CHAPTER FIVE

Capital Flows, the IMF's Institutional View, and an Alternative

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In these remarks, I first review the IMF's recently developed Institutional View on the use of capital controls. I then list a number of concerns I have with this view and outline an alternative approach to the international monetary and financial system.

THE IMF'S INSTITUTIONAL VIEW

The International Monetary Fund put forth its Institutional View in November 2012, when it published the document "The Liberalization and Management of Capital Flows: An Institutional View" (IMF 2012).[1] This was several years after the global financial crisis and the Great Recession of 2007–09. As Blanchard and Ostry (2012) explained in an op-ed at the time, the document brought together much work at the IMF, including that by Ostry et al. (2010) and Ostry et al. (2011). More recent IMF reports (2016a, 2016b) review the experience with the Institutional View over the years since 2012.

The book *Taming the Tide of Capital Flows: A Policy Guide*, by Ghosh, Ostry, and Qureshi (2017) provides an excellent and

1. The document was prepared by a team that included Jonathan Ostry, Atish Ghosh, and Mahvash Qureshi from the IMF's Research Department and was approved by Olivier Blanchard (economic counselor and director of the Research Department), Sean Hagan, Siddharth Tiwari, and José Viñals.

detailed summary of the origins of the Institutional View and the rationale for resulting policies.[2]

Around 2010, several countries were "re-imposing capital controls to stem inflows in the wake of historically unprecedented accommodative monetary policies of the US Federal Reserve (later joined by the European Central Bank and the Bank of Japan). Capital controls, a long-forgotten subject in academia and a taboo among mainstream policy circles, were back in the limelight" (p. 5). "After a remarkable internal effort at consensus building" at the IMF during which many papers were written and seminars were held, a "compromise was hammered out" in the form of the "Institutional View" document (p. 64).

The "Institutional View" argues that "there is no presumption that full liberalization is an appropriate goal for all countries at all times" but rather that "capital controls could be maintained over the longer term" (p. 64) and that "capital controls form a legitimate part of the policy toolkit" (p. 6). To be sure, there is still some mention of the long-held view that "cross-border capital flows to emerging markets have the potential to bring several benefits." But what is new about the Institutional View is that "capital flows require active policy management," which includes "controlling their volume and composition directly using capital account restrictions" (p. 8).

The "Institutional View" document (IMF 2012) defines key terms and gives examples. For example, the annex entitled "Capital Flow Management Measures: Terminology" states, "For the purposes of the institutional view, the term capital flow management measures (CFMs) is used to refer to measures that are designed to limit capital flows." CFMs thus include "capital controls" that "discriminate on the basis of residency" and macroprudential policies that differentiate on the basis of currency (p. 40). But other mac-

2. The quotes and page numbers in the next two paragraphs are from Ghosh, Ostry, and Qureshi (2017).

roprudential measures, such as changes in the loan to value ratio, are not considered CFMs.

The distinction between capital flow management measures and macroprudential measures (MPMs) is important as stressed in IMF (2013): "CFMs are designed to limit capital flows. Macroprudential measures are prudential tools that are designed to limit systemic vulnerabilities. This can include vulnerabilities associated with capital inflows and exposure of the financial system to exchange rate shocks. While there can therefore be overlap, macroprudential measures do not seek to affect the strength of capital flows or the exchange rate per se."

Nevertheless, CFMs and MPMs are often responding to the same forces. For example, a very low interest rate abroad may lead to an outflow of capital from abroad and an inflow of capital to the home country, an example of a "push" factor from abroad.[3] If monetary policy makers, concerned about an appreciation of their currency, respond with lower interest rates at home, they risk an unwanted housing boom at home. To combat this, they may decrease the required loan-to-value ratio in housing (an MPM but not a CFM). Alternatively, policy makers may leave interest rates alone and impose capital controls on inflows (a CFM) to prevent capital from seeking the higher return and driving up the exchange rate. Thus, CFMs and MPMs are alternative ways of responding to the same push factor from abroad. As I discuss later, both CFMs and MPMs may be inferior to other policy actions, including actions abroad which do not cause a capital outflow.

The best way to understand the scope of actions that constitute the IMF's Institutional View is to examine a list of capital flow management measures. As part of recent research on the impact of CFMs on such variables as exchange rates, capital flows, and interest rates, a paper by Forbes, Fratzscher, and Straub (2015) provides

3. See Cerutti, Claessens, and Puy (2015) for further discussion of such push factors.

such a list of capital flow management measures which the IMF has in mind. Here is the list:

Capital controls

- Quantitative limits on foreign ownership of domestic companies' assets
- Quantitative limits on borrowing from abroad
- Limits on ability to borrow from offshore entities
- Restrictions on purchase of foreign assets, including foreign deposits
- Special licensing on FDI and other financial transactions
- Minimum stay requirements for new capital inflows
- Taxes on capital inflows
- Reserve requirements on inflows of capital (e.g., unremunerated reserve requirements)

Macroprudential measures

- Reporting requirements and limitations on maturity structure of liabilities and assets
- Restrictions on off-balance-sheet activities and derivatives contracts
- Limits on asset acquisition
- Limits on banks' FX positions
- Limits on banks' lending in FX
- Asset classification and provisioning rules
- Taxes on FX transactions
- Capital requirements on FX assets
- Differential reserve requirements on liabilities in local and FX currencies

To be sure, an action such as a change in the loan-to-value ratio is a macroprudential measure that is not also a capital flow management measure.

It is also useful to understand the connection between the OECD (Organisation for Economic Co-operation and Development) Code of Liberalization of Capital Movements and the IMF's Institutional View. According to the OECD (2015): "The IMF uses its Institutional View on capital flow liberalisation and management for providing advice and assessments when required for surveillance, but the Institutional View does not alter Fund members' rights and obligations under the IMF Articles of Agreement or other international agreements." In contrast, "The OECD Code is an international agreement among governments on rules of conduct for capital flow measures."

CONCERNS

The primary motive underlying the recent interest in capital flow management is the increase in capital flow volatility and exchange rate volatility in recent years. This increase is clearly demonstrated in the research reported in Ghosh, Ostry, and Qureshi (2017) and is also found in research by Rey (2013), Bruno and Shin (2015), Carstens (2015), Taylor (2016), and Coeuré (2017).

There is some debate about the reasons for this increased volatility, but the main explanation offered by Ghosh, Ostry, and Qureshi (2017) is that "capital surges into emerging markets—and stops surging—largely because of global factors outside the countries' control, with US monetary conditions notable among them" (p. 415). Similarly, Fratzscher, Lo Duca, and Straub (2016) find that "QE increased the pro-cyclicality of flows outside the US, in particular, into emerging market equities." Rey (2013) and Taylor (2013) came to similar conclusions about the role of monetary policy in the advanced countries.

However, having recognized that the source of the increased volatility of capital flows is the advanced country central banks, the Institutional View effectively takes these actions as given and proceeds to develop a toolkit for emerging market economies to use to limit the flows into and out of their countries. As explained by Ghosh, Ostry, and Qureshi (2017), "We have mostly concentrated on the unilateral response of emerging market countries, given the reality that they are mostly on their own." Perhaps this is the tack they have taken because, as they note, the reality was that the Fed, as they quote then chairman Ben Bernanke, "countered such arguments vehemently," saying that the policies "left emerging markets better off." Bernanke (2013) argued that capital controls should be considered, perhaps as in the Institutional View, saying, "Nevertheless, the International Monetary Fund has suggested that, in carefully circumscribed circumstances, capital controls may be a useful tool." While Blanchard (2016) found that monetary policy in advanced economies has had spillover effects on emerging market economies, he viewed capital controls as "a more natural instrument" for achieving macroeconomic and financial stability.

In any case, my first concern with the Institutional View is that it does not endeavor to address the main cause of the problem—which is the push by policy actions in the advanced countries. Efforts should be made to deal with that issue in any reasonable international reform. Mishra and Rajan (2018), for example, argue that the advanced countries' central banks should avoid—be given a no-go red light for—unconventional monetary policies with large spillover effects. In my view, outright coordination is not necessary to achieve this international outcome, as I explain in the next section.

A second concern is the harm caused by using, in on-again, off-again fashion, a package of uncertain discretionary interventions such as those on the list above, which the IMF staff may suggest to emerging market countries under the banner of the Institutional View. A surprise turning-down of capital controls—especially with the threat of reimposition—can cause as much uncertainty as a surprise turning-up of controls. There are clear analogies with the danger of discretion versus rules in fiscal and monetary policy. To be sure, there are disagreements among economists on the rules-versus-discretion issue. But in practice, the CFMs under the Institutional View are discretionary rather than rule-like policies.

A third concern is that research by Forbes (2007) and others shows that CFMs have uncertain effects, often do not work, and can have harmful effects by cutting off useful lending to emerging markets. Edwards (1999) considered the evidence from Chile and other countries. He concluded that controls on outflows are easily circumvented, although controls on inflows gave the Chilean monetary authorities a better ability to change the domestic interest rate. Calvo, Leiderman, and Reinhart (1996) note that capital flows can be rerouted around controls perhaps through "under-invoicing of exports" or "over-invoicing of imports." Forbes, Fratzscher, and Straub (2015) found that "most CFMs do not significantly affect" exchange rates, capital flows, interest-rate differentials, inflation, equity indices, and different volatilities. One exception is that removing controls on capital outflows may reduce real exchange rate appreciation. They found that certain CFMs "can be effective in accomplishing specific goals—but most popular measures are not 'good for' accomplishing their stated aims."

It is possible to incorporate formally the effect of capital flow management measures (such as capital controls or currency-based prudential measures) in macroeconomic models, say by adding a term to a capital flow equation as in Ghosh, Ostry, and Qureshi (2017, 164). But the coefficients of such equations are very uncertain, and the quantitative impact of the CFMs is thus largely impossible to estimate accurately when computing impacts by differentiating with respect to the capital control term. Moreover, to properly assess CFMs, it would be necessary to perform a rules-based analysis of the impact of capital controls in which systematic dynamic properties and expectations are taken account of.

A fourth concern is about side effects of attempts to evade the controls. Edwards (1999) found evidence that "controls on capital outflows have resulted in corruption, as investors try to move their monies to a 'safe haven.' Moreover, once controls are in place, the authorities usually fail to implement a credible and effective adjustment program . . . There is also evidence suggesting that controls on capital outflows may give a false sense of security, encouraging complacent and careless behavior on behalf of policymakers and market participants."

A fifth concern is the possible negative spillover to international trade policies. Interventions into capital markets, including capital restrictions, often go together with interventions in good markets, including tariffs and quotas, although some argue that they can be separated as was once the subject of a debate (Bhagwati and Taylor 2003). With the current heightened tensions over trade policy, there are understandable concerns about trade wars. But there is an inconsistency about arguing against restrictions in goods markets while at the same time arguing for restrictions in capital markets.

A sixth concern is the possible slippery slope between CFMs and other restrictions on investment—including fixed investment—which are imposed for competitive reasons, such as to gain firm ownership or rights over intellectual property. Most would say that an open trading system would avoid such restriction on investment. But in some political contexts it is difficult to advocate CFM limits on so-called "hot money" while saying this does not apply to other forms of capital flows.

AN ALTERNATIVE APPROACH

The first plank of an alternative approach would be a normalization of monetary policy in the advanced countries along with a departure from unconventional balance sheet policy and a move toward more rules-based monetary policies. At the least, it would be useful to list key ways to reduce the "push" factors in the advanced countries, rather than simply taking them as given and focusing on interventionist actions in the emerging market economies. See Cerutti, Claessens, and Puy (2015) for examples. The rules-based reform suggested by Mishra and Rajan (2018) would try to avoid monetary policies with large negative spillover effects. More generally, a rules-based reform of the international monetary system would lead to greater economic and financial stability and less volatile capital flows as shown in Taylor (1985, 2016, 2018). The best way to achieve a rules-based international monetary system is to put in place a rules-based system in each country. It would be the job of each central bank to choose its monetary policy rule and what it reacts to. In this respect, it is encouraging that speeches, publications, appointments, and actions at the Federal Reserve during the past year and a half are consistent with being on such a path to normalization. This paves the way to an international normalization.

A second plank would be a commitment to a principle that liberalization of capital flows is an appropriate goal for the world economy. Of course, we all recognize that we are not in a world of open capital markets now, that a transition will take time, and that, during the transition, controls may sometimes be needed as a stopgap measure. As Edwards (1999) explained: "Controls on capital movements should be lifted carefully and gradually, but—and this is the important point—they should eventually be lifted." As discussed above, this goal is not now part of the Institutional View, which would have capital flow management measures continue into perpetuity. Nor is it part of the OECD's interpretation of the IMF's Institutional View. According to the OECD (2015), "The OECD shares the IMF Institutional View that there is no presumption that full liberalization is an appropriate goal for all countries at all times."

A third plank would be the adoption of reforms in individual countries that make markets more resilient to capital flows and thus pave the way toward this goal. If there were agreement reached on the first and second planks, then it would be easier to develop reform recommendations and implement them with these other planks in mind. This could involve gradual and permanent phaseouts of capital flow restrictions. The emphasis would be placed on creating a credible, well-functioning, market-based, flexible exchange rate system for countries that are not part of currency areas.

CONCLUSION

In these remarks, I first described the IMF's Institutional View consisting of capital flow management measures designed to restrict the flow of capital across international borders. I reviewed how this approach evolved in the past five years to become an integral part of the international monetary system, as viewed by the IMF, largely in response to increased capital flow volatility which in turn can be traced to policies in the advanced countries. I listed concerns with the use of such measures, including that they may lead to more restrictions on international trade and investment. Finally, I proposed an alternative approach based on three planks: a more rules-based international monetary system, a long-term goal of liberalized capital flows, and country reforms to make the financial system more resilient.

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GENERAL DISCUSSION

GEORGE SHULTZ: We have a few minutes for questions.

ROBERT HALL: John Taylor and Secretary Shultz opined here that modern central banking is a disturbing influence in the world capital market. I'd like to argue against that. A modern central bank borrows in the open capital market. The Fed funds itself today in the short-term debt market by issuing bank reserves. It uses those funds to buy more securities. So, it's indistinguishable from a hedge fund executing a carry trade. The Fed borrows short-term to fund a portfolio of about six-year average maturity. There is no meaningful sense that these transactions create money in modern central banking. The Fed isn't creating money when it borrows from banks. There's no sense in which central banks are somehow expanding anything. All they're doing is buying one kind of fixed-income asset and funding that by issuing fixed-income claims.

So, why do we worry? The Fed cannot have any net effect in debt markets. It's just exchanging one type of debt for another. And that's what all kinds of financial institutions do. There's nothing special about what central banks do. The only thing special about central banks is that their obligations serve as the definition of the monetary unit. It's not disturbing world capital markets. It's not issuing money. It's not increasing liquidity. It's not doing any of those things. It's just borrowing at market rates in one market and buying securities in a very closely related market. It can't have much effect. Instead of having the Fed borrow short-term and buy longer-term, it would be equivalent for the Treasury just to issue short-term in the first place.

JOHN TAYLOR: I disagree completely that the balance sheet part of monetary policy doesn't have any effect. Just because you're issuing reserves to finance the purchases of certain things doesn't mean the short-term interest rate or other financial variables, including exchange rates, don't change. It's not true theoretically that such monetary policy actions do not have any effect, and it's not true empirically.

ROBERT HALL: No, the number that the Fed picks, that is highly influential, is the rate on reserves, which is how it controls interest rates in dollar-denominated securities. And that's part of its exercise in determining the value of the monetary unit, and that's centrally important. But that's what's special. But it's not sloshing money around. It's changing the return that it's paying and locking dollar interest rates into the Taylor Rule, or whatever policy rule they're using. That's totally influential, and that's subject to all of the things that we normally think about.

But the idea that there's a special effect in the capital markets from this intervention is what I'm arguing against. There are very important effects if they decide that we need more inflation or less inflation and change the interest rate. The important thing that the Federal Open Market Committee does every six weeks is determine the interest rate.

JOHN COCHRANE: I want to come back to capital controls. Central banking discussions tend to slip into euphemistic language for rather brutal policies. Governments don't control "capital flows," they control people. A capital control is the same as a trade restriction. The government may say, "Bob Hall, you may not buy steel from a Japanese producer." A capital control is, "Bob Hall, you may not borrow from a Japanese bank. You've got to borrow from my favorite bank here." Capital controls are financial repression, and really a financial expropriation.

I think Jonathan has basically stated a theorem, which I agree with, in that the "thens" follow from the "ifs." A planner could achieve wonderful things with capital and all sorts of other controls. But the planner would need to be omniscient. The planner needs to know the difference between a bubble and a boom. He or she has to be able to tell a supply surge from a demand pull, to tell a glut from a proper supply response, an imbalance from a change, an overvaluation from a proper enthusiasm.

JOHN COCHRANE: The planner has to be apolitical. The planner has to not funnel money to domestic banks because he or she is trying to prop up the domestic banks or his or her cronies. The planner has to understand all the effects of a policy. Jonathan went so far as to say central banks should start worrying about inequality. Maybe China shouldn't have opened up so much because they got unequal. They opened up, they got unequal as well as stupendously better off.

That such a hypothetical planner could do wonderful things is true. That central bank staffs like to write optimal policy papers that dream of such competent technocratic dirigisme is true. But is it really wise to go to the central bank of Argentina in its current troubles, armed with the theorem that an omniscient, apolitical, disinterested central planner could do wonderful things? That seems to me very dangerous advice—and this danger seems to be the core of the disagreement before us.

JONATHAN OSTRY: John, I don't assume, and the Fund doesn't assume, omniscience. But your point about informational requirements of policy making could be made about any number of economic policies, and not just capital controls. So I'm really not sure why you are singling out the informational challenges for implementing capital controls especially. I am also not sure why you and others on the panel have more doubts about the effectiveness of capital controls than about the effectiveness of other policy instruments—such as macroprudential tools—which seem to command broader support in this room. If we need humility about instrument effectiveness in managing the financial-stability risks arising from volatile capital flows, I think the humility is warranted for both types of instrument: capital controls and macroprudential tools.

Just to clarify a point that John Taylor made about the need to say more about the role of source countries, let me just make two factual points there. There is an entire series of papers that lead up to the IMF's Institutional View, while this panel has focused on only two of them (the ones from 2012 and 2016). There is a separate paper, that was discussed at the IMF's board a few years back, and that deals explicitly with the role of source countries (an issue that Keynes and White thought was essential to confront when they spoke about "managing both ends" of the capital flow transaction). Unfortunately, we haven't had a chance to talk about the issues in today's panel, though Raghu came closest to touching on them this morning.

JOHN TAYLOR: In making my point that not much is said about source countries, I referred to, and quoted extensively from, your 2017 book with Atish Ghosh and Mahvash Qureshi; the book incorporates the views and research in the papers in that series. Don't forget the book.

JONATHAN OSTRY: On the book, I need to reiterate that there's a sharp line between the book and the IMF's position as laid out in the board paper for the Institutional View. I did not spin the book today as being about the IV (quite the contrary), and the IV, of course, predates the book by several years (although the analytical frame for the IV is based on the thinking in the staff papers and journal articles I coauthored, that are cited in the book). I was careful in delineating at the outset of my talk that I was basing it largely on my book, rather than on the IV paper.

Coming back to the role of source countries, I should mention that, apart from the work for the IV, there was a separate initiative around the same time, undertaken by the IMF, in relation to what is known as the Integrated Surveillance Decision. The ISD sought to deal with the issue of spillovers from the policies of large players in the international monetary system, but it only got so far. What the international community was prepared to endorse in the ISD was simply that, if there are two policies that have roughly the same domestic benefit, but differ in terms of their spillover, the Fund would ask the country to choose the policy that exerts the smaller adverse spillover. This is quite some distance from the rules of the road that Raghu mentioned this morning and indeed that I talked about in an earlier paper of mine published some years ago.

I just want to respond to Sebastian on the issue of countercyclical fiscal policy in emerging market countries. The statements in my presentation were not normative, they were positive. They were in the vein that emerging market countries have not made much use of countercyclical fiscal policy to respond to capital inflow surges. This is what the data we've collected show. This says nothing about whether they should have used this instrument more. Certainly, the received wisdom is that they should have. And that's why it's all the more puzzling to us that they have not.