At issue: Rethinking the IMF's capital account mandate

While the intellectual thinking within some parts of the international financial institutions has recognised the usefulness of capital controls[i], there is yet to be formal acceptance of them within the International Monetary Fund (IMF). The IMF is reconsidering its mandate over the summer and autumn of 2010. While the IMF's Articles of Agreement already contain important provisions about the rights of countries to use capital controls, consensus has not been achieved among the Fund's largest members on capital account management, despite its importance for both large and small developing countries.

In October 2009, the G20 asked the IMF to conduct a review of its mandate.[ii] It is unclear whether the IMF's major shareholders are willing to undertake a radical rethink of any of the Fund's roles, or whether the review will only result in some minor tweaking. The last such IMF review, launched by then managing director Rodrigo de Rato, resulted in little change. It approved a multilateral consultation process, launched to discuss global imbalances in 2006, but this process failed to produce any tangible results or concrete agreements among IMF members to adjust their economic policies.[iii]

Changing economic thinking?

In February 2010, the IMF released a staff position note, *Capital inflows: The role of controls*[iv], which stated that "capital controls are a legitimate part of the toolkit to manage capital inflows in certain circumstances." This admission by selected members of the IMF staff seems to be a reversal of some of the Fund's historic approach to macroeconomic policy, but reflects only the opinion of staff, not the accepted position of the IMF board and thus of the institution.

The paper, after examining the experience of governments that have regulated capital flows, notes "that the use of capital controls was associated with avoiding some of the worst growth outcomes associated with financial fragility." Specifically the authors find that GDP fell less sharply during the financial crisis in countries that already had such policies in place. The report cites Brazil's taxes on short-term debt, and policies pursued by Chile, Colombia and Thailand which require inflows of short-term debt to be accompanied by a deposit with the central bank.

large capital inflows may lead to excessive foreign borrowing and foreign currency exposure, possibly fuelling domestic credit booms and asset bubbles

The study accepts the view – long held by development economists, developing country policy makers, and NGO critics – that "large capital inflows may lead to excessive foreign borrowing and foreign currency exposure, possibly fuelling domestic credit booms (especially foreign-exchange denominated lending) and asset bubbles (with significant adverse effects in the case of a sudden reversal)."

The paper goes on to ask: "Can such concerns justify the imposition of controls on capital inflows — not only from the individual country's perspective, but also taking account of multilateral considerations? The answer is yes — under certain circumstances." However, the IMF's significant caveats have drawn criticism.

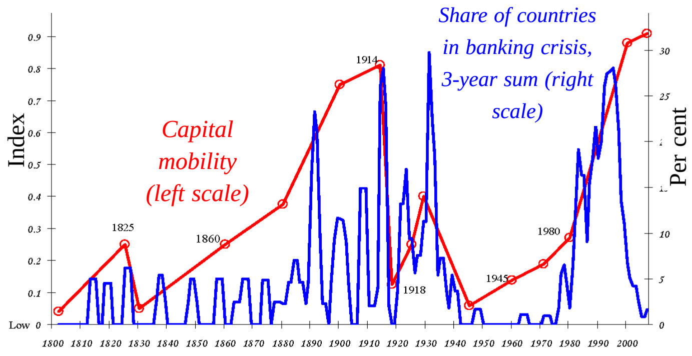
Falling down in practice

The IMF staff paper cautions against "excessive" use of controls, but fails to be more specific. It also argues that capital controls should be "temporary", warning that their "widespread" use may have "distortionary" effects and that, in the longer term, the controls would "lose their effectiveness." Additionally, the paper does not have much to say on what an effective system of controls on capital inflows would look like, nor does it offer any advice on how countries may design them. Harvard professor Dani Rodrik argues that "the IMF should now get to work on developing guidelines on what kind of controls work best and under what circumstances."[v]

Developing country policy makers have been requesting the IMF to work on such advice for years now, but have usually been rebuffed. Even after then IMF chief economist Ken Rogoff admitted that financial liberalisation could not be proved to have benefitted growth and acknowledged the usefulness of capital controls, the IMF as an institution has not budged on more systemic capital account management. As recently as November 2009, IMF Managing Director Dominique Strauss-Kahn criticised Brazil's efforts to regulate capital inflows, stating that he would not recommend such controls "as a standard prescription."[vi]

Brazil was not the only country to introduce some new

Capital mobility and the incidence of banking crisis: all countries, 1800 - 2007



Reinhart and Rogoff (2008)[ix] *show the linkages between global capital mobility and banking crisis.*

controls, but for the most part the measures were all minimal in scope. While some select IMF staff members seem willing to broach more progressive thinking on the design of controls, optimism about the elimination of stigma associated with capital controls would be premature until the Fund takes a more institutional view in their favour.

What is the Fund's capital account mandate?

In the 1990s, IMF management and several major shareholders tried to amend the Fund's Articles of Agreement to explicitly require it to promote unrestricted capital flows. This approach, part of the then ascendant belief in the infallibility of completely unfettered markets, was only stopped because of the awful consequences of the Asian financial crisis in 1997-8 and subsequent contagion to other emerging markets.

The IMF Articles of Agreement guarantee the rights of members to use capital control techniques.[vii] While the IMF members are generally required to avoid restrictions on current payments, that is payments generally related to ordinary trade, they must also "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions."[viii]

There is, in fact, an entire Article (VI) devoted to capital transfers, which clearly shows that the IMF's mandate includes advising, and even sometimes requiring, countries to use capital controls to prevent "large or sustained outflow of capital", namely financial crises of the type seen in many emerging markets. The Article even forbids the use of Fund resources for financing such outflows and states that if "… a member fails to exercise appropriate controls, the Fund may declare the member ineligible to use the general resources of the Fund."

Where to next?

While the renewed interest in capital controls by the IMF is a positive development, the bias within even the more accepting staff towards viewing capital controls as temporary, short-term solutions to deal with volatile capital flows is still unsatisfactory. Capital flows to developing countries have become increasingly large and volatile, with the risk of instability more acute now than before the Asian financial crisis, let alone when the Articles of Agreement were written.

A formal IMF board discussion on *Capital flows: the Fund's role*, focussing on the adequacy of tools related to capital flows, was planned for September 2010. The IMF board needs to accept that capital controls should be seen as a permanent and important macroeconomic policy instrument in the hands of governments, so that they can pursue independent economic policy making, growth and financial stability. IMF staff must finally be instructed to develop toolkits to help developing country policy makers design controls that are best suited to their own national circumstances and desired economic policies.

i Grabel, Ilene (2010). Capital Controls: "The new normal" (Part 1), Triple Crisis Blog, 9 July 2010, http://triplecrisis.com/capital-controls/.

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iii Bretton Woods Project (2007). "IMF crisis prevention: running on the spot", Bretton Woods Update, No. 54, 31 January 2007, London, http://www.brettonwoodsproject.org/art.shtml?x=548943.

iv Ostry, Jonathan, et al., (2010). Capital Inflows: The Role of Controls, IMF Staff Position Note 10/04, International Monetary Fund, 19 February 2010, Washington, DC.

v Rodrik, Dani (2010). "The End of an Era in Finance", Project Syndicate, 11 March 2010, http://www.project-syndicate.org/commentary/rodrik41/English.

vi Bretton Woods Project (2009). "IMF pours cold water on monetary reform", Bretton Woods Update, No. 68, 20 November 2009, London, http://www.brettonwoodsproject.org/art.shtml?x=565603.

vii Independent Evaluation Office (2005). *The IMF's Approach to Capital Account Liberalization*, Washington: International Monetary Fund.

viii IMF Articles of Agreement, Art IV, Sec 1 (ii).

ix Reinhart, C., Rogoff, K. (2008). "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises", NBER Working Paper No. 13882.

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