Debt crisis prevention: We need to talk about capital controls

At issue

By Daniela Prates, UNCTAD

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While the IMF's evolving approach to capital controls is welcome, it must adapt its institutional view to recognise them as an essential and permanent part of the macroeconomic policy toolkit of emerging and frontier market economies. It remains unclear, however, whether the ongoing review of its institutional view on capital controls will address the significant shortcomings of its current approach and allow states the policy autonomy needed to prevent future debt crises.

The Covid-19 crisis hit when developing countries were already struggling with high debt burdens accumulated over the boom of capital flows (financial resources entering these middle and low-income countries in search of higher returns due to low interest rates in developed countries) after the 2008 global financial crisis (GFC). The pandemic shock put additional pressure on these countries' external debt sustainability – i.e., their external solvency or capacity to meet the external debt service in the medium and long term – and brought on liquidity constraints, that is, the need of short-term external finance. These pressures and constraints were induced by falls in global trade, export earnings, remittances and commodity prices, by the virtual collapse of the tourism industry, as well as by record-high non-resident portfolio capital outflows in the first phase of the pandemic, as outlined in the UN Secretary General's July 2020 note to the UN General Assembly. From the second half of 2020, foreign portfolio flows have been exceptionally volatile, with phases of inflows and outflows amid an uncertain global context.

Therefore, the Covid-19 crisis has laid bare once again the risks and challenges posed by capital flow liberalisation adopted by an increasing number of developing countries since the end of the 1980s. Initially these consisted of "emerging-market economies" and more recently middle- and low-income developing countries that have become "frontier-market economies". This strategy has been fostered not only by the International Monetary Fund (IMF) but also by developed countries through trade agreements and as a pre-condition for OECD membership under the influence of powerful global financial interests and, in many instances, domestic elites.

Capital flow liberalisation has made these two groups of developing countries extremely vulnerable to capital flow cycles as, in the current hierarchical and asymmetrical international financial architecture, their currencies are not accepted at the international level and these cycles are determined by the

Daniela Magalhaes Prates is a Senior Economic Affairs Officer at the Division of Globalisation and Development Strategies of UNCTAD and Associate Professor of Economics (on leave) at the University of Campinas (UNICAMP, Brazil). Her fields of expertise are development economics and international macroeconomics and finance with a focus on debt, development finance and the asymmetrical integration of developing countries in the international monetary and financial system. She has published many papers in academic journals, book chapters and co-edited books.

monetary and financial conditions in developed countries. The boom-and-bust pattern of capital flows tends to create macroeconomic imbalances, financial fragilities, and exchange rate instability that can trigger debt and/or currency crises and curb the economic policy autonomy of affected countries to pursue domestic goals. Sovereign debt crises are an obstacle to sustainable development and a serious impediment to the realisation of human rights, as stressed in the report of the Independent Evaluation Expert on the effects of foreign debt and other relate international financial obligations of States on the full enjoyment of all human rights.

Capital controls and other financial regulations that reduce the degree of financial liberalisation are therefore a crucial policy tool not only for debt crisis prevention but also for a development strategy geared towards the achievement of the 2030 Agenda.

Debt crises resolution amid the Covid-19 crisis

Even if unevenly distributed, August's record IMF Special Drawing Rights allocation has alleviated developing countries' liquidity constraints, but the international community's response has nonetheless been insufficient when it comes to external debt sustainability (see *Dispatch* Annuals 2021; *Observer* Autumn 2021). The much-criticised G20 Debt Service Suspension Initiative (DSSI), which ends this month, provided only temporary debt relief to 47 out of the 73 low-income countries (LICs) who are eligible for finance from the International Development Association (IDA), the World Bank's concessional lending arm (see *Observer* Winter 2021, Winter 2020). Debt service payments suspended under the DSSI will be added to repayment schedules from 2022, putting additional pressures on the debt burdens that must be met while responding to the pandemic's health, social, and economic impacts.

As underscored by Belgium-based network Eurodad in its November 2020 analysis and in the UN Secretary General's July 2021 report to the UN General Assembly, the G20 Common Framework for Debt Treatments beyond the DSSI also falls short of addressing the worsening debt crisis. First, it encompasses only DSSI-eligible debtor countries, excluding middle-income countries (MICs) with unsustainable debt burdens. Second, eligible countries can only seek debt relief and restructuring from the Group of 20 and Paris Club bilateral creditors and are expected to get equal treatment from powerful private creditors with much greater bargaining power (see *Observer* Winter 2021). Private creditors have remained unmoved by requests for participation in debt restructuring from World Bank President David Malpass, IMF Managing Director Kristalina Georgieva and the Cancel the Debt Campaign. Third, negotiations are supported by the IMF and the World Bank, including through their much-criticised Debt Sustainability Analyses, which are usually accompanied by austerity programmes as policy conditionalities for debt relief and restructuring (see *Observer* Autumn 2021, Autumn 2020).

The multilateral institutions, for their part, have prioritised concessional and non-concessional emergency lending as part of their pandemic response. This has implied the issuance of *new debt* that has contributed more to softening the external liquidity needs of borrowers than to improving their external solvency. The IMF cancelled debt repayments due to it by the 29 poorest developing economies through the Catastrophe Containment and Relief Trust, amounting to merely $727 million in cancelled debt payments, while the Fund's concessional lending under the Poverty Reduction and Growth Fund increased by $16 billion between March 2020 and October 2021. Moreover, financial assistance by the IMF through non-concessional lines in the same period was much greater (around $104 billion) and the lines with standard conditionalities (and related austerity programmes) predominated, as demonstrated by the Global Financial Safety Net Tracker of the Global Development Policy Center at Boston University (GDP Center), the Latin American Institute at Freie Universitat Berlin (LAI) and UNCTAD. The response of multilateral and regional development banks has been more muted during the Covid-19 crisis than following the GFC. The approvals from all MDBs (regional and multilateral) increased only 25 per cent in 2020 in comparison to 45 per cent in 2009 according to a study by the Economic Commission for Latin America and the Caribbean.

In this setting, it is not surprising that policy discussions and recommendations from civil society, think tanks, academia, and

[UN bodies](#) such as UNCTAD have stressed the need for bolder initiatives on debt restructuring and cancellation. This would require coordinated and comprehensive debt restructuring and cancellation, as well as other instruments – such as debt-swaps and debt-buy-back programmes – to alleviate developing countries' debt burdens and increase their fiscal space to face the pandemic and to build back better towards the achievement of the 2030 Agenda.

The urgency of improving the current approach for debt resolution was not only discussed in this year's World Bank and IMF Annual Meetings (see *Dispatch* Annuals 2021), but is also one of the "policy actions to strengthen the recovery" featured in a toolkit included in the World Economic Outlook launched during the meetings.

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Debt crises prevention

The discussions on debt prevention, in turn, have focused on areas that were already priorities before the Covid-19 crisis, such as the promotion of debt transparency, especially in debtor countries, and the use of innovative market-based financial instruments (like enhanced collective action clauses in sovereign bonds, State-contingent debt instruments, and green bonds), as has been suggested by the UN.

However, for the first time since the pandemic outbreak, the IMF included capital flow management measures (CFMM) – measures specifically designed to limit capital flows – in its toolkit of "policy actions to strengthen the recovery", noting in the October *Global Financial Stability* report that CFMM, "may be useful…in some circumstances in countries with balance sheet vulnerabilities and market frictions," to respond to the likely tightening of external financial conditions.

The IMF introduced the term "CFMM" in the place of "capital controls" in its institutional view on the *Liberalization and Management of Capital Flows*. This view was launched in 2012 in the context of the increase of capital flows to emerging market economies after the GFC. Concerned with the amount and volatility of these flows, the IMF shifted its official position regarding capital controls and recognised that CFMM may be useful to avoid or curb the negative impacts of capital inflows on financial stability and macroeconomic policy autonomy.

Although the view made progress in comparison to the traditional rejection of capital controls and the first approaches to tolerate these controls in highly specific circumstances in the beginning of the 2000s, four shortcomings remain. First, CFMMs are seen as a *temporary instrument* embedded in an overall strategy of financial liberalisation that should be adopted only under *specific circumstances*. Second, the Fund insists on a separation of prudential financial regulation (called Macroprudential Measures (MPM) in the 2012 view), which should be permanent, while in many cases both CFMM and MPM are needed and many times they are interdependent and overlapping. Third, it seeks to establish a set of common rules for all countries, disregarding many macroeconomic and institutional specificities. Last but not the least, controls on capital outflows are not considered, while they may be also crucial to curb negative impacts.

Therefore, it is welcome that the IMF has started talking about CFMMs again and that it recognises that they contribute to debt crisis prevention. But the degree to which these measures are currently integrated into country programmes remains in doubt and it is still not clear if the ongoing review of the fund's institutional view will address these shortcomings (see *Observer* Spring 2021).

Capital controls must be recognised as key policy tool

Capital controls are a key mechanism to prevent debt crises in developing countries, but it may already be too late for some of these countries to adopt control on inflows to avoid these crises, including some "frontier" vulnerable LICs and MICs, as normalisation of monetary policies in developed countries and the tightening of financial conditions is already underway. The regulation of capital inflows should have been done countercyclically during the return of capital flows that followed the record portfolio outflow at the beginning of the Covid-19 crisis either to curb exchange rate volatility, reduce the volume of speculative portfolio investments, or to change the composition of foreign capital toward less volatile modalities, depending on each country's external constraints (i.e. the need for foreign currency to pay for imports and other external obligations, such as the external debt service). The inherent volatility of such investments has increased during Covid-19 pandemic and this tends not only to create balance-sheet vulnerabilities, as the IMF stresses, but also to pose other risks to developing countries, as mentioned above, which undermine their capacity to recover from the pandemic, achieve the 2030 Agenda and fulfil related international human rights obligations.

To achieve these goals in the current hierarchical and asymmetrical international financial architecture, developing countries need multiple policy instruments without preconditions for their use. Despite the challenges created by impediments to their use to date, as mentioned above, capital controls remain the only effective instrument depending on the type of capital flow and the agents involved (e.g., financial institutions or non-financial corporations) and should be considered as such by the IMF. Legislation for comprehensive and lasting capital controls would allow policymakers to act quickly and avoid lengthy debates and procedures, especially during surges of inflows when the political forces against regulation tend to be the strongest, as highlighted in the 2019 *Trade and Development Report*.

The regulation of capital flows – that encompasses capital controls and prudential regulations (that mostly corresponds to the CFMMs and MPMs in IMF terminology) – should be recognised by the IMF as an essential and permanent part of the macroeconomic policy toolkit of emerging and frontier market economies. Moreover, such a toolkit needs to be country-specific, determined by external constraints, the degree of capital flow liberalisation, the institutional specifics of the domestic financial market and the policy goals of the regulation (e.g., change the composition of capital inflows, reduce volatile and speculative portfolio flows to curb currency appreciation, avoid the build-up of external and/or domestic financial fragilities that may trigger financial crises, and increase the economic policy autonomy).

Changes to Fund's institutional view are required

The revised IMF institutional view on capital flows should therefore be amended to ensure it supports the above-mentioned policies. It should also consider and respond to new challenges to the effectiveness of capital controls stemming from the so-called "crypto-ecosystem", the features of which are detailed in chapter two of the IMF's *Global Financial Stability* report. These challenges were addressed in the IMF Annual Meetings' session *New Economy Forum: Capital Flow Measures in the Digital Age*. Yet, the discussion did not consider one measure that would be crucial to increase the effectiveness of capital controls in this context: The adoption of cooperative capital controls (i.e., including the countries of origin and destination of these flows). UNCTAD has argued that this could be achieved through multilateral endorsement of specific cooperative mechanisms, as John Maynard Keynes and Harry Dexter White envisaged in their proposals related to the establishment of the Bretton Woods system.

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This article expresses the author's opinion and does not necessarily represent the view of UNCTAD.

BRETTON WOODS project

Bretton Woods Project
33-39 Bowling Green Lane
London EC1R 0BJ
United Kingdom
Tel: +44 (0)20 3122 0610
info@brettonwoodsproject.org

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