolio investment brought in after February 1999. The system was entirely abolished in 2001.

According to internal documents, the IMF staff initially believed that an orderly exit strategy should be considered as soon as possible because of ample evidence that outflow controls did not work. The staff advocated a move to a nominal exchange rate band accompanied by inflation targeting, but was not opposed to maintaining the controls on short-term inflows that had been in place prior to September 1998 during the process of financial and corporate restructuring. It even suggested considering a market-based "prudential" measure on capital inflows of the Chilean type. The fall of 1998 also coincided with the end of the active dialogue of previous months between the IMF and the Malaysian authorities on policy issues, including IMF technical support. Internal documents, however, are surprisingly silent on whether the disagreement over the measures taken in September had any role to play in the process.

In 1999, however, the staff became more accommodating as it recognized that the controls had been administered effectively and that Malaysia had used wisely the breathing space created. The mission recommended a shift to the prudential risk-based management of cross-border capital transactions, while advocating an immediate removal of the exit levy on profits from portfolio investment. The staff supported the authorities' intention to use the capital controls as a temporary measure. Executive Directors commended the authorities for wisely using the breathing space provided by the capital controls. On the use of the controls itself, however, the Executive Board was divided: a number of Directors supported the maintenance of capital controls in order to manage an orderly exit, while others urged an immediate removal of the exit levy on profits. In 2001, the elimination of the system was welcomed by both the staff and the Executive Board.

The assessment of the effectiveness of Malaysia's capital outflow control is made difficult by the fact that it was introduced in September 1998, after the contagion from elsewhere in Asia had worked its way through the region. The Malaysian experience has received both positive and negative academic assessment, depending on whether one thinks that, in the fall of 1998, Malaysia still faced a significant risk of further capital flight (Kaplan and Rodrik, 2001; Johnson and Mitton, 2003). If the capital controls indeed worked in Malaysia as intended, it may be due to the controls' strictly temporary nature, the supporting policies (including measures to strengthen the banking and corporate sectors), Malaysia's institutional capacity, and a generally favorable external environment (see Abdelal and Alfaro, 2003).

[1]According to some studies, these measures had temporary effectiveness in delinking the two markets (Edison and Reinhart, 2001).

[2]The prohibition on baht lending to nonresidents was replaced by a 50 million baht limit per counterparty without an underlying current or capital account transaction.

[3]The staff report for the 1999 Article consultation noted that, in the view of LEG and MAE, the newly introduced restrictions (including the recent modifications) were not in violation of obligations under Article VIII.

by Article XXX).[35] At the same time, the authorities requested technical assistance from the IMF to help develop a more effective and less intrusive mechanism for preventing illegitimate capital outflows. "In view of the need to stem pressures on reserves," the staff did not oppose the maintenance of these restrictions, but refrained from formally recommending their approval in the absence of "a time-bound plan" for removing "all remaining restrictions."

Assessment

In this concluding section, we attempt a brief assessment of how the IMF's policy advice measured up to some of the "tests" set out in Chapter 1, namely: (1) Was there any difference between the IMF's general policy pronouncements and the advice it gave to individual countries? (2) Was the IMF policy advice operational and based on solid evidence? (3) How did the IMF advice change over time, and did this change keep pace with available evidence? (4) Did the IMF give similar advice to countries in similar situations? and (5) Was the policy advice on the capital account set in a broader assessment of the authorities' macroeconomic policies and institutional framework? Given the absence of consensus in the academic and official policymaking communities, however, this assessment is not about whether the IMF's particular policy advice was right or wrong; rather, it is meant only as a broad characterization of the IMF's overall advice on capital account issues.

Capital account liberalization

In all the countries that liberalized the capital account during the 1990s, whether partially or almost fully, the process was for the most part driven by the country authorities' own economic and political agendas. When programs were involved, the IMF never required capital account liberalization as formal conditionality for the use of its resources. The IMF, however, did not hesitate to support capital account liberalization as part of the authorities' overall policy package as expressed in program documents. Most of the advice on capital account liberalization was given to member countries through policy dialogue and technical assistance (as broadly defined) in the context of surveillance or financial support. Against this broad background, the IMF's approach toward capital account liberalization evolved over time.

In the early 1990s, the IMF encouraged member countries to liberalize the capital account without necessarily raising the issue of pace and sequencing. This attitude was particularly evident in those countries that had program relationships with the IMF. It was not uncommon during this period for the LOIs to include the authorities' intention either to further liberalize capital account transactions or to maintain the opening they had achieved. Occasionally, the staff expressed concern over financial sector weakness or macroeconomic instability, but this did not translate into operational advice on pace and sequencing. From around 1994, and certainly after the Mexican crisis, some within the IMF took a more cautious attitude toward capital account liberalization. Discussion of sequencing and the need to meet preconditions became more systematic and routine. Although the change was gradual, there is no denying that the East Asian crisis had a profound impact on this process.

This evolutionary process is reflected in the *apparent* inconsistency observed in the IMF's advice on capital account liberalization, particularly during the early years: from the very beginning, sequencing was mentioned in some countries but not in others (see Table 3.1). This is not especially surprising because there was no official policy. Consequently, the content of policy advice in country work was largely determined by individual staff members as they assessed the situation and as new evidence emerged. To the extent that country circumstances differ, *uniformity* cannot be the only criterion to judge the quality of policy advice and our evidence suggests no "one size fits all" approach. But in this case, it appears that the IMF's policy advice lacked not only uniformity but also *consistency* because, in the absence of clear official guidelines, it was almost entirely left up to the discretion of individual country teams and the resulting differences in approach between countries are sometimes difficult to explain.

Managing capital flows

The staff's policy advice to specific countries on managing capital flows was largely in line with the policy conclusions typically derived from the scholarly literature on open economy macroeconomics. To deal with large capital inflows, this advice advocated tight fiscal policy and greater exchange rate flexibility, but discouraged the use of capital controls. The staff's position on sterilization, consistent with the conventional wisdom, emphasized its quasi-fiscal costs and its longer-term ineffectiveness but

[35]Article XXX (*d*) includes "payments of moderate amount for amortization of loans" (in addition to "payments due as interest on loans") as current transactions. By appealing to this provision, in a memorandum to management dated August 18, 1998, the Legal Department took the position that these restrictions covering nonresidents' repatriation of proceeds from bond transactions constituted restrictions subject to approval under Article VIII, Section 2 (*a*).

was, to a surprising extent, supportive of the country authorities' policy choices, whatever they may have been. In a few instances, the staff also recommended further trade liberalization, liberalization of capital outflows, and tightening of prudential regulation as measures to deal with large capital inflows. These and other structural measures, however, received relatively little attention in the IMF's policy advice. Given the IMF's focus and comparative advantage, this was probably appropriate.

In order to make a full assessment of the IMF's overall policy advice on managing capital inflows, one must understand the staff's assessment of the countries' macroeconomic frameworks and institutional constraints under which advice is given. However, internal country documents (let alone staff reports) generally do not provide sufficient analytical basis, much less a well-articulated analytical model, for understanding why a particular combination of policies was advised in a particular case. Without such understanding, there appears to be inconsistency in the intensity with which advice for fiscal and exchange rate policies was given both across time and across countries. It would be helpful for country documents to be more explicit in articulating the rationale for advocating certain policy actions, and not others.

Temporary use of capital controls

Temporary use of capital controls has been a controversial subject, not only within the IMF but also in the academic and official policymaking communities. It is possible here to make a broad generalization that the IMF staff was in principle opposed to the use of such instruments, either on inflows or outflows. Its view was that they were not very effective, especially in the long run, and could not be a substitute for the required adjustments in macroeconomic policies. Nevertheless, in some countries, the IMF staff displayed a remarkable degree of sympathy with the use of capital controls even from the earliest days. In some cases, it even suggested that market-based controls could be introduced as a prudential measure.

The key question is whether the difference reflected the IMF's assessment of the role of these controls in the authorities' overall macroeconomic framework. This may well be the case in some instances. For example, the staff's tacit support for Russia's outflow controls may be related to the fact that the Russian authorities had already agreed to a comprehensive program of fiscal consolidation and banking reform, whereas it might have given less support to Thailand's use of outflow controls because there was no agreed program in place. Similarly, in some cases there is evidence that differing judgments on the appropriateness of temporary controls reflected differing assessments of underlying exchange rate policies. Such an approach seems reasonable. More generally, however, documents are not sufficiently explicit to allow us to make a definite judgment about the consistency of the IMF's overall advice on capital controls, except to say that the staff became much more accommodating of the use of capital controls from the mid-1990s, and certainly following the East Asian crisis.

CHAPTER

4 Ongoing Country Dialogue on Capital Account Issues

This chapter reviews the IMF's ongoing work in a sample of 14 countries for which outstanding issues on capital account liberalization and the temporary use of capital controls were documented during 2003–04. The countries are divided into two groups. The first group of nine countries were at different stages in the ongoing process of capital account liberalization during 2003–04, with some at an early stage and others at a relatively advanced stage. The second group of six countries (with Russia overlapping both groups) represent countries for which the IMF staff expressed a view on use of capital controls during 2003–04. The chapter first discusses the IMF's advice on capital account liberalization and then shifts to a discussion of how the IMF viewed the temporary use of capital controls.

Capital Account Liberalization

The evaluation reviewed the documents for nine countries that were moving toward greater capital account convertibility during 2003–04: China, India, the Islamic Republic of Iran, Kazakhstan, Libya, Morocco, Russia, South Africa, and Tunisia (Table 4.1). In addition, the evaluation looked at technical assistance reports for two other countries in the process of capital account liberalization: Lesotho and Tanzania. Not only were these countries at different stages of capital account openness, but they also differed in the way they interacted with the IMF during this period. Some had a more formally arranged dialogue on specific capital account liberalization issues with the IMF, while for others the IMF's inputs were limited to what it provided as part of routine Article IV consultation discussions. Seven of the nine countries reviewed here received an assessment of their financial systems under the FSAP. For each of these countries, we explain below the context in which advice on capital account liberalization was offered and the content of that advice.

In China, the IMF staff supported the country's gradual approach to capital account liberalization. The briefing paper for the 2003 Article IV consultation indicated that the staff's support for gradual liberalization was based on its view of "structural weaknesses in the financial sector." A staff note of March 2004 argued that capital account liberalization should come only after the establishment of a floating exchange rate system, whose introduction should be phased in order not to pose risks to the weak financial sector. The gradual introduction of exchange rate flexibility was viewed as helpful to create stronger incentives for developing the foreign exchange market and for currency risk management, which in turn could facilitate further capital account liberalization. Capital controls were seen to support this process. In this context, the importance of pursuing consistent policies was stressed. Clearly, in China, the staff's advice was intimately connected with its assessment of the financial sector.

Within the context of gradual liberalization (see Box 4.1), the Indian authorities considerably liberalized the capital account in 2002. The briefing paper for the 2003 Article IV consultation indicated that the mission welcomed these measures but expressed caution in proceeding with further significant opening, particularly in view of the large fiscal deficits and the still weak financial system. The back-to-office report suggested that, in this context, the mission reiterated the need for greater exchange rate flexibility, which would create incentives for risk hedging. Additional measures were taken in 2004 to liberalize the capital account, including easing resident firms' access to international capital markets, raising the ceiling on the stock of government bonds that could be held by foreign investors, and relaxing the limits on capital outflows by residents. During the 2004 Article IV consultation, the staff again expressed support for the government's gradual approach to capital account liberalization and stressed the importance of addressing fiscal and financial sector weaknesses before proceeding further. It thus appears that the IMF's advice on capital account liberalization in recent years was framed in its assessment of India's macroeconomic and structural conditions.

Direct investment flows into the Islamic Republic of Iran picked up significantly during 2002–04, in part as a response to a revision of the foreign direct invest-

Table 4.1. Policy Environments for Capital Account Liberalization in Selected Countries[1]

	1999	2000	2001	2002	2003	2004[2]
China	. . .	. . .	. . .	. . .	. . .	. . .
India[3]	. . .	FSAP	. . .	. . .	. . .	. . .
Iran, I.R. of	. . .	M, FSAP	. . .	. . .	TA	. . .
Kazakhstan	M	FSAP	. . .	TA	TA	FSAPu
Libya	. . .	. . .	. . .	. . .	. . .	. . .
Morocco	. . .	. . .	. . .	FSAP	. . .	. . .
Russia[3]	. . .	. . .	. . .	FSAP	. . .	. . .
South Africa[3]	. . .	IT, FSAP	FSAPu	. . .	. . .	. . .
Tunisia	. . .	. . .	FSAP	TA	. . .	. . .

Source: IMF database.

[1]A shaded area corresponds to a period in which the country had a floating exchange rate (including a managed float). M and IT indicate the introduction of a monetary policy anchor and inflation targeting, respectively. FSAP (FSAPu) indicates the year in which an assessment of the country's financial sector was made (or updated) under the Financial Sector Assessment Program. TA indicates the year in which the country received IMF technical assistance with regard to capital account liberalization issues.

[2]As of the second quarter.

[3]There was a monetary policy anchor in these countries during the whole period.

ment law. In supporting the authorities' gradual approach to capital account liberalization, the IMF staff emphasized the importance of financial sector reform and, in this context, encouraged the authorities to open the banking system to foreign strategic investors. The staff consistently pressed the authorities to tighten fiscal policy, increase exchange rate flexibility, and improve monetary policy instruments in order to deal better with the rising capital inflows. It did not suggest an introduction of inflation targeting at this time, however, because of the Islamic Republic of Iran's weak institutions. The briefing papers for both the 2003 and the 2004 Article IV consultations expressed the view that the speed of liberalization should be linked to progress in addressing weakness in the financial system and improving fiscal and monetary policy coordination. This clearly indicated that the staff's view of capital account liberalization was based on its assessment of the Islamic Republic of Iran's overall macroeconomic, financial sector, and institutional conditions.

In Kazakhstan, the authorities indicated their intention gradually to liberalize the capital account, with technical assistance from the IMF, beginning in 2003 (Box 4.2). The staff supported the authorities' cautious approach to capital account liberalization, but stressed the need for supporting policies, including establishing effective consolidated prudential supervision and implementing sound risk management practices. The briefing paper for the 2003 Article IV consultation noted that the staff was more concerned with the authorities' ability to manage risks in the face of large capital inflows than with the potential for capital flight, and stated its intention to emphasize the importance of building a sound financial system "regardless of the pace of liberalization." The staff's discussions with the authorities during 2003–04 focused on the need for greater exchange rate flexibility. On the monetary policy framework, however, the staff in reviewing departments expressed doubt about the appropriateness or feasibility of inflation targeting in a country highly dependent on oil revenues and at Kazakhstan's stage of institutional development. The briefing paper for the 2004 Article IV consultation noted the same concerns but stated the staff's intention to discuss "plans to accelerate capital account liberalization in light of de facto openness of the capital account and strong macroeconomic fundamentals." Given Kazakhstan's strong fiscal position, however, little concern was expressed about fiscal policy.

The Libyan authorities expressed in 2004 their intention to open up Libya's economy to the global market and to move forward with the implementation of structural reforms with IMF support. In the staff report for the 2004 Article IV consultation, the staff outlined a preferred sequence for structural reform consisting of two phases. The first phase, which is to last 1–12 months, involves adopting a medium-term budget framework, lifting sectoral credit restrictions, gradually liberalizing interest rates, and finalizing the plan to restructure public banks. The second phase, which is to last another 12–36 months, involves the building of institutions for an efficient market economy, including accelerating the process of creating a sound investment climate, restructuring or privatizing public enterprises and banks, and developing money markets and monetary policy instruments. The staff report then suggested that, over the medium term, "capital account convertibility could be considered" once the first two phases have been sufficiently imple-

Box 4.1. India

In the early 1990s, India made a historic departure from the inward-looking and interventionist policies of the past to embark on outward-looking reforms (Ahluwalia, 2002). Trade was considerably liberalized over time, and liberalization of FDI received considerable attention. The reforms of 1991 removed many of the restrictions on FDI inflows. In 1993, foreign institutional investors were also allowed to purchase shares of listed Indian companies, opening a window for portfolio investment. Recognizing the link between current and capital transactions, however, the authorities included certain safeguards in foreign exchange regulations when current account convertibility was established (Jadhav, 2003). These were: (1) surrender requirements; (2) need to present documentary evidence; and (3) indicative limits for representative current account transactions.[1]

Along with current account convertibility, capital account transactions expanded substantially, and India experienced a surge in capital inflows from the end of 1993 through 1994. In view of the expansion in capital flows, it became an urgent priority for the authorities to determine the systematic approach they should take toward the capital account. It was against the backdrop of these developments that, in March 1997, the Reserve Bank set up a Committee on Capital Account Convertibility in order to "chalk out the road map and time frame for achieving capital account convertibility" (Tarapore, 1998; see also Reserve Bank of India, 1997). The Committee's report, released in early June 1997, concluded that India was "ready for a cautious and phased move" toward capital account convertibility and outlined a three-year program to meet a set of certain preconditions covering fiscal discipline, price stability, and banking system soundness.

The Indian authorities for the most part accepted these preconditions and embarked on a gradual approach to greater capital account openness. In this approach, controls have been applied more strictly for outflows than for inflows; for residents than for nonresidents; for banks than for institutional investors; and for individuals than for corporations (Jadhav, 2003). FDI has been encouraged by progressively expanding both the automatic and the case-by-case routes. Access to external long-term borrowing has generally been limited to corporations and development financial institutions, and subject to annual ceilings, but the threshold for automatic approval has been raised over time. Short-term borrowing is strictly controlled, except for trade-related purposes. Liberalization of capital outflows has just begun.

Various internal documents suggest that the IMF staff consistently supported India's gradual approach to capital account liberalization. The staff during the 1995 Article IV consultation, for example, endorsed the maintenance of an annual limit on external commercial borrowing, while suggesting that sufficient flexibility be retained to allow adequate financing for high priority infrastructure projects. The 1996 mission stressed the importance of sequencing, arguing that priority should be given to FDI and equity investment and that liberalization of restrictions on short-term debt capital and outward investment should be gradual.[2] At the same time, it cautioned the authorities against the risks of rapid capital account liberalization in the absence of a strong fiscal position and a more robust financial sector. In April 1997, the staff prepared a comprehensive note on the pace and sequencing of capital account liberalization in support of the just-formed Committee on Capital Account Convertibility, stressing the need to sequence capital account liberalization with other structural and macroeconomic policy measures to contain potential risks. It also emphasized the importance of exchange rate flexibility and the need to have market-based instruments for monetary control. The briefing paper for the 1998 Article IV consultation expressed the staff view that contagion to India from the East Asian crisis had been limited, in part because of its relatively closed capital account.

The Executive Board broadly endorsed these staff views. There were, however, always dissenting voices, particularly before the East Asian crisis. At the Board meeting to discuss the 1996 Article IV consultation, some Directors remarked that a more rapid pace of capital account liberalization could be beneficial in encouraging fiscal consolidation and financial reforms. At the 1997 meeting, while welcoming the proposal put forward by the Committee on Capital Account Convertibility, some Directors argued that there was considerable scope to move forward at an early stage to liberalize further equity inflows and FDI. Such views became rarer following the East Asian crisis. The summing up of the 1998 Board meeting simply noted: "Directors encouraged the authorities to persevere with the phased opening of the capital account."

[1]These limits were raised over time.

[2]From the point of view of promoting fiscal discipline, the mission further advised against liberalizing restrictions on foreign investment in government securities, even if such a measure could foster the development of the government securities market.

mented. The IMF staff strongly urged the authorities to take advantage of the window of opportunity provided by favorable macroeconomic and external conditions (with a budget surplus, a current account surplus, and low inflation) to pursue the needed reforms rigorously.

In Morocco, the Article IV consultation discussions in both 2003 and 2004 focused on the need

Box 4.2. Technical Assistance

During the 1990s, the IMF staff provided a number of countries with technical assistance (TA) on issues broadly related to capital account liberalization. For example, an Executive Board paper prepared by MAE in July 1998 stated that "about one quarter" of "the 54 countries that received technical assistance on exchange rate systems" during 1994–97 "received assistance on capital account liberalization."[1] However, an examination of TA documents and staff's explanation in Board papers indicate that the TA advice was quite broad and general. It was often given to help build supporting institutions for an open capital account, including the reform of the foreign exchange system, improvements in monetary control, the strengthening of domestic financial systems, and the preparation of new foreign exchange legislation. It was in the context of these more general discussions that the staff in some cases encouraged the authorities to make progress in capital account liberalization.

More specific TA on sequencing capital account liberalization—including on specific measures of institution building and coordination with other reforms—was not given until the very end of the 1990s. The first country to request such technical assistance on sequencing was Tanzania (1999), followed by Kazakhstan (2002), Tunisia (2002), the Islamic Republic of Iran (2003), and Lesotho (2003). To date, only these five countries have formally requested IMF technical assistance on sequencing capital account liberalization. Of these, technical assistance to Tanzania and Lesotho was given in the context of an IMF-supported program (Lesotho also underwent an assessment of the financial system under the FSAP, which included advice on capital account liberalization).

In providing advice to these countries, the staff advocated a gradual approach to capital account liberalization. While the staff argued that the benefits of capital account liberalization were large, it also highlighted the risks that would arise in the absence of supporting policies and institutions, particularly a sound financial sector and effective prudential regulation. In terms of order of liberalization, the staff's consistent position was that long-term flows should be liberalized before short-term flows, and that the internationalization of domestic currency should be limited at an early stage of the liberalization process in order to retain greater monetary autonomy.

Among the five countries, only two—Kazakhstan and Tunisia—have completed the initial objectives of the TA received. In the case of Tanzania and the Islamic Republic of Iran, on the other hand, data limitations prevented the staff from providing constructive advice, except to suggest strengthened efforts at better data collection and monitoring capacity. As to Lesotho, its special monetary relationship with South Africa complicated the domestic strategy for capital account liberalization; the staff's recommendation was therefore limited to stressing the need to establish an appropriate environment for liberalization, including larger foreign exchange reserves, a more sound financial sector, and more prudent fiscal policy.

In Kazakhstan and Tunisia, the staff devised a multistage strategy of starting with measures that could be implemented immediately before proceeding to those that required prior institution building. At the same time, it advised the authorities to introduce an early warning system to monitor speculative capital flows as the first line of defense, and to enforce such a mechanism by pursuing appropriate exchange rate and monetary policies. In particular, the staff urged the central banks to increase exchange rate flexibility and to expand the menu of monetary policy instruments (e.g., repo facilities and government securities). In the case of Kazakhstan, the staff even listed use of capital controls to complement these measures, by stating that capital controls on short-term flows could be reinstated "under very exceptional circumstances" in which monetary or financial stability was threatened by large capital flows.[2]

[1]Monetary and Exchange Affairs Department, "Developments and Issues in the International Exchange and Payments System," SM/98/172, July 7, 1998.

[2]Monetary and Exchange Affairs Department, "Kazakhstan: Capital Account Liberalization and Financial Sector Supervision," March 2002.

for fiscal consolidation, "a new monetary policy framework," and financial sector restructuring as the essential prerequisites for moving ahead with capital account liberalization. The 2003 FSAP report noted that, while the banking system was in a reasonably good shape, removal of capital account restrictions could put adverse pressure on banks. The staff consistently argued that a pegged exchange rate could not be sustainable in the absence of restrictions on capital account transactions. It advised the authorities to consider exiting from the peg over the medium term when the preconditions for capital account liberalization have been achieved. Under the existing macroeconomic conditions, the staff advised against attempting a greater integration of the Moroccan economy with world financial markets.

In Russia, a new law to liberalize foreign exchange transactions was submitted to the Duma in early 2003. This included the immediate reduction of surrender requirements to 30 percent from 50 percent and the replacement of the approval requirements by reporting requirements for many capital account transactions. The proposals also included

the possibility of introducing unremunerated reserve requirements to discourage short-term capital flows (see the section "Temporary Use of Capital Controls"). The briefing paper for the 2003 Article IV consultation indicated that the staff welcomed these steps, but expressed concern over the weak state of the financial system if the capital account was to be opened quickly. The back-to-office report stated that the mission had advised the authorities that capital account liberalization should be carefully phased and had recommended, under the circumstances, only an early removal of controls on outflows. Further, the briefing paper for the 2004 Article IV consultation recorded the staff's view that a sound banking system was all the more important because of "the relatively ambitious schedule for liberalization of capital controls."

In South Africa, the IMF staff for a long time took a very cautious attitude toward capital account liberalization, particularly in view of the central bank's net open position in the forward exchange market. During the 2003 Article IV consultation, the mission reiterated its support for the gradual approach but suggested that, in view of the possible impact on exchange rate volatility, completion of the process should wait until international reserves had been built up to more comfortable levels.[1] The open forward position of the central bank was eliminated in February 2004, after which the staff's position clearly changed. The 2004 Article IV consultation report indicated that, given the relatively healthy banking system, the strength of the South African rand presented "an opportune time to move ahead" in relaxing controls, particularly on resident companies. The mission continued to support the authorities' gradual approach to capital account liberalization, but expressed the view that the current strength of the rand could be exploited to move more quickly with the removal of remaining controls.

As noted in greater detail in Appendix 1, the Tunisian authorities have been pursuing gradual capital account liberalization since the mid-1990s. The briefing paper for the 2004 Article IV consultation noted that the staff would advise the authorities to establish a new monetary framework as a nominal anchor and to increase exchange rate flexibility gradually in their phased movement toward capital account convertibility. At the same time, the need for a sound banking system was repeatedly stressed. During the discussions, the staff urged the authorities to address banking sector weaknesses to support the gradual liberalization of the capital account.

[1]A similar view had been expressed by the 2000 FSAP report.

Temporary Use of Capital Controls

During 2003–04, use or possible use of capital controls was on the agenda for discussion between the IMF staff and the authorities of at least six countries: Bulgaria, Colombia, Croatia, Romania, Russia, and Venezuela. In four of these countries (Bulgaria, Croatia, Romania, and Russia), the subject of policy discussion was market-based controls on inflows. In Colombia, a minimum stay requirement was introduced to limit short-term capital flows, while the controls in Venezuela were targeted at outflows and initially introduced as part of a system of comprehensive exchange controls covering both current and capital account transactions. We first discuss the four cases of market-based controls, followed by a discussion of the other cases of administrative controls.

Market-based controls

Bulgaria experienced a rapid credit growth financed by external borrowing within the context of a currency board arrangement. In the briefing paper for the 2004 Article IV consultation in March, the staff expressed its intention to advise the authorities to implement additional measures to contain credit growth if necessary, including market-based controls on capital inflows as a last resort measure. A similar view was expressed in the briefing paper for a staff visit in September as well as in the subsequent briefing paper for a Stand-By review.

Financed by external borrowing, private credit expanded rapidly in Croatia. In view of the authorities' commitment to the use of the exchange rate as a nominal anchor,[2] the IMF staff in its November 2003 briefing paper for a Stand-By review argued for a tight monetary policy while suggesting that the authorities consider raising the marginal deposit requirements on banks' liabilities or introducing market-based controls on capital inflows, if necessary.[3] In the briefing paper for the 2004 Article IV consultation, the staff repeated the same point but emphasized that capital controls should remain a last-resort and "stop-gap" option to deal with large and unexpected capital inflows "until other policies adjust or inflows abate." In the event, in July 2004, the authorities introduced a marginal reserve requirement, which required banks to deposit 24 percent of net increases in their foreign liabilities into a special inter-

[2]Croatia had a managed float, but the authorities were reluctant to allow greater exchange rate flexibility because of their success with exchange rate-based stabilization in the previous years.

[3]A new foreign exchange law, in May 2003, gave the central bank additional authority to restrict capital inflows.

est-free account held with the central bank, for an unlimited time period.[4]

Romania has also experienced a rapid credit growth in recent years. Romania, however, maintains restrictions on short-term capital inflows. In this context, in the November 2003 briefing paper for a request for a Stand-By Arrangement,[5] the staff's position was that the authorities should continue to restrict the access of nonresidents to short-term domestic currency instruments until price stability was firmly achieved.[6] As things turned out, while the growth of domestic currency credit slowed in 2004, foreign currency credit steadily grew. In the briefing paper for the first Stand-By review, the staff expressed its intention to discuss the possibility of introducing greater exchange rate flexibility.[7] Effective August 2004, the authorities raised the reserve requirements on foreign exchange liabilities to 30 percent from 25 percent. A briefing paper of January 2005 indicated the staff's intention to advise the authorities to extend the reserve requirements on foreign currency liabilities to those with a residual maturity of more than two years as a way of creating scope for limited monetary easing.[8]

In Russia, the law establishing an unremunerated reserve requirement (URR) on both inflows and outflows took effect on July 1, 2004. At the time, the Russian authorities abolished most of the existing administrative controls on capital movements (see also the section "Capital Account Liberalization"). The URR thus served as a device to liberalize the capital account while retaining safeguards against excessive flows. The IMF staff and management views were somewhat mixed. During 2003, when the provisions of the law were being discussed against the background of steady capital inflows, the staff had written in a briefing paper that it intended to recommend as a policy response to this situation fiscal tightening and possibly introduction of additional temporary controls on inflows. To this, management suggested that the staff should focus on the measures currently proposed by the authorities without advocating any new contingent capital control measures.

When the law was enacted, the staff considered the introduction of the URR as a significant improvement over the previous system of administrative controls. At the same time, it viewed the large capital inflows as being caused largely by Russia's exchange rate policy[9] and considered that fiscal policy was too loose, which burdened monetary policy with the task of controlling inflationary pressure. Under these circumstances, the staff thought that there was no need to activate the URR if appropriate adjustment was made in exchange rate and macroeconomic policies. According to the back-to-office report for the 2004 Article IV consultation, the mission argued that while the URR was appropriate as a transitional measure from the system of permits and controls, its effect on capital inflows would be only temporary and its main effect would be to raise the cost of capital for small and medium-sized domestic borrowers. It then noted that controls should not be a substitute for tight fiscal policy and the adoption of a more flexible exchange rate policy. In the case of Russia, the staff's assessment of capital controls was clearly framed within its assessment of the authorities' macroeconomic strategy.[10]

Administrative controls

In Colombia, faced with a sharp and sustained appreciation of the Colombian peso, in December 2004 the authorities introduced a one-year stay requirement for inward portfolio investment by nonresidents, while allowing the profits from these investments to be repatriated freely. Interviews suggest that the IMF staff, while skeptical of the effectiveness of the capital control in arresting aggregate capital inflows (given its limited coverage), understood the political economy context in which it was introduced. The issue was not raised in negotiations for a Stand-By Arrangement in early 2005.

As explained in greater detail in Appendix 1, the Venezuelan authorities introduced "temporary" comprehensive foreign exchange controls in February 2003, covering both current and capital account transactions. While the staff recommended that all restrictions on current transactions be eliminated, it expressed its understanding that capital controls

[4]In February 2005, the authorities raised the deposit requirement to 30 percent from 24 percent; in March 2005, they announced that they would liberalize controls on capital outflows.

[5]The Stand-by Arrangement was to be treated as precautionary.

[6]Under EU accession agreements, the authorities had made a commitment to allow nonresidents to hold domestic currency deposits, tentatively from April 2005, and to liberalize the treasury bill market in 2007. In early 2004, however, the authorities made a decision to delay by 12 months the implementation of their commitment to this schedule of capital account liberalization under EU accession agreements. This decision was supported by the IMF staff.

[7]Romania abandoned the de facto (unannounced) crawling band in November 2004.

[8]This measure was taken in February 2005.

[9]From early 2003, the authorities allowed the ruble to appreciate against the U.S. dollar but temporarily discontinued this policy in early 2004. The ruble's appreciation resumed later in the year.

[10]There was a contradiction in the staff assessment at a different level. In 2003, the staff's position was that Russia should only gradually dismantle administrative controls on capital flows, in view of its weak banking system and weak enforcement of prudential norms. In 2004, however, the staff took a position against the URR which had been introduced to replace the administrative controls, while the macroeconomic situation had not materially changed from 2003.

Box 4.3. The IMF's "Integrated" Approach to Capital Account Liberalization

The IMF's "integrated" approach, developed from the late 1990s to the early 2000s and as outlined in Ishii and others (2002), was discussed in an Executive Board seminar in July 2001.[1] Although the Board has never endorsed it as official policy, it nonetheless appears to enjoy wide acceptance among the IMF staff as representing the institution's current thinking on capital account liberalization.

The approach is called "integrated" because it considers capital account liberalization as part of a comprehensive program of economic reforms in the macroeconomic policy framework, the domestic financial system, and prudential regulations. In terms of sequencing, the policy paper sets forth ten general principles: (1) capital account liberalization is best undertaken with sound macroeconomic policies; (2) those reforms that support macroeconomic stabilization should be given priority; (3) reforms that are operationally linked should be implemented together; (4) domestic financial reforms should be complemented by prudential regulation and financial restructuring; (5) sequencing should take account of the concomitant risks of various types of instruments; (6) pace should take account of conditions in the nonfinancial sector; (7) reforms that take time should be started early; (8) reforms need to take account of the effectiveness of the controls in place; (9) the pace, timing, and sequencing of liberalization need to take account of political and regional considerations; and (10) the arrangements for policy transparency and data disclosure should be adapted to support capital account opening (see Ishii and others, 2002, pp. 16–18).

The paper argues that these general principles on sequencing are to be applied in a specific instance in such a way as to reduce or better manage various types of credit, market, and liquidity risks that are typically magnified by cross-border transactions. In particular, the paper identifies a number of risks associated with different types of capital flows and suggests key policy measures to manage those risks. The operational "methodology" would first make a diagnosis of the existing regulations and institutions and, on the basis of this diagnosis, develop a three-stage plan for sequencing and coordinating capital account liberalization with other policies: (1) the first stage involves achieving a high degree of macroeconomic stability and developing markets and institutions, fostering good risk management by banks and other economic entities, and remedying the most important shortcomings in prudential regulation, with low-risk capital flows (such as FDI) being allowed to take place first; (2) the second stage entails a consolidation and deepening of the progress made in the first stage, with considerable further capital account liberalization taking place; and (3) in the third and final stage, all remaining capital controls are lifted, as macroeconomic and financial sector conditions have improved to the point where risks are effectively managed.

As a statement of general principles, few would disagree with the prudence and judiciousness of the integrated approach, and its emphasis on the need to tailor the pace and sequencing to particular country circumstances is welcome. However, while the paper states that "a gradual approach would not by itself guarantee an orderly liberalization," there is an unmistakable bias toward gradualism in this approach. More importantly, by emphasizing all of the potential interlinkages without any clear approach to identifying a hierarchy of risks, this approach may inadvertently create a false notion that a country can achieve full capital account convertibility only when it has fully developed all relevant markets, institutions, and regulatory frameworks. In this connection, a group of Asian experts have described the IMF's integrated approach as including "virtually every conceivable aspect of microeconomic, institutional, and macroeconomic policy possible," "unnecessarily complex," and "unoperational, as it lacks a clear hierarchy of priorities" (Asian Policy Forum, 2002). While this assessment is perhaps too severe, the principles, while giving some—albeit incomplete—indications on prioritization, do not provide criteria for judging what reforms are more critical than others overall. It is certainly true that such judgments would have to be made in the context of country-specific circumstances. However, because the approach identifies a complex set of risks and the requisite measures without clear criteria for balancing those risks, it has proven to be difficult to apply in practice.

[1]A further elaboration of this approach is given by Karacadag and others (2003).

might be necessary in the short run, mainly on capital outflows. In 2004, the staff advised a gradual approach to liberalize capital account restrictions, which had to be well sequenced and supported by macroeconomic and institutional reforms.

Assessment

In ongoing country work, the IMF staff has in general been accommodating of the authorities' policy choices when they have involved a gradual approach to capital account liberalization or temporary use of controls. In terms of capital account liberalization, the IMF staff was sometimes more cautious than the authorities (for example, in Russia in 2003) when their preferred policy was rapidly to liberalize the capital account. In most cases, it appears that the staff took a medium-term perspective and emphasized the importance of meeting certain preconditions, the most important of which were fiscal consolidation, a

sound financial system, and the adoption of a floating exchange rate (usually with inflation targeting). The staff's generally cautious attitude toward capital account liberalization is in part a reflection of the new "integrated" approach (Box 4.3), which has been more fully applied in countries that have requested technical assistance from the IMF.

In terms of advice on temporary use of capital controls, the IMF staff seldom challenged the authorities' decision and even had a positive attitude toward market-based controls, if only as a temporary measure. There was, however, a slight difference in emphasis across countries. In some cases (as in Russia in 2004), the staff expressed a view quite forcefully that capital controls, no matter how useful they might be in the short run, could not be expected to be effective over time and should not be used as a substitute for appropriate adjustment in macroeconomic and exchange rate policies. In others (as in Colombia), the use of controls introduced by the authorities did not figure prominently in policy discussions. In still other cases (as in Bulgaria and Croatia), the staff recommended a market-based control as a last resort measure.

Clearly in some countries (for example, China and India), the IMF's advice on the sequencing of capital account liberalization was framed in its assessment of the countries' macroeconomic or financial sector conditions. In other cases (as in the Islamic Republic of Iran, Kazakhstan, and Libya), its cautious approach was conditioned by its assessment that the requisite institutional infrastructure for an open capital account was not yet in place. In one case (South Africa), on the other hand, a favorable assessment of the overall macroeconomic situation prompted the staff to suggest that the remaining controls could be removed quickly. In terms of temporary use of capital controls, the staff proposed market-based instruments in the form of marginal reserve requirements on banks' foreign exchange liabilities when it saw a limit to the effectiveness of conventional macroeconomic policy tools to deal with large capital inflows. These are indications that the staff is giving greater attention than previously to the overall economic policy environment and institutional constraints of the countries concerned in providing advice on capital account issues.

CHAPTER

5 Major Findings and Recommendations

This report has evaluated the IMF's approach to capital account liberalization and other related capital account issues. It first reviewed the IMF's general operational approach and analysis as they evolved from the early 1990s into the early 2000s. The report then assessed the IMF's country work for 1990–2004 in terms of (1) its role in capital account liberalization, (2) advice to member countries on managing capital flows, including the temporary use of capital controls, and (3) ongoing work on capital account issues. Most of the analysis on country work was based on IMF documents for a sample of over 30 emerging market and developing economies.

This concluding chapter summarizes the major findings of the evaluation and presents two broad recommendations designed to help improve the IMF's operational work on capital account issues.

Major Findings

Major findings are summarized below under (1) the IMF's general operational approach and analysis, (2) the IMF's country work, and (3) overall assessment of the IMF's approach to capital account liberalization and related issues.

The IMF's general operational approach and analysis

The Articles of Agreement left considerable ambiguity about the role of the IMF in capital account issues. Even so, in the early 1990s the IMF responded to the changing international environment, characterized by large cross-border capital movements, by paying greater attention to issues related to the capital account. From the mid-1990s, staff analyses began clearly to advocate capital account liberalization. Concurrent with the initiatives to amend the Articles to give the IMF an explicit mandate for capital account liberalization and jurisdiction on members' capital account policies, management and staff expanded the scope of the IMF's operational work on capital account issues in Article IV consultations and technical assistance in an effort to promote capital account liberalization more actively.

The IMF's analysis prior to the mid-1990s tended to emphasize the benefits to developing countries of greater access to international capital flows and to pay comparatively less attention to the potential risks of capital flow volatility. More recently, however, the IMF has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the more fundamental causes and implications of their boom-and-bust cycles. Still, the focus of the analysis remains on what emerging market countries should do to cope with the volatility of capital flows (for example, through macroeconomic and exchange rate policy, strengthened financial sectors, and greater transparency). The IMF has addressed the moral hazard aspect of boom-and-bust cycles, for example, by encouraging greater exchange rate flexibility in recipient countries and attempting to limit access to IMF resources during a crisis, but has not been at the forefront of the debate on what, if anything, can be done to reduce the cyclicality of capital movements through regulatory measures targeted at institutional investors in the source countries.

From the beginning of the 1990s, the IMF's management, staff, and Executive Board were aware of the potential risks of premature capital account liberalization and there is no evidence to suggest that they promoted capital account liberalization indiscriminately. They also acknowledged the need for a sound financial system in order to minimize the risks of liberalization and maximize its benefits. Such awareness, however, largely remained at the conceptual level and did not lead to operational advice on preconditions, pace, and sequencing until later in the 1990s. At the same time, a subtle change was taking place within the institution. As preliminary evidence emerged on the apparent effectiveness of Chile's capital controls in the mid-1990s, some in the IMF began to take a favorable view of the use of capital controls as a temporary measure to deal with large capital inflows.

In the event, the proposed amendment of the Articles put forward in the late 1990s failed to garner

sufficient support, leaving ambiguity about the role of the IMF. In the meantime, something of a consensus—the so-called "integrated" approach—has emerged within the IMF that places capital account liberalization as part of a comprehensive program of economic reforms in the macroeconomic policy framework, the domestic financial system, and prudential regulations. While few would disagree with the prudence and judiciousness of the new approach, it has proved to be difficult to apply as an operational guide to sequencing because it emphasizes all of the potential interlinkages but does not provide clear criteria for identifying a hierarchy of risks. Moreover, these views remain unofficial, as they have not been explicitly endorsed by the Board. The IMF still does not have a formal statement from the Board providing guidance on what its policy advice is, and a number of senior staff expressed unease about this lack of clarity on the IMF's formal position.

The IMF's country work

The evaluation reviewed the IMF's country work in a sample of emerging market economies and assessed its approach in terms of the following criteria: (1) Was there any difference between the IMF's general policy pronouncements and the advice it gave to individual countries? (2) Was the IMF policy advice operational and based on solid evidence? (3) How did the IMF's advice change over time, and did this change keep pace with available evidence? (4) Did the IMF give similar advice to countries in similar situations? and (5) Was the policy advice on the capital account set in a broader assessment of the authorities' macroeconomic policies and institutional framework?

The role of the IMF in capital account liberalization

During the 1990s, the IMF encouraged capital account liberalization in its country work, but the evaluation suggests that in all the countries that liberalized the capital account, partially or almost fully, the process was for the most part driven by the country authorities' own economic and political agendas. In none of the program cases examined did the IMF require capital account liberalization as formal conditionality, although aspects of it were often included in the authorities' overall policy package presented to the IMF. In the early years, the issues of pace and sequencing were seldom raised. Occasionally, staff expressed concern over financial sector weakness or macroeconomic instability, but this did not lead to operational advice to individual countries on pace and sequencing. From around 1994, and certainly after the Mexican crisis, some within the IMF became more cautious in their policy advice on capital account issues in country work, but it was only after the East Asian crisis that the whole institution's approach clearly changed. In later years, the IMF took a more cautious attitude toward capital account liberalization in country work, emphasizing pace and sequencing and the need to satisfy certain preconditions. Through much of the 1990s, there was apparent inconsistency in the IMF's advice on capital account liberalization (for example, sequencing was emphasized in some countries but not in others), suggesting that the staff took a pragmatic approach in country work in the absence of clear official guidelines. On the other hand, there was little systematic difference in terms of policy advice between program and nonprogram countries.

Advice on managing capital flows

As countries experienced large capital inflows and associated macroeconomic challenges in the 1990s, the question of how to manage large capital inflows became a routine subject of discussion between the IMF and the country authorities. The staff's policy advice on managing capital flows did not deviate much from the policy conclusions typically derived from the scholarly literature on open economy macroeconomics. To deal with large capital inflows, it advocated tightening fiscal policy and greater exchange rate flexibility. Advice on sterilization, in line with the conventional wisdom, emphasized its quasi-fiscal costs and its longer-term ineffectiveness but, to a surprising extent, was supportive of country authorities' policy choices, whatever they may have been. In a few instances, the staff also recommended further trade liberalization, liberalization of capital outflows, and tightening of prudential regulation as measures to deal with large capital inflows, but these and other structural measures received relatively little attention. In terms of detail and emphasis, the staff's views differed both across time and across countries, but country documents do not provide a clear analytical basis to make a definite judgment about the consistency of the IMF's overall advice on managing capital inflows.

Temporary use of capital controls

Use of capital controls has been a controversial subject, not only within the IMF but also in the academic and official policymaking communities. It is possible here to make a broad characterization that the IMF staff was in principle opposed to the use of such instruments, either on inflows or outflows. Its view was that they were not very effective, especially in the long run, and could not be a substitute

for the required adjustments in macroeconomic policies. Even so, from the earliest days, the IMF staff displayed a remarkable degree of sympathy with some countries in the use of capital controls. In a few cases, both before and after the crises of 1997–98, it even suggested that market-based controls could be introduced as a prudential measure. As a general rule, the IMF staff in its country work, in line with the evolution of the institution's view, became much more accommodating of the use of capital controls over time, albeit as a temporary, second-best instrument.

Ongoing country dialogue on capital account issues

In ongoing country work (as documented for 2003–04), IMF staff has been quite accommodating of authorities' policy choices when they have involved a gradual approach to capital account liberalization or temporary use of controls. In terms of capital account liberalization, the staff has sometimes been more cautious than the authorities (for example, Russia in 2003) when their preferred policy was to liberalize the capital account quickly. In most cases, the staff has taken a medium-term perspective and emphasized the importance of meeting certain preconditions, the most important of which are fiscal consolidation, a sound financial system, and the adoption of a floating exchange rate (usually with inflation targeting). There has been some variation across countries, however. For example, at least in one country (South Africa), the IMF staff has urged the authorities to move more quickly in removing the remaining restrictions in view of favorable external conditions.

In terms of advice on temporary use of capital controls, IMF staff seldom challenged the authorities' decision and even supported market-based controls in some cases. There was a slight difference in emphasis across countries. In a few countries (as in Russia in 2004), the staff expressed forcefully the view that capital controls, no matter how useful they might be in the short run, could not be expected to be effective over time and should not be used as a substitute for appropriate adjustment in macroeconomic policies. In others (as in Colombia), the use of controls introduced by the authorities did not figure prominently in policy discussions. In still other cases (as in Croatia), the staff recommended a market-based control, albeit as a last resort measure.

Overall assessment

These findings allow us to provide answers to the following fundamental and related questions: (1) Did the IMF pressure member countries to liberalize the capital account in the 1990s? and (2) Did the IMF encourage capital account liberalization prematurely, without ensuring that necessary institutions and regulations were in place to maximize its benefits and minimize its risks?

The answer to the first question is a definitive no, at least for the emerging market countries examined. In none of these countries did the IMF use the most binding tool of influence at its disposal: conditionality in the use of its resources. This is consistent with the interpretation of the Articles of Agreement, which states that the IMF, as a condition for the use of its resources, cannot require a member to remove controls on capital movements. In several program countries, however, aspects of capital account liberalization were included in the authorities' package of economic policies presented to the IMF. These may well reflect different degrees of "pressure" in specific instances, but the evaluation has not uncovered any such cases. In summary, the IMF undoubtedly encouraged countries that wanted to move ahead with capital account liberalization, and even acted as a cheerleader when it wished to do so, especially before the East Asian crisis, but there is no evidence that it exerted significant leverage to push countries to move faster than they were willing to go. The process of liberalization was often driven by the authorities' own considerations, including OECD or EU accession and commitments under bilateral or regional trade agreements.

The answer to the second question is less clearcut. Yes, the IMF did encourage capital account liberalization and this encouragement probably got ahead of the prevailing evidence in the early 1990s. At the same time, in so doing, it made the point of highlighting the risks inherent in an open capital account as well as the need for a sound financial system, even from the beginning. The problem was that these risks were insufficiently highlighted and the recognition of these risks and preconditions did not translate into operational advice on pace and sequencing until later in the 1990s (and even thereafter the policy advice has often been of limited practical applicability).

In this connection, it should also be noted that the IMF's analysis in the earlier period emphasized the benefits to developing countries of greater access to international capital flows, while paying comparatively less attention to the risks inherent in their volatility. As a consequence, its policy advice was directed more toward emerging market recipients of capital flows, focusing on how to manage large capital inflows and their boom-and-bust cycles. Little policy advice was offered, in the context of multilateral surveillance, on how source countries might help reduce the volatility of capital flows through regulatory measures on the supply

side. In more recent years, the IMF's analysis of supply-side factors has become more sophisticated, and the institution has also addressed the moral hazard aspect of investor behavior. Even so, the focus of policy advice remains on the recipient countries. Admittedly, this reflects the lack of a theoretical and empirical consensus on what practical steps could be taken in this area, but the IMF has played a relatively limited role in exploring options.

The evaluation suggests that the IMF has learned over time on capital account issues. This seems to have affected the work of the IMF through two channels. First, the IMF's general approach did respond—albeit gradually—to new developments or new evidence. Second, independent of how the general approach changed, some of the learning became more quickly reflected in the IMF's country work through its impact on individual staff members. As a result, in the case of capital account issues, the IMF's general approach lagged behind developments in some of the country-specific approaches taken in the field.

The lack of a formal IMF position on capital account liberalization and the associated partial disconnect between general operational guidelines and country work had different consequences. On the one hand, it gave individual staff members freedom to use their own professional and intellectual judgment in dealing with specific country issues. On the other hand, the disconnect reflected the inherent ambiguity of this aspect of the IMF's work on capital account issues and led to some lack of consistency in country work. Country work must of necessity be tailored to country-specific circumstances, so uniformity cannot be the only criterion for judging the quality of the IMF's policy advice. Even so, it appears that the apparent inconsistency to a large extent reflected reliance on the discretion of individual staff members, and not necessarily the consistent application of the same principles to different circumstances.

In more recent years, somewhat greater consistency and clarity have been brought to bear on the IMF's approach to capital account issues. For the most part, the new paradigm upholds the role of country ownership in determining pace and sequencing; takes a more consistently cautious and nuanced approach to encouraging capital account convertibility; and acknowledges the usefulness of capital controls under certain conditions, particularly controls on inflows. But these are still unofficial views, though they may well be widely shared within the institution. While the majority of staff members now appear to accept this new paradigm, some continue to feel uneasiness with the lack of a clear formal position by the institution.

Recommendations

The evaluation suggests two main areas in which the IMF can improve its work on capital account issues.

Recommendation 1. There is a need for more clarity on the IMF's approach to capital account issues. The evaluation is not focused on the arguments for and against amending the Articles of Agreement, but it does suggest that the ambiguity about the role of the IMF with regard to capital account issues has led to some lack of consistency in the work of the IMF across countries. This may reflect the lack of clarity in the Articles, but with or without a change in the Articles it should be possible to improve the consistency of the IMF's country work in other ways. For example:

- *The place of capital account issues in IMF surveillance could be clarified*. It is generally understood that while under current arrangements the IMF has neither explicit mandate nor jurisdiction on capital account issues, it has a responsibility to exercise surveillance over certain aspects of members' capital account policies. However, much ambiguity remains on the scope of IMF surveillance in this area. The clearest statement of the basis for surveillance of capital account issues is embodied in the 1977 Executive Board decision calling for surveillance to consider certain capital account restrictions introduced for balance of payments purposes, but the qualification limiting the scope to balance of payments reasons is too restrictive to cover the range of capital account issues that surface in the IMF's country work. On the other hand, the broader statement of the IMF's surveillance responsibility, found in the preamble to Article IV, is too wide to serve as an operational guide to surveillance on capital account issues. There would be value if the Executive Board were formally to clarify the scope of IMF surveillance on capital account issues. Such a clarification would recognize that capital account policy is intimately connected with exchange rate policy, as part of an overall macroeconomic policy package, and that in many countries capital flows are more important in this respect than current flows; capital controls can be used to manipulate exchange rates or to delay needed external adjustment; and a country's capital account policy creates externalities for other countries. Capital account policy is therefore of central importance to surveillance.
- *The IMF could sharpen its advice on capital account issues, based on solid analysis of the par-*

ticular situation and risks facing specific countries. Given the limited evidence that exists in the literature on the benefits or costs of capital account liberalization in the abstract, the IMF's approach to any capital account issue must necessarily be based on an analysis of each case. For example, if a capital control is involved, the IMF must ask in the context of a specific country what objectives the control is designed to achieve; if it is accomplishing them; and whether there are more effective or less distortionary ways of achieving the same objectives. Such assessments need to be set in an overall consideration of the macroeconomic policy framework and whether controls are being used as a substitute for, or to seek to delay necessary changes in, such policies. The evaluation indicates that this is already done in some but not all cases. If a capital control measure is judged useful to stem capital flight under certain circumstances, the IMF should ask what supporting policies are needed to make it more effective or less distortionary (for example, setting up a system of monitoring external transactions). In terms of providing advice on capital account liberalization, just to spell out all the risks inherent in opening the capital account is of limited usefulness to countries seeking IMF advice. To assist the authorities decide when and how to open the capital account, the IMF should provide some quantitative gauge of the benefits, costs, and risks (and, indeed, practicality) of moving at different speeds. Admittedly, this is not an easy task. Drawing on the well-established literature on welfare economics, the IMF must ask such questions as: What distortions are being created when one market is liberalized but not another? What is the nature of risks being borne by residents when capital account transactions are liberalized only for nonresidents? And what are the costs to the economy (in terms of investment flows) of allowing equity inflows but not debt inflows?

- *The Executive Board could issue a statement clarifying the common elements of agreement on capital account liberalization*. At present, there remains considerable uncertainty among many staff members on what policy advice to provide to individual countries. This has led to hesitancy on the part of some within the staff to raise capital account issues with country authorities. The Executive Board could provide clear guidance to staff on what the IMF's official position is. This is not to say that the Executive Board must come up with a definitive statement on all aspects of pace and sequencing. Given the lack of full consensus, one should not expect such a definitive view from the Board. However, Board guidance on what are the minimum common elements on which there is broad, if not universal, agreement would be useful to the staff and member countries. Although the details are for the Board to decide, such a statement might include some or all of the following elements: (1) that in a first-best world there would be no need for controls over capital movements (though financial markets may not always operate accordingly); (2) that controls should not be used as a substitute for adjusting macroeconomic or structural policies; (3) a broad (as opposed to unnecessarily complex) framework of sequencing based on the consensus in the literature on the order of economic reforms; (4) the importance of taking country-specific circumstances into account; and (5) that risks can never be totally eliminated, so they should not be used as a reason for permanently delaying liberalization.

Recommendation 2. The IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and what can be done to minimize the volatility of capital movements. The IMF's policy advice on managing capital flows has so far focused to a considerable extent on what recipient countries should do. While this is important, it is not the whole story. As discussed in the evaluation report, the IMF's recent analyses have given greater attention to supply-side factors, including the dynamics of boom-and-bust cycles in emerging market financing. The IMF has also established an International Capital Markets Department (ICM) as part of an effort to better understand global financial markets; it participates actively in the work of the Financial Stability Forum, which was established to monitor potential vulnerabilities in global financial markets; and it has proposed a Sovereign Debt Restructuring Mechanism (SDRM), encouraged the use of collective action clauses (CACs), and has attempted to place limitations on countries' access to IMF resources in a crisis, in an effort to reduce the perceived moral hazard that may have led capital markets to pay insufficient attention to the risks of investing in developing countries and contributed to the boom-and-bust cycles of capital movements. These are important and welcome initiatives, but the IMF has not yet fully addressed issues of what, if anything, can be done to minimize the volatility of capital flows by operating on the supply side— as yet, little attention seems to be paid to supply-side risks and potential mitigating actions in the industrial countries that are home to the major global financial markets. The IMF could usefully provide more input into ad-

vanced country financial supervision and other financial market policy issues globally. Are current global supervision guidelines designed to help create stability?[1] What if any action could be taken on the supply side to reduce cyclicality and herd behavior? Admittedly, this is a difficult topic on which little professional consensus exists. Yet, this is an area where a significant debate has taken place in the academic and policymaking communities and to which the IMF could contribute further. Indeed, one of the broad themes identified as potential priorities for the IMF's research program over the medium term—on institutions and contractual mechanisms that can help protect countries from external volatility—goes some way in this direction, but should not focus only on policies in countries that are recipients of capital inflows.

[1]To give one example where the IMF did provide such inputs, in July 2003, the staff commented on the proposed New Basel Capital Accord (Basel II), pointing to its potentially procyclical effects.

APPENDIX
I A More Detailed Assessment of Some Country Cases

This appendix presents four specific contexts in which the IMF interacted with member countries in terms of their capital account policies: (1) the Czech Republic, which liberalized the capital account relatively quickly in the mid-1990s; (2) Colombia, which introduced market-based controls to deal with large capital inflows during much of the 1990s; (3) Venezuela, which introduced controls on capital outflows in 1994 and 2003; and (4) Tunisia, which has pursued a gradual approach to capital account liberalization. These four cases are chosen for diversity of experience and are designed to illustrate what the role of the IMF was in each case and how the IMF viewed different policy issues regarding the capital account. Although we briefly explain the policy measures taken by the authorities to give context, the focus remains on the IMF.

The Czech Republic: Liberalization in a Transition Economy

Capital account liberalization

At the beginning of the transition process, Czechoslovakia was the most centrally planned economy in Central Europe (Bakker and Chapple, 2003). This in part explains the authorities' general propensity for rapid reforms, aided by recourse to foreign capital (Blejer and Coricelli, 1995). Following the division of the country into two republics, in 1993, the Czech authorities began to map the steps toward capital account liberalization. According to a number of former officials interviewed, the process was largely driven by the country's prospective accession to the OECD and the EU.[1] The liberalization of capital transactions, which initially proceeded through a progressively liberal application of existing controls (first on banks and then on firms), was virtually completed in October 1995 with the enactment of a new Foreign Exchange Act.

[1]The Czech Republic signed an association agreement with the EU in October 1993 and became the first transition country to join the OECD at the end of 1995.

Some restrictions did remain (mostly on the outflow side but some on inflows), including restrictions on the issuance of debt and money market securities abroad by residents and on foreign securities transactions executed through domestic agents. Moreover, the new Foreign Exchange Act enacted in 1995, while codifying the framework for a liberal foreign exchange regime, included a provision under which the authorities could introduce an unremunerated reserve requirement on nonresident deposits if necessary.[2]

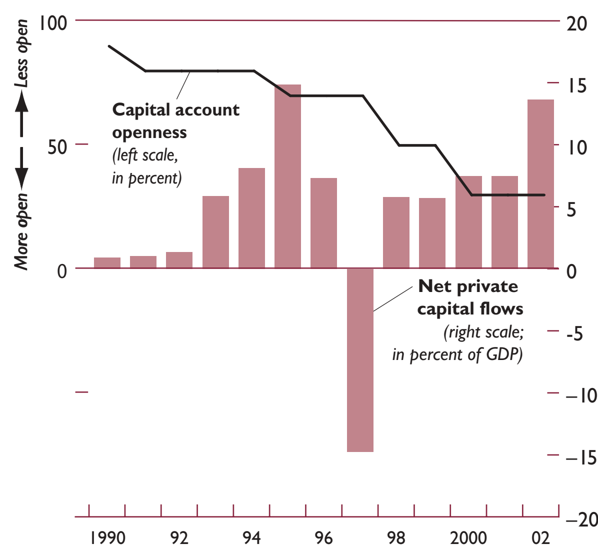
The remaining restrictions were eliminated within the framework of a plan agreed with the EU. In February 1996, the Czech Republic, in formally applying for EU membership, adopted a tentative five-year plan for full capital account liberalization, which was revised in mid-1998 in the light of the 1997 currency crisis (see below). The authorities lifted the restrictions on foreign security transactions in 1999, those on the issuance of debt securities abroad by residents in 2001, and the ban on purchases of agricultural land by nonresidents in 2002. In this manner, the Czech Republic virtually completed the full liberalization of the capital account before joining the EU in May 2004.

Policies to deal with capital flows

With the progress of capital account liberalization, a large amount of foreign capital flowed into the country (Figure A1.1). The authorities responded to the surge in inflows by taking various measures, including sterilization and increases in reserve requirements. Monetary policy assumed most of the burden of adjustment, however, and fiscal policy remained loose. In late 1994, the nature of capital inflows evidently turned more speculative, with a shift from long-term external borrowing by Czech companies to inflows of nonresident bank deposits. A staff memorandum of November 1994 stated that the authorities at this time considered introducing capital controls, though the idea was overruled by the

[2]This provision has never been activated.

Figure A1.1. Czech Republic: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.
[1]Net foreign direct investment, net private portfolio investment, and net private other investment.

prime minister. In 1995, the authorities introduced measures targeting short-term speculative inflows:[3] a foreign exchange transaction fee in April and a limit on banks' net short-term liability positions to nonresidents in August.[4] These measures, however, remained largely ineffective, with net private capital inflows in 1995 amounting to as much as 15 percent of GDP.

In early 1996, capital inflows began to slow, coinciding with the decision by the authorities to widen the fluctuation band of the exchange rate peg in February (from 0.5 percent on either side of parity to 7.5 percent). Capital inflows continued to decline throughout 1996, and a sharp reversal in 1997 culminated in a currency crisis. Responding to the situation, in April 1997 the authorities announced a package of tight macroeconomic policies designed to restore internal and external balance. After a brief respite, the currency soon began to fall again, forcing the authorities to abandon the exchange rate peg[5] and to strengthen the macroeconomic policy package in May 1997. In the event, these measures allowed the Czech Republic to pull itself out of the crisis rather quickly despite the turbulence in East Asia, and the exchange rate stabilized after a modest depreciation of 10 percent from the original parity. The country was relatively unaffected by contagion from the subsequent East Asian and Russian crises.

When the economy recovered in 1998, the authorities revised their strategy toward foreign capital flows in favor of an explicit promotion of FDI. Recognizing the weak corporate governance and low productivity of firms that had resulted from a mass (voucher) privatization scheme, the authorities introduced measures to encourage more concentrated shareholding, followed by attempts to sell the entities to foreign strategic investors (OECD, 1996 and 1998). In addition, they introduced a foreign investment incentive scheme and offered subsidies to qualified greenfield projects. Thanks to the new FDI incentive scheme, the Czech Republic again began to receive large capital inflows, this time mainly driven by FDI, while there remained a net outflow of short-term capital.

The IMF's views of capital account measures

The process of capital account liberalization was initiated by the Czech authorities. As noted, it was in part motivated by the country's prospective accession to the OECD and the EU, and the explicit role of the IMF was consequently rather limited, except to endorse the decisions taken by the authorities. The country's first and only Stand-By Arrangement with the IMF, agreed in 1993 and treated as precautionary, made no reference to capital account liberalization.[6] The IMF, however, expressed a range of views on capital account measures taken by the authorities throughout the period.

In the early 1990s, in keeping with the predominant thinking of the time, the IMF was clearly encouraging the authorities to liberalize the capital account rapidly. By 1994, however, the attitude of the area department staff had become more cautious, particularly as the banking sector weaknesses came to the surface. A briefing paper of May 1994 supported the authorities' decision to liberalize the capital account "in a phased manner," given the problems in the banking system and the volatility of capital flows.[7] The area department's views became even more cautious following the Mexican

[3]In early 1995, there were signs of informal tightening of capital inflow controls. A staff memorandum, for example, noted a sharp decline in approved capital transactions.

[4]The first measure was abolished in May 1997 and the second measure in November of the same year.

[5]Inflation targeting was formally adopted in December 1997.

[6]The LOI included the intention of the authorities to "extend" current account convertibility by dismantling restrictions on current account transactions. In the context where the country had not yet accepted the obligations under Article VIII, the focus of IMF support was necessarily placed on the liberalization of the current account.

[7]Interestingly, the paper also noted that the authorities had adopted a gradual approach to capital account liberalization, "following a well-publicized debate."

crisis. A briefing paper of April 1995 expressed the view that "unduly quick liberalization [of capital outflows], for short-term easing of the capital inflow pressure" would create vulnerability to crisis and proposed that the mission not press for more ambitious liberalization of capital outflows than was then envisaged.

MAE and PDR, however, remained sanguine. From late 1994 to early 1995, MAE, through its technical assistance work, continued to emphasize the benefits of removing all remaining controls, citing their ineffectiveness. In February 1995, a technical assistance report stated that both administrative and market-based capital controls had proved to be ineffective except in the very short run, by appealing to the experience of other countries.[8] Commenting on the April 1995 briefing paper, PDR opposed the cautious approach of the area department and argued for a continued liberalization of remaining outflow restrictions. Management's comments on the paper emphasized the need to be pragmatic in order to avoid an early reversal of policies.

A similar evolution can be seen in the attitude of the area department staff toward use of capital controls. By 1995, when capital controls reemerged as a topic for policy discussion, the staff's earlier ambivalence was gone. The staff report for the 1995 Article IV consultation stated that "[given] the political constraints on the early use of other instruments of policy, the introduction of capital controls had become unavoidable." It added, however, that capital controls should be market based and nondiscriminatory across borrowers, and should be limited to short-term inflows; and they should be seen as a temporary measure intended to buy time for more fundamental correction in policy, "given the likely progressive leakages over time" and the associated allocative inefficiency.

The staff report for the 1996 Article IV consultation took the view that capital controls on short-term inflows had "helped lengthen the maturity of banks' foreign liabilities," though they had been "less successful in limiting the total volume of capital inflows." Judging from the comments on briefing papers and minutes of Board discussions, it appears that management was more skeptical of capital controls. The Executive Board, on the other hand, was generally more sympathetic, though several Directors questioned the effectiveness of capital controls and argued that use must be temporary.

[8]Monetary and Exchange Affairs Department, "Issues Related to External Liberalization," February 1995. The earlier back-to-office report noted that the mission had argued for a "more decisive" program of liberalization and helped "strengthen the hand of those in favor of more rapid liberalization."

Throughout much of this period, capital inflows were an important topic of discussion between the staff and the authorities.[9] In late 1994, the staff thought that the inflows were being mainly driven by large interest rate differentials and demand by Czech companies for long-term credit. On the grounds that these factors reflected the banking sector's limited ability to intermediate, it argued that the authorities should not only further liberalize outflow controls but also improve the banking sector. In the 1995 Article IV consultation discussions, the staff argued that there was room for sterilization, because capital inflows were no longer primarily driven by interest rate differentials. Throughout the period, the staff's consistent position was that tight fiscal policy was desirable.

As to exchange rate policy, the staff supported the authorities' policy of resisting any appreciation of the exchange rate.[10] In fact, the staff did not advise the authorities to increase exchange rate flexibility until 2000. As noted earlier (Chapter 3, the section "Temporary Use of Capital Controls"), part of this reflected the staff's assessment that most of the gains in competitiveness from the initial depreciation had been lost by 1995, and that any nominal appreciation should be avoided in order to maintain competitiveness. The staff did mention that an exchange rate band could be a useful exit mechanism from the peg, but did not consider that a period of large capital inflows should be the time to attempt an exit as it would surely result in further appreciation. The staff report for the 1995 Article IV consultation noted: "While the introduction of a band might provide some help in stemming the capital flows, it would result in an immediate stepped-up real appreciation of the currency that would further worsen the external balance."[11] As late as 1999, the staff continued to argue that "any significant upward pressures on the exchange rate (potentially arising from substantial foreign direct investment inflows related in part to the planned privatization) should be resisted."

[9]At least 12 staff memoranda were prepared on the subject between 1993 and 1997.

[10]The staff report for the 1995 Article IV consultation offered commentary on the reluctance of the Czech authorities to allow the exchange rate to appreciate: "They are very conscious of the experience in the 1920s when revaluation of the currency in response to heavy capital inflows induced by successful stabilization was followed by an export slump and banking crisis that required the Government to step in."

[11]In discussing this report, however, some Executive Directors disagreed with the staff assessment and called for greater exchange rate flexibility and an appreciation of the koruna. The staff report for the 1996 Article IV consultation notes that, following the Board discussion, the staff adopted "that position during follow-up discussions with the authorities in November 1995, after taking into consideration revised data that mitigated concerns about export performance," but it appears that the staff's support for exchange rate flexibility disappeared quickly.

Box A1.1. Hungary

Hungary took a gradual approach to capital account liberalization. It first liberalized FDI. Liberalization of portfolio investment began toward the middle of the 1990s in the context of OECD accession, which culminated in the Foreign Exchange Act of 1995. It continued, however, to maintain controls on short-term capital inflows, notably restrictions on purchases of short-term domestic instruments by nonresidents and restrictions on external lending to nonresidents by residents in the domestic currency. The authorities clearly stated at that time that the final step to full capital account convertibility should be taken only after the system of regulation and prudential supervision was firmly in place for banking and securities market activities. This was achieved in June 2001, when Hungary eliminated the remaining restrictions and at the same time widened the exchange rate band substantially (from 2.25 percent to 15 percent).

The process was largely defined by the country's political agenda and institutional capacity. In line with the established practice, none of the three successive IMF-supported programs with Hungary in the 1990s included conditionality related to capital account liberalization. However, the LOI for the 1991 extended arrangement included the authorities' intention to encourage foreign participation in the banking sector and in the privatization process. Likewise, the LOI for the 1993 SBA referred to the prospective Foreign Exchange Act, which would provide the basis for continuing "the process of liberalization of the trade and exchange system"; the LOI for the 1996 SBA indicated their intention to take measures to "facilitate a further liberalization of capital flows." In this manner, the IMF supported the country's overall strategy of capital account liberalization.

Some experts have argued that prolonged use of capital controls explains the resilience Hungary demonstrated through the turbulent years of the late 1990s (Nord, 2003). The country was little affected by the East Asian crisis, and it had little difficulty in managing the contagion from the Russian crisis. Others, however, have emphasized the importance of sequencing (Ishii and others, 2002). Hungary began banking reform from the late 1980s and allowed a significant presence of foreign banks from the beginning (Szakadat, 1998). Moreover, the negative legacy of the socialist era (characterized by large fiscal and external deficits) was much greater in Hungary than in other central European countries, causing the country to experience an economic crisis relatively early in the transition process, in late 1994. As a result, it was able to undertake many of the necessary but painful macroeconomic and microeconomic reforms before embarking on capital account liberalization.

The Hungarian experience is instructive not only for the sequencing the country took but also for illustrating how the IMF viewed capital account issues during this period. When there was a surge in short-term capital inflows in early 1996, the IMF staff considered the main cause to be the large interest rate differential under a narrow crawling peg. When the authorities began to consider introducing capital controls, the staff was divided on the issue. A staff memorandum of March 1996 suggests that the area department, along with PDR and RES, took an accommodating view of market-based controls, while MAE was adamantly opposed. When in early 1999 a law was enacted to allow the introduction of a reserve requirement on nonresident bank deposits, the IMF had already unified its position. The staff unanimously supported the right of the authorities to activate the measure in the event of a surge in short-term capital flows.[1] After the economic crisis of 1994, Hungary maintained reasonable fiscal discipline. This is why the IMF staff's advice of fiscal tightening was not as consistent as in many other countries. Rather, the staff consistently argued for a move to greater exchange rate flexibility.

[1]The reserve requirement was stipulated to be at below-market yields. In the event, this has never been activated, with the rate maintained at zero.

Assessment

The Czech Republic relatively quickly lifted most restrictions on capital inflows while its fiscal policy remained expansionary, its banking system was weak, and it maintained a fixed exchange rate regime. This experience can be contrasted to that of Hungary, which followed a more gradual and sequential approach to capital account liberalization (see Box A1.1). A number of experts consulted by the evaluation team have expressed the view that these factors, and not the mere fact that the capital account was liberalized, explain why a currency crisis took place in the Czech Republic in the spring of 1997. This is not to minimize the risk of opening the capital account with a weak banking system. As it turned out in the Czech Republic, the costs of bailing out the banking system amounted to more than 10 percent of GDP.

The IMF staff initially encouraged the Czech authorities to liberalize the capital account rapidly but it soon recognized that there were weaknesses in the banking system and pressed for banking reform from an early stage. The problem was that the staff did not translate this recognition of the banking sector weakness into operational advice on the pace and sequencing of capital account liberalization, for example, by suggesting that the authorities slow down

the pace of liberalization. The staff generally did not favor greater exchange rate flexibility before the currency crisis of 1997, in part owing to its view that the gains in competitiveness from the initial gains had been eliminated and that any movement would be in the direction of appreciation once the exchange rate was allowed to float.

The staff's country work in the Czech Republic reflected the changing views of the risk of capital account liberalization within the profession, much more quickly than the general policy guidelines emanating from the IMF's headquarters. Soon after the Mexican crisis, even before its full implications were widely discussed, the staff began to take a cautious approach to further capital account liberalization, particularly on the outflow side, and became more accepting of measures to control short-term capital inflows.

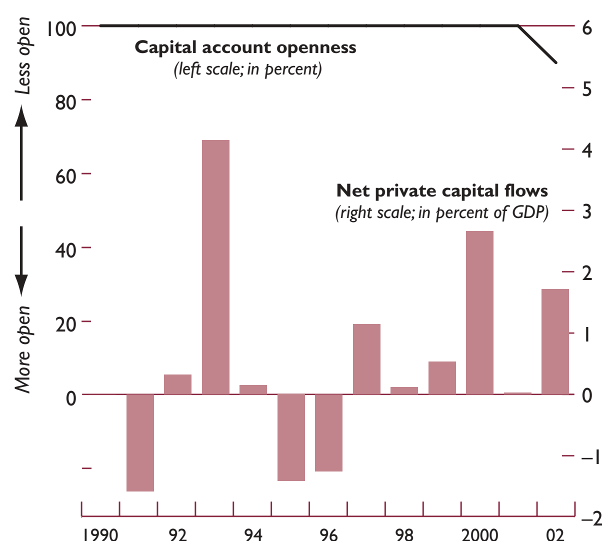
In terms of policies to deal with large capital inflows, the staff consistently advised the authorities to tighten fiscal policy, but to no avail. The staff should have given a greater warning about rapid capital account liberalization and begun to advise alternative policy measures, such as greater exchange rate flexibility, when it was evident that its preferred policy was unlikely to be followed. In retrospect, the staff underestimated the contribution of the fixed exchange rate to the capital inflows. The IMF staff should have argued for greater exchange rate flexibility in the mid-1990s when the pace of speculative inflows picked up, regardless of its fiscal policy advice.

Colombia: Market-Based Controls on Inflows

Colombia's unremunerated reserve requirement

In September 1993, the Colombian authorities introduced an unremunerated reserve requirement (URR) on external borrowing. At the time, the authorities were concerned with the large capital inflows, the pace of which had picked up as the authorities accelerated the opening of the economy (Figure A1.2). In 1991, for example, regulations on inward foreign investment were relaxed; in 1992, restrictions on long-term external borrowing as well as purchases of domestic assets by foreign investment funds were substantially eased. Responding to the surge in capital inflows, the authorities took various measures, including sterilization, further import liberalization, and easing of capital outflow restrictions. The authorities also allowed the Colombian peso to appreciate somewhat and, in 1991, introduced a 3 percent withholding tax on transfers and nonfinancial private services (the rate was increased to 10 percent in 1992), but the inflows increased sharply in 1993. It was under these conditions that the authorities introduced the URR, which was modeled after a similar measure introduced earlier by Chile.

Figure A1.2. Colombia: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.
[1]Net foreign direct investment, net private portfolio investment, and private other investment.

The URR was a system requiring that a designated percentage of foreign loans with a maturity of less than a designated maximum be kept as a deposit at the central bank, at zero interest for a designated holding period (Ocampo and Tovar, 1999). Alternatively, the deposit could be redeemed immediately by paying the equivalent cost calculated at a preestablished discount rate. Initially, exemptions were made for certain loans and credit transactions, including loans to finance the import of capital goods, trade credits with a maturity of up to six months, credits to finance investment abroad, and capital inflows related to privatization and concessions. FDI was never subject to the URR.[12]

The URR was a market-based measure and, in this respect, was very much in line with the country's overall strategy of economic liberalization. In fact, as the authorities introduced the URR, they concurrently eliminated most remaining administrative controls on capital movements. For example, surrender requirements on services and transfers

[12]This exemption created an incentive to substitute FDI for debt, for example, by establishing a holding company in a tax-haven country. External borrowing by such holding companies and their transfer of funds to Colombian firms were regarded as FDI.

Table A1.1. Colombia: The Unremunerated Reserve Requirement, 1993–2000

Effective Date	Maximum Applicable Maturity	Deposits	
		Holding period (In months)	Applicable share (Percent of loan)
September 1993	18	12	47
March 1994	36	12	93
		18	64
		24	50
August 1994	60	Variable[1]	43–140[2]
February 1996	48	Variable[1]	10–85[3]
March 1996	36	18	50
March 1997	60	18	50
May 1997	Eliminated[4]	18	30
January 1998	. . .	12	25
September 1998	. . .	6	10
May 2000	. . .	. . .	0

Source: Banco de la República.
[1]Corresponded to the maturity of the loan.
[2]The maximum rate applied to loans with a maturity of 30 days or less.
[3]The maximum rate applied to loans with a maturity of 180 days or less.
[4]The URR was made applicable to all foreign loans irrespective of maturity.

(except for interest and profits) were eliminated. At the same time, surtaxes on remittances of earnings from foreign investments were reduced, and approval was granted to lending denominated in foreign currency and hedging operations by foreign exchange intermediaries.

Initially, the URR was set at 47 percent for one year, applicable to external borrowing with a maturity of up to 18 months. Depending on the strength of capital inflows, the URR was tightened from time to time (see Table A1.1 for details). During 1994, for example, the applicable maturity was lengthened to 60 months, and the share of a loan subject to the URR was raised to 43–140 percent.[13] After some easing in early 1996, in March 1997 the authorities raised the maturity of external borrowing subject to the URR back to 60 months. In May 1997, the system was switched to a Chilean-style URR (in which no maximum maturity is specified), with the loan share of 30 percent for 18 months (except that, unlike the Chilean system, the deposit needed to be made in domestic currency).[14] Following the East Asian crisis, in 1998, the authorities eased the URR and, in May 2000, reduced the applicable loan share to zero.[15]

[13]At the same time, all foreign investments unrelated to tourism or plant and infrastructure were prohibited.
[14]A senior official interviewed by the evaluation team gave simplicity as the reason for the change.
[15]Although the share of a loan subject to the URR is currently set to zero, the URR as a control system still exists.

The IMF's stance on the URR

Initially, IMF staff was not opposed to the URR itself. During a staff visit of early 1994, however, the mission cautioned the authorities against introducing any additional control measures in the absence of fiscal tightening. During the 1994 Article IV consultation, the mission took the view that the effects of the URR were likely to be limited in reducing inflation and preserving competitiveness. Thus, it argued for a tighter fiscal policy, further liberalizing trade and reducing labor market rigidities. The staff also suggested that restrictions on external borrowing were increasingly being circumvented, and that these could not only inhibit productive investment but also send a wrong signal to the markets. According to the Summing Up of the Executive Board meeting, "A few speakers encouraged the authorities to remove the recent restrictions on external borrowing, but others considered that capital controls—despite their shortcomings— would be an acceptable temporary response to capital inflows."

At the time of a staff visit in mid-1995, the mission argued that contagion from the Mexican crisis had been limited because of Colombia's tight monetary policy stance and restrictions on external borrowing introduced in August 1994. In view of the emerging pressure on the foreign exchange and stock markets associated with a political crisis, the staff recommended a tightening of both fiscal and monetary policies. During the 1995 Article IV consultation, the staff argued that, given the slowdown in cap-

ital inflows, the authorities could ease restrictions on external borrowing, while noting that if such a measure were reinforced by fiscal tightening, it would likely ease pressure on domestic interest rates. At the Executive Board meeting, some Directors argued for a phased relaxation of the restrictions on external borrowing, accompanied by a tighter fiscal policy.[16]

An intensification of political difficulties further diminished the prospect for fiscal adjustment in 1996, and the central bank came under intense pressure to ease liquidity conditions. The easing of the URR in early 1996 took place in this context. The situation, however, quickly changed as capital inflows seemed to pick up again toward the end of the year. In January 1997, the government announced a package of "economic emergency" measures, including a tax on capital inflows (which would be levied in addition to the URR). When the tax was ruled unconstitutional by the Constitutional Court in March 1997, the authorities immediately responded by tightening the URR.

In the briefing paper for the 1997 Article IV consultation, the staff expressed the view that the recurrent use of capital controls in Colombia had served mainly to crowd out the private sector and had only bought time for the policymakers to strengthen the fundamentals; but that tightening of restrictions on external borrowing could temporarily help ease upward pressure on the real exchange rate and shift the composition of borrowing in favor of longer-term maturities. During the consultation discussions, the staff noted that the effectiveness of capital controls was likely to be eroded over time and continued to argue for fiscal tightening, which would help create conditions for a gradual relaxation of the restrictions on external borrowing. At the Executive Board meeting, Directors emphasized that fiscal consolidation was critical to avoiding a further real appreciation of the currency, while some Directors expressed concern over the recent broadening of restrictions on foreign borrowing.

The East Asian crisis of 1997–98 drastically changed the external environment faced by Colombia. Owing to pressure on the peso, the country lost a substantial amount of foreign exchange reserves. During the 1998 Article IV consultation, the IMF staff encouraged an elimination of the tax on profit remittances and other restrictions in order to promote capital inflows. The staff and the Board welcomed the easing of the URR and the subsequent floating of the currency in September 1999.

[16]The Colombian representative stated at the January 1995 meeting that the restrictions on external borrowing would remain for some time because, as in the case of Chile, they could help deter short-term speculative inflows and thereby moderate an appreciation of the currency.

Assessment

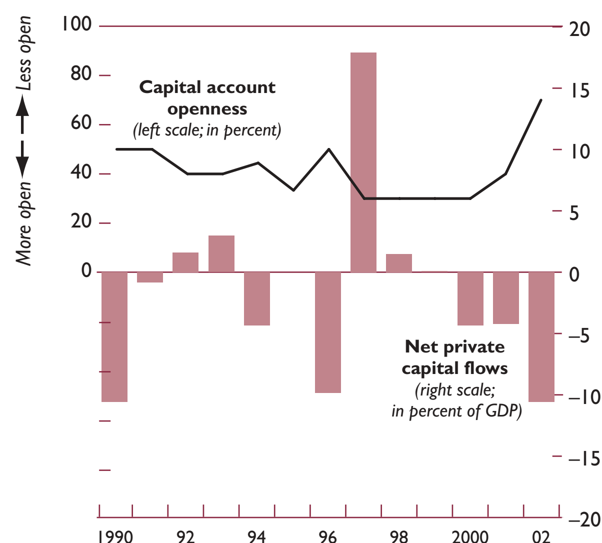
It is difficult to assess the effectiveness of the Colombian URR because its intensity changed over time and, while it was in place, fiscal policy was expansionary and some administrative controls on external borrowing remained.[17] The IMF staff's view of the URR seemed to moderate over time. It was not initially opposed to the URR. This may have reflected the staff's understanding that the URR in Colombia was a tool to manage the transition from an administrative control regime to a liberal one: the URR was introduced as a number of administrative controls were lifted.

The view then turned negative, and it was some time before the staff recognized the potential usefulness of the URR as a temporary measure, in line with the evolution of the institution's general thinking on the temporary use of capital controls. The Executive Board, on the other hand, was more consistent, although the composition of views may well have shifted: there were always some Directors who recommended a relaxation of the URR, while there were also others who were more supportive of the measure. The gradual moderation of the staff's negative view toward Colombia's URR, however, failed to highlight the fact that it was in fact used as a substitute for the needed correction in fiscal policy.

In fact, IMF staff consistently advised fiscal tightening as the most effective measure to mitigate the pressure on real appreciation created by the large capital inflows. Political constraints proved formidable, however, and did not allow the Colombian authorities to pursue successfully the IMF's preferred strategy. When this became evident, IMF staff could have suggested other policy options to complement fiscal tightening. Admittedly, that would have been a difficult task. To advise a tightening of the URR could have been counterproductive and highly distortionary, given the loose fiscal policy. On the other hand, to advise an elimination of the URR would not have served the purpose of controlling the capital inflows. Greater exchange rate flexibility—going beyond the crawling band of 7 percent introduced in January 1994—may well have been the only sensible policy alternative available at the time, and the staff could have pushed harder for this policy. In the event, it only continued to insist on fiscal tightening.

[17]If one could isolate the impact of the URR from those of other factors, it may well be that the URR was effective in limiting capital inflows and lengthening their composition when it was intensely applied. Some recent research seems to support such a conjecture (e.g., Ocampo and Tovar, 1999 and 2003; Villar and Rincon, 2003).

Figure A1.3. Venezuela: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.
[1]Net foreign direct investment, net private portfolio investment, and net private other investment.

Venezuela: Use of Capital Controls on Outflows

Controls on capital outflows in 2003

In February 2003, the Venezuelan authorities introduced temporary comprehensive foreign exchange controls on both current and capital transactions. The decision was made in an environment of great political uncertainty and economic difficulties, which had resulted in large capital outflows (Figure A1.3), and followed an earlier decision to suspend foreign exchange trading temporarily in late January. At the same time, the exchange rate was fixed (to be devalued by 20 percent a year later), and price controls were also introduced. This was the second time Venezuela had introduced capital outflow controls in recent years, the previous occasion being in June 1994 (Quirk and others, 1995; Ariyoshi and others, 2000).[18]

The control regime worked in the following way. First, all foreign exchange proceeds needed to be surrendered to the central bank. Second, foreign exchange was allocated, with priorities given to the import of basic goods, foreign debt service, and repatriation of profits and dividends. In view of concerns over possible misuse of discretionary powers, the authorities made it clear that the system of foreign exchange allocation would be managed in a transparent manner. In addition, they stressed from the beginning that the imposition of foreign exchange controls was a temporary emergency measure and that the controls would be gradually relaxed and eventually eliminated as foreign exchange earnings from state oil exports were restored. The system was considerably eased in 2004, when a wider coverage of transactions was made eligible for foreign exchange allocation.

The 2003 system of foreign exchange controls was designed to minimize the problems encountered under an earlier system. In the system introduced in June 1994, the exchange controls also covered both current and capital account transactions; capital outflows unrelated to the amortization of external debt and the repatriation of capital by nonresidents were prohibited; foreign exchange earnings were to be surrendered to the central bank; and limits were set on the allocation of foreign exchange for education, travel abroad, and family remittances, and for transfers of profits from certain investments. However, there was considerable evasion of capital controls through permitted current account transactions. Thus, the authorities came to the conclusion that an effective system of controls over capital account transactions required a more comprehensive arrangement for monitoring all foreign exchange transactions.

How the IMF viewed the capital controls

According to a memorandum of February 2003, the staff thought that the new control regime would give rise to a parallel foreign exchange market and an arbitrary system of foreign exchange rationing that could be subject to political manipulation.[19] The briefing paper for a subsequent fact-finding mission noted the staff view that a flexible exchange rate system should be introduced and foreign exchange restrictions on current transactions eliminated. The staff, however, believed that capital controls might be necessary in the short run in order to reduce pressure on the exchange rate, the balance of payments, and the banking system.

In evaluating the IMF's views of the capital controls in Venezuela, it is important to keep in mind that the control regime also covered exchange controls on current account transactions, which are subject to IMF approval under Article VIII. In this respect, the position of the IMF staff in 2003–04 is strikingly different from the position taken earlier. During 1994–96, the staff took the position that all exchange controls—both for current and capital

[18]The first occasion was also in the context of political uncertainty, accented by an evolving banking crisis and declining oil prices.

[19]A parallel foreign exchange market did emerge, in part supported by residents' access to the ADR market in New York.

transactions—should be eliminated, along with the restoration of a flexible exchange rate regime.[20] While it was willing to accept a *gradual* elimination of capital controls as oil revenues were restored, its view on the desirability of restoring full capital account convertibility was unambiguous. In response to the concern of the authorities that an elimination of capital controls might lead to capital flight, the staff stated that capital outflows would not result if tight fiscal policy was maintained[21]—a view broadly endorsed by the Executive Board in its discussion of the 1994 Article IV consultation. In the context of a negotiation for a Stand-by Arrangement from 1995 to 1996, the staff proposed a "two-stage approach involving the immediate liberalization of most current account transactions accompanied by the gradual liberalization of capital transactions."[22]

In contrast, in 2003, the IMF staff was much more accommodating of capital controls, though it firmly opposed the maintenance of exchange controls for current transactions. As part of an overall strategy to eliminate foreign exchange controls, the mission supported a floating exchange rate mechanism for all current transactions, an export surrender requirement to the domestic interbank market (as opposed to the central bank), and, if necessary, explicit controls on capital outflows. The staff argued that, given the aim of capital controls to reduce capital flight, controls should focus on capital outflows, while other controls should be eliminated to reduce the adverse impact on domestic real activity.

During the 2004 Article IV consultation, the IMF mission urged the authorities to reinstate a floating exchange rate regime and to remove all restrictions subject to Article VIII or indicate a timetable for doing so. The mission also argued for a gradual elimination of most capital controls, stressing that the process must be well sequenced and supported by reforms in fiscal, monetary, and exchange rate policies, including the adoption of inflation targeting. Given the comfortable international reserve position, the mission urged the authorities rapidly to eliminate foreign exchange controls on all current account transactions and to develop a strategy for eliminating "the majority" of capital controls. The authorities in principle agreed with the staff position, though they preferred a somewhat slower pace of liberalization and stressed the importance of political developments in determining the precise timing. The elimination of capital controls would come later, except perhaps for controls on short-term flows.

Assessment

The IMF's position on the 2003 system differed from that on the 1994 system in an important respect. On both occasions, the IMF opposed the imposition of foreign exchange controls on current transactions, which are subject to IMF approval under Article VIII. In terms of controls on capital outflows, the IMF's position in 2003 was much more accommodating. The IMF staff was willing to see at least some of the control measures, particularly on outflows, as part of Venezuela's foreign exchange regime.[23] In 1994, on the other hand, the IMF had argued for a full elimination of capital controls, although it was pragmatic enough to recognize the virtue of gradual liberalization.

The positions taken by the staff on two occasions certainly reveal how the views of the IMF on the use of capital controls has changed over the years. At the same time, they also highlight the reluctance IMF staff now seems to feel about expressing its position forcefully on capital control issues. Not all capital controls can be appropriate tools of economic policy under all circumstances. The appropriateness of a particular capital control measure must be judged on the basis of an assessment of the overall macroeconomic policy and institutional framework under which it is introduced. In 1994, the staff had judged the capital controls to be inappropriate, given the unsustainable macroeconomic policies, and argued that their elimination would not lead to capital flight if supported by tight macroeconomic policies. In 2003, no such assessment of the place of capital controls in the overall macroeconomic policy framework was offered.

Tunisia: Gradual Liberalization

Capital account liberalization

Tunisia has pursued a gradual approach to capital account liberalization since the mid-1990s. Considerable de facto liberalization has taken place but, as

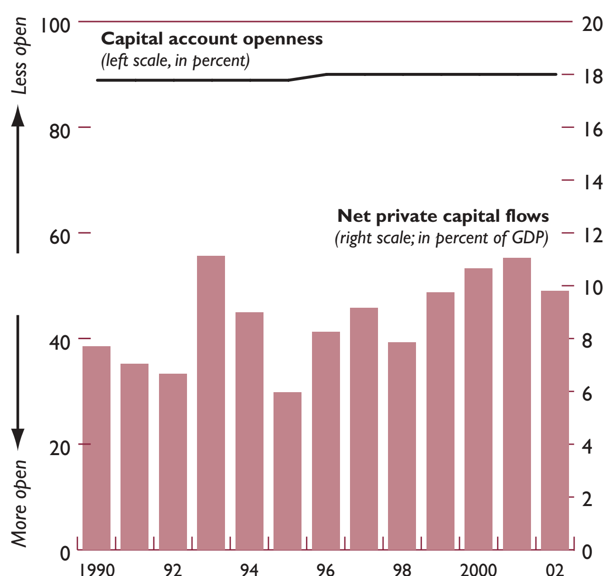
[20]The back-to-office report of July 1994 expressed the initial reaction of the staff that the price and exchange controls would "introduce serious distortions without really restraining exchange rate and price pressures."

[21]From 1993 to 1994, Venezuela's fiscal deficit deteriorated sharply to 7.3 percent of GDP from 2.9 percent of GDP; inflation increased from 38 percent to 61 percent.

[22]In the event, in April 1996 the authorities eliminated all exchange controls on current and capital account transactions as part of an agreed economic program. In approving the program, Executive Directors commended the Venezuelan authorities on the elimination of all exchange controls.

[23]In commenting on the draft report, the IMF staff stated that its accommodative stance, as expressed in the 2004 staff report, referred only to the need to retain foreign exchange surrender requirements for the state oil company, and should not be taken as a general endorsement of permanent capital controls.

Figure A1.4. Tunisia: Capital Account Openness and Net Private Capital Inflows[1]



Sources: IMF database; and Appendix 5.
[1]Net foreign direct investment, net private portfolio investment, and net private other investment.

indicated by the constant value of the index of de jure openness (Figure A1.4), restrictions remain on almost all categories of capital account transactions, particularly for residents. In terms of speed and sequencing, the experience of Tunisia is similar to that of India (see Box 4.1 in the main text). Unlike the case of India, however, capital account liberalization in Tunisia has taken place in the context of extensive IMF support, which included an assessment of its financial sector under the FSAP and technical advice on sequencing.

The Tunisian authorities have been engaged in a program of broad economic liberalization since 1986, aimed at reducing the role of government in the country's economic activities (Nsouli and others, 1993). The new development strategy has been decisively more outward looking and market oriented, and involved a gradual dismantling of restrictions on domestic financial and international transactions. Macroeconomic stability was achieved, and prudent macroeconomic policies have been maintained. The process of financial liberalization and financial market development began in the late 1980s, followed by the launch of banking sector restructuring in the early 1990s. The trade regime was liberalized from the outset of the reform process, with a focus on gradually reducing quantitative restrictions on imports.

Along with trade liberalization, progress was made toward currency convertibility. In terms of current account convertibility, the authorities gradually eased foreign exchange controls by decentralizing the allocation of foreign exchange, increasing exchange allocations for invisible transactions, and easing regulations on opening foreign currency accounts and using them for making payments abroad. Following these measures, in January 1993 Tunisia accepted the obligations under Article VIII of the IMF Articles of Agreement (Souayah, 1996).

A step-by-step approach was taken to the liberalization of capital account transactions. Among the first to be liberalized were transactions related to the resident export sector and nonresident FDI in certain export-oriented sectors. However, many restrictions remained on inward portfolio investment by nonresidents and outward capital transactions (except for export-oriented activities and enterprises). It was only in 1995 that the Tunisian authorities initiated a concerted effort to liberalize the capital account.[24]

The pace of capital account liberalization, however, has been slow. In part, this reflected Tunisia's consensus-building culture. The authorities adopted a particular liberalization measure only after it had received broad sociopolitical support and they were certain that it would not be reversed.[25] The back-to-office report of November 2000 stated that the authorities were concerned about the risks of unstable portfolio flows. Yet the authorities have publicly stated on a number of occasions that achieving full capital account convertibility remains the official policy of the government.[26] This is still an ongoing process.

The IMF's early views on Tunisia's capital account liberalization

The IMF supported Tunisia's economic reforms through a series of financing arrangements, and has maintained a highly collaborative relationship with the Tunisian authorities. Exchange of views on capital account liberalization over the years has taken place within the context of this broad policy dialogue.

Responding to the authorities' expressed intention to pursue capital account liberalization, in June 1995, the IMF staff suggested the following sequence for removing restrictions on external capital

[24]In the same year, Tunisia signed an Association Agreement with the EU, which implied the eventual goal of full trade liberalization and capital account convertibility.

[25]A point emphasized in a March 1997 back-to-office report by an IMF mission.

[26]For example, see the statement of the central bank governor, "La Convertibilité Totale du Dinar," May 24, 2001. In this statement, the governor listed five preconditions to be met before full convertibility was established: (1) strengthening of the country's productive capacity; (2) continuation of sound and sustainable macroeconomic policies; (3) maintenance of a sustainable balance of payments position; (4) a sound banking and financial system; and (5) sufficient international reserves.

transactions: (1) FDI, (2) portfolio inflows, (3) foreign borrowing, and finally (4) outward portfolio investment. The staff also stressed the need to pursue prudent fiscal and monetary policies, encourage financial sector reform, and improve the domestic financial markets. Executive Directors agreed with the staff and encouraged the authorities to take further steps toward full currency convertibility, while noting the preconditions to be satisfied. Both the staff and Executive Directors welcomed the association agreement with the EU as a signal of the authorities' commitment to full integration with the global economy. From 1996 through 1998, the staff clearly favored a faster pace, with an immediate and complete liberalization of inward FDI, while acknowledging the importance of further financial sector reform. A briefing paper of September 1998 added to the list of preconditions the privatization of the provision of forward foreign exchange cover.

The staff's position turned clearly more cautious in 1999. The briefing paper for the 1999 Article IV consultation expressed the view that the restrictions on the capital account had helped Tunisia weather the East Asian crisis by limiting its exposure to short-term capital flows, and hinted that the staff might reconsider the whole liberalization strategy. Moving further in this direction, the briefing paper for the 2000 Article IV consultation stated that limited capital mobility had allowed monetary policy autonomy and "had served Tunisia well." During the consultation discussions, the staff cautioned against significant further capital account liberalization until additional progress was made toward strengthening the banking system. While the staff continued to support the lifting of restrictions on outward FDI, it raised the fragile banking sector, undeveloped domestic financial markets, and uncompleted trade liberalization as reasons to argue against broader capital account liberalization. Executive Directors broadly supported the staff's position.

The IMF's inputs in the ongoing process

Since 2001, the IMF has played a more explicit role in Tunisia's capital account liberalization. In early 2001, the Tunisian authorities requested an assessment of its financial sector by the IMF and the World Bank under the jointly administered FSAP. The resulting report, issued in November 2001, noted that the series of measures taken since the early 1990s had significantly liberalized the regulatory framework for capital account transactions in favor of export-oriented activities and corporations, but that other transactions, including inward direct and portfolio investments, were still subject to a large number of restrictions. The report then concluded that a wide-ranging capital account liberalization would be premature before a "financial market economy" emerged. The 2001 FSAP assessment subsequently formed the basis for the IMF's advice on sequencing capital account liberalization.

In September 2001, the staff and the authorities agreed that the focus of the 2002 Article IV consultation discussions would be on (1) sequencing and pace of capital account liberalization and (2) exchange rate policy in the context of capital account liberalization.[27] As agreed, the 2002 Article IV consultation involved intense discussions on capital account liberalization, in which the authorities expressed their preference for a gradual approach. The staff agreed, stressing the importance of proceeding with caution, and encouraged the authorities to prepare ground work by (1) making further progress in establishing a monetary policy framework that could provide a nominal anchor to inflation and exchange rate expectations, (2) allowing market conditions to play a greater role in determining the exchange rate, and (3) reducing the existing vulnerabilities of the banking system.[28]

The background paper prepared by the staff, drawing on the 2001 FSAP assessment, spelled out achievements and remaining challenges in the areas of (1) macroeconomic stabilization, including exchange rate policy; (2) financial sector liberalization, including financial sector supervision; (3) systemic liquidity framework (meaning availability of market-based monetary policy instruments); (4) government securities market; (5) corporate sector restructuring; (6) legal framework; and (7) gaining access to international capital markets (emphasizing the need to diversify sources of balance of payments financing by giving the private sector greater access to external financing). The paper then drew on previous work by MAE staff to argue that long-term capital account transactions needed to be liberalized before short-term movements; FDI inflows should be among the first categories of transfers to be liberalized; and the transfer and use of domestic currency abroad should be limited in the early phases of liberalization.[29]

In terms of specific sequencing, the background paper advocated a three-phase approach to capital account liberalization. The first phase included steps that could be taken immediately, such as removing restrictions on FDI by nonresidents and long-term loans to listed firms, and allowing limited nonresident investment in local currency government securities. The second phase involved steps that pre-

[27]Back-to-office report for a staff visit, September 20, 2001.

[28]Briefing paper for the 2002 Article IV consultation.

[29]The paper, entitled "Liberalization of the Capital Account in Tunisia—Progress Achieved and Prospects for Full Convertibility," was included as Chapter 2 of the Selected Issues paper for the 2002 Article IV consultation. SM/02/155, May 2, 2002.

sumed the attainment of a solid banking system, a flexible exchange rate regime, and a market-based monetary policy framework, such as liberalizing outward FDI, portfolio investment by institutional investors, and inward portfolio investment in debt instruments. The third and final phase entailed steps requiring a robust financial sector and a resilient balance of payment position, such as lending by residents to nonresidents. Some Tunisian officials interviewed by the evaluation team indicated that they found the paper's exposition of various country experiences to be particularly useful, although the overall approach lacked operational specificity. The broad conceptual scheme of the staff advice, however, received wide support when it was discussed by the Executive Board.

During the 2003 Article IV consultation, the staff reviewed progress under the capital account liberalization plan. The staff stressed the need for a floating exchange rate regime to preserve independent monetary policy, while noting the importance of adopting a "monetary reference target" to provide a nominal anchor as steps were taken to further liberalize the capital account.[30] Executive Directors welcomed the planned move to a floating exchange rate regime but stressed that full capital account liberalization should be delayed until the proposed monetary policy framework was established and the transition to a floating exchange rate complete.

Assessment

The case of Tunisia illustrates how the IMF has applied the new conceptual framework of sequencing to a specific country context. Indeed, it is one of only a few examples of the IMF's new "integrated" approach in operation. The IMF staff has warned the authorities of all potential risks involved in moving toward full capital account convertibility; it has in some cases discouraged the authorities from moving further until banking sector problems were better addressed; and it has spelled out how institutional and regulatory constraints could condition the pace and sequencing of removing restrictions. This new approach has received wide support from the Executive Board and also appears to be accepted by most IMF staff members.

The IMF staff has assessed Tunisia's macroeconomic policies as being broadly prudent, and viewed its recent structural reforms as generally successful. At the same time, the staff considered the state of the banking sector to be still insufficient to support a fully open capital account. Given the government's publicly stated commitment to achieving full convertibility of the dinar, however, one cannot avoid the impression that the recent involvement of the IMF has not had much impact on the pace of capital account liberalization, which began almost 10 years ago. How quickly to liberalize the capital account (as well as how much risk to tolerate in the process) must remain the decision of a sovereign government and, given Tunisia's consensus-building culture, there may not be much the IMF could have done to alter the pace of liberalization, in line with the commitments Tunisia made in its association agreement with the EU. However, part of the problem may also be the lack of clear priorities in sequencing in the IMF's new approach (see Box 4.3). By emphasizing all the potential interlinkages without identifying a hierarchy of risks, the integrated approach may have created an inevitable tendency to err on the side of caution. Despite the staff's encouragement, and despite the government's stated intention and international commitments, the process of capital account liberalization has been painstakingly slow.

[30]In this monetary framework, base money was to serve as an operating target. The system would be replaced by inflation targeting when conditions were met.

Appendix 2 Staff Research

The IMF staff prepared more than 100 research papers on capital account issues between the early 1990s and the early 2000s. The volume of research output in this area increased significantly in the second half of the 1990s. The findings of staff research in this area broadly corresponded to the views expressed in multilateral surveillance (see Chapter 2, the section "Multilateral Surveillance"), indicating that there was considerable synergy between these two areas of activity. Research consistently found that permanent capital controls were ineffective, while staff research began to see the temporary use of capital controls in a more favorable light over time, at least as a short-term measure. The review of staff research provided below is not meant to be comprehensive, but to cover only those studies that either reflected or influenced the evolution of ideas within the IMF.

Early Work on Capital Controls and Capital Flow Management

Mathieson and Rojas-Suarez (1990), Mendoza (1990), and Calvo and others (1992) were among the first to analyze capital controls. Mathieson and Rojas-Suarez (1990) showed that exchange rate policy would be affected by the removal of capital controls as the economy would become more vulnerable to foreign shocks, but that there was no single optimal exchange rate regime consistent with a particular process of liberalization. Mendoza's theoretical study (1990) showed that the use of capital controls had little, if any, impact on the output, consumption, and welfare of a small open economy facing balance of payments problems. Calvo and others (1992) argued that a case could be made for the policy mix of a tax on short-term inflows, exchange rate flexibility, and an increase in marginal reserve requirements, and noted that capital controls could be effective only in the short run because investors could find a way to evade them over time.

Two significant policy-oriented papers were issued as Occasional Papers during 1993.[1] First, Mathieson and Rojas-Suarez (1993) advanced the idea that capital controls had lost effectiveness in the 1980s with the liberalization of exchange and trade controls. They identified channels of evasion such as under- and over-invoicing, transfer pricing policies, and leads and lags. This does not mean that capital controls cannot affect certain types of capital transactions and market participants, but the authors argued that, given the distortionary effects, adjustment of macroeconomic policies was generally more appropriate than imposition of capital controls when faced with large capital movements. They then concluded that, in order to support capital account convertibility, efforts should be made to strengthen the prudential supervision of financial institutions, establish more flexible interest rates, and restructure and recapitalize domestic financial institutions. The "consistency of macroeconomic, financial, and exchange rate policies is more important for sustaining an open capital account than is the sequencing of the removal of capital controls."

The other Occasional Paper, by Schadler and others (1993), was an analysis of how countries had responded to surges in capital inflows. In particular, it used the recent experiences of Chile, Colombia, Egypt, Mexico, Spain, and Thailand to document the policies adopted and the effectiveness of these measures. It argued that tight fiscal policy was the only means to prevent overheating and avoid a real appreciation "regardless of [the] cause" of the inflows. Its assessment of sterilization, the most common policy tool, was generally negative because its quasi-fiscal cost and its effect on the level of interest rates made it infeasible on a sustained basis. The authors were cautious toward exchange rate flexibility because a

[1]Compared with Working Papers, Occasional Papers tend to be more department driven and less individually motivated, and have greater internal status and outside visibility. Some Occasional Papers are initially written as Board papers and are discussed by the Executive Board in a formal meeting or an informal seminar before they are published.

change in the equilibrium real exchange rate might not be warranted. They recognized a case for capital controls when "bandwagon effects are important or there are doubts about the capacity of the economy to absorb inflows efficiently," but found little evidence to argue for their effectiveness. Instead, they argued that the easing of the external constraint provided an ideal opportunity to address structural weaknesses by liberalizing trade, moving toward capital account convertibility, and reforming the financial sector.

Later Work on Capital Controls

Studies that appeared in 1994 and later reinforced the argument that capital controls were ineffective. For example, Johnston and Ryan (1994) argued that capital controls were not effective in developing countries, and caused problems in macroeconomic management with little effect on the balance of payments. The authors then advocated rapid capital account liberalization, given its positive impact on capital inflows and domestic financial development. A review of theoretical and empirical literature by Dooley (1996) concluded that controls were somewhat effective in creating a wedge between domestic and international interest rates, but there was little evidence to show that they were effective in significantly affecting the volume of capital flows. At the same time, the study noted that capital controls previously employed by many industrial countries had been effective (relative to developing country experience), and concluded that administrative capacity was a critical factor in determining the effectiveness of controls. Once the apparatus of control was removed, however, reintroducing controls in a liberalized regime would be unlikely to be effective.

As the experience of Chile with market-based controls became widely known (see Boxes 1.2 and 2.2), some on the IMF staff began to see temporary use of controls in a more favorable light. In 1996, Galbis (1996) argued that there were grounds for the temporary use of a tax on capital inflows, while noting that quantitative controls on capital flows were inefficient and discriminatory and should be the first to be removed. Laurens and Cardoso (1998), however, stressed that Chilean-style controls could be a policy option only for a limited number of developing countries because of the high level of enforcement capacity required for its implementation. On the other hand, Lopez-Mejia (1999) argued that the capital controls in Chile, Colombia, and Malaysia had proved useful in lengthening the maturity of capital inflows.

Determinants of capital controls received some attention in IMF research. The seminal work of Grilli and Milesi-Ferretti (1995) used a large sample of over 60 countries to find that capital controls were more likely to be present in a country if it was less open, its income lower, its public sector larger, its central bank less independent, its exchange rate less flexible, and its current account deficit larger. The authors found little evidence that capital controls were associated with higher economic growth, but controls tended to be associated with higher inflation and lower real interest rates. Likewise, Johnston and Tamirisa (1998) identified additional factors to explain the imposition of capital controls by governments, including balance of payments reasons, macroeconomic management, weak domestic regulatory systems, and the stage of economic development.

Work on Sequencing

As early as 1994, staff research, while supporting capital account liberalization, was already aware of the need for sequencing, which was well known from the literature on the order of economic liberalization. For example, Quirk (1994) argued that capital account liberalization should be implemented with credible fiscal policy. Galbis (1994) argued that "a pragmatic approach to the sequencing issue [was] necessary as there [were] only a few general principles valid for all countries." He added that a case could also be made from the literature that an early introduction of capital account liberalization in the reform process could promote acceleration of domestic financial reforms. The conventional wisdom from the literature was reiterated by the previously cited work of Galbis (1996), who listed fiscal consolidation, noninflationary finance of public deficits, macroeconomic stability, an appropriate monetary-fiscal policy mix, and a strong domestic financial sector as preconditions for capital account liberalization. Surprisingly, however, exchange rate flexibility was not accorded the same emphasis it receives today as desirable for an open capital account.[2]

An Occasional Paper by Quirk and others (1995) was much more explicit on sequencing. The paper included the idea that one must consider a set of preconditions and the sequencing of liberalization in moving toward capital account convertibility, and highlighted the danger of opening the capital account too rapidly without supporting policies. It then noted that the most important precondition was domestic financial market reforms, including

[2]An earlier expression of the view intimating the need for exchange rate flexibility under high capital mobility is found in Goldstein and Mussa (1993), who argued that greater capital flows have "made the conditions more demanding for operating durably and successfully a fixed exchange rate arrangement."

strengthened prudential regulations. In terms of sequencing, it suggested that (1) with a strong balance of payments position, exchange rate pressure could be minimized by liberalizing capital outflows before inflows; and (2) one might also want to limit potentially more destabilizing short-term inflows by first liberalizing long-term inflows, such as direct investment. The authors, however, added that "such fine-tuning" might be difficult in practice as "liberalization of one component of the capital account" would create pressure to liberalize all capital transactions.

Toward the end of the 1990s, even before the East Asian crisis, staff research began to focus on the pace and sequence of capital account liberalization in a more explicitly operational way. Johnston and others (1997) documented the sequence of financial sector reforms and capital account liberalization followed by Chile, Indonesia, Korea, and Thailand, and suggested that the speed should depend on macroeconomic and exchange rate policies. Likewise, Johnston (1998) argued that prudential measures should not be considered to be equivalent to capital controls because they were not meant to restrict capital flows directly, but were designed to support the gains achieved in moving toward capital account convertibility by providing safeguards. These and other contributions were later compiled as a book, which was published by the IMF (Johnston and Sundararajan, 1999). An influential Occasional Paper by Eichengreen and others (1998) discussed the role of sequencing in a broader context of discussion on the risks of capital account liberalization and the need for sound macroeconomic and prudential policies to minimize those risks.

In the early 2000s, there was a proliferation of work on pace and sequencing. For example, Karacadag and others (2003) considered hierarchy and interlinkages among financial markets, and made a proposal on the modality of sequencing. In particular, the authors emphasized the importance of undertaking central banking reforms and other measures that would allow a more effective conduct of monetary and exchange rate policies, and the need to implement technically and operationally connected measures simultaneously. Kaminsky and Schmukler (2003) were skeptical of the need to follow a particular order of liberalization, but nevertheless acknowledged the importance of doing institutional reforms before opening the capital account. Duttagupta and others (2004) used country experience to argue that attaining exchange rate flexibility before capital account liberalization had the advantage of enabling the economy to absorb capital account shocks at a lower cost to the real economy. The authors also argued that a transition to exchange rate flexibility should involve a gradual elimination of existing asymmetries (if any) in capital account openness between outflows and inflows in order to facilitate an orderly correction of any potential misalignment in the exchange rate.

More Recent Work

The areas of research on capital account issues also expanded in the early 2000s. We review here two strands of research covering (1) the impact of capital account liberalization and (2) analyses of market dynamics. First, among recent studies to quantify the effect of capital account liberalization on economic growth or policy discipline, Edison and Warnock (2003) supported the view that removal of restrictions provided developing countries with increased access to international capital markets, but found no evidence that capital controls created a bias in favor of domestic capital. An Occasional Paper by Prasad and others (2003) found no strong relationship between capital account openness and growth (but suggested the importance of the quality of domestic institutions in defining that link), while Tytell and Wei (2004) suggested no robust or causal relationship between liberalization and fiscal discipline (although there was a weak discipline effect on inflation).

A number of recent studies have investigated the working of financial markets, particularly as it relates to international linkages through capital flows. For example, Arora and Cerisola (2001) provided a quantitative indication of how U.S. monetary policy influenced sovereign bond spreads in emerging market economies, and concluded that the spreads were influenced not only by country-specific fundamentals but also by the stance and predictability of U.S. policy. Herding among international institutional investors was the topic of empirical studies by Borensztein and Gelos (2000) and Gelos and Wei (2002); a literature review on herd behavior was provided by Bikhchandani and Sharma (2001). More recently, Chan-Lau (2004) analyzed, among other things, the main determinants of the emerging market asset allocation of pension funds in industrial countries, while Ong and Sy (2004) showed the importance of foreign investor presence in securities markets in emerging market economies and how asset allocation decisions by mature market funds could possibly affect emerging market countries.

APPENDIX
3 Public Communications

This appendix reviews public speeches and statements of IMF management during 1990–2004, in order to see what messages were communicated to the public on capital account issues. Much of the information in this appendix relies on various issues of the *IMF Survey*.

In the early 1990s, IMF management viewed capital account liberalization, along with macroeconomic discipline and IMF financial support, as essential ingredients of sustained growth for developing countries. Management, however, was explicit in spelling out the potential risks of capital account liberalization. In 1994, for example, the Managing Director stated: "The Fund encourages countries to liberalize their capital account restrictions, while adopting policies that ensure that the risks involved are avoided and the potential benefits fully realized."[1]

Following the Mexican crisis, management focused on the need for strong financial institutions, a competitive domestic financial system, and effective supervision and regulation; it opposed use of capital controls, including market-based ones. In 1995, the Managing Director stated that the IMF's response to the challenges of globalization was to strengthen surveillance and to secure appropriate resources to assist countries. Surveillance needed to be strengthened, particularly in terms of attention to capital account developments and financial flows. At a seminar held in April 1995, the First Deputy Managing Director said that the pace of capital account liberalization depended on the liberalization process of the domestic financial sector and that a strong financial system was a prerequisite.

In September 1995, in responding to criticisms that the IMF was an impediment to capital account liberalization, the Managing Director wrote an article for the *Wall Street Journal* emphasizing that freedom of capital movements is "an objective that the IMF seeks to promote." At the same time, he stated that, in the absence of certain prerequisites, "open capital accounts may impose considerable costs in terms of financial and economic instability, and risk costly reversal" and listed as the necessary prerequisites a strong financial system and macroeconomic stability. He then noted that, in the circumstances of some developing countries, "certain kinds of measures to discourage capital inflows or influence their character might be appropriate" (*Wall Street Journal*, September 27, 1995).

In 1997, there was a marked change in management's view of capital controls. While fiscal discipline and greater exchange rate flexibility remained the preferred policies, the First Deputy Managing Director stated that market-based controls were less harmful than administrative ones, which were ineffective and costly. He continued to advocate liberalization of outflows as a tool to manage capital inflows. In 1998, he again reiterated the same views, namely, that controls on outflows should be removed as the country circumstances became appropriate, but market-based controls could be retained to discourage short-term inflows.

At the same time, management began to pay more attention to sequencing and gradualism. The Managing Director emphasized the importance of sound macroeconomic policies, a strong domestic financial system, phased capital account liberalization, properly sequenced reforms, and timely and accurate dissemination of information. At a meeting of the Pacific Basin Economic Council held in May 1999, the Managing Director stated that controls were more effective on inflows than on outflows, and that they worked best when they were market-based and temporary. He then added that stronger macroeconomic policies and banking sectors—not the controls per se—were the key factors behind the success of the countries that imposed controls after the crisis.

The Managing Director, at the January 2001 Asia-Europe Meeting of finance ministers from Asia and Europe, conceded that there had been excessively rapid capital account liberalization in some emerging market countries, and emphasized the need for preconditions to be met before proceeding with full liberalization. At the same time,

[1] Transcript of remarks made at a meeting of financial and business leaders in Korea in October 1994.

he advised countries with open capital accounts not to reimpose controls, but rather to strengthen institutions. He then noted the mixed experience with the use of capital controls and called for "further research and analysis to assess the costs and benefits of controls in particular circumstances." In 2003, at the January Asia-Pacific Economic Cooperation meetings, the Managing Director stressed the need for sequencing, saying: "Ensuring careful sequencing, particularly in relation to the development of well-regulated and well-managed financial sectors, is a critical ingredient to success."

APPENDIX
4

Cross-Border Capital Transactions and Capital Account Openness in Selected Countries, 1989–2002

	Private Capital Flows[1] (Annual Averages)											
	As a percent of GDP						In billions of U.S. dollars					
	1989–93		1994–97		1998–2002		1989–93		1994–97		1998–2002	
	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities	Assets
Average	2.9	–0.3	6.1	–0.5	5.4	–1.4	2.4	–0.4	5.9	–1.7	4.9	–2.7
Bulgaria	0.40	–2.34	1.39	–4.76	7.62	0.71	0.76	–0.04	0.15	–0.42	1.05	0.11
Chile	6.50	0.16	8.86	–0.76	7.15	–5.03	2.60	0.03	6.30	–0.57	5.19	–3.68
China	2.38	–1.24	6.55	–1.53	4.21	–3.05	12.09	–5.80	48.43	–12.47	45.85	–31.74
Colombia	1.36	–0.58	0.85	–1.56	2.61	–1.72	0.83	–0.31	0.91	–1.53	2.23	–1.48
Croatia	1.66	–0.93	6.01	2.23	11.37	0.22	0.10	–0.11	1.18	0.43	2.30	0.09
Czech Republic	1.44	0.71	7.54	–3.53	7.42	0.66	0.61	0.22	4.10	–2.06	4.67	0.55
Estonia	1.55	0.00	16.50	–6.41	12.95	–5.21	0.02	0.00	0.69	–0.26	0.77	–0.31
Hungary	4.44	–0.28	7.36	–1.09	9.38	–1.01	1.66	–0.08	3.21	–0.51	4.65	–0.52
India	1.81	0.50	2.40	–0.04	2.20	–0.15	5.24	1.41	8.58	–0.14	10.16	–0.74
Israel	2.49	–2.14	5.02	–1.09	5.33	–4.36	1.41	–1.27	3.97	–0.77	5.77	–4.72
Latvia	3.18	0.00	14.79	–5.27	12.98	–4.15	0.21	0.00	0.78	–0.31	1.03	–0.34
Lebanon	1.20	4.81	–0.46	32.30	–1.93	15.51	0.00	0.36	–0.22	3.98	–0.33	2.58
Lithuania	–2.15	0.00	7.77	–1.22	9.33	–0.89	–0.06	0.00	0.65	–0.11	1.09	–0.10
Malaysia	11.12	–0.60	6.73	–2.57	–5.32	–1.51	6.44	–0.52	6.38	–2.43	–4.49	–1.30
Mexico	5.52	–1.17	4.64	–0.87	2.95	0.26	18.24	–3.20	16.47	–2.83	16.13	1.80
Peru	1.61	0.45	8.35	–0.50	1.55	0.42	0.55	0.16	4.41	–0.24	0.86	0.22
Philippines	2.73	0.58	8.20	1.82	5.20	–2.35	1.31	0.26	6.21	1.46	3.83	–1.73
Poland	–2.29	–1.88	–1.17	0.92	6.30	–1.13	–2.21	–1.24	–0.24	1.69	10.83	–1.93
Romania	1.34	–0.27	4.52	–0.52	4.95	0.10	0.16	–0.08	1.54	–0.16	2.05	0.04
Russia	0.17	0.54	4.18	–5.45	2.57	–6.25	–1.38	1.00	16.08	–19.92	6.44	–16.33
Slovak Republic	0.71	0.59	11.82	–2.72	11.51	–1.11	0.12	0.09	2.40	–0.60	2.53	–0.21
Slovenia	–0.21	–0.71	3.78	–0.96	6.75	–2.76	0.02	–0.10	0.73	–0.18	1.40	–0.58
South Africa	0.02	–0.70	5.65	–3.05	4.69	–3.35	0.04	–0.84	8.31	–4.48	6.22	–4.43
Thailand	10.47	–0.03	5.69	0.24	–4.53	–0.84	9.89	0.13	9.92	0.28	–5.30	–0.95
Tunisia	6.91	–0.24	9.73	–1.63	12.85	–3.03	0.99	–0.03	1.76	–0.30	2.60	–0.61
Ukraine	4.31	0.00	3.14	0.13	2.48	–2.10	1.60	0.00	1.12	0.06	0.88	–0.75
Venezuela	8.39	–3.51	4.62	–4.62	2.52	–6.68	4.35	–1.81	4.19	–3.43	2.55	–6.94

Sources: IMF, WEO and other IMF databases.

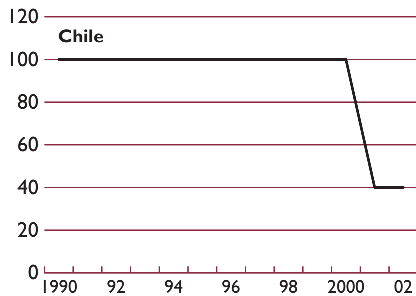
[1]Portfolio investment, other private investment, and foreign direct investment. Excludes government borrowing.

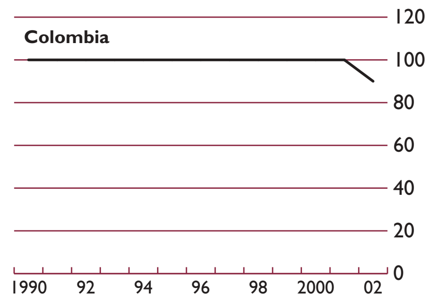
[2]Taken from IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions,* various issues. The index indicates the number of restricted categories divided by the total number of capital control categories. A smaller number means a smaller number of existing restrictions on capital account transactions.

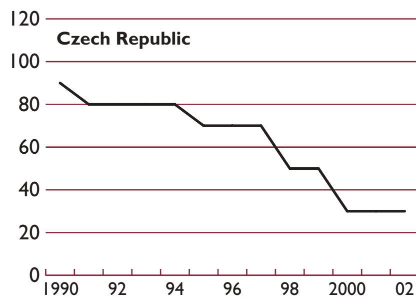
Capital Account Openness[2]				Memorandums	
Global ranking in 2002	Openness index			IMF-supported programs (1990–2002)	Technical assistance in banking and external sectors (1990–2002)
	1995	2002	Change		
81	0.7	0.6	–0.1		
97	0.9	0.8	–0.1	Yes	Yes
58	1.0	0.4	–0.6	Yes	Yes
132	0.9	1.0	0.1	No	Yes
114	0.9	0.9	0.0	Yes	Yes
114	0.9	0.9	0.1	Yes	Yes
44	0.6	0.3	–0.4	Yes	Yes
44	...	0.3	...	Yes	Yes
1	0.8	0.0	–0.8	Yes	Yes
132	1.0	1.0	0.0	Yes	Yes
1	0.8	0.0	–0.8	No	No
31	0.2	0.2	0.0	Yes	Yes
83	0.3	0.7	0.5	No	Yes
31	0.4	0.2	–0.2	Yes	Yes
114	0.8	0.9	0.1	No	Yes
83	0.9	0.7	–0.2	Yes	Yes
1	0.2	0.0	–0.2	Yes	Yes
114	0.9	0.9	0.0	Yes	Yes
83	0.9	0.7	–0.2	Yes	Yes
73	0.8	0.6	–0.2	Yes	Yes
97	0.8	0.8	0.0	Yes	Yes
132	0.7	1.0	0.3	Yes	Yes
73	0.8	0.6	–0.3	Yes	Yes
114	0.9	0.9	0.0	No	Yes
97	0.6	0.8	0.2	Yes	Yes
114	0.9	0.9	0.0	Yes	Yes
114	1.0	0.9	–0.1	Yes	Yes
83	0.3	0.7	0.4	Yes	Yes

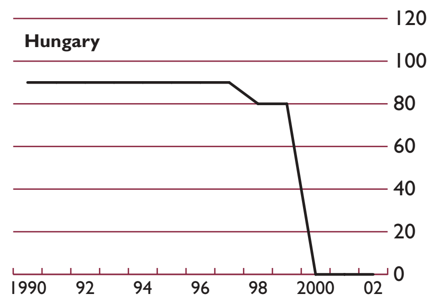
Appendix 5

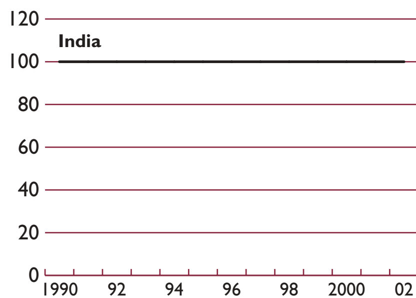
Capital Account Openness in 12 Sample Countries, 1990–2002

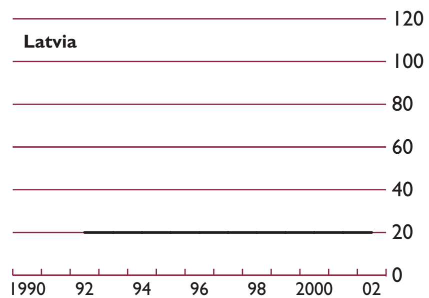


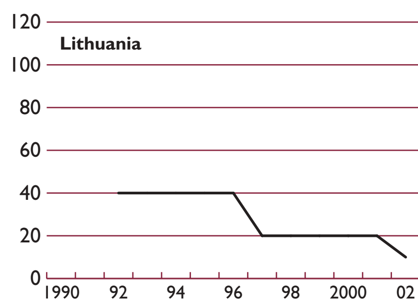


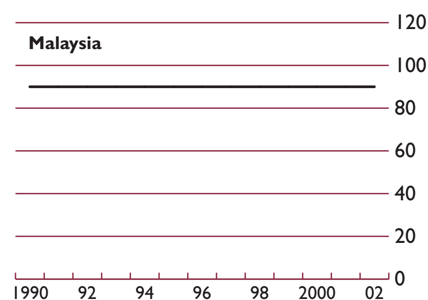


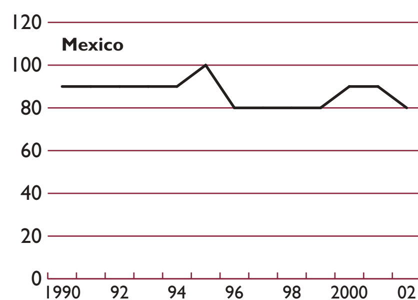


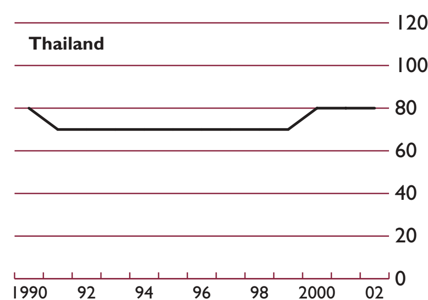


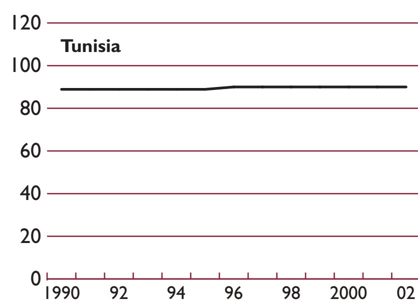


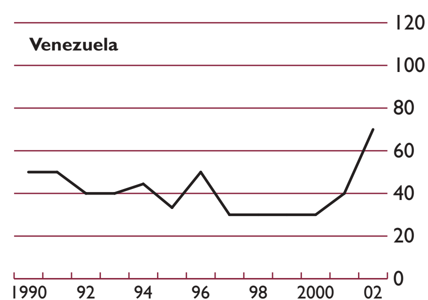












Sources: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)*; Miniane (2004); and IEO estimates.

[1]The index shows in percentage terms how many of the 10 types of capital account transactions are subject to restrictions; a lower value indicates greater capital account openness.

APPENDIX

6 List of Interviewees

The IEO team has spoken to more than 30 current and former members of IMF staff and the Executive Board. In addition, the following individuals have provided their views to the IEO, mostly through personal interviews but also through seminars and workshops. We express our gratitude for their time and apologize for any errors or omissions. They assume no responsibility for any errors of fact or judgment that may remain in the report.

Former and current officials of international and regional organizations

Bank for International Settlements

David Archer
Madhu Mohanty
Philip Turner
Benjamin Cohen
Ramon Moreno
Augustin Villar

European Commission

Maria-Rosario Areizaga
Ken Lennan
Heliodoro Temprano
Maurice-Pierre Guyader
Oliver Schmalzriedt

Organization for Economic Cooperation and Development

Robert Ley
Pierre Poret
Paul O'Brian

United Nations Conference on Trade and Development

Yilmaz Akyuz
Heiner Flassbeck
Andrew Cornford
Benu Schneider

Current and former officials of member countries

Chile

Jorge Cauas Lama
Nicolas Eyzaguirre
Leonardo Hernandez
Luis Eduardo Escobar
Ricardo Ffrench-Davis
Luis Oscar Herrera
Esteban Jadresic
Carlos Massad
Bernardita Piedrabuena
Claudio Soto
Rodrigo Valdes
Manuel Marfan
Felipe Morande
Klaus Schmidt-Hebbel
Kathleen Uribe

Colombia

Gerardo Hernandez
Guillermo Perry
Herman Rincon
Miguel Urrutia
Salomon Kalmanovitz
Jose Antonio Ocampo
Jose Dario Uribe
Leonardo Villar

Czech Republic

Oldrich Dedek
Tomas Holub
Jan Miladek
Petr Sedlacek
Joseph Tosovsky
Vladimir Dlouhy
Pavel Mertlik
Petr Prochazka
Pavel Stepanek
Jiri Vetrocsky

Hungary

Laszlo Akar
Akos Peter Bod
Tibor Erhart
Agota Repa
Gyorgy Szapary
Lajos Bokros
Sandor David
Klara Kamaras
Gorgy Suranyi

India

Montek Singh Ahluwalia
Surjit Bhalla
Shyamala Gopinath
Narendra Jadhav
Ashok Lahiri
Kirit S. Parikh
Y.V. Reddy
V.K. Sharma
R. Bannerji
Himadri Bhattacharya
Sujan Hajra
F.R. Joseph
Rakesh Mohan
Rajiv Ranjan
Ajay Shah
S.S. Tarapore

Latvia

Helmuts Ancans
Juris Kravalis
Zoja Medvedevskiha
Uldis Osis
Uldis Cerps
Andris Liepins
Einars Repse
Guntis Valujevs

Mexico

Pedro Aspe
Alfonso Guerra
David Madero Suarez
Miguel Mancera
Manuel Ramos Francia
Alberto Torres
Alejandro Werner
Samuel Alfaro
Javier Guzman
Javier Maldonado
Roberto Marino
Julio Santaella
Jesus Marcos Yacaman

Tunisia

Badreddine Barkia
Samir Brahimi
Habib Essafi
Samira Ghribi
Belhadj Jameleddine
Aloui Messaoud
Ali Ridha Ben Achour
Abdelhamid Triki
Negib Bouselmi
Habib El Montacer Sfar
Chedly Ezzaouia
Brahim Hajji
Golsom Jaziri
Mohamed Rekik
Monia Saadaoui

Other countries

Bryan Chapple
Marco Committeri
Ignazio Visco
Lorenzo Bini Smaghi
Giorgio Gomel
Vicenzo Zezza

Academics and other individuals

Jacques Ardant
Tahar Ben Marzouka
Mauricio Cardenas
William Cline
Christian Gardeweg
Laszlo Halpern
Faycal Lakhoua
Ashwini Mehra
Christian Moreno
Aditya Narain
Bandi Ram Prasad
Ricardo Rocha
Mohan Shenoi
Edwin Truman
John Williamson
Suman Bery
Slah E. Bouguerra
J.B. Chandradhara
Michael Dooley
Morris Goldstein
Joseph Joyce
Rohini Malkani
Abdelhamid Miladi
Michael Mussa
Indranil Pan
Shubhada Rao
Girts Rungainis
Kanhaiya Singh
Fabio Villegas Ramirez

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Statement by the Managing Director

IMF Staff Response
IEO Comments on Management/Staff Response

Summing Up of IMF Executive Board Discussion by the Acting Chair

Statement by the Managing Director on the Evaluation by the Independent Evaluation Office of the IMF's Approach to Capital Account Liberalization

Executive Board Meeting
May 11, 2005

The Independent Evaluation Office's study on the IMF's approach to capital account liberalization should help in disseminating the lessons for Fund practice and enhancing the learning culture of the Fund. The staff has prepared a statement indicating its reactions to the report's recommendations in the period ahead.

The Board discussion of the IEO report will provide an opportunity to draw out its implications for the Fund's policies and procedures. The questions on capital account issues raised in this report will be addressed in the ongoing strategic priorities review, the results of which will help shape our agenda going forward.

Staff Response to the Evaluation by the Independent Evaluation Office of the IMF's Approach to Capital Account Liberalization

Executive Board Meeting
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1. *The IEO report (SM/05/142) highlights the difficulties and complexities the Fund faces in providing advice on capital account issues.* The two main recommendations put forward in the report are: the need for (i) greater clarity in the scope of the Fund's policy advice on capital account issues to its membership, and (ii) greater attention to supply-side factors of international capital flows with a view to minimizing their volatility. This statement elaborates on some of the report's analytical underpinnings. The report is timely in view of the ongoing work on the Fund's strategic priorities.

2. *The staff considers the sample underlying the report's evaluation of our advice on capital account issues a fair representation of the diverse membership, although it believes that a finer distinction among these countries would have been useful.* The staff appreciates the considerable work that was involved in evaluating 27 countries, and finds the description of the cases broadly accurate. However, in discussing the staff's policy advice, the report could have made a useful distinction between three cases: countries with an actual or potential balance of payments or banking crisis; countries facing a major capital inflow; and those under "normal" conditions but with some remaining capital controls. This distinction would help to clarify and nuance the staff's advice on capital account liberalization and imposition of temporary capital controls.

3. *Relatedly, the report's finding of some apparent inconsistencies in the Fund's advice on capital account liberalization across countries needs to be more nuanced.* The Fund is sometimes criticized as being a monolithic institution following a "one-size-fits-all" approach. In contrast, the IEO concludes that its evidence suggests no "one-size-fits-all" approach by the Fund staff. Indeed, the staff has used its own professional judgment in approaching capital account liberalization in individual countries, and there was active debate on the issue within the staff. In its assessment, however, the report seems critical of this discretion, and calls for greater consistency in country work and institutional approach. The apparent lack of consistency in the Fund's advice to its members may have a number of causes, as acknowledged in the report, including the tailoring of policy advice to country-specific circumstances or the absence of an official position in the Fund on capital account issues. While we do not disagree with the report's finding that the latter could have contributed to some variation in policy advice across the membership, the report could have gone further into explaining the different country circumstances that would warrant differentiated advice. Indeed, a detailed case study approach of the sampled countries would have perhaps made a more convincing analysis.

4. *The staff largely concurs with the evaluation's two key findings on the Fund's policy advice to its member countries on capital account issues (Chapters III and IV).* The IEO report finds that the Fund staff has been quite accommodating of the authorities' policy choices when they involved a gradual approach to capital account liberalization or temporary use of capital controls. Moreover, in no case did the Fund require capital account liberalization as formal conditionality for use of its resources. In particular, the Fund has not pressured member countries—certainly not the emerging market countries sampled—to liberalize their capital accounts or to move faster than they wanted to go. In terms of advice on the temporary use of capital controls, the IEO concludes that the Fund staff seldom challenged the authorities' decisions and even supported market-based controls in some cases as a second-best option. It notes that the staff pointed out the risks inherent in an open capital account as well as the need for a sound financial system, even in the early 1990s. However, the IEO considers that these risks were insufficiently highlighted and did not translate into operational advice until later in the 1990s. We would

stress that the IEO sees recent improvements in this area. Indeed, substantial analytical work has been carried out by the Monetary and Financial Systems Department (MFD), the International Capital Markets Department (ICM), Research Department (RES), and area departments.

5. *The report does not do justice to the role played by external forces in promoting capital account liberalization.* While it acknowledges the presence of exogenous factors, the country cases do not fully reflect their role. In particular, free trade agreements (FTAs) and multilateral trade liberalization through the World Trade Organization have covered significant components of the capital account related to financial services and investment chapters. In addition, recent bilateral investment treaties (BITs) frequently cover a broad range of instruments (including portfolio investments, inter-bank transactions, and sovereign debt) with no balance of payments safeguards; that is, signatories, to a point, cannot impose capital controls even during times of macroeconomic or financial stress. Moreover, a major source of pressure for liberalization is often a country's own commercial sector, which may be looking for sources of competitive financing. All in all, the policy choices of emerging markets may have reflected these external factors at least as much as Fund policy advice.

6. *The report proposes two main recommendations in light of the Fund's experience with capital account issues.* As discussed below, the Fund is already implementing some aspects and plans to address these issues further in its future work program and in the strategic priorities review.

7. *Recommendation 1 is that more clarity is needed on the Fund's approach to capital account issues.* There are three aspects to this proposed recommendation, which are discussed in turn.

- *The report suggests that the place of capital account issues in Fund surveillance could be clarified, and there would be value if the Executive Board were to clarify formally the scope of Fund surveillance on capital account issues.* The Board and the Fund staff have recognized that capital account developments and vulnerabilities constitute an increasingly important focus of the Fund's work on promoting stability, and the process of clarifying the scope of Fund surveillance to include capital account issues is already underway. The Executive Board noted in the context of recent Biennial Surveillance Reviews (2002, 2004) that Fund surveillance needed to adapt to "a changing global environment, most notably to the rapid expansion of international capital flows." This adaptation would imply a broadening of the coverage of surveillance "from a relatively narrow focus on fiscal, monetary and exchange rate policies, to a broader purview encompassing external vulnerability assessments, external debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies that have an impact on macroeconomic conditions" (SUR/02/81). The Board has also highlighted the risks of opening the capital accounts before floating the exchange rate, and especially the risks of sudden outflows (PIN No. 04/141). More recently, in the context of the discussion of the "Fund's Medium-Term Strategy—Framework and Initial Reflections" (BUFF/05/60), the Board has called for additional work on capital account issues.
- *Relatedly, the report proposes that the Executive Board could issue a statement clarifying the common elements of agreement on capital account liberalization.* While this is an issue for the Executive Board to decide, the staff agrees that it would be useful to have some clear operational guidance that lays out the broad principles that Fund staff needs to follow in its policy advice across countries and that the outline of these principles in the IEO report is a useful starting point for such guidance. Indeed, staff (especially MFD) has already undertaken policy research and operational work on various aspects of capital account issues (including capital account liberalization and financial sector reform, country experiences with use and subsequent liberalization of capital controls, and sequencing), in the context of FSAPs and technical assistance. We would, however, caution that there is no single "right" approach. Our advice needs to take into account the different situations confronting our members. It also must recognize that for many members full capital account liberalization is an aspiration that will likely take substantial time to achieve.
- *Against this backdrop, the Fund's future work on capital account issues should seek to buttress efforts to promote financial stability, while helping ensure that controls are not used to impede adjustment.* An approach would be to build on the existing Fund expertise in this area, and to ensure that policy advice on capital account issues is fully incorporated into the mainstream of bilateral and multilateral surveillance, with analytic work being used to strengthen the basis for policy advice and technical assistance. This strategy would imply a measured approach to liberalization to facilitate countries' integration into global economy while maintaining stability, rather than promoting liberalization, per se.

- *The report also suggests that the Fund could sharpen its advice on capital account issues, based on solid analysis of the particular situation and risks facing specific countries.* The staff endorses this recommendation, which is in line with best practice and longstanding general guidance on Fund surveillance. In its policy advice to countries the staff will continue to draw on all existing analytical work as well as any future findings that may arise from staff studies that have been requested by the Board, or from other sources. Further, technical assistance provided by the Fund on operational issues provides hands-on advice to countries on how to proceed with capital account issues. We also note that MFD is reviewing, for the upcoming Biennial Review of Exchange Arrangement, Restrictions and Markets, the role of capital controls during financial stress and issues relating to financial liberalization and capital account regulations. However, the IEO's suggestion that the Fund should provide some quantitative gauge of the benefits, costs, and risks of moving at different speeds is likely to prove difficult to put into practice, given the conflicting theoretical and empirical evidence on the subject and the political and economic complexities that capital account issues typically involve.

8. *Recommendation 2 is that the Fund's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and what can be done to minimize the volatility of capital movements*. Staff agrees with the crux of this recommendation, although given the large number of staff studies already completed (and more under way), we are not sure what other specific actions, if any, the IEO may have in mind. We agree with the report's assessment that this is a difficult topic on which little professional consensus exists. That said, past work and current initiatives demonstrate that the staff recognizes that reducing volatility and cyclicality in the supply of capital are critical to achieving capital markets stability.

- *To strengthen Fund surveillance in this regard, several research initiatives have been under way.* ICM has aimed to focus on global financial market linkages, financial and risk-related flows, and global asset allocation decisions of institutional investors. Recent *Global Financial Stability Reports* (*GFSRs*) have focused on the volatility of private capital flows to emerging markets (September 2003), and provided analysis of the institutional investor base in emerging markets (March 2004). The next *GFSR* will include studies of home bias and global diversification, and financial stability considerations of regulatory and accounting policies. Further, a considerable number of studies by IMF staff (appearing in both Fund documents and outside journals) have in recent years examined supply-side aspects, including: the potential impact of interest rates and risk appetite in advanced countries on emerging market spreads; herding behavior, contagion, and the possible role of institutional investors and hedge funds in this regard. The Fund has also delved into deepening domestic capital markets by examining ways in which local securities and derivative markets can be developed to tap on a more stable segment of the investor base.

- *The Fund is undertaking a number of initiatives at the country level.* Through the Financial Sector Assessment Program (FSAP) initiative, the Fund is also contributing to identifying potential vulnerabilities and risks in the financial systems, particularly of systemically important countries, whose vulnerabilities may spill over to other countries owing to strong ties in the financial sector. Further, by way of the Reports on Observance of Standards and Codes (ROSC), Special Data Dissemination Standards (SDDS), General Data Dissemination System (GDDS), and technical assistance, the Fund is helping to improve information flow to investors, which in turn contributes to greater stability. In addition, the Fund has developed operational guidance to assist in maintaining the soundness of relatively large and complex banking organizations, with a view to creating stability in domestic and international financial sectors.

- *Several broader initiatives have also been undertaken by the Fund.* The Capital Markets Consultative Group (CMCG), established in July 2000 by the IMF's Managing Director, provides a forum for informal dialogue between participants in international capital markets and the IMF. More generally, the IMF is working on improving its understanding of recent trends in and future prospects of foreign direct investment (FDI) in emerging market countries (EMCs), the investment strategies of large multinational companies, and the determinants of FDI in EMCs. The Fund has also played a leading role in discussions about the possibility of a statutory sovereign debt restructuring mechanism (SDRM) for orderly debt workouts, and has encouraged the use of collective action clauses (CACs) to strengthen crisis resolution and reduce uncertainty associated with debt restructuring. As indicated in the report, the staff comments on the proposed New Basel Capital Accord (Basel II)

have highlighted that using credit ratings to set capital charges could increase volatility and procyclicality.

- *With so many initiatives under way at the Fund, we are puzzled by the report's finding that the Fund pays too little attention to supply-side risks.* The past and current work, noted above, shows that the Fund staff has been at the forefront of the analysis and policy debate in this area. However, staff recognizes that it cannot rest here, and it will strive to enhance further its understanding of supply-side factors and their implications for our membership. However, it would have been more helpful if the IEO had proposed specific actions that could be taken on the supply-side to minimize volatility and cyclicality.
- *Beyond the present list of activities within the Fund to deal with the supply-side risks of capital flows, the staff emphasizes that additional internationally coordinated efforts could help give these issues higher priority among policymakers in advanced economies*. In this regard, the Financial Stability Forum (FSF), established in 1999 and, in whose work the Fund participates, works as a conduit for promoting international financial stability, improving the functioning of financial markets, and reducing systemic risks. Further, the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, a private-sector-led initiative with the support of a number of emerging market country issuers, are also aimed at improving the engagement between sovereign debtors and their creditors, with a view to promoting global financial stability.

Independent Evaluation Office Comments on Management/Staff Response to the Evaluation of the IMF's Approach to Capital Account Liberalization

Executive Board Meeting
May 11, 2005

We would like to offer a few points of clarification, in response to the comments made by management and staff on the IEO report.[1]

The staff suggests that the report is critical of the discretion exercised in tailoring policy advice on capital account liberalization to country-specific circumstances (paragraph 3). This is not what the report says. The report tries to explain how the staff tailored its advice on capital account issues to country-specific circumstances but concludes that a full assessment is not possible because country documents generally do not provide sufficient analytical basis for understanding why a particular combination of policies was advised in a particular case. The IEO report does not take issue with discretion as such and we certainly agree that the IMF did not adopt a "one size fits all" approach in its approach to capital account liberalization (and other related issues) in individual countries. Rather, the message of the report is that this potentially admirable discretion needs to be guided by general principles and therefore would have benefited from a clearer official position in the IMF on capital account issues. Indeed, we read the staff response as agreeing that it would be useful to have some further operational guidance that lays out the broad principles that staff should follow in its policy advice across countries.

The staff notes that the IEO report does not do justice to the role played by external forces in promoting capital account liberalization (paragraph 5). We agree that the exogenous factors noted by the staff were an important influence on capital account liberalization in many countries. Indeed, the report does refer to these external forces; some of the detailed country cases in Appendix 1 and some boxes on country experiences are quite explicit in spelling out the external forces that influenced the decisions of these countries to open their capital accounts. The focus of the report, however, remains on the IMF's approach. If the forces driving capital account liberalization were indeed beyond the IMF's control, this does not alter the fact that the IMF had a potentially critical role to analyze the risks involved and to offer appropriate policy advice to minimize those risks. An assessment of the IMF's approach to capital account liberalization does not depend on where the impetus came from.

Regarding Recommendation 1, the broad approach to the IMF's future work on capital account issues set out in the third bullet of paragraph 7 of the staff response is consistent with what we had in mind. The staff also notes the practical difficulty of providing a quantitative gauge of the benefits, costs, and risks of liberalizing the capital account at different speeds. We concur that it is not an easy task, but assessing the trade-offs involved in different approaches is critical if the IMF's advice on sequencing capital account liberalization is to be useful. Sequencing necessarily involves a piecemeal process in which some markets are liberalized while others remain closed. Then, sequencing is the right approach only if the risks avoided exceed the risks created by partial liberalization. While it is unlikely to be possible to quantify precisely the trade-offs involved, policy advice would be of limited usefulness unless some guidance on the nature and magnitude of the trade-offs were provided. Welfare economics—in which the consequence of opening a market when domestic distortions exist has been an important topic—may provide insight for thinking about how to make policy advice on sequencing more operational.

Finally, regarding Recommendation 2, the staff notes a number of initiatives that are already under way, to analyze supply-side factors influencing the volatility of international capital flows. We welcome these initiatives, some of which, but not all, were noted in the report. The point we make in the report

[1]Paragraph references are to the staff response.

is that the IMF's analysis of supply-side factors has been largely descriptive and that the policy implications drawn are mainly targeted at recipients of capital flows. There are, of course, good reasons for this—including the evolving nature of the literature which has generated limited consensus on specific actions that could be taken on the supply side to minimize volatility and cyclicality. Therefore, our recommendation was not a call for the IMF to back any specific policy measure but rather to strive to enhance further its understanding of supply-side factors and their operational or policy implications, with the focus on how such factors influence interlinkages between countries. But we agree that considerable progress has already been made in this direction, including through the various forthcoming activities noted by the staff in its response. Not all of these were known to us at the time the IEO report was prepared. For example, the planned thrust of the next *GFSR* is the type of activity we had in mind.

The Acting Chair's Summing Up

IEO Report on the Evaluation of the IMF's Approach to Capital Account Liberalization

Executive Board Meeting
May 11, 2005

Executive Directors welcomed the report by the Independent Evaluation Office (IEO) on the IMF's approach to capital account liberalization. They noted that financial integration can confer benefits to the global economy by promoting an efficient allocation of savings and a diversification of risks, with some Directors emphasizing the importance of orderly and well-sequenced liberalization. Directors stressed the increasing significance of capital account issues in Fund surveillance, and of fully understanding and addressing the difficulties and complexities faced by the Fund in providing advice in this area. They thus welcomed the opportunity that the report provides to explore how the Fund's effectiveness in this area can be further advanced.

Directors appreciated the IEO's efforts in evaluating the Fund's experience since the early 1990s with a large sample of representative countries. They noted that the report offers a broadly accurate account of the evolution of Fund thinking and practice on the issues surrounding capital account liberalization and capital flow management, including the temporary use of capital controls. Such a history provides a crucial background for a discussion of these issues. Directors welcomed the IEO's confirmation that the Fund did not apply an inappropriate "one-size-fits-all" approach to capital account liberalization in individual countries. Some Directors noted that, while it was important to apply discretion in individual cases, it would have been helpful for policy advice to have been guided by general principles. Directors concurred with the report's finding that the Fund did not pressure members to liberalize their capital account sooner than desired by the authorities, and generally did not challenge the use of temporary capital controls. They considered that the Fund should continue to adopt a flexible approach to capital account liberalization that takes due account of countries' specific circumstances and preferences. At the same time, Directors recognized that in the earlier period the risks of an open capital account had not always been sufficiently highlighted in the Fund's operational policy advice, and that little policy advice had been offered in the context of multilateral surveillance. Directors were encouraged, however, that in recent years substantial strides have been made, based on the lessons of experience and supported by the Fund staff's extensive analytical work on capital account issues and financial system stability. In this connection, some Directors suggested that the IEO report could have offered specific suggestions on how to ensure greater consistency and coordination between ongoing analyses on capital account liberalization issues at a conceptual level and their practical application in country operational work.

Directors expressed a variety of views on the importance of factors motivating capital account liberalization, such as free trade agreements and bilateral investment treaties. It was acknowledged that such agreements are negotiated voluntarily by country authorities when they are considered to be in the national interest. Some Directors felt that the role of such agreements in capital account liberalization should not be underestimated. At the same time, many Directors saw a key role for Fund involvement in policy advice on capital account issues as a means of promoting orderly and nondiscriminatory capital account liberalization.

Directors also commented on the two main recommendations of the IEO report.

Recommendation 1. There is a need for more clarity on the IMF's approach to capital account issues.

Directors stressed that the Fund has long attached importance to capital account issues and vulnerabilities, and that the process of clarifying their role in surveillance is well under way. They noted that the

Executive Board, in its various discussions including in the context of the Biennial Surveillance Reviews, has called for Fund surveillance to adjust to the changing global environment, notably the expansion in capital flows. The Fund has provided country-specific guidance to member countries on strengthening domestic policies and practices to manage risks related to capital account liberalization, including in the context of FSAPs and ROSCs. Furthermore, regional and global surveillance has increasingly focused on global financial market linkages, looking at demand- and supply-side factors, and the implied costs and benefits of capital account liberalization. Some Directors, however, saw merit in further clarifying the scope of Fund surveillance to recognize explicitly the central importance of capital account policies. Such clarification will also serve to improve the consistency of the Fund's approach in this area across countries. Directors agreed that the Fund has an inherent responsibility to its members to analyze the benefits and risks involved in a world of open capital markets, and to provide practical, sound, and appropriate policy advice to its members on those issues. On the broader aspects of the Fund's role in capital account liberalization, most Directors did not wish to explore further at present the possibility of giving the Fund jurisdiction over capital movements. However, a number of Directors felt that the Fund should be prepared to return to this issue at an appropriate time. Directors also noted that additional work on capital account issues is contemplated in the context of the Fund's ongoing strategic review.

Directors expressed a variety of views on the merit of an Executive Board statement clarifying the elements of agreement on capital account issues. A number of Directors supported such a statement, which could build on the "integrated" approach that has gradually evolved in the Fund's operational work, as outlined in the IEO report. However, many Directors underlined the challenge that would be faced in developing such a statement in view of the inherent difficulty in developing common guidelines that adequately take into account country-specific circumstances. Further, these Directors noted that, at present, firm theoretical and empirical conclusions are lacking, and accordingly, such a statement might need to be crafted in rather general terms, thereby not providing significant additional guidance. Directors noted that they would have an opportunity to come back to this issue in the context of the Fund's ongoing strategic review. More generally, Directors stressed that staff will need to continue to exercise their informed professional judgment and discretion.

Directors saw scope for sharpening the Fund's advice on capital account issues. They emphasized that Fund staff should continue to draw upon all available research in its policy advice to members, and that further research and study are needed to fully understand how best to obtain the benefits and manage the risks of capital account liberalization, including sequencing issues. Directors urged the staff to base its policy advice on solid analysis of individual country situations. To this end, a number of Directors recommended that staff reports should include a clearer and more systematic and analytical rationale for Fund advice. Directors also encouraged the staff to further strengthen its technical expertise on capital account issues. With regard to the IEO's suggestion that the Fund staff should aim to provide more quantitative assessments of the benefits, costs, and risks of liberalizing the capital account at different speeds, a few Directors saw merit in the proposal, while others considered it to be very difficult to implement because of the technical challenges and economic complexities involved.

Recommendation 2. The IMF's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and to what can be done to minimize the volatility of capital movements.

Directors welcomed the various initiatives under way in the Fund to strengthen research, analysis, and surveillance of the supply side of capital flows, and agreed with the IEO's view that considerable progress has already been made in this area. A number of recent analytical staff studies have examined supply-side features of capital flows, and Directors noted that the recent *Global Financial Stability Reports* have examined the determinants and volatility of capital flows to emerging market countries including their institutional investor base. Directors further pointed to the Capital Markets Consultative Group, which serves as an informal forum for dialogue between participants in international capital markets and Fund management, as well as to the visibility given to supply-side issues by staff at the Financial Stability Forum and the Basel Committee of Bank Supervisors. A number of Directors accordingly felt that the Fund is already paying due regard to supply-side factors that influence the volatility of capital flows.

Directors encouraged the staff to continue to build on the work already being undertaken at the Fund in order to further its understanding of supply-side factors and their operational and policy implications, including how such factors influence interlinkages and imbalances among countries in the context of the Fund's multilateral and bilateral surveillance. In particular, they suggested that more attention be devoted to the spillover effects from regional developments and from policies in systemically important

advanced and developing countries. Directors cautioned that any expanded work on supply-side issues should not entail Fund involvement in the regulation of the sources of capital, noting that the Fund should instead coordinate with the FSF and other fora that have the necessary expertise and mandate in the setting of standards. Some Directors would have welcomed suggestions by the IEO for additional specific actions that the Fund could take to address risks related to the volatility of capital flows.

In concluding, Directors agreed that the Fund's future work on capital account issues should seek to buttress efforts to promote financial stability, while helping ensure that controls are not used as a substitute for adjustment. The aim would be to build on the existing Fund expertise in this area, and to ensure that policy advice on capital account issues is fully incorporated into the mainstream of bilateral and multilateral surveillance, with analytical work being used to strengthen the basis for policy advice and technical assistance. This strategy would imply orderly and nondiscriminatory liberalization aimed at facilitating countries' integration into the global economy while maintaining stability. As a follow-up to the findings of the IEO report, Directors looked forward to capital account issues being addressed in the context of the Fund's ongoing strategic review.