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

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In these remarks I first review the IMF's Institutional View on the use of capital controls as it originated in 2012 and has continued today. I point out several concerns I have with this approach. I then outline an alternative approach to the international monetary and financial system.

The IMF's Institutional View

The International Monetary Fund put forth it's Institutional View in November 2012, when it published the document "The Liberalization and Management of Capital Flows: An Institutional View (IMF 2012)."[2] This was several years after the Global Financial Crisis and the Great Recession of 2007-2009. 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 (IMF (2016a, 2016b)) review the experience with the Institutional View over the years since 2012.

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The book *Taming the Tide of Capital Flows: A Policy Guide*, by Ghosh, Ostry, and Qureshi (2017) provides an excellent and detailed summary of the origins of the Institutional View and the rationale for resulting policies.[3]

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 that "For the purposes of the institutional view, the term capital flow management measures (CFMs)

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

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 macro-prudential policies that differentiate on the basis of currency (p. 40). But other macro-prudential measures, such as changes in the loan to value ratio, are not considered CFMs.

The distinction between capital flow management measures and macro prudential 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.[4] If monetary policymakers, concerned about an appreciation of their currency, respond with lower interest rates at home, they risk an unwanted housing boom at home, and to combat this they may decrease the required loan-to-value ratio in housing (an MPM but not a CFM). Alternatively, policymakers 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.

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

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, Straub (2015) provides 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, actions such as a change in the loan to value ratio is a macroprudential measure which is not also a capital flow management measure.

It is also useful to understand the connection between the OECD 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 Coeure (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 (2016) come 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 tool kit 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 country 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 re-imposition—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 the effect of CPMs are uncertain, 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, though controls on inflows gave the Chilean monetary authorities 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, p. 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 Bhagwati-Taylor (2003) debate. 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 item on the above list of concerns suggests that a key plank of an alternative international monetary reform would be a full normalization of monetary policy in the advanced countries along with a departure from unconventional policy of quantitative easing and balance sheet policy. Indeed, I have argued in Taylor (2013) that the increased volatility of exchange rates and capital flow is largely due to the shift away from rules-based policy toward unconventional monetary policy in many advanced country central banks in recent years starting as early as 2003-2005.

For the reasons I have given elsewhere (Taylor (1985, 2016, 2018)) a rules-based reform of the international monetary system would lead to greater economic and financial stability and less volatile capital flows. Moreover, the 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 too. In this respect it is encouraging that speeches, publications, appointments and actions at the Federal Reserve during the past year and a half is consistent with being on a such a path to normalization. This may pave the way to an international normalization.

At the least I think it would be useful to list, as part of any reform, key ways to reduce the "push" factors fin 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

A second plank would be a commitment to a principle that full liberalization of capital flows is an appropriate long-term goal for the world economy. As discussed above, this long-term goal is not now part of the Institutional View, which would have capital flow management measures continue into perpetuity as full liberalization is not a goal for all countries at all times. Nor is it part of the OECD's interpretation of the IMF's Institutional View or its own Code: 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."

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."

A third plank would be transition paths that countries could use to move to this goal. If there were agreement reached on the first and second planks, then it would be easier to develop reform recommendations and discuss them with countries with these other planks in mind. This could involve gradual and permanent phase-outs. Most important is that emphasis would be placed on a credible well-functioning market-based flexible exchange rate system for countries that are not part of currency areas.

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