CHAPTER FOUR

The IMF's Institutional View: A Critique

Sebastian Edwards

Thank you, first of all, to John Taylor and John Cochrane for inviting me. And it's always a pleasure to be here at Hoover and in particular to be at this conference, which has become a big tradition and an opportunity to meet old friends.

I don't have a PowerPoint. And I do have a new book as well, but I'm not going to advertise it. [Laughter] And I am going to follow the instructions that were given to us on the panel, which is to talk about the International Monetary Fund's Institutional View. I do have some comments on what Jonathan said outside the sphere of the Institutional View and I will address those if I have time toward the end of my presentation.

The IMF's Institutional View on capital flows management, which is a euphemism, of course, for capital controls, is provided in two documents. If you read who were the authors of those documents, the intersection between the 2012 and the 2016 documents is one person, and that's Jonathan Ostry. So that makes him the perfect person to talk about the Institutional View. I must as a way of disclosure say that Jonathan and I are coauthors and we've known each other for a very, very long time. I was a visiting scholar at the IMF when he arrived as a young economist, just graduated from Chicago, where I think he wrote his thesis under the guidance of Assaf Razin. So the IMF Institutional Views are two papers, one from 2012 and one from 2016.

The two IMF documents that capture and summarize the IMF Institutional View are extremely well written and very, very carefully done. And a very large number of people participated in preparing them. There is something in the papers for everyone. If I were to be a little provocative, just a little, and sort of label or title this session, one possible title would be, "When Did the IMF Lose its Groove?" Or, "When Did the IMF Become a Really Boring Institution?" I remember a conference that Rudi Dornbusch and I organized in Seoul, South Korea. The local institution was the KDI and Jung Sun Park was the key person there. It was about capital controls. It was twenty-five years ago. There was a huge debate throughout the conference between the IMF representative at the conference and one of the participants, where the IMF was absolutely clear in stating that capital controls were *never* good. We talked about the dynamics of liberalization, and in that context someone asked: What about sequencing of reforms? And the IMF said, no sequencing. They should be lifted immediately. What about maybe relaxing them gradually? Not gradual at all, we were told. They should be abolished very fast. So who were these two people? On the IMF side was Manuel Guitian, whom some of you may remember, who was number two to David Finch. If David had been there, he'd have had exactly the same view. And on the other side, none other than Bob Mundell. So, if you have the IMF being more in favor of capital mobility than Bob Mundell, you know that it is really out there. And that was the old time—not any longer. As the Institutional View documents clearly show, the IMF now hedges its position. It argues that there are a number—many, indeed—of circumstances when capital controls may be warranted.

Indeed, what the two papers do is give you a little bit about everything, and as I said: Capital controls? Well, sometimes yes, sometimes no; it depends on this, it depends on that; it is good sometimes, you should really look at the long term and maybe without capital controls. But during his presentation Jonathan several times said it's structural, not cyclical. That means that, well, maybe even in the very, very long run, since the structure doesn't really change, maybe we should still have capital controls.

Let me just focus on what the papers say. In what follows, I will focus on the most recent document, the one from 2016. The first thing that I think is quite remarkable, and it connects with the first session, is how little we know about the models, about the effects, even about the policies. The 2016 IMF paper has a very interesting table, which is table 2 on page 31. And what that table says is how many capital flow management measures were taken between the years 2013 and 2016, and it's about 900 of them. Then they classify them in four categories: control on portfolio investment, control on derivatives, control on direct investment, and differentiated reserve requirements on capital flows. And then there is a fifth category, which is "other." Well, about 70 percent of the measures are under "other." So, although one of the IMF's tasks is to analyze the nature of controls, it has found it difficult to classify them. We don't even have a very good view of what are the policies or measures that we're talking about.

The second point that I think is interesting is made in paragraph 50 and, again, it relates to the point made in the first session of this conference. The paper says: we really don't know much about how effective capital controls on inflows are. And it says: we need better assessment of the effectiveness of capital controls. This is an ongoing issue, and I think that's a very important point. The main aspect of this issue, of course—this refers to capital controls on inflows—is that they are never taken as a sole measure, they are never taken on their own. They're always part of a package. One of the lessons that I learned from Rudi Dornbusch is that when you're older than fifty, it's not really good taste to talk too much about your own work. I'm going to break that golden rule and talk a little bit about my work. A few years ago I did a paper with Roberto Rigobon from MIT about the effectiveness of the Chilean capital controls. What we found out is that they were effective, but the effectiveness was really the accompanying policy, which was a band for the exchange rate. And the band dictated that every time the peso tried to break through the band, the band was widened. So it was a flexible, very pragmatic band that had a very low degree of credibility. But sometimes it was binding, while other times it wasn't. So we really could not tell at first how effective the controls themselves were. And then we found out that the controls on inflows weren't really that effective; the effectiveness really came from the intervention in the foreign exchange market.

The two papers refer repeatedly to the sequencing of policy. But the sequencing discussion is concentrated and deals exclusively with the sequencing of capital controls. They start by saying, *first you have to liberalize FDI inflows. Then you have to liberalize FDI outflows, and only slowly, long-term bonds, and so on and so forth*. I would have liked to have had a broader discussion of sequencing involving other markets. In particular, when it comes to emerging markets, the interaction between capital markets and the labor markets, it is essential. Jim Heckman did quite a bit of work many years ago trying to measure the degree of distortions in labor markets in the emerging markets. The interaction between labor market constraints, which are gigantic, and the financial sector is something one should take into account when discussing the sequencing of policy.

Another issue that I would have liked to see more deeply treated by the IMF is the whole question of moral hazard. Of course, the term appears in both reports, and Jonathan did mention it in his presentation. But I don't think that it is discussed strongly enough. The question, of course, is: How differently are policy makers going to behave if they have the option of saying, at any time, "Well, the IMF allows us to use capital controls"? A number of examples from Latin America indicated, quite clearly, that the extent of moral hazard is deeply affected by the institutional setup. For instance, there is a huge difference between Chile, which has a completely independent central bank, and Brazil, where it is not independent but sort of well behaved, and Venezuela, where it is not independent and it is very badly behaved.

Let me move into a different topic which appears repeatedly in the two official papers that summarize the IMF's Institutional View. Both documents are replete with the notion: *you should do this if the currency is not overvalued.* Or, *you should do that if the degree of overvaluation is large.*

But it turns out that we don't really know very well how to recognize real exchange rate misalignment. In spite of the fact that the IMF spends thousands of men- and women-hours per year on its models on exchange rate overvaluation, we have made very, very little progress on that issue. If you analyze carefully what investment banks do regarding trying to determine whether a currency is out of line or whether it responds to fundamentals, you will conclude that the models are very crude. We are doing almost exactly the same thing that we were doing twenty-five years ago. Very little progress has happened, and the paper proceeds as if we have good, powerful models to understand misalignment. But the truth is that we don't.

The two documents that summarize the Institutional View deal in detail with the so-called originator countries. This is related to the very interesting paper presented earlier by Raghu Rajan on the responsibility of central bankers in advanced countries with regard to their policies' impact on the emerging nations. I think that the notion that central banks in the advanced nations will take into account how their own policies will affect emerging countries is pure wishful thinking. Historically it has not happened, and unless we are talking about major systemic crisis it is very unlikely to happen in the future. Let's think of what happened just one day before this conference. Our good friend Freddy Sturzenegger, the governor of the central bank of Argentina, raised the policy rate by 700 basis points. The policy rate in Argentina now is 40 percent. And the inflation rate is 22 percent. So you just do the math. What's the real policy rate in Argentina? Can you imagine that Jay Powell and the FOMC are going to think twice about raising the Federal Funds Rate because poor Freddy is under a lot of pressure in Buenos Aires? It's not going to happen. And I can go and tell you many stories from history. When Miguel Mancera —and John Taylor knows this—came and talked to Alan Greenspan in 1994 because the *tesobonos* were being sold like crazy in Mexico as a response to the Federal Reserve raising rates, Greenspan said, "I'm sorry. Mexico is not one of the regional Feds. I don't care what's going on there. My job is to worry about inflationary pressures in the United States." Now, to be fair, the Treasury then responded by using the stabilization fund, although Congress didn't like that. The stabilization fund was created in 1934, after the devaluation of the dollar. Larry Summers used it and helped Mexico, and Mexico paid every penny back. So the "originator countries" discussion—I think it's nice, but I think it's really not very realistic.

Something else I found missing . . . and I know that it's easy to ask for more in a paper that is already quite comprehensive. But since it doesn't cost me anything to ask for more, I will do it. I think there should be a greater discussion on the benefits of free capital mobility and pension funds management. If you look at the countries that have funded pension systems—and I go back to Chile, for instance—you will find out that the extremely good rate of return obtained by these funds was related to the ability to diversify internationally and move capital in and out of the country easily.

So to end let me mention three countries—only three, since I already talked about Argentina. The first one is my own country of origin, Chile. As Jonathan pointed out during his presentation, the IMF's decision to write about the Institutional View started in 2009 with the global financial crisis. Country after country after country would come to the IMF and say, "Should we do what Chile did and impose controls on inflows?" Or, "Could we follow in Chile's steps?" Or, "What do you have to say about the Chilean experience?" And the IMF would say at first in the 1990s, "Well, we don't know." And the ministers in a bind would come back and say, "But Chile does it, and it's worked very finely." So Chile, I think, is a case that we have to talk more about. And one good reason to talk about Chile is that the country got rid of controls in 2000 and since then the economy has worked perfectly fine. And not only that, it continues to be the number one country in Latin America, it continues to be the country everyone looks at, and it continues to be one where in terms of policy one looks and tries to follow. So here we have a case of the poster child of capital controls, getting rid of them and opting for capital mobility, and yet the IMF does not deal with that case in the two main documents about the Institutional View.

The second country I want to mention is Venezuela. That, of course, is an obvious case where capital controls on outflows don't work because they are imposed without any supporting policy. But a question is: When Venezuela comes in, what is the IMF going to tell it? Don't get rid of the controls? Get rid of them very fast? So that is a question I think is very important. There are Venezuelas out there that are coming and urgently need to know what to do about capital controls in the short run, in the middle run, and in the longer run.

The other country I want to mention is Iceland. Iceland had controls on outflows. They were opposed by almost everyone. They were criticized, and Iceland has recovered from its gigantic 2008 crisis in a very beautiful way. It's been growing at 6 percent. Inflation is almost nonexistent and there are 1,318 people unemployed in Iceland. But Iceland still has controls on outflows. Should they keep them? I don't think so. But there is a question there: Maybe it's an exception? Structurally, it's a small country. It really has only four types of exports. And I think that every indication is that in the longer run Iceland should have no capital controls. Of course, there should be concerns about macrostability, but that can be achieved with other policies, macroprudential policies.

Let me finish with one point that is not in the papers, but that Jonathan made during his presentation, and that's the connection between crises, social conditions, and capital flows. If you look at Latin American crises during in the last twenty years, you will find that they were all quite different from each other. Some crisis countries had very significant capital controls. Chile in 1982 is a good example. Unemployment ended up being 32 percent. And there was a dictatorship that contained social pressure at a certain level. Mexico '82 also happened in the presence of significant capital controls. Mexico '93 is another case of a crisis with nontrivial capital controls. Brazil '98, once again a crisis in a country with fairly stiff capital controls. So the notion that they were capital-controlled did not mean that the crisis didn't happen.

Now, of course, there were crises without capital controls, Uruguay and Argentina, and John Taylor was very much involved in trying to solve the Uruguayan crisis. What is very interesting is that after those two crises, which were very similar, Argentina reverted to very tight controls on everything. And it imposed a haircut of 75 percent on debt holders. Uruguay, with the assistance of the IMF and the Treasury—Anne Krueger and John Taylor were involved there—very quickly recovered, enacted very temporary measures, and the haircut was only 7 percent.

My bottom line is that I missed a stronger prescription from the IMF. The prescription that I would like to hear from the IMF is that emerging countries should generally aim toward having no controls. Of course, there may be dangers getting there, but we will help you deal with those problems.