CHAPTER

3 Advice to Member Countries, 1990–2002

This chapter reviews the IMF's advice (or views expressed) to member countries on capital account issues, particularly capital account liberalization and managing capital flows. It first discusses the role of the IMF in capital account liberalization during 1990–2002 in the full sample of emerging market economies, paying particular attention to how its views, as expressed in country work, evolved over time. It then shifts to the IMF's advice on managing capital flows in the context of bilateral surveillance, covering macroeconomic and structural policies to deal with large capital inflows and, in a separate section, the temporary use of capital controls to deal with both inflows and outflows.

Capital Account Liberalization

Out of the 27 countries examined, the evaluation identified 18 countries for which the IMF staff provided advice or otherwise expressed a view on capital account liberalization in staff reports during 1990–2002 (Table 3.1).[1] The table summarizes the evaluation team's best judgments on whether or not the staff's view or advice made a reference to the need for proper sequencing. For each country, when the staff report for a particular year makes no mention of sequencing, it is indicated by 1; when mention is made of sequencing, it is indicated by 2.

The nine countries not listed in the table include six countries that either had a relatively open capital account or liberalized the capital account at the beginning of 1990 (or before becoming members of the IMF): Estonia, Latvia, Lithuania, Malaysia, Mexico, and Venezuela. In most of these countries, the IMF had endorsed the authorities' overall capital account liberalization strategies. In the case of Mexico and Venezuela, this endorsement was given in the context of IMF-supported programs;[2] in the Baltic states of Estonia, Latvia, and Lithuania, the IMF endorsed the liberal regimes already in place when they joined the IMF in 1992 or in subsequent policy dialogue. The absence of Colombia and Malaysia from the list may be conspicuous, as they substantially opened the capital account in the early to mid-1990s. Surprisingly, no discussion of capital account liberalization can be found in staff reports for these countries (Malaysia's capital controls are discussed in the section "Temporary Use of Capital Controls" of this chapter).[3]

Some countries had a very open capital account but are still included in the table, when remaining restrictions were a subject of discussion. For example, Thailand, which had a very liberal capital account regime in 1990 with respect to inflows, retained some restrictions on outflows, and the IMF staff expressed its views on the liberalization of outflow controls (as well as on capital inflow promotion measures). Likewise, Chile abolished or eased most administrative controls on inflows from the late 1980s to 1991, so the IMF staff's subsequent views on Chile mostly concerned the liberalization of outflow controls (Chile's capital inflow controls are discussed in the section "Temporary Use of Capital Controls" of this chapter).

[1]It is not always straightforward to make this judgment. For example, in some cases reference may be made to the "liberalization of the trade and exchange system," in which case one cannot be sure if capital account liberalization is included. In other cases, liberalization of capital transactions can mean either an overall opening of the previously closed capital account or a removal of temporary capital controls (the latter case is treated separately later in this chapter). More fundamentally, the absence of an explicit reference to capital account liberalization in staff reports may not mean that the staff expressed no view to the authorities in policy dialogue. In the case of program countries, we assumed that the staff favored liberalization if a capital account opening measure was included in the authorities' policy statements even if no mention was made in the staff reports. The selection of countries in Table 3.1 represents the IEO's best judgments.

[2]Mexico launched a major program of economic liberalization in the late 1980s, which the IMF subsequently supported with an arrangement under the Extended Fund Facility; and Venezuela lifted most capital account restrictions in January 1990 under an IMF-supported program.

[3]For Colombia, the staff report for the 1992 Article IV consultation endorsed the liberalization measures taken by the authorities during the previous years.

Table 3.1. The Nature of the IMF's Advice on Capital Account Liberalization in Selected Countries[1]

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Bulgaria	. . .	. . .	. . .	. . .	. . .	. . .	. . .	1	2	2	2	. . .	. . .
Chile[2]	. . .	1	1	1	1	. . .	1	. . .	. . .	. . .	2	. . .	. . .
China	. . .	. . .	. . .	1	. . .	. . .	2	2	. . .	2	. . .	. . .	. . .
Croatia	. . .	. . .	. . .	. . .	. . .	. . .	. . .	1	. . .	. . .	. . .	2	. . .
Czech Republic	. . .	. . .	. . .	1	2	2	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Hungary	. . .	1	. . .	1	. . .	. . .	2	. . .	2	. . .	. . .	. . .	. . .
India	. . .	2	. . .	. . .	. . .	2	2	2	2	. . .	. . .	. . .	. . .
Israel	2	1	. . .	. . .	1	. . .	. . .	. . .	. . .	. . .	2	1	. . .
Peru	1	1	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
Philippines	. . .	1	1	. . .	. . .	. . .	. . .	. . .	1	. . .	. . .	. . .	. . .
Poland	. . .	1	. . .	. . .	. . .	. . .	. . .	. . .	2	. . .	1	1	. . .
Romania	. . .	. . .	. . .	1	. . .	1	. . .	. . .	2	. . .	. . .	. . .	. . .
Russia	. . .	. . .	1	. . .	. . .	. . .	. . .	. . .	. . .	2	. . .	. . .	2
Slovak Republic	. . .	. . .	. . .	. . .	. . .	. . .	. . .	2	. . .	. . .	. . .	. . .	. . .
Slovenia	. . .	. . .	. . .	1	. . .	. . .	. . .	2	2	. . .	. . .	. . .	. . .
South Africa[3]	. . .	. . .	2	. . .	. . .	2	2	2	. . .	. . .	2	2	. . .
Thailand[4]	. . .	1	1	. . .	. . .	. . .	2	. . .	. . .	. . .	. . .	. . .	. . .
Tunisia	. . .	. . .	. . .	. . .	2	2	1	1	2	2	2	2	2

Source: IEO judgments based on IMF staff reports, supplemented by internal documents where necessary.

[1]The IMF's advice for a particular year is assessed when capital account liberalization was part of that year's discussion with country authorities. "1" indicates that no explicit mention is made of sequencing, and "2" indicates that mention is made. A shaded area corresponds to a period in which there was an IMF-supported program.

[2]The advice refers mostly to the liberalization of outflows after 1991.

[3]In the case of South Africa, in addition to the financial sector, documents also explicitly spelled out country-specific risks whenever capital account liberalization was raised.

[4]The advice refers mostly to the liberalization of outflows.

We first discuss the role of the IMF in capital account liberalization in terms of program conditionality and technical assistance. We then divide the period 1990–2002 into three subperiods, (1) the early 1990s, (2) following the Mexican crisis; and (3) following the East Asian crisis. For each period, we discuss how the IMF viewed capital account liberalization within the context of a specific country and see how its views might have changed over time.

Program conditionality and technical assistance

Of the 18 countries to which the IMF staff provided advice on capital account liberalization, 13 countries had an IMF-supported program at one time or another. In none of these countries did the IMF require capital account liberalization as formal conditionality for the use of its resources, where formal conditionality is understood to include prior actions, performance criteria, or structural benchmarks. In addition to the country documents for these countries, the evaluation also examined PDR's comprehensive database on conditionalities for all programs, which confirms the almost complete absence of formal conditionality on capital account liberalization. This is consistent with the established interpretation of the Articles of Agreement, as given by the IMF's Legal Department (LEG), which states that the IMF, as a condition for the use of its resources, cannot "require a member to remove controls on capital movements."[4]

The Articles, however, are interpreted to allow the IMF to require as conditionality certain actions related to the capital account that are relevant to the mandate of the IMF, notably elimination of payment arrears (which typically arise from capital controls) and imposition of limits on external borrowing (which may implicitly require capital controls). Moreover, programs may also support capital account liberalization as part of country authorities' overall package of economic policies. In fact, a number of IMF-supported programs with some of the sample countries included references to aspects of capital account liberalization in the letters of intent (LOIs) or accompanying policy memorandums. LOIs are statements of the authorities' policy intention and do not constitute conditionality that links compliance with disbursements of funds.

[4]See Legal Department, "Capital Movements—Legal Aspects of Fund Jurisdiction Under the Articles," SM/97/32, Supplement 3, February 21, 1997. Records on structural conditionality indicate, however, that the 2001 program with Lesotho included completion of "the first stage of capital account liberalization" as a structural benchmark. The IEO cannot ascertain why, given the standard LEG interpretation, this particular measure was deemed appropriate to be included as formal conditionality.

For example, Hungary's 1991 LOI for an extended arrangement expressed the authorities' commitment to promote FDI by encouraging foreign participation in the banking sector and in the privatization process. Likewise, Russia's 1992 LOI for the first credit tranche included the authorities' intention to issue necessary foreign exchange regulations covering both capital and current transactions and to extend the same convertibility to nonresidents as soon as the monetary arrangements in the ruble area had been settled. The LOI for Croatia's 1997 request for an extended arrangement was more explicit in stating the authorities' intention to "put the liberalization of capital account transactions on its policy agenda, including restrictions that relate to outward portfolio and direct investment."[5]

For the most part, available evidence suggests that the process of capital account liberalization was determined by country authorities' economic and political agendas. In some cases, the process was driven by prospective OECD or EU accession and, in later years, commitments under bilateral or regional trade agreements. In other cases, such as Latvia (Box 3.1), it was driven by the countries' desire to attract foreign investment. The IMF's deference to country ownership is particularly evident in countries that chose a gradualist approach to capital account liberalization, such as Hungary or India; in these cases, we found no evidence that the IMF pushed for a faster pace in program negotiations or other policy discussions.

The IMF also provided technical assistance on issues that are broadly related to capital account liberalization. The documents we examined for 15 countries included advice on such issues as the development of indirect monetary policy instruments, establishment or development of a foreign exchange market, and drafting of a foreign exchange law. A Board paper prepared by the staff in 1995 noted that, while "the IMF's treatment of the issue of capital account convertibility [had] been on a case-by-case basis in the context of its surveillance and use of IMF resources activities, an effort to facilitate capital liberalization [had] been applied more generally through the medium of technical assistance to develop foreign exchange markets" (Quirk and others, 1995).

In technical assistance discussions, the staff in the early years tended to be more encouraging toward capital account liberalization. The back-to-office report for a 1995 technical assistance mission to the Czech Republic, for example, stated that the mission "argued strongly" in favor of a "more decisive program of liberalization." A 1995 technical assistance report for China concluded that an effective way to enhance the efficiency of the foreign exchange market was to eliminate restrictions that prohibited foreign banks from operating in the domestic market. Even in India, where the staff supported the country's gradualist approach in its surveillance work, a 1995 technical assistance report on foreign exchange market development noted the need for a broad strategy for capital account liberalization as a precondition for developing a dynamic market. Little advice was given, however, on the specifics of sequencing capital account liberalization until later in the 1990s.

In the late 1990s, the nature of the IMF's technical assistance seemed to change in two important respects. First, it began to emphasize the notion of sequencing. For example, in a December 1997 seminar held in China, the staff stressed the need to coordinate capital account liberalization measures with concurrent measures to strengthen financial markets and institutions and to sequence properly the liberalization measures in FDI, portfolio inflows, and outward investments. Second, technical assistance also became more accommodating of use of capital controls, especially for prudential purposes. In January 1999, for example, the technical assistance mission to Russia argued that countries that had opened up their capital account typically had in place regulations restricting certain transactions between residents and nonresidents, and recommended that the ability of nonresidents to access credit in the domestic market be restricted, especially where such borrowing could be leveraged to speculate against the ruble.

Surveillance in the early 1990s

In the early 1990s, the IMF viewed capital account liberalization favorably in its country work. The countries that liberalized the capital account may have done so on their own, but the IMF approvingly accepted their liberalization plans. In Israel, the IMF even advised the authorities to accelerate the pace of liberalization. For example, the staff report for the 1991 Article IV consultation with Israel stated: "The removal of foreign exchange controls should be speeded up to encourage capital inflows and improve allocation." In Thailand, in 1992 the staff "urged" the authorities to remove the remaining restrictions on capital outflows.

The IMF staff, in its discussions with country authorities, stressed the benefits of an open capital account, including greater resource flows to supplement domestic savings (as in Poland in 1991), better resource allocations (Israel in 1991), lower interest

[5]Korea's economic program supported under the 1997 Stand-By Arrangement included three measures to liberalize the capital account: (1) greater foreign participation in the domestic financial sector; (2) opening of the equity, money, and corporate bond markets; and (3) elimination of foreign borrowing by corporations. These measures were also included, not as formal conditionality, but in the memorandum attached to the LOI.

Box 3.1. Latvia

In 1991, independence for Latvia meant an immediate dismantling of all the capital controls that existed in the former Soviet Union. Independence also meant a reorientation of trade away from the Soviet bloc, which brought about a deterioration in the terms of trade and a shortage of energy and raw materials. In the early 1990s, coupled with the impact of a severe drought affecting agriculture, the economic outlook for Latvia was bleak. From 1992 to 1993, industrial output collapsed and unemployment soared, threatening to undermine the broad political support for economic reforms. Under these circumstances, the Latvian authorities chose not to replace the Soviet-era capital controls with new ones and, in November 1991, enacted a liberal foreign investment law in order to establish a legal framework for attracting foreign direct and portfolio investment. Effectively, capital account liberalization was completed overnight and preceded domestic financial liberalization, the establishment of a central bank, and the introduction of a national currency.[1]

Although the IMF had no formal role to play in Latvia's decision to open the capital account,[2] it supported the authorities' outward-looking, market-oriented reforms through financing and technical assistance.[3] The IMF's position on Latvia's capital account policy is evident in program documents. For example, in August 1992, the LOI for a Stand-By Arrangement stated that "[the] current stipulations in the foreign investment law allowing liberal repatriation of capital and transfers of shares in the event of liquidation [would] be maintained." Differences of view between the IMF staff and the Latvian authorities concerned the use of exchange rate policy to deal with capital inflows. When Latvia received large capital inflows, the staff's consistent view was to encourage greater exchange rate flexibility. A briefing paper of January 1995 was typical, by arguing that it would be better for any real appreciation of the lats to be achieved through a nominal appreciation than through higher monetary growth. The authorities on their part viewed nominal exchange rate stability as critical to price stability in a small, highly open economy such as Latvia, and insisted on maintaining the de facto peg to the SDR, which they had introduced in early 1994.

Latvia experienced a major banking crisis in the first half of 1995, which involved a closure of several prominent banks, including the largest one. This was in fact the culmination of a crisis that had been brewing for some time. In 1994, the licenses of several commercial banks were suspended. When several major banks failed to submit audited reports in March 1995, this turned into a major crisis of confidence in the banking sector. In May, the announcement by the government to take over the largest bank (accounting for 30 percent of total deposits) precipitated capital flight amounting to 10 percent of total foreign exchange reserves, exerting downward pressure on the exchange rate. Through decisive intervention in the banking sector and demonstrated commitment to the fixed exchange rate policy, however, the crisis was resolved relatively quickly and capital inflows resumed in the latter part of the year. A number of Latvian experts consulted by the evaluation team have expressed the view that the banking crisis of 1995 had little to do with capital account liberalization per se but resulted from the weak regulatory system that had allowed too many banks to be established without the necessary internal control procedures or sufficient capital and allowed them to adopt unsound lending practices.[4] Fortunately, Latvia's financial and foreign exchange markets lacked the depth and breadth to allow major international players to speculate against the currency.

[1]In May 1992, the authorities introduced the Latvian ruble initially as a supplement to the Russian ruble (to deal with a cash shortage), before the formal introduction of the national currency *lats* in March 1993.

[2]Latvia signed the IMF Articles of Agreement in May 1992.

[3]From 1992 to 1995, MAE provided extensive technical assistance on foreign exchange operations, central bank operations, and banking supervision.

[4]Some experts have even suggested that banks were engaged in activities bordering on criminal behavior. When the largest bank was suspended, most of the assets had been stripped, leaving a negative net worth of around 8 percent of GDP.

rates (Slovenia in 1993), and greater price stability (Russia in the early 1990s). The 1992 staff report on Russia noted that the anti-inflationary policies crucially depended on accelerating the pace of institutional and structural reforms, including opening the economy to foreign capital. For Israel (in 1994), the staff listed Israel's strong financial market and stable currency as reasons for moving forward with capital account liberalization. The staff occasionally pointed out the problems posed by a weak banking system, lack of exchange rate flexibility, or weak fiscal policy, but the awareness of these problems did not translate into operational advice on the pace and sequencing of capital account liberalization (for example, Poland in 1991; and the Czech Republic in 1993).

The staff's views of the offshore Bangkok International Banking Facility (BIBF) were typical. The BIBF was established in March 1993, with the goal of developing Thailand into a regional financial center. Various tax incentives were granted to BIBF banks, including a lower corporate income tax rate and several outright exemptions. The IMF staff took little note of this, however, and made no comments on its implications for capital inflows in documents prepared around this time. The staff report for the 1993 Article IV consultation saw the BIBF, not in terms of its implications for capital inflows, but more in terms of the benefits it would provide in improving competition and technical skills in the financial sector. Even after the composition of capital inflows shifted to shorter-term maturities in 1994, the staff paid little attention to the vulnerabilities being created by the BIBF. For example, the briefing paper for the 1994 Article IV consultation noted the staff's intention to discuss with the authorities the progress they had made in developing the BIBF and the measures to be taken to "complete the process of financial market deregulation."

This does not mean that the IMF staff was unaware of the risks of rapid liberalization, and the staff seems to have explicitly supported a cautious pace in some cases. When the Indian government requested a Stand-By Arrangement (SBA) in 1991, for example, the staff supported the authorities' intention, as spelled out in the LOI, to liberalize the capital account slowly by first removing restrictions on FDI and equity inflows. In South Africa, the IMF agreed with the cautious attitude of the authorities toward capital account liberalization, albeit for a country-specific reason involving the climate of political uncertainty. Despite these specific instances, however, our review of country documents indicates that the IMF generally supported rapid capital account liberalization in the early 1990s and offered little practical advice on pace and sequencing.

Following the Mexican crisis

The Mexican crisis did not seem to have a significant impact on the broader institutional thinking of the IMF on capital account liberalization. As noted in Chapter 2, the "staff operational note," instructing area department staff to encourage countries to liberalize the capital account, was issued in December 1995, after the Mexican crisis. This may reflect the fact that this crisis was largely seen as one that had resulted from the country's choice of an inappropriate exchange rate regime under the circumstances; correctly or incorrectly, it was not necessarily seen to have resulted from rapid capital account liberalization. Nevertheless, internal documents suggest that the Mexican crisis did cause the staff's policy dialogue with some countries to become more cautious, questioning the wisdom of rapid capital account liberalization, particularly on outflows and short-term reversible inflows.

From 1995 to 1997, for example, some country teams argued that the liberalization of outflows or short-term flows could trigger capital flight (as in the Czech Republic in 1995), exacerbate unstable capital inflows (in Hungary in 1996), or make it more likely to reintroduce capital controls (in India in 1996). The idea of preconditions, familiar in the academic literature (and which was appearing in the staff's analytical work), also became more evident in the IMF's country work during this period. In the staff report for the 1996 Article IV consultation with the Slovak Republic (issued in 1997), the staff cautioned against further liberalization because of the country's large current account deficit. The staff was also aware of banking sector weakness (as in China in 1997), lack of exchange rate flexibility (in Hungary in 1996), and underdeveloped domestic financial markets (in the Slovak Republic in 1997), and urged the authorities to undertake reforms in these areas. In India, the staff in 1996 specifically advised against lifting restrictions on purchases of government bonds by nonresidents until fiscal consolidation was achieved.[6] In South Africa, the staff based its support for gradualism on vulnerabilities arising from the central bank's large net open position in the forward exchange market.[7]

Even in those cases where the staff did not provide operational advice to slow down the pace of liberalization, it clearly gave greater attention to the potential vulnerabilities associated with large capital inflows and the need for a strong financial system. In Thailand, for example, the briefing paper for the 1995 Article IV consultation indicated the staff's intention to discuss with the authorities the policy implications of the recent increase in short-term capital inflows, underscoring the importance of close banking supervision and the need to maintain adequate capital ratios for financial institutions. The staff report for the 1996 Article IV consultation paid attention to the currency and maturity mismatches being created through the BIBF. It expressed concerns over the "rapid growth of foreign currency lending to local firms, which is only partly hedged, suggesting that foreign exchange risk needs to be closely monitored."

Of course, these instances of cautious attitude and support for gradualism in the IMF's country work must be placed in context. As noted, the Mexican crisis did not have a major institutional impact on the overall philosophical orientation of the IMF. The

[6] As early as 1995, IMF staff had stressed that financial sector reform, fiscal discipline, and development of indirect monetary policy instruments would be necessary before capital account convertibility could be achieved in India. In 1997, these ideas led to a draft note on the pace and sequencing of capital account liberalization, which the staff submitted to the Indian authorities. The note explicitly listed preconditions for capital account liberalization, including fiscal consolidation, banking sector reform, and exchange rate flexibility.

[7] In 1995, South Africa lifted most controls on capital movements by nonresidents but retained restrictions for residents.

staff continued to encourage liberalization in such countries as Romania (1995) and Chile (1996). An earlier IEO report (IEO, 2003) documents that, during this period, the IMF also encouraged the Korean authorities to remove remaining restrictions on long-term capital flows, with insufficient attention to sequencing and supervision (see also Box 1.3). In the case of Russia, the staff encouraged the opening of the public debt market to nonresidents, though arguably this was related more to the question of how to finance fiscal deficits than to that of capital account liberalization per se. These sentiments were shared by some on the Executive Board. When the staff report for the 1997 Article IV consultation with India was discussed, some Executive Directors criticized the staff for its support of India's gradualist approach to capital account liberalization and argued that the benefits from further rapid liberalization would outweigh any risks.[8]

Following the East Asian crisis

The evolution of the IMF's thinking on capital account liberalization was a gradual process, and it is not correct to point out a single event as triggering a fundamental shift. Even so, there is no denying that the East Asian crisis had a major impact. From around 1998, one sees the IMF staff giving greater attention than previously to the risk of rapid liberalization when preconditions were not met. During this period, expressions of caution toward capital account liberalization or views accommodating of capital controls were no longer isolated cases. In a wide range of cases, the staff now saw virtue in limited capital account openness as a means of protection from contagion (as in Slovenia in 1998, Romania in 1998, India in 1998, and China in 1999) or as a way of providing breathing space for necessary reforms (Russia in 2002). The staff report for the 1999 Article IV consultation with China stated that the capital controls had helped the country reduce external vulnerability, while the staff report for the 1998 consultation with Slovenia noted that the country's cautious approach to capital account liberalization had helped avoid serious contagion from the emerging market crises of the recent years.

At the same time, the staff began to pay greater attention to the sources of capital flow volatility, and the need to address these as a precondition for full capital account liberalization. The staff in its country work suggested financial system weakness (in Bulgaria in 1999, Croatia in 2001, and Russia in 2002) and the lack of market-determined interest rates (Slovenia in 1998) as among the factors contributing to capital flow volatility. The staff report for the 2001 consultation with Russia (issued in 2002) expressed support for cautious liberalization "in light of the global uncertainties and potential risks from premature liberalization with an underdeveloped domestic financial system." For countries that requested advice on capital account liberalization, the IMF suggested that, as preconditions for liberalization, they should increase exchange rate flexibility (or introduce a floating exchange rate system with inflation targeting, if feasible), undertake banking sector reform, and strengthen financial sector regulation possibly in the context of the FSAP. At the same time, for those countries that had broadly met the preconditions, the IMF staff at least implicitly endorsed their move toward full capital account liberalization (as in the cases of Chile, Hungary, Israel, Poland, and South Africa).[9]

Macroeconomic and Structural Policies to Manage Capital Inflows

The 1990s saw a surge in capital flows to emerging market economies. In part, this reflected global "push" factors. But at the same time, policies pursued by these countries to liberalize the capital account were also an important "pull" factor contributing to the pickup in capital inflows (see Calvo and others, 1996). As countries experienced the large capital inflows and associated macroeconomic challenges, the question of how to manage such inflows became a routine subject of discussion between the IMF and country authorities. The evaluation found that the staff expressed views on capital inflow issues in 16 of the 27 countries in the broader sample that experienced large capital inflows (see Table 3.2). This section reviews how, in response to the large capital inflows, the IMF advised or otherwise expressed its views to the country authorities in these 16 countries in terms of macroeconomic and structural policies.

Macroeconomic policies

There is a large literature that discusses policy options available to countries desiring to manage large capital inflows (for example, Goldstein, 1995). Depending on the nature of the inflows, the options often considered include sterilization through open

[8]All Directors recognized, however, that progress on domestic financial sector reform and fiscal consolidation would help reduce these risks.

[9]The staff's policy advice in South Africa throughout this period was to tailor the further capital account liberalization to the strengthening of the balance of payments position, as reflected in the elimination of the net open forward foreign exchange position.

Table 3.2. The IMF's Advice on Managing Large Capital Inflows, 1990–2002[1]

		Policy Measures Advocated by the IMF						
	Years[2]	Tighten fiscal policy	Greater exchange rate flexibility	Sterilization	Further trade liberalization	Liberalization of capital outflows	Tightening of prudential regulation	Imposition of capital controls
Chile	1990–97	Yes	Yes	Yes[3]	Yes	Yes		
Colombia	1991–97	Yes		Yes	Yes			
Czech Republic	1994–96	Yes		Yes		Yes		
	1999–2001	Yes	Yes	Yes				
Estonia	1996–97	Yes		Yes[4]				
	2000–01	Yes		Yes[4]				Yes
Hungary	1995–2000	Yes	Yes	Yes		Yes		
India	1994	Yes	Yes	Yes	Yes	Yes	Yes	
	2002		Yes	Yes[3]	Yes			
Latvia	1993–97		Yes	Yes[4]				
Malaysia	1991–96	Yes	Yes	Yes				
Mexico	1990–93		Yes[5]	Yes[3]			Yes	
Peru	1992–98	Yes	Yes	Yes[3]				Yes
Philippines	1994–97		Yes	Yes				
Poland	1995–98	Yes	Yes					
Russia[6]	1995, 1997		Yes	Yes				
Slovak Republic	1995–2001	Yes					Yes	
Slovenia	1995–97	Yes	Yes	Yes[3]		Yes		
Thailand	1990–96	Yes	Yes	Yes	Yes	Yes	Yes	

Source: IEO judgments based on IMF staff reports.
[1] "Yes" indicates that IMF staff advised the policy measure concerned in one or more years.
[2] These years represent a period of substantial inflows.
[3] No explicit advice was given, but the IMF staff did not oppose the use of sterilization by country authorities.
[4] Tighter monetary policy.
[5] Support given to the crawling peg.
[6] In Russia, significant capital outflows were recorded in 1996.

market sales of domestic securities, increases in reserve requirements, fiscal tightening, and greater nominal exchange rate flexibility. Further trade liberalization, removal of restrictions on capital outflows, and tightening of controls on capital inflows are also considered. The consensus, however, seems to be that none of these policies is a panacea, as each may involve significant costs or otherwise bring about other policy challenges.[10] There is thus a difficult trade-off between the potential short-term costs of large capital inflows and the side effects of the policies to deal with them.

The 16 countries reviewed here used a combination of various policy instruments at different times to deal with the capital inflows, and the IMF provided advice or expressed views on them. As early as 1993, the IMF staff (Schadler and others, 1993) stated that the conventional policy prescription included fiscal tightening and real appreciation (preferably through nominal appreciation) but argued against sterilization (which would keep domestic interest rates high and therefore encourage more

[10] For example, sterilization has quasi-fiscal costs (as higher-yielding domestic securities are typically exchanged for lower-yielding industrial country securities) and may lose effectiveness as substitutability of assets increases; high reserve requirements affect the allocation of credit adversely by reducing financial intermediation; exchange rate flexibility may lead to a large real exchange rate appreciation; elimination of restrictions on capital outflows can send a positive signal to the markets, thus encouraging further capital inflows; and fiscal policy lacks short-run flexibility. Given the quasi-fiscal costs, moreover, there is a conflict between use of sterilization and fiscal tightening.

inflows) and use of capital controls (which were judged to be either ineffectual or distortionary).[11] Broadly, a review of country experiences suggests that the IMF's policy advice and views did not deviate much from this conventional wisdom. However, there were different emphases across time and across countries.

Fiscal policy

The IMF staff's most frequent advice was to tighten fiscal policy, preferably through a cut in public expenditure. Fiscal tightening was expected to reduce pressure on the exchange rate not only through lower domestic absorption but also by limiting the increase in the relative price of nontradables.[12] On the other hand, fiscal tightening could promote capital inflows by signaling the authorities' commitment to prudent macroeconomic management and thereby cause the exchange rate to appreciate, especially over the medium term.

The advice to tighten fiscal policy was given constantly throughout the period of large capital inflows in five countries: Chile, Colombia, Estonia, India, and Peru. The cases of Chile, Colombia, and India are of particular interest because the IMF provided this advice in connection with its advice on the use of capital controls. In Chile, the staff on some occasions discussed with the authorities the possibility of relaxing capital controls pari passu with fiscal restraint. In Colombia, in 1995 and 1997, the staff suggested that fiscal tightening could create conditions for a relaxation of the controls. Likewise, in India, the staff argued that fiscal tightening, complemented by further trade and capital outflow liberalization, would make it unnecessary to resort to administrative controls.

In seven other cases (the Czech Republic, Hungary, Malaysia, Poland, the Slovak Republic, Slovenia, and Thailand), the staff advised fiscal tightening, but only occasionally or with apparently less intensity. In Poland, for example, the advice was given only in 1995.[13] In Slovenia, it was offered as a contingency measure to be used in the event large capital inflows reemerged. The fiscal policy advice offered in the Slovak Republic was similar: in 2001, the staff suggested that the authorities should "stand ready to rebalance the policy mix toward a tighter fiscal stance if persistent upward pressure on the exchange rate posed a challenge to macroeconomic management."

In most of these countries, when support for fiscal tightening was expressed, the policy was perceived largely as an auxiliary measure. For example, the staff report for the 1994 Article IV consultation with Malaysia stated: "While fiscal policy can be expected to make a contribution, attaining the needed degree of restraint will ultimately fall largely on the side of monetary and exchange rate policy." Likewise, the staff report for the 1992 Article IV consultation with Thailand, after arguing that tighter monetary policy should be attempted through sterilization, suggested: "Sterilization would become increasingly difficult to sustain over time, and fiscal policy would have to be tightened."

In the remaining countries (Latvia, Mexico, the Philippines, and Russia), the IMF staff did not advise the authorities to tighten fiscal policy in response to large capital inflows. This is not to say that fiscal policy was not discussed in policy dialogue between the IMF staff and the authorities. To the contrary, in all these countries, fiscal policy was a major topic of discussion. However, discussion on fiscal policy took place as part of the authorities' overall macroeconomic strategy, and not necessarily in terms of managing capital inflows. For example, the Philippines was already committed to achieving fiscal consolidation by 1997 through structural fiscal reforms under an IMF-supported program and, in this context, there was probably little need to make a separate case for further fiscal tightening.

Country-specific factors must have been an important part of the observed cross-country differences in the intensity with which the IMF staff advised a tightening of fiscal policy. The staff's consistent advice of fiscal tightening in Estonia, for example, may be related to the fact that fiscal policy was the primary macroeconomic policy instrument available under the currency board arrangement. On the other hand, the less-intensive advice in Thailand may be explained by the assessment, as expressed during the 1994 Article IV consultation, that there was "little room for fiscal policy to contribute to restraining demand as the fiscal consolidation of the late 1980s involved sizable cuts in expenditure." Fiscal tightening was apparently not advocated strongly in Latvia because the staff viewed the capital inflows as resulting from increased confidence, and not from "high real interest rates caused by the combination of lax fiscal policy and tight credit policy."[14]

[11]Schadler and others (1993) reviewed experiences with surges in capital inflows in Chile, Colombia, Egypt, Mexico, Spain, and Thailand, focusing on what the policymakers did rather than how the IMF provided advice or expressed views.

[12]This assumes that government consumption is more intensive in the use of nontradable goods.

[13]Fiscal tightening was advised in subsequent years, but not in the context of managing capital inflows.

[14]Briefing paper for the first review under the SBA, January 16, 1996.

Table 3.3. Fiscal and Other Macroeconomic Indicators in Selected Countries with Large Capital Inflows, 1990–2002

(In percent of GDP; percent a year)

	Years[1]	Average Net Private Capital Flows[2]	Initital Fiscal Balance	Average Fiscal Balance	Average Improvement in Fiscal Position[3]	Average Primary Balance	Initial Public Debt[4]	Average Inflation	Average Current Balance
Countries for which fiscal tightening was advised with greater intensity									
Chile	1990–94	7.4	3.2	–0.3	–3.5	1.3	42.8	17.5	–2.4
	1995–97	7.4		2.1	–1.1	3.2		7.2	–3.5
Colombia[5]	1991–94	1.5	–0.1	–0.4	–0.3	1.4	n.a.	25.7	–0.4
	1995–96[6]	–1.3		–2.0	–1.8	–0.2		20.8	–4.9
	1997	1.1		–3.2	–3.1	–1.1		18.5	–5.4
Estonia	1996–97	14.0	–1.8	0.1	1.9	0.6	7.5	17.1	–10.0
	2000–01	7.8	–0.6	–0.1	0.5	0.2	2.8	4.9	–5.6
India	1994	3.2	–7.6	–7.6	n.a.	–2.5	73.3	10.2	–0.5
	2002	3.1	–9.7	–9.7	n.a.	–3.4	80.8	4.3	1.4
Peru	1992–94	6.3	–3.9	–3.5	0.4	0.6	80.2	48.6	–6.1
	1995–98	6.9		–1.3	2.6	1.1		9.6	–6.8
Countries for which fiscal tightening was advised with less intensity									
Czech Republic	1994–96	10.1	–1.8	–1.3	0.5	–0.2	16.2	9.3	–3.6
	1999–2001	6.9	–3.1	–3.1	0.1	–2.1	13.4	3.6	–4.2
Hungary	1995–97[6]	2.8	–6.2	–4.6	1.5	4.7	84.3	23.4	–4.6
	1998–2000	11.0		–3.8	2.3	3.2	60.6	11.4	–7.9
Malaysia[7]	1991–96	8.4	–0.9	1.3	2.1	n.a.	73.3	3.9	–6.4
Poland	1995–98	5.7	–2.8	–3.0	–0.2	0.5	50.8	18.6	–2.3
Slovak Republic	1995–98	10.1	0.3	–3.1	–3.4	–0.9	21.6	7.1	–6.7
	1999–2001	5.8		–5.9	–6.3	–2.9		10.0	–5.6
Slovenia[8]	1995–97	2.3	0.0	–0.3	–0.3	0.9	17.8	10.6	0.1
Thailand	1990–93	10.6	4.4	3.4	–1.0	n.a.	18.4	4.8	–6.6
	1994–96	10.5		2.3	–2.1	n.a.		5.6	–7.1
Countries for which no or little advice on fiscal tightening was given									
Latvia	1993–97	8.6	0.6	–1.7	–2.3	–0.7	11.2[9]	39.2	0.1
Mexico	1990–93	5.1	–2.8	–0.1	2.6	5.1	50.2	18.6	–5.0
Philippines	1994–97	9.8	–1.7	–1.1	0.6	n.a.	72.5	7.8	–4.2
Russia	1995, 1997	1.8	–6.5	–7.5	–1.0	–3.1	n.a.	106.4	0.4

Sources: IMF databases; and IEO estimates.
[1]Unless noted otherwise, these years cover a period of large capital inflows.
[2]Foreign direct investment, private portfolio investment flows, and other private investment flows.
[3]Average balance less initial balance.
[4]For most countries, gross debt of central or general governments; for Estonia, net debt; for Latvia, Peru, and Thailand, total debt of consolidated central governments (obtained from the IMF's Government Finance Statistics database).
[5]In calculating average net private capital flows, 1991 is excluded. Net capital inflows in 1993 amounted to 4.2 percent of GDP.
[6]Net private capital outflows were recorded in 1996–97.
[7]Net private capital outflows were recorded in 1994. For 1991–93, net private capital inflows amounted to 12.4 percent of GDP.
[8]Net private capital outflows were recorded in 1996.
[9]For 1994.

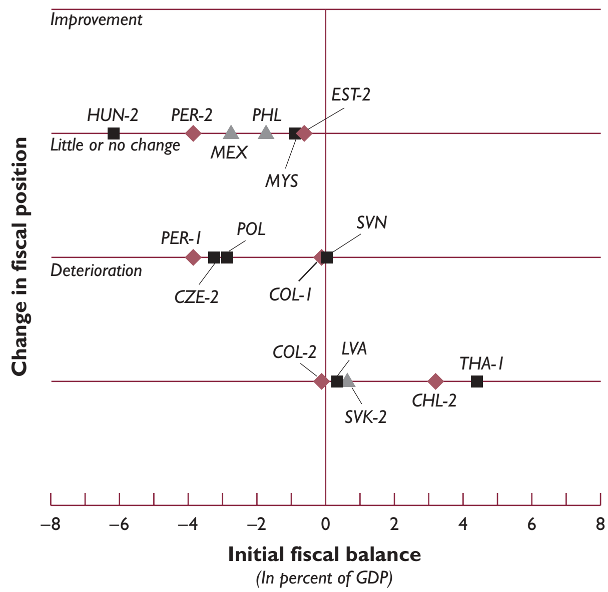
While we can try to explain the IMF's policy advice in some of these individual instances, a more systematic assessment of its overall advice on fiscal policy is more difficult. When we assess fiscal policy advice against the strength of capital inflows, inflation, and various fiscal indicators, we find little systematic relationship: advice was given in some countries but not in others; and the same advice was given in countries with different fiscal positions (Table 3.3). Neither do we find any systematic relationship between initial fiscal positions, changes in the fiscal position, and the strength of IMF advice on fiscal tightening (Figure 3.1). One wonders, for example, why the IMF staff gave the same advice of strong fiscal adjustment to both Chile and Colombia, when Chile was already following a tight fiscal policy and Colombia was not.[15]

Exchange rate policy

The IMF staff also frequently advised countries receiving large capital inflows to increase exchange rate flexibility. In an environment in which the institution was moving (at the time) toward a "two-corner" solution view of sustainable exchange rate policy under high capital mobility, this advice appears to be all tending toward one of the corners only. It should be remembered, however, that none of the countries to which this advice was given had a de jure peg, let alone a currency board arrangement. It was in this context that the IMF advised the authorities to allow the exchange rate to appreciate in response to large capital inflows or to allow greater scope for depreciation in order to discourage speculative inflows.

In 4 of the 16 countries (Hungary, India, the Philippines, and Poland), this advice was given constantly throughout the period of large capital inflows (see Table 3.2). In Poland, in 1997, the staff stressed that "allowing more flexibility within the exchange rate band would be an effective instrument to contain inflows, as increased uncertainty would deter speculative movements." A similar line of argument was offered in the same year (as well as in other years) to Hungary: "From a medium-term perspective, the shift toward a more flexible exchange rate regime would also help contain speculative capital inflows in the context of increased financial liberalization."

Figure 3.1. Fiscal Performance and the IMF's Fiscal Policy Advice in Selected Countries 1990–2002[1,2]



Source: The IEO's judgment based on Table 3.3.

[1]Fiscal performance is classified into three broad categories: improvement, little or no change, or deterioration. The abbreviations are as follows: CHL-2 = Chile (1995–97); COL-1 = Colombia (1991–94); COL-2 = Colombia (1995–96); CZE-2 = Czech Republic (1999–2001); EST-2 = Estonia (2000–01); HUN-2 = Hungary (1998–2000); LVA = Latvia (1993–97); MYS = Malaysia (1991–96); MEX = Mexico (1990–93); PER-1 = Peru (1992–94); PER-2 = (1995–98); PHL = Philippines (1994–97); POL = Poland (1995–98); SVK-2 = Slovak Republic (1999–2001); SVN = Slovenia(1995–97); THA-1 = Thailand (1990–93).

[2]"◆" indicates a country in which the advice of fiscal tightening was given with greater intensity; "■" indicates a country in which the advice was given with less intensity; and "▲" indicates a country in which no or little advice of fiscal tightening was given.

In 9 countries (Chile, the Czech Republic, Latvia, Malaysia, Mexico, Peru, Russia, Slovenia, and Thailand), the staff supported greater exchange rate flexibility, but with varying degrees of intensity over time. In the Czech Republic, for example, the staff's advice was to increase the flexibility of the managed float when there was a surge in capital inflows in 2000, but similar advice was not given during the earlier surge of 1994–96 when the exchange rate was pegged.[16] Likewise, in Thailand, the staff stressed the need for greater exchange rate flexibility in the

[15]The difference in fiscal performance between Chile and Colombia was much greater than suggested by Table 3.3. The IMF staff in a recent paper characterizes Chile's fiscal performance during the 1990s as by far the best among Latin American countries (Singh and others, 2005). Unlike most other Latin American countries, Chile's fiscal policy was not procyclical and its debt-to-GDP ratio steadily declined.

[16]In fact, the staff report for the 1995 Article IV consultation with the Czech Republic stated that "the main aim of the policy response to the capital inflows should be to limit further real appreciation of the koruna, through avoidance of a nominal appreciation and a deceleration of price and wage increases." A number of Executive Directors, however, disagreed with the staff position and called for a more flexible exchange arrangement and for a nominal appreciation of the koruna.

mid-1990s (when the composition of inflows became more short term), but not in the early 1990s. In Mexico, the staff did not explicitly offer advice, but supported the country's crawling peg regime (while implicitly expressing preference for a wide band or faster crawl). In Latvia, the staff in principle supported the country's peg to the SDR as a nominal anchor, but suggested greater flexibility if the inflows were to become exceptionally large.[17]

In the rest of the countries (that is, Colombia, Estonia, and the Slovak Republic), the advice of greater exchange rate flexibility was not offered. Clearly in the case of Estonia, the country's choice of a currency board arrangement argued against such advice. In the Slovak Republic, the staff during the 1997 Article IV consultation discussed with the authorities the need to "consider making more active use of flexibility within the band" as a way of deterring contagion from the East Asian crisis, but not as a way of managing large capital inflows.

Several considerations seemed to influence the IMF's policy advice on exchange flexibility in specific instances. In some cases, competitiveness considerations were paramount. In Thailand, for example, in 1991–92 the staff believed that exchange rate appreciation was not advisable because of the large and growing current account deficit. A similar reason was given for not recommending greater exchange rate flexibility in the Czech Republic during much of the 1990s. The staff report for the 1995 Article IV consultation was typical in arguing that appreciation was not warranted, "given the apparent slowdown in the growth of exports in recent months, the sharp increase in imports, and the loss of most of the gains in competitiveness from the initial depreciation."

Another factor determining the staff's advice was its perception of the degree of actual exchange rate flexibility. In Peru, for example, the staff generally considered the exchange rate arrangement to be flexible (though at times highly managed), so the advice for greater flexibility, as offered more frequently after 1995, focused on how to manage the existing policy. Likewise, in Chile, the staff in 1993 apparently thought that substantial flexibility had been introduced to the exchange rate in 1992 when the Chilean authorities adopted a basket of currencies to determine the reference exchange rate and widened the band. By 1994 or 1995, however, the staff no longer considered Chile's crawling peg to be flexible enough. In 1995, it thus advised the authorities to abandon the exchange rate band in favor of a managed float and subsequently became much more emphatic about the need for greater exchange rate flexibility.

The staff's advice for Malaysia changed from year to year, as its perception of actual flexibility changed. In general, the staff considered Malaysia's exchange rate policy to be flexible. Thus, it supported "the authorities' intention to accept, if necessary, a moderate appreciation of the ringgit" (1991 Article IV consultation) or expressed caution against "substantial further upward movement" of the exchange rate "in view of the speed and extent of the recent appreciation" (1992 Article IV consultation), depending on the particular circumstance. But when the authorities began to intervene heavily to support the exchange rate in late 1993 despite the large capital inflows, the staff noted during the 1994 Article IV consultation: "Movements in the exchange rate should reflect underlying market conditions. As developments in late 1993 well illustrate, efforts to force an exchange rate policy that is not in line with underlying fundamentals are bound not to succeed for long and, ultimately, are more likely to complicate the conduct of monetary policy." At this point, the staff strongly argued for greater exchange rate flexibility.

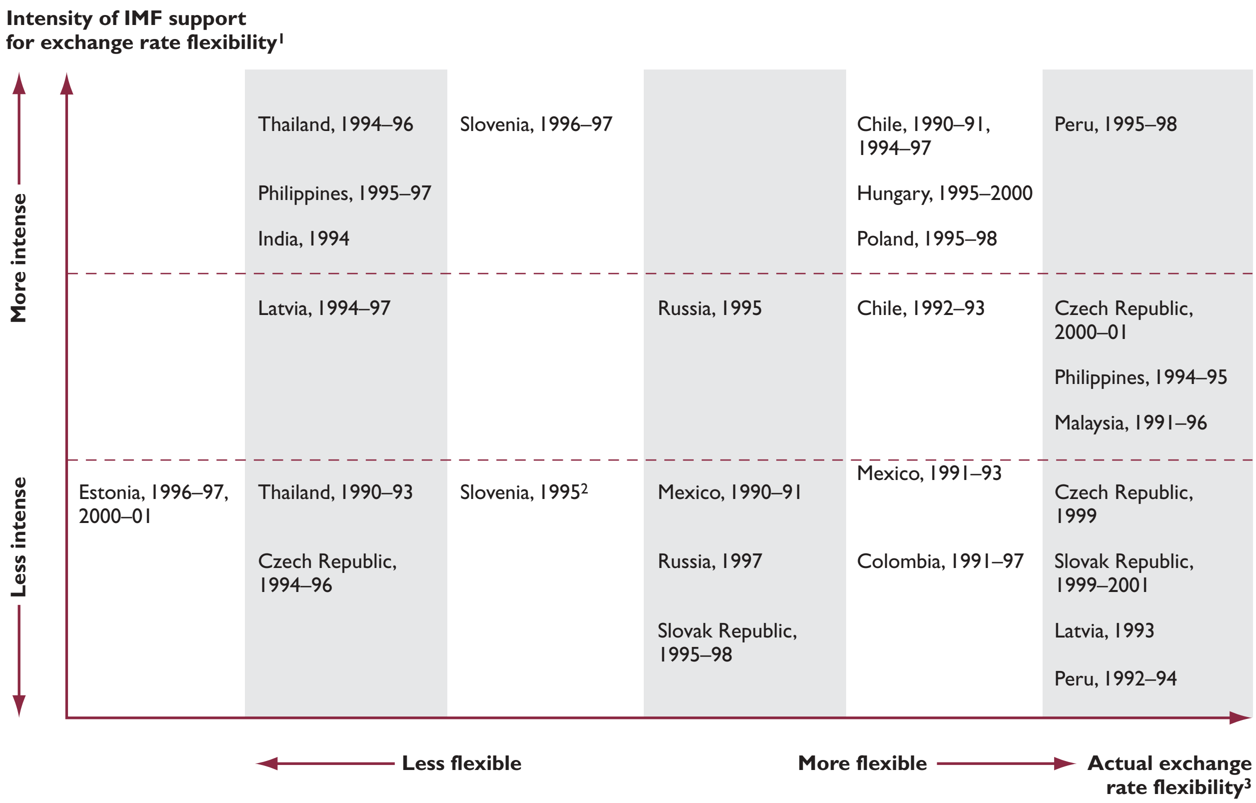
As in the case of fiscal policy, the review of these cases does not support the criticism of a "one size fits all" approach to the IMF's policy advice. However, although we can explain the IMF's advice in some individual instances, a more systematic assessment of the factors underlying its overall advice on exchange rate flexibility is much more difficult. Figure 3.2, which depicts the relationship between the intensity of policy advice on exchange rate flexibility and the degree of actual flexibility, clearly shows that actual flexibility was not a dominant determinant of IMF advice. At the same time, the figure also suggests that at least part of this diversity in policy advice may be a reflection of the evolution of the IMF's views on appropriate exchange rate policy for emerging market economies. It appears that the IMF staff placed somewhat more emphasis on exchange rate flexibility in the latter part of the period than had been the case earlier.

Sterilization

The IMF staff expressed its views on sterilization in all countries. In general, the staff took a stance that accommodated the policy choices of the authorities, but in two countries (Poland and the Slovak

[17]From early 1994, Latvia had a de facto peg to the SDR, which the authorities considered to be critical as a nominal anchor. It appears that the IMF staff viewed the de facto nature of the SDR peg as providing room for flexibility. In reality, the authorities' commitment to the peg was quite firm, although they wanted to maintain some uncertainty in the minds of market participants by not announcing it formally. A briefing paper of October 1994 stated the mission's intention to urge the authorities to reclassify the exchange rate regime from "independently floating" to "pegged to the SDR" or "other managed floating," while a management comment in February 1995 asked why the Latvian authorities did not want to "go to a currency board."

Figure 3.2. IMF Support for Exchange Rate Flexibility in Selected Countries, 1990–2002



Source: The IEO's judgment based on IMF documents.
[1]As given in the context of managing large capital inflows.
[2]Slovenia briefly adopted a managed float during the last two quarters of 1995.
[3]According to MFD classification.

Republic) the staff opposed the use of sterilization. In Estonia and Latvia, support was given to sterilization in the broader sense of the word, in the form of tight monetary policy. For example, the staff report for Latvia's Stand-By request in early 1995 stated: "The staff . . . argued for more active liquidity management, preferably through the use of treasury bills, in order to encourage the development of a government securities market." In many cases, the staff advised tight fiscal policy or greater exchange rate flexibility to complement the use of sterilization. In view of inflation risks, the staff advised sterilization (and tight monetary policy) in such countries as India (1994), the Philippines (1995), and Hungary (1996). In several countries, including Latvia, as noted above, the staff encouraged the authorities to develop secondary markets for government bonds in order to increase the effectiveness of sterilization.

In the context of the policy advice offered, the staff's view differed from those of the Czech and Thai authorities on the use of sterilization, but on different sides of the argument. Both countries experienced a surge in private capital inflows under a pegged exchange rate system in 1995. In the Czech Republic, the staff argued that there was room for sterilization,[18] while the authorities were reluctant to do so aggressively because of its presumed costs and ineffectiveness. In Thailand (where fiscal policy was tight), on the other hand, the staff favored greater exchange rate flexibility, while the authorities viewed sterilization as superior.

Staff was aware of the limitations of sterilization and accordingly qualified its advice by emphasizing its quasi-fiscal costs and the risk that such operations might increase the level of interest rates in a self-defeating manner. In Thailand, for example, the staff noted in 1994 that "maintaining the desired monetary stance may well require large-scale sterilization

[18]An accompanying selected background study showed that between 35 percent and 65 percent of domestic monetary operations could be offset by external capital inflows.

which could be very costly." In Malaysia, in 1993, the staff argued: "Large-scale mopping-up operations, in addition to their quasi-fiscal costs, may also induce further inflows." In the Slovak Republic, in 2000, the staff noted that the authorities were "more sanguine" about the effectiveness of sterilized intervention to deal with short-term capital inflows but agreed that it would not be effective to deal with "the larger, FDI-related inflows" being projected in connection with EU accession. Sterilization, however, remained a frequently used policy measure to deal with large capital inflows well into the late 1990s and early 2000s, including in Slovenia (1997),[19] Latvia (1998), the Czech Republic (1999), the Slovak Republic (2000), and India (2002).

Structural policies

Structural reform constitutes an important topic of policy dialogue between the IMF and member countries. As such, the documents examined indicate that a wide range of structural reform issues were discussed between the IMF staff and country authorities in all sample countries over the entire period. Of the many issues covered, some had obvious relevance to capital account liberalization, including privatization (which may affect policies toward inward foreign direct investment) and bank supervision (which has been increasingly recognized as a critical precondition for liberalization). However, the documents identify only a limited number of structural measures as discussed or proposed for the specific purpose of managing large capital inflows. The more important of these are noted below.

Further trade liberalization. Further trade liberalization, as a supporting policy to cope with the effects of large capital inflows, was advised in at least four countries: Chile, Colombia, India, and Thailand. In Chile, the advice offered in 1997 involved a reduction in the uniform import tariff. In Colombia, the advice was to liberalize the trade regime to increase competitiveness, while the staff suggested in India that trade liberalization should be accelerated through the elimination of import restrictions on consumer goods.

Liberalization of capital outflows. Elimination of restrictions on capital outflows was suggested as a complementary measure to offset the large capital inflows in at least six countries: Chile, the Czech Republic, Hungary, India, Slovenia, and Thailand. In the Czech Republic, the advice was given in 1994 but, as noted earlier, was reversed in 1995 when the staff recognized that such a measure was premature as it would make the country more vulnerable to speculative capital movements. The advice to Thailand was given in 1992 and again in 1996 (this time by suggesting that pension funds be allowed to invest in foreign assets). The advice was given to Slovenia in 1997 and to Hungary in 2000.

Tightening of prudential regulation. Prudential regulation received much attention from the IMF staff, but generally as part of broader surveillance of the financial sector. In four countries (India, Mexico, the Slovak Republic, and Thailand), however, the IMF staff advised a tightening of prudential regulations as a way of dealing with the large capital inflows (the advice in two countries took the form of endorsing what the authorities had already done). In Mexico, in August 1991 the authorities imposed liquidity requirements on short-term external borrowing by banks, which a number of Executive Directors welcomed; at the end of 1993, the staff explored the possibility of further tightening the rules on foreign borrowing by commercial banks. In Thailand, the staff in 1992 recommended that the authorities require appropriate provisioning by commercial banks for the guarantee they provided for foreign borrowing. In India, the authorities tightened prudential regulations on portfolio investment in 1994, a measure the staff subsequently endorsed. In the Slovak Republic, on the other hand, the staff took the initiative to suggest tightening foreign exposure regulations for commercial banks during 1999–2000.

In some countries, additional measures were mentioned. For example, in the Czech Republic, banking sector reform (including privatization) was advised in 1995 as a measure to reduce the high cost of intermediation (hence the high level of interest rates that were attracting foreign capital inflows). In Colombia, accelerated labor market reform was suggested on several occasions as necessary to maintain competitiveness in the face of upward exchange rate pressure created by the large capital inflows. In Chile, structural fiscal reform (in the form of a tax on nonrenewable natural resources) was proposed in 1997 as a way to moderate foreign investment flows in the mining sector. In India, the IMF staff in 1994 proposed the elimination of a floor on bank lending rates in order to reduce incentives for speculative capital inflows by reducing the level of interest rates.

There may well be other instances where the IMF staff or country authorities recognized structural reforms as a component of the broader strategy to manage large capital inflows (for example, through their effect on efficiency and competitiveness). Financial market development, sometimes encouraged as part of advice on sterilization (see "Sterilization" above), may be one such instance. The difficulty in identifying these cases, however, is that, as structural reform

[19]At the time of the 1995 Article IV consultation, the Slovenian authorities stated that the costs of sterilization had reached 1 percent of GDP in late 1994 and therefore suspended "proactive sterilization." Large-scale intervention resumed in late 1996.

is usually set in a long-term, country-specific framework, it is often not mentioned as part of a response to large capital inflows even when a particular structural measure could serve such a purpose. Nevertheless, it is probably fair to say that structural policies received much less attention than conventional macroeconomic policies, as measures to deal with large capital inflows. Given the IMF's focus and comparative advantage, this was probably appropriate, especially since the structural area that has received considerable, and increasing, attention from the IMF—strengthening the regulatory framework for the financial sector—is most closely linked to capital account sequencing.

Imposition of capital controls

Rather surprisingly, the IMF staff in the latter part of the 1990s advised the authorities of two countries (Estonia and Peru) to impose capital controls to deal with speculative capital inflows.[20] In neither of these countries, however, did the authorities accept the IMF advice. In Estonia, the staff stated in 2000 that the authorities' ability to offset the impact of capital inflows was limited unless they were willing to introduce temporary capital controls or raise reserve requirements, which were already very high. Previously, in 1996 and 1997, the authorities had been more amenable to introducing such a capital control measure if necessary (and a system of reserve requirements on foreign interbank liabilities was introduced in mid-1997). In 2000, however, they objected to such a measure because it was precluded by an agreement with the EU. In Peru, the staff was concerned with the rapid credit expansion, which was increasingly funded by short-term foreign currency liabilities. In 1997–98, the staff proposed to the Peruvian authorities that the coverage of marginal reserve requirements on foreign currency deposits be extended to external borrowing, while lowering the rate.[21]

Temporary Use of Capital Controls

The evaluation reviewed the relevant IMF documents for 10 countries involving 12 cases of temporary controls on either capital inflows or outflows during 1990–2002, with a view to trying to judge whether the differences in approach, if any, reflected a consistent set of underlying principles (Table 3.4).[22] Of the 12 cases reviewed here, 8 concerned capital inflow controls, and the other 4 capital outflow controls. We review below each of these cases.

Inflow controls

Of the eight cases of capital inflow controls, the IMF staff did not initially object to the introduction of controls in five of them (Chile, Colombia, the Philippines, Slovenia, and Thailand); however, in three of these (Chile, Colombia, and the Philippines), the staff changed its views over time. In the remaining three countries (the Czech Republic, Hungary, and Malaysia), the staff initially opposed the introduction of controls, though it became more accepting of them over time in two cases (i.e., the Czech Republic and Hungary). We explain below the context in which the IMF staff expressed its views on capital inflow controls by dividing the countries into those for which the staff's initial reaction was positive and those for which it was negative.

Cases of positive initial staff response

The IMF staff initially supported the unremunerated reserve requirement (URR) introduced by Chile in 1991 and Colombia in 1993, as we discuss more fully elsewhere in the report (see Box 2.3 for Chile; Appendix 1, the section "Colombia: Market-Based Controls on Inflows"). Likewise, the staff was supportive of inflow controls introduced by the Philippines, Slovenia, and Thailand.

In January 2000, the Philippine authorities introduced a 90-day minimum holding period on nonresident deposits. At the time of a program review in July 2000, the staff considered this to be a relatively minor measure designed to limit speculative capital flows and it supported the authorities' intention not to introduce additional controls. In late 2000, when the authorities tightened the reporting and compliance rules for capital account transactions,[23] the staff argued that the benefits of these measures needed to be weighted against the costs, while acknowledging

[20]The control measures suggested by the IMF could also be interpreted as having a prudential element. However, these are "restrictions" as the term is generally applied in the IMF, because their impact discriminates against international (as opposed to domestic) transactions.

[21]In 1993—based on an earlier technical assistance (TA) report by MAE—a briefing paper had indicated the staff's intention to explore ways of tightening credit policy through an increase in marginal reserve requirements on U.S. dollar deposits (then at 50 percent). In 1995, the staff took a position against capital controls except as a last resort measure.

[22]The list of countries in Table 3.4 is not meant to be exhaustive. For example, according to a Board document, 29 countries either introduced new controls or tightened existing ones during 1993–97 alone. See Monetary and Exchange Affairs Department, "Developments and Issues in the International Exchange and Payments System," SM/98/172, July 7, 1998.

[23]These measures included the prohibition of "engineered swaps" (operations to exploit weaker regulation and lower taxation for foreign exchange deposits relative to peso deposits), stricter reporting requirements for all foreign exchange transactions, and the requirement that bank-affiliated foreign exchange corporations be subject to the same rules as the banks themselves.

Table 3.4. The IMF's Position on Temporary Use of Capital Controls, 1991–2001

	Period	Position When Controls Were Introduced	Did the Position Change?
Controls on inflows			
Chile	1991–98	Supportive	Yes
Colombia	1993–2000	Supportive	Yes
Malaysia	1994	Not supportive	No
Czech Republic	1995	Not supportive	Yes
Slovenia	1995–99	Supportive	No
Thailand	1995–97	Supportive	No
Hungary	1996, 1999	Not supportive	Yes
Philippines	2000	Supportive	Yes
Controls on outflows			
Venezuela	1994–96	Not supportive	No
Thailand	1997–98	Partly supportive	Yes
Malaysia	1997–2001	Not supportive	Yes
Russia	1998–2000	Partly supportive	No

Source: IEO judgments based on IMF documents.

that these measures would improve monitoring and help close the regulatory loopholes. At the same time, the staff expressed regret that these measures had resulted in less freedom of capital movements, and welcomed the authorities' assurance that they were not the start of a tighter regime of controls.

In Slovenia, in 1995, the authorities introduced an unremunerated reserve requirement on non-trade-related loans with a maturity of up to five years. This measure was tightened during 1996 and remained in effect until September 1999. The staff initially endorsed the measure as a prudent response to the uncertainties of capital flows, but very little was said in the subsequent staff reports.[24] Slovenia had a reasonably sound fiscal policy (with virtual balance in 1994–95 and a deficit of only 1 percent of GDP in 1997) and, in 1994, active sterilization had been terminated because of its huge fiscal costs. The staff's tacit approval of the capital control measure can be understood in this context.

Thailand introduced market-based control measures in 1995 and 1996.[25] The briefing paper for the 1996 Article IV consultation indicates that the staff viewed the use of temporary controls on short-term instruments as ineffective, but did not "rule them out ex ante provided they were used as a complement to, not a substitute for, the macroeconomic measures proposed." The staff report for the 1996 Article IV consultation stated the mission's view that these measures would likely have some impact on foreign borrowing by banks, but they would not be expected to have impact on nonbank sources of credit, or hence on the overall level of inflows. The Executive Board supported the staff's view.

Cases of negative initial staff response

As noted in greater detail in Appendix 1, when capital control issues became a topic of discussion in early 1995 in the Czech Republic, the staff objected to use of capital controls by saying that experience in many countries had proved them to be ineffective. In mid-1995, however, the staff became more sympathetic to the authorities' use of capital controls, if financial stability was threatened or if use of other policy instruments was prevented by political constraints. This support for the capital controls was expressed while, as noted, the staff was not in favor of greater exchange rate flexibility.

When the Hungarian authorities considered introducing capital controls in 1996, the staff expressed the view that the controls as proposed would easily be circumvented. When a reserve requirement on nonresident bank deposits was introduced in early 1999,[26] however, the staff was sup-

[24]In 1998, the staff expressed views sympathetic to the temporary use of capital controls on short-term banking flows as a way of preserving domestic monetary policy autonomy in the transition period to participation in the European Economic and Monetary Union (EMU), provided that they were market based.

[25]In 1995, a 7 percent reserve requirement was introduced on nonresident baht accounts with a maturity of less than one year and on finance companies' short-term foreign borrowing. In 1996, the 7 percent requirement was extended to short-term baht borrowing by nonresidents and short-term foreign borrowing by commercial and BIBF banks.

[26]The reserve requirement was to be set below market rate. In the event, the rate was set at zero percent, and was never activated.

portive, saying that it could help the country respond to a possible resumption of large capital inflows. Unlike the case of the Czech Republic, however, the staff throughout the period was strongly in favor of greater exchange rate flexibility.

In Malaysia, a set of administrative controls was imposed in early 1994 on short-term capital inflows. These included prohibiting residents from selling short-term monetary instruments to nonresidents and a ban on forward transactions (on the bid side) and non-trade-related swaps by commercial banks with foreign customers.[27] The briefing paper for the 1994 Article IV consultation stated that the authorities should phase out these controls and allow the ringgit to appreciate. In 1995, the staff welcomed the authorities' decision to lift most of these controls.

Outflow controls

With respect to the use of outflow controls, the evaluation reviewed the related IMF documents for four countries that introduced them during 1990–2002: Venezuela (1994), Thailand (1997), Malaysia (1997), and Russia (1998). The documents suggest that the IMF's position differed across countries and over time (Table 3.4, bottom panel).

As explained more fully in Appendix 1, in June 1994, Venezuela introduced comprehensive price and exchange controls, covering current transactions and capital outflows. From the beginning, the staff consistently argued for an elimination of all exchange controls, saying that the "complete elimination of controls need not lead to a renewal of capital outflows" if supported by tight macroeconomic policies.[28] In March 1996, in view of the weak banking system, the staff proposed "a two-stage approach" involving the immediate elimination of exchange controls on current and nonportfolio capital transactions, accompanied by a public commitment to liberalize portfolio investment gradually.[29]

When Thailand introduced capital controls on outflows in May–June 1997 (see Box 3.2 for details),[30] the staff argued that it was essential to use the capital controls as a breathing space in which to implement a comprehensive macroeconomic policy package but, following the outbreak of an all-out crisis in July 1997, it argued for their immediate elimination. The staff's view remained negative when the Thai authorities attempted to tighten the existing controls in October 1999.[31] When the authorities intensified the enforcement of the existing controls in 2000,[32] the staff argued that the controls had been more effective in reducing offshore baht liquidity than in limiting exchange rate depreciation and that any tightening of the controls would likely impede trade and hedging activities.

The Malaysian authorities introduced capital control measures twice in connection with the East Asian crisis of 1997–98, first in August 1997 and then in September 1998 (see Box 3.2 for details on the second set of measures). When the first set of measures was introduced,[33] the mission expressed its strong disagreement and recommended that they be removed as soon as possible. A briefing paper of January 1998 expressed the staff's intention to urge the authorities to remove the swap limits imposed in the previous summer. When the second set of measures was introduced in September 1998, the IMF staff initially advocated a more flexible exchange rate and the simultaneous removal of most of the capital controls that had just been introduced. When the administrative controls were replaced by a system of exit levy for portfolio investment in February 1999, the staff recommended prudential risk-based management of cross-border transactions while continuing to favor the immediate removal of the exit levy.

The Russian authorities introduced capital outflow controls in August 1998, while simultaneously defaulting on domestic-currency-denominated government bonds. The controls included the suspension of conversion operations through nonresident accounts for those who had participated in the restructuring of government bonds,[34] and repatriation of ruble balances by other nonresidents—these measures effectively suspended capital transfers abroad by nonresidents (though some were *current* transfers as defined

[27]In August 1994, the authorities eliminated most of these control measures.

[28]Briefing paper for the 1994 Article IV consultation, October 28, 1994.

[29]In mid-April, the authorities abolished all exchange controls, on both current and capital transactions, in the context of an IMF-supported program.

[30]Most of the exchange restrictions and capital control measures introduced were relaxed in January 1998.

[31]This involved a clarification that the existing nonresident borrowing limit of 50 million baht for each customer (with no underlying real transaction) applied on a consolidated basis to subsidiaries as well.

[32]Stricter reporting requirements were applied to banks, and fines were imposed on banks found violating baht lending limits to nonresidents without an underlying real transaction.

[33]Limits were imposed on ringgit offer-side swap transactions (those that are not related to trade) by banks with nonresidents, except for hedging for trade-related transactions and genuine portfolio and FDI flows.

[34]A noninterest-bearing transit account was created for the ruble proceeds from government bond transactions.

Box 3.2. Outflow Controls in Thailand (1997) and Malaysia (1998)

Thailand

In May–June 1997, the Thai authorities introduced temporary selective capital controls on outflows by prohibiting the lending and sale of baht to nonresidents and requiring that any purchase before maturity of baht-denominated securities, or purchase of equities, from nonresidents be made in foreign currency. The measures were aimed at limiting the speculation of nonresidents against the baht by delinking the onshore and offshore markets.[1]

The IMF staff initially argued that these measures could not substitute for more fundamental adjustment measures and suggested that the breathing space provided by the control measures should be used to implement further fiscal consolidation, greater exchange rate flexibility, and financial sector reforms—a view endorsed by the Executive Board. Executive Directors, however, cautioned against use of permanent controls because they would risk undermining the confidence of long-term investors. A staff memorandum of June 1997 noted that, although the new measures had been effective in the short run, they had done "long-term damage" and led to a reduction in capital inflows.

Following the floating of the baht in July, the mission took the position that the capital controls should be eliminated as early as confidence was restored. The August 1997 LOI for an SBA indicated the authorities' commitment to eliminate the restrictions on purchases and sales of baht by nonresidents as well as sales of debt securities and equities for baht, once the currency was stable. Over the subsequent months, the IMF staff argued for an early elimination of the restrictions for baht sales to nonresidents (first review) and suggested that the unification of the onshore and offshore exchange markets remained a priority (second review in January 1998). In the event, at the end of January 1998, the authorities relaxed most of the control measures introduced in 1997.[2]

Malaysia

In September 1998, the Malaysian authorities introduced temporary capital outflow controls, while pegging the exchange rate to the U.S. dollar.[3] The measures were designed to restore a degree of monetary independence and included, among others, the introduction of a one-year holding period for the repatriation of portfolio investment. In February 1999, the one-year holding period was replaced by a graduated system of exit levy (in which principal and profits were allowed to be repatriated by paying an exit tax, the amount of which was determined by the duration of the investment). In September 1999, the exit levy was abolished, except for profits from portfolio investment brought in after February 1999. The system was entirely abolished in 2001.

According to internal documents, the IMF staff initially believed that an orderly exit strategy should be considered as soon as possible because of ample evidence that outflow controls did not work. The staff advocated a move to a nominal exchange rate band accompanied by inflation targeting, but was not opposed to maintaining the controls on short-term inflows that had been in place prior to September 1998 during the process of financial and corporate restructuring. It even suggested considering a market-based "prudential" measure on capital inflows of the Chilean type. The fall of 1998 also coincided with the end of the active dialogue of previous months between the IMF and the Malaysian authorities on policy issues, including IMF technical support. Internal documents, however, are surprisingly silent on whether the disagreement over the measures taken in September had any role to play in the process.

In 1999, however, the staff became more accommodating as it recognized that the controls had been administered effectively and that Malaysia had used wisely the breathing space created. The mission recommended a shift to the prudential risk-based management of cross-border capital transactions, while advocating an immediate removal of the exit levy on profits from portfolio investment. The staff supported the authorities' intention to use the capital controls as a temporary measure. Executive Directors commended the authorities for wisely using the breathing space provided by the capital controls. On the use of the controls itself, however, the Executive Board was divided: a number of Directors supported the maintenance of capital controls in order to manage an orderly exit, while others urged an immediate removal of the exit levy on profits. In 2001, the elimination of the system was welcomed by both the staff and the Executive Board.

The assessment of the effectiveness of Malaysia's capital outflow control is made difficult by the fact that it was introduced in September 1998, after the contagion from elsewhere in Asia had worked its way through the region. The Malaysian experience has received both positive and negative academic assessment, depending on whether one thinks that, in the fall of 1998, Malaysia still faced a significant risk of further capital flight (Kaplan and Rodrik, 2001; Johnson and Mitton, 2003). If the capital controls indeed worked in Malaysia as intended, it may be due to the controls' strictly temporary nature, the supporting policies (including measures to strengthen the banking and corporate sectors), Malaysia's institutional capacity, and a generally favorable external environment (see Abdelal and Alfaro, 2003).

[1]According to some studies, these measures had temporary effectiveness in delinking the two markets (Edison and Reinhart, 2001).

[2]The prohibition on baht lending to nonresidents was replaced by a 50 million baht limit per counterparty without an underlying current or capital account transaction.

[3]The staff report for the 1999 Article consultation noted that, in the view of LEG and MAE, the newly introduced restrictions (including the recent modifications) were not in violation of obligations under Article VIII.

by Article XXX).[35] At the same time, the authorities requested technical assistance from the IMF to help develop a more effective and less intrusive mechanism for preventing illegitimate capital outflows. "In view of the need to stem pressures on reserves," the staff did not oppose the maintenance of these restrictions, but refrained from formally recommending their approval in the absence of "a time-bound plan" for removing "all remaining restrictions."

Assessment

In this concluding section, we attempt a brief assessment of how the IMF's policy advice measured up to some of the "tests" set out in Chapter 1, namely: (1) Was there any difference between the IMF's general policy pronouncements and the advice it gave to individual countries? (2) Was the IMF policy advice operational and based on solid evidence? (3) How did the IMF advice change over time, and did this change keep pace with available evidence? (4) Did the IMF give similar advice to countries in similar situations? and (5) Was the policy advice on the capital account set in a broader assessment of the authorities' macroeconomic policies and institutional framework? Given the absence of consensus in the academic and official policymaking communities, however, this assessment is not about whether the IMF's particular policy advice was right or wrong; rather, it is meant only as a broad characterization of the IMF's overall advice on capital account issues.

Capital account liberalization

In all the countries that liberalized the capital account during the 1990s, whether partially or almost fully, the process was for the most part driven by the country authorities' own economic and political agendas. When programs were involved, the IMF never required capital account liberalization as formal conditionality for the use of its resources. The IMF, however, did not hesitate to support capital account liberalization as part of the authorities' overall policy package as expressed in program documents. Most of the advice on capital account liberalization was given to member countries through policy dialogue and technical assistance (as broadly defined) in the context of surveillance or financial support. Against this broad background, the IMF's approach toward capital account liberalization evolved over time.

In the early 1990s, the IMF encouraged member countries to liberalize the capital account without necessarily raising the issue of pace and sequencing. This attitude was particularly evident in those countries that had program relationships with the IMF. It was not uncommon during this period for the LOIs to include the authorities' intention either to further liberalize capital account transactions or to maintain the opening they had achieved. Occasionally, the staff expressed concern over financial sector weakness or macroeconomic instability, but this did not translate into operational advice on pace and sequencing. From around 1994, and certainly after the Mexican crisis, some within the IMF took a more cautious attitude toward capital account liberalization. Discussion of sequencing and the need to meet preconditions became more systematic and routine. Although the change was gradual, there is no denying that the East Asian crisis had a profound impact on this process.

This evolutionary process is reflected in the *apparent* inconsistency observed in the IMF's advice on capital account liberalization, particularly during the early years: from the very beginning, sequencing was mentioned in some countries but not in others (see Table 3.1). This is not especially surprising because there was no official policy. Consequently, the content of policy advice in country work was largely determined by individual staff members as they assessed the situation and as new evidence emerged. To the extent that country circumstances differ, *uniformity* cannot be the only criterion to judge the quality of policy advice and our evidence suggests no "one size fits all" approach. But in this case, it appears that the IMF's policy advice lacked not only uniformity but also *consistency* because, in the absence of clear official guidelines, it was almost entirely left up to the discretion of individual country teams and the resulting differences in approach between countries are sometimes difficult to explain.

Managing capital flows

The staff's policy advice to specific countries on managing capital flows was largely in line with the policy conclusions typically derived from the scholarly literature on open economy macroeconomics. To deal with large capital inflows, this advice advocated tight fiscal policy and greater exchange rate flexibility, but discouraged the use of capital controls. The staff's position on sterilization, consistent with the conventional wisdom, emphasized its quasi-fiscal costs and its longer-term ineffectiveness but

[35]Article XXX (*d*) includes "payments of moderate amount for amortization of loans" (in addition to "payments due as interest on loans") as current transactions. By appealing to this provision, in a memorandum to management dated August 18, 1998, the Legal Department took the position that these restrictions covering nonresidents' repatriation of proceeds from bond transactions constituted restrictions subject to approval under Article VIII, Section 2 (*a*).

was, to a surprising extent, supportive of the country authorities' policy choices, whatever they may have been. In a few instances, the staff also recommended further trade liberalization, liberalization of capital outflows, and tightening of prudential regulation as measures to deal with large capital inflows. These and other structural measures, however, received relatively little attention in the IMF's policy advice. Given the IMF's focus and comparative advantage, this was probably appropriate.

In order to make a full assessment of the IMF's overall policy advice on managing capital inflows, one must understand the staff's assessment of the countries' macroeconomic frameworks and institutional constraints under which advice is given. However, internal country documents (let alone staff reports) generally do not provide sufficient analytical basis, much less a well-articulated analytical model, for understanding why a particular combination of policies was advised in a particular case. Without such understanding, there appears to be inconsistency in the intensity with which advice for fiscal and exchange rate policies was given both across time and across countries. It would be helpful for country documents to be more explicit in articulating the rationale for advocating certain policy actions, and not others.

Temporary use of capital controls

Temporary use of capital controls has been a controversial subject, not only within the IMF but also in the academic and official policymaking communities. It is possible here to make a broad generalization that the IMF staff was in principle opposed to the use of such instruments, either on inflows or outflows. Its view was that they were not very effective, especially in the long run, and could not be a substitute for the required adjustments in macroeconomic policies. Nevertheless, in some countries, the IMF staff displayed a remarkable degree of sympathy with the use of capital controls even from the earliest days. In some cases, it even suggested that market-based controls could be introduced as a prudential measure.

The key question is whether the difference reflected the IMF's assessment of the role of these controls in the authorities' overall macroeconomic framework. This may well be the case in some instances. For example, the staff's tacit support for Russia's outflow controls may be related to the fact that the Russian authorities had already agreed to a comprehensive program of fiscal consolidation and banking reform, whereas it might have given less support to Thailand's use of outflow controls because there was no agreed program in place. Similarly, in some cases there is evidence that differing judgments on the appropriateness of temporary controls reflected differing assessments of underlying exchange rate policies. Such an approach seems reasonable. More generally, however, documents are not sufficiently explicit to allow us to make a definite judgment about the consistency of the IMF's overall advice on capital controls, except to say that the staff became much more accommodating of the use of capital controls from the mid-1990s, and certainly following the East Asian crisis.