CHAPTER 2

General Policy and Analysis

This chapter discusses the legal basis for the IMF's work on capital account issues, intellectual and operational developments within the IMF relating to its policies in this area, and how capital account issues were viewed by staff and the Executive Board in the context of multilateral surveillance exercises. In reviewing the IMF's general policies and analyses, we discuss, but only briefly, the background to the debate in the 1990s on whether or not the IMF's authority in this area should be expanded and the associated initiatives taken by IMF management to amend the IMF Articles of Agreement. Although the consequences of such an amendment would have been significant for the IMF's formal role, the focus of this report remains on what the IMF actually did or said in the course of its operational work.

The Legal Basis

The IMF's approach to capital account issues, including capital account liberalization in particular, has been a controversial topic, in part because there exists little consensus on what the role of the IMF in this area should be. To give a sense of issues involved, we first discuss what the IMF Articles of Agreement say, including the distinction between "purpose" (or "mandate") and "jurisdiction," as well as between current and capital account transactions. We then discuss the evolving role of the IMF in capital account issues, as it was interpreted by the Executive Board, and the context in which the evolution took place.

Mandate versus jurisdiction

Within the IMF, the term "mandate" has been used, in place of the legal term "purpose," to refer to the objectives which the IMF must pursue in its operations and activities;[1] "jurisdiction," on the other hand, refers to the IMF's legal authority to assess and enforce member countries' compliance with obligations specified under the Articles.[2] Article I of the IMF's Articles of Agreement sets out the "purposes" of the IMF and, in effect, defines the institution's mandate, including:

- To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems;
- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy;
- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation; and
- To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

Consistent with the IMF's mandate to facilitate the expansion and balanced growth of international trade, the members of the IMF bestowed upon the institution jurisdiction over restrictions on the making of payments and transfers for *current* international transactions. Article VIII ("General Obligations of Members") stipulated that, without the approval of the IMF, members could not (except under "transitional arrangements" defined in Article XIV, Section 2 or with respect to "scarce currency" provisions under Article VII) impose restrictions on the making of payments or transfers for current international

[1] "Mandate" is not a legal term used in the Articles of Agreement, but it assumed currency in place of "purpose" as used in the Articles. These two terms are often used interchangeably within the IMF, because an institution's mandate is essentially the purposes for which it was founded or which were subsequently assigned to it.

[2] How "jurisdiction" is defined here is consistent with the usage of the word as it pertains to the IMF's responsibilities vis-à-vis the making of payments and transfers associated with current account transactions.

transactions, such as purchases of imports. At the same time, the IMF was *not* given jurisdiction over the underlying current account transactions for which the payment was required.[3]

It should be noted that current international transactions as defined in the Articles are broader than the standard statistical definition of current transactions and include some categories that are normally considered to be capital transactions and capital transfers. In particular, Article XXX defines payments for current transactions as "payments which are not for the purpose of transferring capital." It then explicitly mentions restrictions on "normal short-term banking and credit facilities" and "payments of moderate amount for amortization of loans or for depreciation of direct investments" as being subject to IMF jurisdiction.

The IMF and the capital account

The evolution of the IMF's involvement with the capital account was different. The Articles of Agreement did not provide the IMF with a clear mandate to encourage capital account convertibility. The exclusion of most capital transactions (and the associated making of payments and transfers) from IMF jurisdiction was deliberate (de Vries, 1969, p. 224). Both of the main architects of the Bretton Woods institutions, John Maynard Keynes and Harry Dexter White, argued that countries should be protected from the disruptive impact of speculative international capital movements and that a world of unrestricted capital movements was not compatible with either a stable exchange rate system or a liberal international trading system.[4] These views reflected the consensus, held at the time the Articles were being drafted, that "the large short-term capital flows of the 1920s and 1930s had led to disaster" by threatening exchange rate stability and making it difficult to achieve monetary and fiscal stability (James, 1996, pp. 37–38). Bloomfield (1946) characterized this consensus as a "highly respectable doctrine, in academic and banking circles alike" and having "been officially crystallized in the Bretton Woods Fund Agreement."

Consequently, unlike restrictions on the current account, capital controls were seen to be a necessary and useful instrument of economic management, particularly for giving governments autonomy from financial markets and discouraging "speculative" capital and "hot money."[5] Thus, Article VI, Section 1 allowed the IMF to request a member to exercise controls to prevent the use of the IMF's general resources to finance a large or sustained outflow of capital, and stated that failure to do so could result in the member being declared ineligible to use the IMF's general resources. Section 3 of the same article recognized the right of members to "exercise such controls as are necessary to regulate international capital movements," as long as it were done in a manner that did not restrict current international payments or transfers. This provision was reaffirmed in a subsequent decision of the IMF Executive Board, approving a report of its Committee on Interpretation, which provided that: "Subject to the provisions of Article VI, Section 3 concerning payments for current transactions . . . members are free to adopt a policy of regulating capital movements for any reason, due regard being paid to the general purposes of the Fund. . . . They may, for that purpose, exercise such controls as are necessary . . . without approval of the Fund."[6]

Over the subsequent decades, however, two important developments took place, which changed the environment envisaged in the Articles. First, starting in the late 1950s, an increasing number of countries have removed restrictions on the making of payments and transfers for current transactions and accepted the obligations under Article VIII, Sections 2, 3, and 4 of the IMF Articles. The effectiveness of capital controls depends to some extent on the ability to control or at least monitor current account transactions, because (1) some current transactions can substitute for capital account transactions that are otherwise restricted and (2) current transactions can create scope for disguised capital transactions through leads and lags or under- and over-invoicing. The removal of restrictions on current payments and transfers has to

[3]There are several reasons for the distinction that emerged between current transactions and the making of payments and transfers for those transactions. Jurisdiction over the underlying current transactions was to have resided with a proposed International Trade Organization. However, opposition to this approach from key constituencies led instead to reliance upon the much less ambitious General Agreement on Tariffs and Trade (GATT). For a more in-depth discussion of the political context underlying decisions on current account convertibility and jurisdiction, see James (1996).

[4]Helleiner (1994, pp. 33–38) discusses how the views of Keynes and White influenced the provisions of the Articles of Agreement regarding capital account issues. Keynes argued that international capital movements should be allowed only "for legitimate purposes" and that there must be "a means . . . of controlling short-term speculative movements or flights of currency." White, for his part, argued that "the task . . . is not to prohibit instruments of control but to develop those measures of control . . . as will be the most effective in obtaining the objectives of world-wide sustained prosperity" (as quoted in Horsefield, 1969, pp. 32, 64). See Boughton (2002) for a detailed analysis of the views of Keynes and White, who differed in their assessments of why controls on capital movements were necessary.

[5]Such a view, shared by both Keynes and White, had been initially advanced by League of Nations economists in the 1930s (see Nurkse, 1944).

[6]Executive Board Decision No. 541-(56/39), July 25, 1956.

some extent diminished the effectiveness of any remaining capital controls. More recently, the expansion of financial market innovation, including the development of new and more complex financial instruments, has made it even more difficult to enforce capital controls effectively. These were important factors accelerating moves toward liberalization among industrial countries in the 1970s and 1980s.

Second, de facto capital account liberalization proceeded in the context of such multilateral agreements as the OECD Code of Liberalization of Capital Movements (1961)[7] and the European Communities Directives on Capital Account Liberalization (1986–88). The WTO's General Agreement on Trade in Services (GATS) also served to ease restrictions on trade in financial services and, as a consequence, facilitated associated capital movements among a wider group of countries. The increased freedom of capital movements, particularly among industrial countries, generated large cross-border capital flows globally, with implications for macroeconomic stability and exchange rate management in many countries. These were some of the developments that put into question the ability of the IMF to deal with these issues effectively and highlighted the potential role the IMF could play in ensuring orderly liberalization.

The role of the IMF in capital account issues

An important milestone in this process was the Second Amendment of the IMF's Articles of Agreement, which was put in place in the wake of the collapse of the Bretton Woods system of pegged exchange rates. At that time, a new Article IV, inter alia, provided for surveillance by the IMF over the exchange rate policies of members and established certain obligations of members with respect to exchange rate stability. The preamble to Article IV (Section 1) states that "the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries."[8] In enumerating specific obligations of members, Article IV, Section 1 required each member to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

Under the new framework, the Executive Board adopted a decision setting out principles and procedures for surveillance over members' exchange rate policies (the 1977 Surveillance Decision).[9] These principles noted the importance of restrictions on capital movements and included, among the developments that might indicate the need for discussion with a member, "the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital," "the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows," and "unsustainable flows of private capital."[10] However, while unambiguously noting the importance of the capital account for the purposes of IMF surveillance, the 1977 Surveillance Decision implied neither the encouragement nor discouragement of capital account convertibility.

In the latter half of the 1990s, the IMF reassessed its mandate and jurisdiction over capital account transactions and considered the possibility of amending the IMF's Articles of Agreement (Box 2.1).[11] In the event, the proposed amendment of the Articles failed to materialize. As it stands, Article IV ("General Obligations of Members") and the associated 1977 Surveillance Decision of the IMF Executive Board, as amended in April 1995, define the role of the IMF in surveillance with respect to capital account issues. It is now generally understood that while the IMF does not have the authority to assess or enforce a standard of capital account convertibility among the general membership, it has a responsibility to exercise surveillance over capital account policies, albeit as part of its larger responsibility to exercise firm surveillance over exchange rate policies. It is also understood that the IMF can use technical assistance for capital account issues. Ambiguity remains, however, because the Articles do not prescribe a member's specific obligation with respect to capital account policies and technical assistance is not an activity explicitly mandated by the Articles.

General Operational Approach

Most of the intellectual and operational developments of the 1990s related to capital account issues

[7]See Thiel (2003) for a discussion of the role of the OECD Code in encouraging capital account liberalization in recent accession countries.

[8]The IMF's Legal Department, however, has emphasized that this refers to a "purpose of the international monetary system," and not necessarily of the IMF.

[9]Executive Board Decision No. 5392-(77/63), April 29, 1977.

[10]The last item "unsustainable flows of private capital" was added in the 1995 amendment.

[11]As part of this debate, the distinction between restrictions on the making of payments and transfers for capital transactions and the underlying capital transactions did not figure as prominently as with the current account. This was largely because—for many capital account transactions (e.g., long-term loans)—it was often difficult to distinguish operationally between the underlying transaction and its associated payments and transfers.

Box 2.1. The Proposal to Amend the Articles of Agreement[1]

In the latter half of the 1990s, IMF management proposed and actively promoted an amendment to the Articles of Agreement that would have transformed the IMF's formal role in capital account liberalization and capital account issues in general. The idea for an amendment had been raised within the IMF for some time, at least since 1994, but it was in 1996 that the agenda to amend the Articles received priority in the work program of the IMF. During 1996 and 1997, the Executive Board made intensive deliberations of the issues involved, to which IMF staff contributed significant intellectual inputs. At the level of the Board of Governors, the Interim Committee gave both encouragement and specific directives from time to time. The support of the Interim Committee reached its height in September 1997, when, at its annual meeting in Hong Kong SAR, the Committee issued a communiqué outlining the logic of its support for an amendment and requesting the Executive Board to "accord high priority" to submitting "a draft amendment to the Board of Governors."

As the debate evolved, there emerged general agreement that the proposed amendment must involve two fundamental and distinct changes. First, the IMF was to be endowed with a new purpose: to promote the liberalization of capital flows. Article I was to be amended to include the encouragement of the liberalization of capital movements and the elimination of restrictions on capital account transactions. Second, the IMF was to assume jurisdiction over restrictions in the capital account. Jurisdiction would have established as a general rule that member countries would be prohibited from imposing restrictions on certain types of international capital movements without the approval of the IMF. The amendment would also have resulted in a revision of Article VI, which recognizes the right of members to "exercise such controls as are necessary to regulate international capital movements" as long as they do not restrict current international payments or transfers.

In addition to the enthusiasm expressed by IMF management, the vast majority—albeit not all—of industrial countries favored the formalization of IMF authority on the regulation of international capital flows. Their authorities recognized that they lived in a world "very different from that faced by the Fund's founding fathers," characterized by floating exchange rates and large capital movements among the major countries. Many developing countries, however, were more guarded, considering that capital controls could be useful in some circumstances to deal with exchange rate pressure.[2] Their apprehension was not fully erased by the proposed provision for transitional arrangements (comparable to Article XIV for current transactions) and the language emphasizing the IMF's role to ensure "orderly" liberalization. Consensus in favor of an amendment eluded the Executive Board, which continued to discuss the possibilities for achieving more widespread support for an amendment. In the event, in the summer of 1997, most Executive Directors agreed that inward direct investment, often sensitive politically, would have to be excluded from the IMF's expanded jurisdiction.

The East Asian crisis, contagion from which was spreading through Asia and beyond at the time of the Interim Committee's Hong Kong SAR meeting in 1997, changed the dynamics of the debate in a fundamental way. Because the crisis was unexpected and severe, the risks of capital account liberalization began to weigh on the minds of policymakers who had previously emphasized the benefits. In addition, opposition began to emerge from some influential members of the U.S. Congress, who felt reservations about giving more authority to the IMF when it was seeking an augmentation of its quota. Although IMF management never officially abandoned the idea, by the spring of 1999 it was clear that sufficient support was not forthcoming to amend the Articles, at least as it was drafted and proposed.

[1]This is based on a comprehensive analysis of this episode, as provided by Abdelal (2005).

[2]Concluding Remarks by the Acting Chairman, Executive Board Seminar on "Issues and Developments in the International Exchange and Payments System," November 16, 1994.

took place within the context of the management initiatives to amend the Articles of Agreement to expand the IMF's mandate and jurisdiction. From 1995 to 1999, staff prepared a number of policy papers for Executive Board discussion, providing an analysis of legal and other conceptual issues involved in amending the Articles.[12] As noted at the beginning of this chapter, however, this section focuses on those developments that shed light on the IMF's actual operational work. In fact, the IMF's views and operational work on capital account issues evolved, responding to new evidence or new developments (see Table 2.1). We review this evolution in this section, which forms an important part of the basis upon which the IMF's country work will be assessed in the following chapter.

[12]The last of the series of formal Board papers discussing approaches to amending the Articles was prepared in September 1999 by the Legal Department, "The Role of the Fund in the Liberalization of Capital Movements—Further Considerations on a Two-Tiered Approach," SM/99/220, September 3, 1999. The paper was never discussed by the Executive Board.

Table 2.1. Notable Events Affecting Capital Account Issues, 1991–2004

Date	Events
June 1991	An unremunerated reserve requirement (URR) introduced in Chile.
September 1993	Chilean-style controls introduced in Colombia.
October 1994	"Madrid Declaration" issued by the Interim Committee, encouraging countries to remove impediments to the free flow of capital.
December 1994	Mexican peso comes under pressure and is allowed to float.
July 1995	Executive Board's first operational guidance on capital account liberalization issued to IMF staff.
December 1995	Staff operational note on capital account liberalization issued by the Policy Development and Review Department (PDR) and the Monetary and Exchange Affairs Department (MAE).
1995–96	OECD accession for the Czech Republic, Hungary, and Korea.
1996–97	Empirical evidence on the effectiveness of Chilean URR begins to appear.
1996–99	Executive Board deliberations on amending the Articles of Agreement.
March 1997	A supplement to the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* published, with an expanded coverage of capital account regulations.
July 1997	Thai baht comes under pressure and is allowed to float.
September 1997	The Interim Committee meeting in Hong Kong SAR issued a communiqué supporting an amendment of the Articles.
November–December 1997	Executive Board approves Stand-By Arrangements for Indonesia and Korea.
August 1998	Russian default and devaluation.
September 1998	Capital outflow controls introduced in Malaysia.
January 1999	Brazilian devaluation.
May 1999	Financial Sector Assessment Program (FSAP) launched.
July 2001	New "integrated" approach to capital account liberalization discussed in an Executive Board seminar.
May 2004	EU accession for eight transition economies, including the Czech Republic, Hungary, and Latvia.

Expanding role of the IMF

From the late 1980s, the IMF began to give greater attention to capital account issues as part of its surveillance work. Records show that the Executive Board regularly, and with increasing frequency, held meetings to discuss international capital flows.[13] These early efforts, however, tended to be a *positive* analysis of what motivated international capital flows and what the consequences would be, rather than an attempt to make a *normative* case for a particular capital account policy. They also included a review of measures taken by a number of developing countries to access international capital markets, particularly in the aftermath of the debt-servicing difficulties they had experienced in the 1980s, and often emphasized the importance of sound macroeconomic policies in attracting capital inflows.

In the early 1990s, in an environment in which nearly all industrial countries had removed virtually all capital controls, staff prepared policy papers that were clearly advocating the benefits of capital account liberalization, to which many Executive Directors gave broad endorsement.[14] While some of these papers raised questions of IMF jurisdiction and the need to formalize the IMF's role, it was not until the mid-1990s that these jurisdictional issues received the formal attention of the Executive Board.

Clearer support for capital account liberalization emerged in the context of the so-called "Madrid Declaration on Cooperation to Strengthen Global Expansion," adopted by the Interim Committee of the IMF's Board of Governors at its October 1994 meeting. In this meeting, Governors approved a statement welcoming the "growing trend toward currency convert-

[13]For example, the Board met during 1989–90 to discuss a number of policy papers prepared by staff, including: "Policies to Promote Private Capital Inflows in Fund-Supported Adjustment Programs," EBS/89/117; "Study on the Measurement of International Capital Flows," EBAP/89/269; "The Determinants and Systemic Consequences of International Capital Flows," SM/90/128; and "Capital Market Financing for Developing Countries—Recent Developments," SM/90/174.

[14]Some of these papers and the Executive Board's reactions to them are reviewed in Monetary and Exchange Affairs Department, "Issues and Developments in the International Exchange and Payment System," SM/94/202, August 1994.

ibility and [encouraging] member countries to remove impediments to the free flow of capital."[15] Following the Madrid Declaration, in July 1995, the Executive Board gave its first operational guidance to the staff, when it met to review the recent experience of the IMF's membership with capital account liberalization.[16] Here, Directors gave general support to the idea that capital account issues should be covered more fully in Article IV consultations and that surveillance and technical assistance work be strengthened to encourage and support capital account liberalization. These views were broadly endorsed by the Interim Committee in its October 1995 communiqué.

It was around this time that IMF management and staff began to give greater attention to capital account issues in the actual operational work of the IMF. A series of notes were prepared during 1995, providing operational guidelines for area department staff. Of these, a set of notes prepared by the Policy Development Review Department (PDR) and the Research Department (RES) in October 1995 discussed how to incorporate large unexpected capital inflows into program design, particularly when disinflation was an important program objective; and how to identify the causes of large capital inflows and determine appropriate policy responses. For example, the PDR note stated that programs should include the quasi-fiscal costs of sterilization within fiscal performance criteria and medium-term projections. The RES note suggested that the mix of instruments to deal with large capital inflows would depend on the institutional structure of the country and the history of policies, adding that "temporary capital controls" might be necessary if the use of conventional macroeconomic tools was restricted or their effectiveness limited.[17]

These were followed, in December 1995, by a "staff operational note" prepared by the Directors of PDR and the Monetary and Exchange Affairs Department (MAE) and circulated to area departments, outlining "the next steps to be followed by the staff in adapting Fund practices to elicit greater emphasis on capital account issues, and to promote more actively capital account liberalization."[18] The note requested help and cooperation from area department staff in two areas: (1) to give greater attention to capital account developments in mission and technical assistance work; and (2) to assist in the collection of detailed information on capital account regulations for a pilot group of major emerging market economies. While the note's guidance to the staff was clearly to encourage capital account liberalization, it also included a qualification: "Liberalization of capital account transactions should generally be undertaken consistent with progress in macroeconomic stabilization and structural reforms . . . in certain circumstances, the use of capital controls to deter or slow such inflows may provide some temporary breathing room for the authorities, while more fundamental policy adjustments are being prepared."

Over 1996–97, a significant improvement was made in the IMF's capability to collect more detailed information on the regulatory framework of external capital account transactions. Initial work involved adaptation of the well-established codes developed by the OECD; the expanded data on capital controls classified measures into 20 broad categories (10 each for inflows and outflows). In December 1995, a questionnaire was sent to a pilot group of 31 member countries, which was subsequently compiled as a supplement to the 1996 *AREAER*. With the successful completion of the pilot project, the coverage was extended to all IMF member countries, and August 1997 saw the publication of the 1997 *AREAER* with the expanded coverage of capital account regulations for all countries. Subsequently, in 1998, the expanded data set allowed MAE to develop indices of exchange and capital controls capable of providing a quantitative measure of the restrictiveness of a member's exchange and capital control regime that is comparable across countries.[19]

Pace and sequencing of capital account liberalization

The speed with which a controlled regime can (or should) be liberalized depends on various factors, including risks, distortions, and institutional capacity.[20] Developing effective regulatory frameworks takes time, but a lengthy process may create wrong incentives and distortions. There are also political

[15]Similar support was evident in the Interim Committee communiqué of 1996 in which the members "encouraged the Fund, in promoting liberalization in a global market setting, to pay increased attention to capital account issues and the soundness of financial systems."

[16]"Capital Account Convertibility—Review of Experience and Implications for Fund Policy," SM/95/164. The Board discussion was held on July 28, 1995. See EBM/95/73. The paper was subsequently issued as an Occasional Paper (Quirk and others, 1995).

[17]These notes were circulated to the staff under a management memorandum dated October 25, 1995.

[18]"Strengthening Discussions and Information on Capital Account Convertibility—Next Steps." Cover memorandum, dated December 13, 1995.

[19]See, for example, Johnston and Tamirisa (1998), IMF (1999), and Miniane (2004).

[20]Lack of administrative capacity may argue either for or against faster reform, because there is no presumption that the resource requirements of implementing a quick reform are either smaller or larger than those of managing a long transition process or administering capital controls. For a discussion of issues related to the speed of reform, including the choice between a gradualist and a big-bang approach, see Nsouli and others (2002).

considerations. A big-bang approach may be appropriate if a prolonged transition is likely to create resistance from vested interests or if different elements of the existing system are so dependent upon each other that a piecemeal reform is not possible without creating significant distortions. A gradualist approach, on the other hand, may be more appropriate if it takes time to build political consensus or if a slower process is more conducive to minimizing the adjustment costs.

Much of the scholarly literature in economics advocated the big-bang approach in the context of transition economies in the early 1990s, arguing that the lack of credibility in the reform made it more appropriate to act quickly (Funke, 1993). In extending the big-bang approach to nontransition contexts, many experts, including some at the IMF, argued that the best route to an efficient financial sector was to liberalize the capital account quickly, as it would allow market discipline to operate on the banking system (Guitián, 1996).[21] Others in the IMF used the ineffectiveness of capital controls as the argument for faster capital account liberalization, given their distortionary effects. For example, Mathieson and Rojas-Suarez (1993) stated: "Analyses of the sequencing of structural reforms and stabilization policies for developing economies have traditionally argued that capital controls . . . are necessary to prevent capital flows that would undermine the reform program. These policy recommendations, however, stand in sharp contrast to a growing body of empirical evidence that suggests that capital controls have often been evaded."

Following the East Asian crisis, however, "sequencing" emerged as an operational concept in the IMF's approach to capital account liberalization. The IMF staff emphasizes that "sequencing" as used in IMF terminology is an operational concept, involving specific measures of institutional building, which is distinct from "order" as used in the literature on economic reform.[22] A policy paper discussed by the Executive Board in July 1998 stated: "The Asian country experiences confirm that it is necessary to approach capital account liberalization as an integral part of more comprehensive programs of economic reform, coordinated with appropriate macroeconomic and exchange rate policies, and including policies to strengthen financial markets and institutions. The question is not so much one of the capital liberalization having been too fast, since some of the countries in Asia have followed a very gradualist approach. Rather, it is more to do with the appropriate sequencing of the reforms and, more specifically, what supporting measures need to be taken."[23]

At the same time, the greater recognition of the need for sound financial systems led, in May 1999, to the establishment of a Financial Sector Assessment Program (FSAP), which was to be administered jointly by the IMF and the World Bank. The FSAP was meant to fill an identified gap in the international financial architecture in support of crisis prevention, based on a judgment that existing approaches at the IMF under Article IV consultations were not sufficient for effective financial sector surveillance. Although participation is voluntary, over 80 member countries have so far subjected their financial systems to assessment under the FSAP.[24] Because the FSAP's key objective is an early detection of financial sector vulnerabilities, the staff has used its assessments as a basis for dialogue with the authorities of countries considering further capital account liberalization; technical assistance on capital account liberalization has also been given in conjunction with FSAP assessments.

Analytical work by staff on sequencing culminated in a policy paper, which was discussed in an Executive Board seminar in July 2001 and subsequently issued as an Occasional Paper (Ishii and others, 2002). The paper stresses the importance of an "integrated" approach, which considers capital account liberalization as part of a more comprehensive program of economic reform and coordinates it with appropriate macroeconomic and exchange rate policies as well as policies to strengthen the financial system. It analyzes different risks that might be posed to financial and macroeconomic stability by capital account liberalization. In drawing operational principles, it relies on the (both successful and not so successful) experiences of nine countries: Austria, Hungary, Korea, Mexico, Paraguay, South Africa, Sweden, Turkey, and the United Kingdom.[25] The op-

[21]Guitián (1996) was initially presented in a conference held in 1992. In a broader context, the "discipline effect" of international markets has been argued by some to operate on macroeconomic policymaking more generally. See, for example, Tytell and Wei (2004), who suggest that "financial globalization" may have encouraged low-inflation monetary policies but not necessarily low-budget deficits.

[22]The early contributions in this literature were based on the "Southern Cone" experience of Argentina, Chile, and Uruguay in the late 1970s, and emphasized the importance of achieving macroeconomic stabilization, financial liberalization, and trade liberalization before opening the capital account (McKinnon, 1982; Edwards, 1984).

[23]Monetary and Exchange Affairs Department, "Developments and Issues in the International Exchange and Payments System—Background Studies," SM/98/172, Supplement 2, July 8, 1998.

[24]A separate IEO evaluation of the FSAP process is under way. The terms of reference for this evaluation can be found at www.imf.org/ieo.

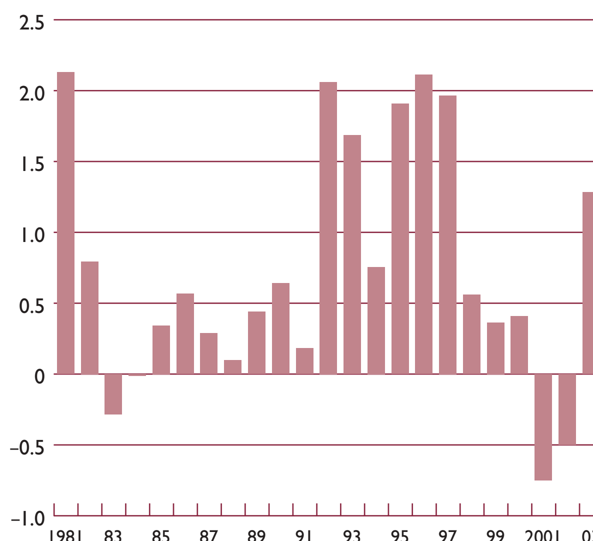
[25]For example, the paper notes that capital controls in South Africa and a cautious approach and early implementation of structural reforms in Hungary, respectively, may have limited the vulnerabilities of these countries to contagion from Russia.

erational principles stress the importance of safeguarding financial sector stability and maintaining consistent exchange rate and macroeconomic policies (see Box 4.3).

At the Executive Board seminar, Directors expressed a range of views on the paper. While some thought that the approach was appropriate, others expressed the view that some of the suggested policy measures could be implemented simultaneously and that countries might want to "use windows of opportunity" to move ahead quickly with capital account liberalization. The Acting Chairman noted that speed was not the issue—"what matters is the relationship between capital account liberalization and other policies, and that liberalization is sustainable." Although there was a broad endorsement of the general approach proposed, the views expressed in a seminar—unlike those in a formal Board meeting—were informal, and no formal decision was taken. Consequently, the paper has not removed the ambiguity that exists on the IMF's formal policy advice on capital account liberalization.

Figure 2.1. Net Capital Inflows to Developing Countries[1]

(In percent of total developing country GDP)



Source: IMF database.

[1]Changes in private foreign liabilities, including equity portfolio. Excludes government borrowing.

Multilateral Surveillance

Multilateral surveillance is an activity of the IMF that, among other things, identifies major risks and vulnerabilities that may affect economic policymaking in member countries through global and regional linkages. As the key outputs of multilateral surveillance exercises—the *WEO* and the *ICMR/GFSR*—are widely disseminated, they also serve as a channel by which the IMF communicates its views to the public.[26] In this section, we review how capital account issues were viewed by the IMF staff and the Executive Board in the context of multilateral surveillance exercises.

Developments in advanced economies—"push" factors

In discussing the IMF's policy advice on capital account liberalization and management of capital flows, one must first address the fundamental question of what determines the volume of global capital flows to emerging and developing countries—the so-called "push" factors that largely originate in advanced economies. In fact, it is well known that global capital flows have been characterized by "boom-and-bust" cycles (Figure 2.1), and it is appropriate to ask at the outset what the IMF's multilateral surveillance was saying about the causes of these cycles and the consequent policy implications for both advanced and emerging market countries.

Although a fuller discussion of this issue goes well beyond the scope of this evaluation,[27] it is useful to place the evaluation of the IMF's multilateral surveillance of "supply-side" factors within the following stylized characterization of the two polar ends of the debate:

- Some observers would argue that the fundamental cause of "excessive" capital inflows to emerging markets followed by sudden outflows lies in weaknesses in both macroeconomic policy (especially exchange rate policy) and in the framework governing financial institutions in emerging markets. According to this view, some of the solutions are to adjust macroeconomic policy settings and to strengthen institutional frameworks (for example, through the various "standards and codes" initiatives). These observers then note that solutions along these lines are under way (through more flexible exchange

[26]In 2002, the *International Capital Markets Report* (*ICMR*) changed its name to the *Global Financial Stability Report* (*GFSR*), but we refer to each report by the title used at the time it was prepared. The *World Economic Outlook* (*WEO*) and *ICMR/GFSR* reports, prepared by the staff in the context of multilateral surveillance, are released to the public, with the disclaimer that the views expressed therein are those of the staff, and not necessarily those of the Executive Board.

[27]A forthcoming IEO evaluation of the IMF's multilateral surveillance is expected to address some of these issues in greater depth.

rate policies and the strengthening of financial sector and transparency frameworks in emerging markets).

- An alternative and perhaps more pessimistic view would be that the unstable nature of these flows has more to do with the fundamentals of how financial markets operate that are much more difficult to resolve (for example, environments of suboptimal information that cause investors to herd; and "informational cascades" or other market imperfections that lead to market myopia). Proponents of these views point to evidence suggesting that the incidence of crises has not declined, and may even have increased over the long run (Eichengreen and Bordo, 2002; Persaud, 2001). These commentators usually emphasize the importance of "supply-side reforms" in advanced economy financial markets as part of the solution—although there are obvious questions about the extent to which official policies can, or should, seek to reduce volatility in these markets.[28]

Most observers would agree that both strands of the debate are important. For the purposes of this evaluation, the question is what the contribution of the IMF has been to the discussion on these issues, in terms of both analyses and policy advice.[29]

A review of multilateral surveillance documents suggests that the IMF paid relatively little attention to the push factors of global capital flows in the early 1990s but has given this topic increased attention in more recent years. This does not mean that the staff was initially unaware of the importance of developments in advanced economies in determining global capital flows. The early analysis, however, did not raise these issues in terms that stressed potential risks to emerging market economies. It appears that the IMF held a rather "fundamentalist" view of international capital flows. For example, the 1992 *ICMR* stated: "International capital flows continued to reflect the current account imbalances of industrial and developing countries and the international diversification of investment portfolios." The staff tended to view any regulatory development that would increase developing countries' access to international capital markets as beneficial.[30]

The prevailing idea that any measure that increases capital flows into emerging market economies is good must be understood within the context of the period. During much of the 1980s, a number of developing countries had lost access to international capital markets. Moreover, with the beginning of transition in former socialist economies, a widely held view stressed the need for greater global saving, and policy advice to advanced economies tended to be framed in these terms. For example, the October 1991 *WEO* noted the shortage of world saving and called for industrial countries to consolidate their fiscal policies. The May 1995 *WEO* continued to note the need to boost world saving: "World capital flows and financial conditions are largely determined by the industrial countries and the trend toward public dissaving is also heavily an industrial country problem. These are the countries where fiscal consolidation can help boost world saving the most."

As a result, multilateral surveillance at this time, while aware of the potential swings in capital flows, did not devote much attention to analyzing the potential risks to emerging market economies of capital flow volatility. The 1994 *ICMR*, for example, noted how hedge funds and other highly leveraged speculators had increased their exposure to emerging markets, particularly in Latin America, but concluded that these institutional investors were "often subject to limitations—ranging from government regulations to self-imposed prudential restrictions—on their holdings of paper from developing country issuers" though, given the still low level of exposure, the limits were not yet binding. The October 1994 *WEO* noted a strong inverse relationship between developments in long-term interest rates in the major countries and stock prices in emerging markets,[31] but included very little discussion of how these developments in advanced economies posed policy challenges to emerging market economies.

The IMF staff expressed the view that the benefits of greater integration brought about by portfolio diversification outweighed the risks. The October

[28]See, for example, Ocampo and Chiappe (2003) for a proposal to introduce a countercyclical element into the regulation of financial intermediation and capital flows. See also Griffith-Jones (1998), Williamson (2002), and Griffith-Jones and Ocampo (2003). Metcalfe and Persaud (2003) emphasize the "fundamental" causes of boom-bust cycles, but are skeptical about solutions that give a central role to improved information flows in crisis prevention. Such questions also apply to the debate over greater disclosure by hedge funds and other institutional investors.

[29]To the extent that crises are inevitable, more systemic crisis resolution procedures are also needed. In this context, the IMF has been involved in discussions on various mechanisms, including collective action clauses and a Sovereign Debt Restructuring Mechanism. See also Buiter and Sibert (1999) for the idea of an automatic debt rollover mechanism. We will not discuss these crisis resolution issues here.

[30]For example, the 1992 *ICMR* mentioned the June 1991 decision by the Japanese authorities to ease the credit rating standards for public placement of bonds in the Samurai market and the regulatory changes in the United States to reduce the transactions costs and liquidity problems facing developing country issues in U.S. capital markets as positive developments that "have facilitated, or have the potential to promote, developing country access to international bond markets."

[31]The *WEO* then added a footnote: "There is no strong evidence that recent capital flows are caused by speculative bubbles."

1995 *WEO*, for example, remained optimistic: "The increased openness of developing countries and their greater integration into the world economy do not necessarily mean greater vulnerability to external conditions. Paradoxically, increased openness and greater integration may reduce vulnerability because of stronger growth momentum in individual developing countries and in the developing countries as a group. . . . In addition, the impact on developing countries of changes in the demand for their exports may be partially offset by countercyclical changes in capital flows, as has been the case recently, implying a dampening of overall cyclical impulse from the industrial countries." Thus, the staff tended not to view any developments in industrial countries that might affect capital flows to be an important risk factor for emerging markets.

In the latter part of the 1990s, and certainly following the East Asian crisis, there was a fundamental change in the way multilateral surveillance viewed capital flow issues. It now began to pay greater attention to the linkage between industrial country developments and their capital flow and risk implications for emerging market economies. In 1998 and 1999, both the *WEO* and *ICMR* reports discussed how an underestimation of risks by international investors and low interest rates in industrial countries had contributed to large capital flows to emerging market economies. In this context, the October 1998 *WEO* suggested that it would be wrong "to attribute financial crises exclusively to policy shortcomings in the crisis countries," and called on investors and regulators in creditor countries to "recognize the inherently fragile and volatile nature of capital flows by better pricing risks." The Executive Board, in discussing the May 1999 *WEO*, "pointed to the need to improve the regulatory oversight, on the supply side, of the highly leveraged activities of financial institutions."[32]

The staff's analysis of risk factors inherent in financial integration has become increasingly sophisticated in more recent years. For example, the 2001 *ICMR*s analyzed the relationship between financial market returns in mature markets and those in developing countries, and its impact on global capital flows to emerging markets; it also discussed the cross-border behavior of investors and how it might affect aggregate private capital flows to emerging markets. The 2003 issues of *GFSR* included an analysis of the "feast or famine" dynamics in emerging debt markets (March issue) and the "boom-and-bust pattern and volatility" of capital flows (September issue). However, the policy prescriptions drawn from this analysis have emphasized, not the actions to be taken by creditor countries, but the actions to be taken by emerging market economies, including the need for greater transparency in data and policies, the need to develop local markets and, as expressed by the Executive Board in March 2004, the need to implement sound macroeconomic policies consistently.[33]

In making this observation, we are *not* implying that there was a set of policies for improving the functioning of the "supply-side" mechanism that the IMF should have been advocating or that there were clear answers to what was an "appropriate" level of volatility. Clearly, there was no such consensus. Nor are we suggesting that the IMF has done nothing to reduce the cyclicality of international capital movements on the supply side. In fact, the IMF has addressed this issue from the standpoint of minimizing moral hazard in investor behavior, by encouraging greater exchange rate flexibility in recipient countries and limiting access to IMF financing during a crisis. The proposal for a Sovereign Debt Restructuring Mechanism (SDRM) and the encouragement of collective action clauses (CACs) can be considered not only as the IMF's search for a crisis resolution measure but also as part of its efforts to minimize the moral hazard aspect of capital flow volatility on the supply side. But it is worth noting that the IMF's contributions to the broader debate on what, if anything, can be done by advanced countries to minimize the cyclicality of international capital flows (for example, through regulatory measures directed at institutional investors) have been much more limited.[34]

Gradual versus rapid liberalization

The documents prepared by the IMF staff in the context of multilateral surveillance during 1990–2003 consistently favored capital account liberaliza-

[32]From 1999 to 2000, the question of how to regulate highly leveraged institutions received considerable attention in the official community, and a number of reports were prepared by various bodies, including the International Organization of Securities Commissions (IOSCO) and the U.S. President's Working Group on Financial Markets. The IMF made its own contribution to the debate through its work on the Financial Stability Forum's Working Group on Highly Leveraged Institutions. See Financial Stability Forum (2000).

[33]In a recent note on the IMF's medium-term strategy circulated to the Executive Board, the staff suggested that its research program should include issues related to institutions and contractual mechanisms that can help protect countries from external volatility. See Caballero (2003) for an example of a "hedging and insurance instrument" to protect a country from volatility arising from commodity price fluctuations. While these ideas are welcome, the focus remains on the recipient countries.

[34]In this context, in July 2003, the IMF staff provided the Basel Committee with comments on the proposed New Basel Capital Accord (Basel II), noting that the use of ratings in setting capital charges could increase market volatility and procyclicality.

Box 2.2. Mexico: Capital Account Liberalization and the Crisis of 1994–95

From the late 1980s to the early 1990s, Mexico liberalized its capital account as part of a larger program of economic stabilization and reform. In 1989, the authorities eliminated major restrictions on FDI, allowed foreign investors to purchase nonvoting shares in the Mexican equity market, and allowed Mexican firms to issue stocks in foreign markets; at the end of 1990, they allowed nonresidents to purchase domestic government bonds; in 1993, they took additional measures to internationalize the stock market and to liberalize FDI. Although the stabilization and reform process took place under an IMF-supported program, the initiatives for capital account liberalization came from the Mexican authorities themselves within the context of negotiations for the prospective North American Free Trade Agreement (which started in 1990). By the time Mexico began to negotiate for OECD accession, it had already achieved almost complete capital account convertibility.

As early as 1989, Mexico's efforts to liberalize the foreign investment regime received a strong endorsement of the IMF Executive Board. On the other hand, potential vulnerabilities created by financial liberalization (1988–89) and what turned out to be an ill-timed privatization of banks (1991–92), when prudential regulation was weak, did not receive adequate attention in the IMF's assessment of Mexico's capital account liberalization strategy. On the contrary, at a Board meeting in 1991, "Directors expressed satisfaction with the progress achieved so far in the reprivatization of the commercial banks and the strengthening of the domestic financial system." When Mexico received large capital inflows between 1989 and 1993, relatively limited discussion took place between the IMF and the Mexican authorities on how to manage the surge in inflows. IMF staff, however, did communicate to the authorities its concern over the large current account deficit financed by short-term capital flows and the rapid increase in external borrowing.[1] Executive Directors expressed similar concern over this period. At the discussion of the 1993 Article IV consultation, for example, Directors expressed the hope that there would be a shift in external financing toward a greater share of direct investment.

The Mexican crisis of 1994–95 had only an incremental impact on the IMF's thinking of capital account liberalization, though it certainly influenced the views of some individuals within the institution. A number of internal and external experts interviewed explained this as reflecting the predominant view held at the time that the crisis had largely resulted from inconsistency between a pegged exchange rate and the pursuit of discretionary monetary policy, and not necessarily from wrong sequencing in capital account liberalization. Even so, some in the IMF did become aware of the danger of rapid liberalization when the prudential supervision of banks was weak. In fact, in discussing an internal assessment of IMF surveillance in Mexico in April 1995, Executive Directors suggested that "management should also invite the Executive Board and the staff to engage more decisively in capital account surveillance and discussion—a domain where the culture of the Fund must no doubt still evolve."

[1]In August 1991, the authorities imposed liquidity requirements on short-term external borrowing by commercial banks, which were extended in April 1992 to cover all foreign currency liabilities at a uniform rate of 15 percent.

tion. The staff in the early years emphasized efficiency gains and the need to attract foreign investment as the predominant reasons for capital account liberalization; the 1993 *ICMR* mentioned the stabilizing role of capital account liberalization that would come from a broader investor base; and in the discussion of the 1994 *ICMR*, Executive Directors stressed the discipline effect of capital flow volatility on macroeconomic and structural policies. In later years, the IMF staff also noted additional factors, such as the need for better risk diversification, greater consumption smoothing, and an improvement in the domestic financial system.

In the early years, the staff generally favored rapid liberalization on the grounds that capital controls were not effective. The staff was aware of the idea of sequencing, however. The October 1992 *WEO*, for example, stated that countries with an "uncompetitive" banking system should not liberalize the capital account until domestic financial liberalization was complete. Yet, the same report advocated "a comprehensive and rapid progress on all fronts." Management and the Executive Board generally supported these views. At the discussion of the May 1994 *WEO*, the Managing Director observed that "[in] its surveillance under Article IV, the Fund was making a great effort to convince countries of the broader benefits of capital account convertibility." Undoubtedly referring to a potential amendment of the Articles, he expressed hope that capital account convertibility would be part of the IMF's "refreshed mandate."

The Mexican crisis had impact on the thinking of some staff (and Board) members (see Box 2.2). The idea of sequencing became more prominent in staff analysis, although the evolution of the institution's stance on capital account liberalization would continue for some time, at least until the East Asian crisis. The *WEO* began more systematically to call for gradualism and sequencing in capital account liber-

alization, citing macroeconomic stability and financial sector soundness as preconditions, a position supported by several Executive Directors, including some representing major industrial countries. The October 1995 *WEO* recommended that countries in the early phases of convertibility should liberalize foreign direct investment (FDI) and trade-related flows before short-term flows. The 1997 issues stressed the need for gradualism in the context of sufficient exchange rate flexibility, sound macroeconomic policies, and a strong banking sector. The Director of RES stated at one of the Executive Board meetings that a flexible exchange rate system was not a prerequisite for capital account liberalization but stressed the importance of having appropriate prudential supervision of the financial sector prior to moving to capital account liberalization.

By 1999, the evolution in the institution's thinking was almost complete, and the voices of caution had become more dominant. In view of the weak evidence provided by the *WEO* to link capital account liberalization with economic growth, an industrial country Executive Director made a statement in the second *WEO* discussion of 2001 questioning the wisdom of undertaking costly and risky reforms to liberalize the capital account in the expectation of "modest and uncertain" benefits, while a developing country Director added that the prerequisites for capital account liberalization did not exist in most of the developing countries.

Although the staff position became more cautious, it remained in favor of capital account liberalization as a long-term goal. The October 1998 *WEO*, for example, stated that countries should pursue a well-sequenced and prudent capital account liberalization instead of "turning the clock back," in view of their need for external resources and the gains to be made from portfolio diversification. The *WEO* then suggested that countries should sustain structural reforms to reduce information asymmetries or market failures in order to reduce resource misallocations and excessive capital flow volatility. Likewise, in 2001, the *WEO* suggested that those countries with significantly open capital markets should strengthen and improve their institutions while others that were not fully involved in global capital markets should pursue capital account liberalization as the ultimate goal, though at the pace of their own choosing.

Temporary use of capital controls

IMF staff in its multilateral surveillance work consistently argued for tight fiscal policy and greater exchange rate flexibility as the best tools to deal with large capital inflows. At the same time, the staff expressed doubt at the effectiveness of sterilization, given its quasi-fiscal costs and its impact on the level of interest rates. However, neither the staff nor Executive Directors had much to say about conventional macroeconomic tools of capital flow management. At the 1995 *ICMR* discussion, an Executive Director representing a major industrial country expressed concern over the lack of "clear policy guidelines" on managing capital inflows "from a monetary policy standpoint."

Throughout the period, both the staff and Executive Directors said much more about the temporary use of capital controls. The staff expressed a generally negative position on the use of capital controls as a tool to manage capital flows. In the early years, the staff was heavily focused on the long-term costs of such a policy. As empirical evidence on the effect of Chile's inflow controls (particularly in lengthening maturities) emerged, however, the staff began to take a less hostile attitude in its multilateral surveillance work toward the temporary use of market-based controls (Box 2.3). It remained opposed to the use of administrative controls, particularly on capital outflows.

During the first two years of the 1990s, the *ICMR*s drew a lesson from developments in Europe (including the Exchange Rate Mechanism (ERM) crisis) that stressed the undesirability of capital controls and the need to strengthen the supervisory and regulatory systems. The staff in the April 1993 *ICMR* observed that "countries faced with massive and unrelenting capital market pressures often conclude that it is less costly over the long run either to realign the parity or to resort to temporary floating than to impose capital controls." The staff seemed to recognize the short-term benefits of capital controls, but a senior staff member stated at the May 1993 Board discussion that capital controls were like "killing the goose that laid the golden egg," especially for those highly indebted countries trying to attract foreign investment. The staff's preferred policy, as expressed in the 1993 *ICMR*, was to "foster a gradual expansion of the investor base and provide sufficient resilience in the face of transient shifts in the availability and terms of international financing" through macroeconomic stabilization and structural reform and by improving transparency and information disclosure. Until about 1994, Executive Directors generally expressed broad agreement with these views of the staff, although a few Directors were of the view that temporary controls could be useful in managing large short-term inflows.

A subtle change was in the making in 1994. While the *WEO* continued to advocate greater exchange rate flexibility and tight fiscal policy as a way of dealing with large capital inflows, it also took a more accommodating stance on the temporary tightening of restrictions. The turnaround was more evident after 1995. The August 1995 *ICMR*

Box 2.3. Chile: The IMF's Views on the Use of Market-Based Controls on Inflows

Responding to a surge in capital inflows, in 1991, the Chilean authorities introduced a 20 percent unremunerated reserve requirement (URR) on all foreign loans, except for trade credits, while relaxing the minimum stay requirements for foreign investment. The URR was a noninterest-bearing deposit in foreign currency to be lodged with the central bank for a specified period of time (one year from May 1992), in an amount proportional to the value of the capital inflow.[1] As experience was gained, the authorities introduced modifications to tighten the URR over time.[2] With capital flows to emerging market economies abating, they reduced the rate of the URR to 10 percent in June 1998 and further to zero percent in September 1998. In 2001, the authorities removed all remaining restrictions on the capital account, including the URR (see Box 1.2 for a review of the effectiveness of the Chilean URR).

The IMF staff's position on the URR changed over time. Initially, it did not oppose the use of the URR. The briefing paper for the 1992 Article IV consultation, for example, argued that the URR, along with the recent revaluation of the Chilean peso, could help counteract the effect of capital inflows on spending. The staff report for the 1994 Article IV consultation, in July, noted a "significant reduction in short-term private capital inflows" as a result of the URR. Later in the year, however, the staff's position turned more negative. In November 1994, the staff strongly advised the authorities against any measure to tighten the URR. The briefing paper for the 1995 Article IV consultation stated that capital controls increased the cost of capital, entailed allocative inefficiency, and would be increasingly evaded over time, and argued for an orderly relaxation of these controls, beginning with an elimination of the one-year stay requirement and prior authorization requirement for capital inflows. During the 1996 consultation, the staff reiterated its view that the URR had not been effective in reducing capital inflows despite the tightening and that it should be eliminated.

As empirical evidence began to emerge, however, the IMF's position was somewhat moderated. Internal documents during 1997–98 indicate that the staff was aware of some positive effects of the URR, particularly in lengthening the maturity of inflows, but it continued to argue against relying excessively on the URR as a substitute for greater fiscal discipline. The views of Executive Directors expressed at successive Board meetings remained mixed throughout the period. In general, more and more Directors over time saw the virtues of the URR in lengthening the maturity of capital inflows, increasing the share of non-debt-creating flows, and thereby reducing the volatility of capital inflows. However, there were always some Directors who argued that the effectiveness of the URR in discouraging short-term capital inflows tended to diminish over time and cautioned against reliance on such a measure.

[1]The deposit requirement could be met by the payment of an up-front fee, equal to the financial cost of the URR (initially calculated at the London interbank offered rate (LIBOR)).

[2]For example, in 1992, the authorities extended the coverage to foreign currency deposits in commercial banks in January, raised the rate of the URR to 30 percent in May (except for direct external borrowing by firms), and applied this rate for all transactions in August. Subsequently, they further extended the coverage to secondary American Depository Receipts (ADRs) in July 1995 and to FDI of a potentially speculative nature in May 1996.

suggested that a mix of several tools (such as tight fiscal policy, foreign exchange market intervention, and temporary prudential controls) should be carefully specified, depending on a country's circumstances; it also stressed the need to strengthen the banking system against financial risks and to limit foreign exchange exposure. When the report was discussed, some Executive Directors expressed support for the temporary use of capital controls.

In the *WEO* discussion of May 1997, the Director of RES clarified the staff position: "staff was not endorsing the use of capital controls; and some of the countries had resorted to controls that were undesirable." During a Board discussion in October 1997, the RES Director stated that "staff encouraged countries that faced capital inflow problems to consider liberalizing capital outflows as part of their overall stabilization strategy." Even after the East Asian crisis, the *WEO* continued to express the view that, while controls to limit short-term inflows could be helpful in specific circumstances (as in the case of India), controls entailed longer-term costs and that open capital markets yielded substantial benefits; it further argued that use of capital controls during crises was not very effective and could "distract the governments from their prime task of strengthening the financial and macroeconomic environment."

In subsequent years, there was little discussion of temporary use of capital controls in multilateral surveillance work, reflecting the sharp decline in global capital flows to emerging market countries. When the subject was discussed, the staff's position remained nuanced. For example, when discussing Malaysia's administrative controls on capital outflows, the October 1999 *WEO* emphasized the progress the country had made in financial and corporate sector restructuring, strengthening the regulation and supervision of financial markets, and implementing corporate governance reforms. It then concluded: "Any negative impact of the capital con-

trols may have been offset by the increase in confidence from the acceleration of structural reforms and by generally sound macroeconomic management." The staff—and Executive Directors—had a more favorable view of market-based controls, but still justified them as a temporary measure and under special circumstances; they considered sustainable macroeconomic policies to be preferred.

Assessment

Despite the ambiguity left by the Articles of Agreements about its role in capital account issues, the IMF in the early 1990s responded to the changing international environment, characterized by large cross-border capital movements, by paying greater attention to issues related to the capital account. The early efforts tended to be an analysis of factors influencing international capital movements. From the mid-1990s, however, the IMF through its staff analyses began to advocate capital account liberalization. Concurrent with the initiatives to amend the Articles to give the IMF an explicit mandate for capital account liberalization and jurisdiction on members' capital account transactions, the IMF expanded the scope of its operational work in the area, encouraging the staff to give greater emphasis to capital account issues in Article IV consultations and technical assistance and to promote capital account liberalization more actively. At the same time, a significant improvement was made in the capacity of the IMF to collect information on members' regulations of capital account transactions.

In the early 1990s, the IMF's multilateral surveillance work generally considered any measure that would promote capital flows to developing countries to be a favorable development. This was understandable in the context of the period when a number of developing countries were just beginning to regain access to international capital markets; this was also a period in which many held the view that, with the beginning of transition in former socialist economies, there was a shortage of global saving. As a consequence, during this period, the IMF staff paid comparatively less attention to potential risks of capital flow volatility. In more recent years, particularly after the East Asian crisis, the staff has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the fundamental causes and implications of their boom-and-bust cycles. The focus of the analysis, however, remained on what emerging market countries should do to cope with the volatility of capital flows, rather than what, if anything, advanced economies could do to reduce the cyclicality of such capital movements.

From the beginning of the 1990s, the IMF's management, staff, and Executive Board were all aware of the potential risks of capital account liberalization and never promoted capital account liberalization indiscriminately. They also recognized the need for a sound financial system in order to minimize the risks and maximize the benefits. Such awareness, however, largely remained at the conceptual level and did not translate into practical advice on preconditions, pace, and sequencing until later in the 1990s. Lacking the operational content, such talk of risks failed to mitigate the impact of the clear voice emanating from the IMF advocating capital account liberalization. Below the surface, however, a subtle change was taking place within the institution. As preliminary evidence emerged on the apparent effectiveness of Chile's capital control in the mid-1990s, some in the IMF, including within management and the Executive Board, began to take a more accommodating stance on the use of capital controls at least as a temporary measure to deal with large capital inflows.

In the event, the proposed amendment of the Articles failed to materialize, leaving ambiguity about the role of the IMF in capital account issues. In the meantime, something of a consensus has emerged within the IMF that emphasizes the need to meet certain preconditions for capital account liberalization and hence the importance of carefully determining appropriate pace and sequencing in light of countries' institutional capacity (the so-called "integrated" approach). The use of temporary capital controls also has become a more respected practice within the IMF, at least under certain conditions. These shared views, however, are unofficial as they have not been explicitly endorsed by the Executive Board, and ambiguity remains about the IMF's work in capital account issues. In the following chapter, we turn to the question of how this ambiguity has been dealt with in the context of a specific country and see if the lack of a formal policy has affected the quality and consistency of the IMF's advice.