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CAPITAL CONTROLS: A TIME FOR PRAGMATISM

In February 2010, a Discussion Note from the IMF acknowledged that capital controls have a place among the instruments governments can use when faced with large capital inflows. This is a decisive change of tack on one of the most controversial issues in the history of the IMF. In any event, it is the result of shockwaves from the global financial crisis and the need for regulation that this crisis produced. Significantly, an official Fund document released on 5 April 2011 proposes a new classification of 'capital flow management' instruments, where capital controls are depicted less as barriers to international movements than as specific regulatory tools.

Poor reputation

The strongest incentive for any economy to liberalise its financial operations with the rest of the world is the deepening of its integration into global trade. However, during the 1990s, various institutions pressed the developing economies to accelerate their financial opening: OECD candidates (Mexico, South Korea and Central European countries) were required to subscribe to the Code of Liberalisation of Capital Movements; commitments to liberalisation were made as part of the bilateral trade and investment agreements signed especially with the USA or in accordance with WTO requirements. The IMF's role was more ambiguous. Its articles of agreement require its members not to restrict payments and transfers for current transactions, but leave them the right to "take all control measures necessary in order to regulate international movements of capital"[1]. However, the Fund has taken an active part in the ideological pressure in favour of such a process of opening up. As part of its "multilateral surveillance"[2], the Fund has much more focused on the benefits of better access to international capital than on the risks of financial openness; when performing "bilateral surveillance" (Article IV), its teams were encouraged to promote liberalisation[3].

Financial openness was uneven across countries (with India and even more China pursuing a very gradual process); it has not come into being without upsets, particularly in Latin America, a pioneer of both liberalisation and financial crises. Tensions and crises have led numerous countries to reimpose (temporarily) restrictions on inflows or outflows, whether quantitative limits on transactions or indirect measures affecting their yield (box 1). Within the IMF itself, some economists admitted that these temporary measures could be justified on prudential considerations. This view, expressed especially in an Occasional Paper of 1995[4], is not different to that expressed fifteen years later in a IMF Staff Position Note that made waves[5]. But, in the late 1990s, unlike today, this view was not supported by the Management of the Fund, whose priority was to include the liberalisation of the capital account into the statutory objectives of the institution[6]; this would have enabled it to include financial openness as one of the conditions of its assistance and would have given it authority to judge if any restriction imposed by a government was compatible with its obligations as a Member State. The repercussions of the financial crisis in Asia (1997-98) prevented this amendment being adopted,

1. This right is however conditional on the obligations regarding adherence to exchange systems under Article IV.
2. Multilateral Fund monitoring is performed via two biannual publications: *World Economic Outlook and Global Financial Stability Report*.
3. Independent Evaluation Office of the IMF (2005), Evaluation Report, "The IMF's Approach to Capital Account Liberalization".
4. IMF (1995), "Capital Account Convertibility – Review of Experience and Implications for IMF Policies", *Occasional Paper* no. 131, October 1995.
5. J. Ostry *et al.* (2010), "Capital Inflows: The Role of Controls", *IMF Staff Position Note*, 19 February 2010 SPN/10/04.
6. Communiqué of the Interim Committee of the Board of Governors of the IMF, Hong Kong, 21 September 1997.

Box 1 – Capital controls and prudential measures

Capital controls are the measures taken by a country to restrict the inflows and/or outflows of capital.

They are traditionally divided into:

♦ direct controls, which are administrative measures that prohibit or restrict transactions, payments for transactions or transfers of payments;

♦ indirect controls, which are market measures that discourage movements of capital by making them more expensive. The most frequently used are:

- a taxation on flows or revenue from the holding by residents (non-residents) of foreign (domestic) financial assets. This tax may depend on the type or maturity of the transactions (*e.g.* Brazilian IFO).
- a mandatory non-remunerated reserve rate that reduces the yield from a capital transaction, especially when its maturity is short (*e.g.* the Chilean encaje).

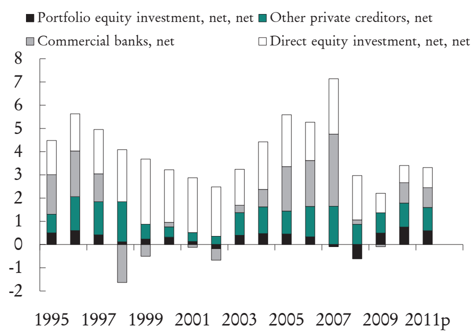
Prudential measures are intended to preserve financial stability. They are rules imposed on financial institutions, particularly banks, to reduce the risks they take. Some prudential rules imposing a limit on the exposure of banks to exchange rate risk can lead to less capital flows. Capital controls, on the other hand, can be used for prudential purposes to fill regulatory loopholes or reduce the risks generated by non-intermediated flows.

but the idea that controls were "bad"[7] long remained pregnant within the institution. The rise of emerging countries, the reinforcement of their financial position, and then the shattering of previous convictions following the global crisis, will result in this point of view being fundamentally questioned.

A wide range of instruments

The growth outlook and the financial development of emerging countries are the structural factors which make these economies attractive to global investors. However, the fluctuations of the capital flows respond very broadly to factors exogenous to these countries: the cyclical position and the monetary stances of advanced economies, and changes in the overall liquidity of investors. Thus, after having fallen during the financial crisis of 2007-2008, net flows of private capital towards emerging countries rapidly recovered as the global crisis increased the differences between North and South in growth

Graph 1 – Net private capital inflows in emerging countries 1995-2011 as a % of GDP



Source: IIF, Capital Flows to Emerging Market Economies, 24 January 2011, author's calculations.

and in short-term yields. Overall, these flows have not returned to the exceptional level they attained in 2007, neither in value nor in percentage of GDP, owing to the weak upturn in bank loans and direct investment. Their composition has however changed in favour of portfolio investments (Graphs 1 and 2). This illustrates a return to the carry trade transactions favoured prior to the crisis: low-rate borrowing in advanced economies to invest in currencies and high-yield assets in a small number of emerging countries.

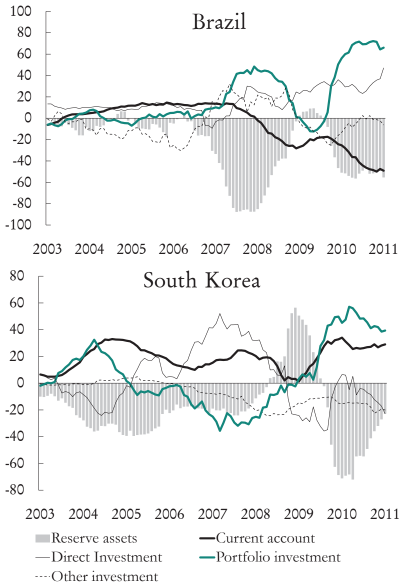
Emerging countries faced with a surge of capital inflows have two main policy objectives. The macroeconomic one is to find within the "Impossible Trinity", while their capital account is kept largely open, a place that will enable them to refrain the appreciation of their currency (in order to ensure their manufacturing sector remains competitive) and to use their monetary tools to fight inflation. The other objective, which is prudential in nature, is to prevent financial instability. To meet these objectives, they can combine their monetary and budgetary policies with various instruments that, while relieving pressure on exchange rates, have a prudential dimension: accumulating exchange reserves represents a sort of self-insurance against the risk of large capital outflows; some prudential rules imposed on banks limit the risks associated with external credit financing (which are particularly high if this financing is short-term and in foreign currency); and capital controls reduce the instability stemming from non-intermediated flows[8]. Brazil and South Korea provide recent examples of how these instruments have been used.

In Brazil, where interest rates are high (the benchmark rate was 11.75% in March 2011), the currency reappreciated strongly after the crisis, despite interventions on the foreign exchange market (Graph 2). Since the monetary tightening required to bring inflation towards the target value risked attracting even more short term flows, Brazil reinforced several prudential rules imposed on banks and, from October 2009, imposed a tax on fixed income instruments bought by non-residents, subsequently extended to equities. In order to slow growth (7.3% in 2010), a budgetary tightening would certainly provide a better policy mix, as it would give more room to monetary policy. Given the political calendar and the time required to implement budgetary measures, capital controls act as a palliative to try to reduce the incompatibility between the external (exchange rate) and internal (inflation) objectives of monetary policy.

For other reasons, Korea has also become a premium destination for carry trade. The current surplus (Graph 2) is applying structural pressure to the appreciation of the won, whereas low interest rates are driving up the price of assets. The Korean Central Bank is seeking both to act to control appreciation on the exchange market and to prevent asset bubble development. A number of prudential measures have

7. Comment from O. Blanchard quoted in Le Monde, 21 April 2010.
8. Several recent publications from the IMF, the BIS and the Financial Stability Forum have analysed the conditions for using these instruments in a macro-prudential way. See R. Moreno (2011), "Policymaking from a "macroprudential" perspective in emerging market economies", *BIS Working Papers* no. 336, January; FSB, BIS, IMF (2011), "Macroprudential policy tools and frameworks, Update to G20 Finance Ministers and Central Bank Governors", 14 February; IMF (2011), "Macroprudential Policy: An Organizing Framework", 14 March.

Graph 2 – Current balances, net capital flows and reserves accumulation, 2003-2010 (12 months moving averages)
billions of dollars



N.B.: The negative figures indicate an accumulation of reserves.
Source: Central banks, author's calculation.

been enacted, which, in somes cases, discriminate foreign and domestic banks, or put some limits on currency transactions. Following the Seoul G20, Korea also announced that a tax would be applied to reduce the yield from public bonds for non-resident investors.

Internationally, the issue is whether the use of these various instruments is justified by prudential considerations, or whether it reflects a manipulation of the exchange rate. One debate concerns the question of the "right" level of exchange reserves and the implementation of financial safety nets that would reduce those accumulated on the grounds of self-insurance[9]. The other debate is about the international consequences of capital controls and the need of multilateral rules in this area.

A framework

Capital controls are the source of numerous distortions (flows are carried over to uncontrolled segments of the financial system, and companies find it harder to obtain financing) and are liable to delay certain necessary macroeconomic adjustments. However, their international ramifications are a major cause for concern. In the wake of the financial crisis, it was precisely the fear of seeing a widespread financial protectionism engaging in a 'currency war' that provoked a lot of debate. However, the role of capital controls in this war could be discussed:

♦ The control measures passed recently have not prevented financial liberalisation taking place. According to the IMF's Annual report on exchange arrangements and exchange restrictions of all IMF member countries, between January 2009 and July 2010, out of 164 modifications reported by 43 member countries, two-thirds were liberalisations. The report deems that most of the restrictions were prudential in nature, with some merely re-establishing the restrictions in place before the crisis and that had been lifted during the risk aversion phase (late 2008-mid-2009).

♦ Capital controls have little effect on the exchange rate. Previous experience has shown that capital controls are especially suited to extending the maturity of incoming flows and granting additional monetary breathing space; in countries with a largely open financial account, their impact on exchange rates is rather controversial[10].

♦ The risk of controls redirecting flows to other countries may be smaller than is often thought: different markets offer various possibilities to diversify portfolios and yield/risk combinations that cannot necessarily be substitutes, particularly when it comes to carry trade transactions.

Finally, it should be noted that market operators consider the restrictions to capital flows so far implemented to be "at the margin"[11]. Nevertheless, the fact remains that the IMF should deliver an official position on an issue on which it has not expressed any doctrine since the debates of the 1990s.

Following the 1977 IMF Board's Decision on surveillance over exchange rate policies, "the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital" is one of the situations which might reveal a manipulation of exchange rates and, thus, give rise to consultations between the IMF and the Member State. The 2005 Evaluation Report (*cf.* note 3) stressed that, in the absence of any operational guidelines, the opinions expressed on the situations of the different countries in this regard were lacking consistency. A new Decision on bilateral surveillance over members' policies adopted in 2007, has actually reinforced the need for consistency. This decision introduced the concept of external stability as an "organizing principle for bilateral surveillance"[12]. Up until that point, the Fund could not ask a country to correct its policy unless that policy threatened the country's own stability. The increase in global imbalances showed that this was a serious loophole that the 2007 Decision was intended to address. For the Fund teams, taking account of external stability makes it even more necessary to be able to call on a consistent reference framework.

This framework was drawn up beginning with the *Staff Position Note* by Ostry et al. in February 2010 (*cf.* note 5). Several other documents followed; on 5 April 2011, the IMF published a *Staff Discussion Note*, and a document submitted to the Board of Directors

9.See A. Bénassy-Quéré, J. Pisani-Ferry & Y. Yongding (2011), "Reform of the International Monetary System: Some Concrete Steps?", *La Lettre du CEPII*, no. 309, 28 March 2011.
10. N. Magud & C. M. Reinhart & K. S. Rogoff (2011), "Capital Controls: Myth and Reality – A Portfolio Balance Approach", *NBER Working paper* 16805, February.
11. IMF (2011), "Recent Experiences in Managing Capital Inflows-Cross-Cutting Themes and Possible Policy Framework", p. 5, 14 February.
12. IMF, Public Information Note no. 07/69.

in order to make the proposed framework official[13]. The former *Note* stipulates the macroeconomic and financial circumstances in which a country can apply capital controls: if the exchange rate is not undervalued, if exchange reserves are at an adequate level and the activity is close to its potential, and if prudential measures are not sufficient to manage the financial risks, capital controls can be used, as a last resort, to respond to temporary inflows of capital.

The place of capital controls in the policymakers'toolkit was thus acknowledged. However, numerous voices in emerging countries criticised the fact that the use of controls as a last resort continues to stigmatise them[14]. The framework document published on 5 April set out a response to this concern by presenting a new typology that removed the traditional distinction between prudential measures and capital controls. A distinction is now drawn between:

- CFMs (Capital flows management measures), which are targeted at capital flows; they are liable to transfer tensions to other countries, and thus to fall within the ambit of bilateral surveillance (Figure 1);
- other measures (non-CFMs), which have other structural or prudential aims.

Among the CFMs, in accordance with the Fund's mandate, preference is given to those that do not introduce discrimination according to the residency criteria; the document does however underline the fact that there is no hierarchy in terms of welfare between the various measures, and that a pragmatic approach must prevail.

This document also throws an interesting light on the ongoing situation. The framework is applied to emerging countries with largely open financial accounts. The result, expressed globally, is significant: 7 or 9 countries (depending on the method used) are alleged to be currently liable to apply CFMs. This is more or less the same number as the countries that tightened their prudential measures or implemented capital controls since the global crisis. This assessment thus provides a sort of *ex post* justification for the measures adopted.

Figure 1 – New typology of capital flow management instruments

Traditional Nomenclature			New Nomenclature		Examples
Capital controls		CFMs *designed to influence capital inflows*	Residency-based CFMs		Taxes on portfolio investments by non-residents
Prudential Measures	discrimin. on the basis of currency		Other CFMs	discrimin. on the basis of currency	Limits on foreign currency borrowings
	non discrimin. on the basis of currency			others	Withholding tax on public sector bonds
		non CFMs *do not target flows*			Loan-to-value ratio

Note: CFMs: Capital Flows Management Measures.
Source: IMF (2011), Strategy, Policy and Review Departments, "Recent Experiences in Managing Capital Inflows-Cross-Cutting Themes and Possible Policy Framework", 14 February, author's presentation.

Several emerging countries, beginning with Brazil, have nonetheless continued to express serious reserves. They are concerned that the reference framework presented by the IMF will be transformed, under the cover of the reforms to the international monetary system launched by the G20, into a code of conduct for capital controls imposed to the emerging countries while the most important external aspects of the policies adopted by systemic economies (monetary policies of advanced economies or Chinese exchange rate policy) are kept unaddressed[15]. Some economists have suggested that the quantitative easing implemented by the USA should be accompanied by a taxation on speculative capital outflows[16], and the Finance Minister of South Africa was one of the first to express a wish for a multilateral formula to act at both the source and the destination of these flows.

The pragmatism now in force at the IMF is certainly welcomed by emerging countries. However, in the current bargaining within the G20 about reforms to the international monetary system, those countries are certainly not about to be the first ones to submit to new multilateral rules without receiving anything in exchange.

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13. J. Ostry *et al.* (2011), "Managing Capital Inflows: What Tools to Use?", *IMF Staff Discussion Note*, 2011 SDN/11/06, 5 April; IMF (2011), "Recent Experiences in Managing Capital Inflows-Cross-Cutting Themes and Possible Policy Framework", 14 February.
14. See in particular the contributions from R. Mohan & J. A. Ocampo during the Conference organised by the IMF on "Macro and Growth Policies in the Wake of the Crisis", Session IV: Capital Account Management, Washington, 7-8 March 2011.
15. According to the 2007 Decision and with the support of the G20, the IMF will produce reports on the external aspects of the policies of the major economies: China, the US, Japan, the UK and the Eurozone.
16. S. Griffith-Jones & K. P. Gallagher (2011), "Curbing Hot Capital Flows to Protect the Real Economy", *Economic & Political Weekly*, 15 January.

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