



## GUIDANCE NOTE FOR THE LIBERALIZATION AND MANAGEMENT OF CAPITAL FLOWS

April 25, 2013

### EXECUTIVE SUMMARY

This note provides operational guidance to staff on the use of the Fund's institutional view on the liberalization and management of capital flows. The institutional view provides a basis for ensuring consistent advice and assessments when relevant for surveillance. There are no mandatory implications for Fund programs. The institutional view does not alter the rights and obligations of members under the Fund's Articles of Agreement or other international agreements.

The application of the institutional view will need to reflect country circumstances, and in several areas a measure of judgment is required. Staff are encouraged to incorporate in staff reports, and find ways to disseminate among staff, policy lessons from country cases, interactions with authorities, and new analysis on capital flow liberalization and management.

Key policy issues that are often relevant for staff advice include: liberalization of capital flows in ways that reap the benefits while managing the risks; a sequenced approach to liberalization that takes into account levels of development and country circumstances; building resilience to large and volatile capital flows; addressing policy issues involving countries from which flows originate as well as those that are recipients of capital flows; responding appropriately to the macroeconomic and financial stability risks associated with capital inflow surges and disruptive outflows, with macroeconomic and financial policies playing a key role and accompanied in some circumstances by capital flow management measures.

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## Glossary

BOP	Balance of Payments
CFMs	Capital Flow Management Measures
EU	European Union
EWE	Early Warning Exercises
FDI	Foreign Direct Investment
FSAPs	Financial Sector Assessment Programs
FSB	Financial Stability Board
FSSAs	Financial System Stability Assessments
GFSR	Global Financial Stability Report
G-RAM	Global Risk Assessment Matrix
IEO	Independent Evaluation Office
IMFC	International Monetary and Finance Committee
IMS	International Monetary System
IOF	Financial Operations Tax
ISD	Integrated Surveillance Decision
MPMs	Macro-Prudential Measures
NPLs	Nonperforming Loans
OECD	Organisation for Economic Co-operation and Development
PGMs	Principles for Guidance of Members' Policies
REOs	Regional Economic Outlooks
ROSCs	Reports on the Observance of Standards and Codes
UFR	Use of Fund Resources
VEA	Vulnerability Exercise for Advanced Economies
VEE	Vulnerability Exercise For Emerging Markets
WEO	World Economic Outlook

## I. INTRODUCTION

1. **This note provides operational guidance to staff for how to use the Fund’s institutional view on the liberalization and management of capital flows.**<sup>1</sup> The institutional view is a consistent basis for providing policy advice on capital flows and policies related to them and assessments when required for surveillance. In the absence of an institutional view, country teams risk providing inconsistent advice to countries in similar circumstances ([IEO, 2005](#)). The view does not have mandatory implications for Fund-supported programs or technical assistance. It does not alter members’ rights and obligations under the Fund’s Articles of Agreement or under any other international agreements. The institutional view and guidance will evolve over time to reflect new experience, emerging views of authorities and staff, and research. Staff teams are encouraged to reflect useful lessons from authorities’ experiences with capital flow liberalization and management in Fund reports so that these experiences can continue to influence the Fund’s approach to these issues.
  
2. **It is useful at the outset to clarify terminology.** A broad range of policies in both recipient and source countries can influence capital flows. Such policies include macroeconomic and structural policies, supervisory and regulatory frameworks, and measures that are designed to limit capital flows. In the institutional view, the latter measures are referred to as capital flow management measures (CFMs).<sup>2</sup> The assessment of whether a measure is designed to limit capital flows needs to take into account country-specific circumstances, including the overall context in which the measure was introduced. (Annex 1 provides a discussion of terminology and examples.) The usefulness and effectiveness of CFMs depend on specific country circumstances; nonetheless, staff will establish and maintain a running roster of country experiences going forward, with a view to developing a taxonomy of CFMs, including their effectiveness. The country experiences and examples will support the review and evolution of the institutional view and guidance.
  
3. **The note is organized as follows.** Section II examines the operational implications for Fund staff, particularly with respect to surveillance. Section III discusses more specifically the considerations for capital flow liberalization and Section IV those for managing surges of inflows and disruptive outflows. In practice, the discussion in Section III is mainly relevant for the removal of long-standing CFMs (that is, CFMs on portions of the capital account that have been restricted for a long period) and the discussion in Section IV for newly-adopted measures (or, CFMs introduced to previously open portions of the capital account). The guidance on managing capital flows is in any case broadly consistent across the two areas.

<sup>1</sup> The institutional view is presented in “[Liberalization and Management of Capital Flows: An Institutional View](#)” and staff should refer to that paper for a detailed exposition of the view. The view was built on country experiences in recent years, previous Fund policy papers, and recent analytical research.

<sup>2</sup> Definitions proposed in the institutional view are intended for use by Fund staff in the context of our policy advice and assessments, and may not correspond directly to definitions used by other organizations or agreements.

## II. OPERATIONAL GUIDANCE FOR FUND STAFF

4. **Context and use of institutional view.** In evaluating balance of payments stability, staff already take into account capital flows and related policies and provide advice where relevant. The institutional view simply provides a consistent way of doing so, while continuing to reflect country circumstances and staff judgment. Box 1 outlines steps for staff to consider at various stages of the surveillance process. Annex 2 notes some examples of relevant recent reports that have covered capital flow issues. Capital flows are usually relevant for discussions when the authorities are considering further liberalization, staff has a view about the benefits of liberalization relative to the costs, capital inflow surges or disruptive outflows pose policy challenges, or there are actual or potential outward spillovers with systemic implications. Capital flows need to be considered as part of the integrated external assessment for each member, along with variables such as the current account and exchange rate. The institutional view should inform the staff's approach. It can also be used for policy advice, in technical assistance and training, and for cooperation with other multilateral and regional institutions on capital flow matters.

5. **Article VIII.** The institutional view does not alter the Fund's jurisdiction or policies under Article VIII, Section 2(a) and 3, concerning restrictions on the making of payments and transfers for current international transactions, and regarding multiple currency practices. While the Articles define "payments for current transactions" to include certain items that, from an economic perspective, are capital in nature,<sup>3</sup> CFMs on outflows that restrict the making of payments and transfers for any of these transactions would continue to be subject to the Fund's Article VIII jurisdiction and prior approval as they are at present.<sup>4</sup> They would also be approved under Article VIII, Section 2 (a) only if this were warranted under the Fund's policies on approval of exchange restrictions.<sup>5</sup>

6. **Bilateral surveillance.** Consistent with the ISD, when evaluating members' economic policies staff should take account of capital flows, particularly their size and sustainability (Box 2).<sup>6</sup> When capital flows or policies related to them have a significant impact on domestic or BOP stability, staff reports should discuss these developments and policies. In particular:

<sup>3</sup> Specifically, under Article XXX(d) of the Articles of Agreement, payments for current transactions include (i) payments of moderate amounts for amortization of loans or for depreciation of direct investments, (ii) moderate remittances for family living expenses, and (iii) normal short-term banking and credit facilities.

<sup>4</sup> CFMs that give rise to exchange restrictions could also give rise to the non-observance of the standard performance criterion under Fund arrangements that call for the avoidance of new/intensified exchange restrictions.

<sup>5</sup> CFMs giving rise to multiple currency practices (MCPs) would similarly be subject to the Fund's policies on approval of MCPs, except for MCPs relating solely to capital transactions which would not be subject to Fund approval as the Fund has declined to assert jurisdiction over these measures.

<sup>6</sup> See [Modernizing the Legal Framework for Surveillance – An Integrated Surveillance Decision \(July 17, 2012\)](#), and the [Guidance Note for Surveillance under Article IV Consultations](#), especially paragraphs 37-39.

- *Capital flows and policies related to them need to be assessed when they are judged to have a significant impact on domestic or BOP stability.* Such policies and developments include macroeconomic and financial sector policies, as well as CFMs and MPMs, and private sector developments. It is useful to flag these issues at the policy consultation stage in a systematic manner, including through tools such as the Risk Assessment Matrix. The assessment in these instances would be based on the institutional view, and the operational considerations laid out in Sections III and IV may be used for doing so. With regard to *liberalization*, Section III would be relevant for discussing the benefits and risks, readiness for liberalization, and potential spillovers. For countries that are *managing inflow surges or disruptive outflows*, Section IV would be relevant for assessing the policies that are used, particularly their appropriateness and risks. In assessing whether data provision by the authorities is adequate for surveillance, staff should keep in mind data needed for assessing capital flows.<sup>7</sup>

- *Certain developments could trigger the need for a discussion with the member on observance of the Principles for Guidance of Members' Policies (PGMs).*<sup>8</sup> One such development is the introduction or substantial modification by a member for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital. The institutional view would provide input for the assessment in these circumstances.

7. **Multilateral surveillance.** Under the ISD, if spillovers from a member's policies are considered to significantly influence the effective operation of the IMS, for example by undermining global economic and financial stability, these policies need to be discussed with the member during the Article IV.<sup>9</sup> In this context, the staff could recommend alternative adjustments to members' policies that would be more conducive to IMS stability, and the recommendations with respect to capital flows should be informed by the institutional view. The operational implications are to:

- *Assess whether policies and developments in a country have the potential to give rise to outward spillovers that are transmitted through capital flows* and may undermine global economic and financial stability or otherwise significantly influence the effective operation of the IMS.<sup>10</sup> Staff should discuss such spillovers with the authorities and examine if viable alternative policy actions

<sup>7</sup> Data required for surveillance are set forth in Article VIII, Section 5.

<sup>8</sup> ISD paragraphs 22(iii)(b), 22(iv), 22 (vii).

<sup>9</sup> Under the Guidance Note on Surveillance, outward spillovers are deemed to "significantly influence" the effective operation of the international monetary system, if by themselves, or in combination with spillovers from other members' policies, or through their regional impact, they enter the macro-financial policy considerations of members representing a significant portion of the global economy.

<sup>10</sup> Staff may also propose to discuss with authorities outward spillovers that have important implications for other members but not for global systemic stability. This dialogue can be useful for several reasons. First, with greater financial interconnectedness, it is not always possible to ascertain ex ante whether the policies and developments in question may have globally significant effects. Second, even where the direct effects are limited, feedback loops may lead to indirect domestic and external stability implications for the member concerned (for example, the cross-border activity of financial institutions headquartered in the country in question may have significant implications for their stability and, therefore, for financial stability in the home country).

could achieve the authorities' objectives while minimizing spillovers, even though the authorities would not be obliged to act on staff recommendations if they are promoting their own domestic and BOP stability.

### **Box 1. Guidance on Considering Capital Flows in Surveillance**

#### **Before the mission (Policy Note and Policy Consultation Meeting)**

*Staff should highlight the following:*

- Capital flow developments that raise concerns regarding domestic and BOP stability (see paragraph 22 of the ISD for specific indicators), including a preliminary view as to whether there is likely an inflow surge or disruptive outflows, the challenges for macroeconomic and financial stability, and, for source countries, potential and actual outward spillovers (drawing on the G-RAM, vulnerability exercises, and multilateral surveillance products).
- Where relevant, how macroeconomic and other policies, including CFMs, have been adjusted in response to capital flows, and if the authorities have announced or implemented measures to liberalize capital flows.

#### **During the discussions**

*Staff should discuss with the authorities:*

- Developments in capital flows, size and sustainability, and impact on macroeconomic and financial stability as well as other risks.

*If capital flows and related policies have implications for the member's domestic and BOP stability, or may affect the effective operation of the IMS, staff should discuss:*

- The appropriateness and effects of the policy mix in the face of capital flows (including whether warranted macroeconomic adjustments are being made), the types of policies being used, including macroeconomic and other policies (such as CFMs, MPMs, whether their classification is clear, and their features), and the soundness of financial supervision and regulation. (Section IV provides further considerations, drawing on Section III of the Board paper.)
- Potential or actual outward spillovers if they may have significant implications for global stability or if they arise when the spillover originating country is not promoting its own (domestic or BOP) stability. (This consideration is related to the ISD (Box 2).) The G-RAM, VEA/VEE, and other multilateral products may be useful for framing the discussion.

*In particular, in the case of proposed/implemented liberalization plans, staff should discuss:*

- How the authorities' approach broadly compares with the "integrated approach", taking into account country circumstances.
- The soundness of the financial sector and institutions, as staff already do but bearing in mind the need to handle capital flows.
- Inward and outward spillover implications of the authorities' plans or measures.

#### **Staff Report**

*Staff reports should discuss capital flows and related policies when these have implications for domestic or BOP stability, as well as if they are judged to have implications for the effective operation of the IMS. In doing so, the assessment would be based on the institutional view and the discussion should cover the aspects above. The level of detail would be at the discretion of mission chiefs and reviewers but it should ensure that the relevant policy challenges are adequately covered. In assessing the adequacy of data for surveillance, staff should keep in mind data related to capital flows.*

### Box 2. Integrated Surveillance Decision: Aspects Related to Capital Flows<sup>1</sup>

**The Integrated Surveillance Decision provides guidance for the Fund and members in the conduct of surveillance and explicitly addresses capital flows.** It lays out the scope and modalities of surveillance, and defines Principles for the Guidance of Members' Policies (PGMs) that provide guidance on their exchange rate and domestic economic and financial policies. The PGMs call on members to: avoid manipulation of exchange rates to prevent adjustment or to gain unfair competitive advantage; intervene in the exchange market if necessary for countering disorderly conditions; take into account in their intervention policies the interests of other members; avoid exchange rate policies that result in balance of payments instability; and seek to avoid domestic economic and financial policies that give rise to domestic instability. The ISD provides that in assessing a member's policies the Fund will always evaluate developments in the member's balance of payments, including the size and sustainability of capital flows. Capital flow management policies shall be covered when they significantly influence the member's present or prospective domestic or BOP stability.

**Certain developments may trigger the need for a thorough review and indicate the need for discussion with the member on whether the PGMs are being observed.** The developments directly related to capital flows include:

- 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 financial policies that provide abnormal encouragement or discouragement to capital flows; and
- Large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

**When policies lead to capital flow implications that, while not undermining domestic and BOP stability for the member in question, may have a significant impact on global stability, staff could encourage the authorities to consider alternative policy options that minimize spillovers while continuing to promote the member's own stability.**<sup>2</sup> This aspect of the ISD allows for a more balanced treatment of capital flows in both recipient and source countries, even though the authorities are not obligated to alter policies. Volatile capital flows, the excessive build-up or depletion of reserves, and imbalances arising from excessive or insufficient global liquidity are among the developments that could affect effective operation of the IMS.

<sup>1</sup> See [Modernizing the Legal Framework for Surveillance – An Integrated Surveillance Decision](#).

<sup>2</sup> [Guidance Note for Surveillance under Article IV Consultations](#).

- *Use the Fund's multilateral surveillance products to assess the extent of push factors and structural changes in global capital flows.* It is important to ensure consistency among country assessments and multilateral surveillance.<sup>11</sup>

8. **Policy advice.** The institutional view provides a basis for policy advice on the liberalization or management of capital flows. Such advice may also occur outside the context of surveillance, for example during outreach or technical assistance.<sup>12</sup>

<sup>11</sup> In particular, the WEO, GFSR, Fiscal Monitor, Vulnerability Exercises (VEA and VEE), EWE, REOs, global risk assessment matrix (G-RAM), and the spillover reports for systemically important members and jurisdictions.

<sup>12</sup> The institutional view does not affect the scope and nature of technical assistance, which is guided by the [Fund's Policy on Technical Assistance](#).



9. **Use of Fund Resources.** The institutional view has no mandatory implications for the Fund’s financing role. In particular, members’ rights under Article VI, Section 3 would continue to be interpreted as generally precluding the Fund from requiring the removal of capital controls as a condition for access to the Fund’s resources.<sup>13</sup> For example, CFMs maintained consistently with the institutional view would not be considered measures “requested” by the Fund pursuant to Article VI, Section 1. Nor would CFMs maintained inconsistently with the institutional view be considered measures that the Fund could require members to eliminate as a condition for the use of Fund resources. As in the surveillance context, however, the institutional view could inform assessments in a UFR context of whether a member’s policies are appropriate for resolving its balance of payments difficulties and regaining external viability.

10. **Enhanced multilateral coordination.** While the institutional view does not alter members’ rights and obligations under other international agreements, staff could use it in their dialogue with members and international organizations to promote a more consistent approach towards the treatment of policies related to capital flows under other international agreements. Staff, particularly in functional departments, need to develop ways of exchanging data and information with other relevant international institutions, addressing data gaps, and strengthening technical support in order to move the regulatory reform agenda forward through forums such as the FSB, the G-20 Data Gaps Initiative, and the OECD.

### III. CAPITAL FLOW LIBERALIZATION

11. **Working definition.** “Capital flow liberalization” refers to the removal of CFMs. The concept includes the underlying capital transaction as well as the related payment or transfer, and it implies unrestricted convertibility of local currency in international financial transactions. Liberalization does not rule out the temporary re-imposition of such measures under certain circumstances, the maintenance of prudential measures that, while possibly CFMs, are needed for financial system stability, or measures that members may retain for reasons of national security.

12. **Use of institutional view and operational issues for capital flow liberalization.** The institutional view provides principles to draw upon when staff advice covers capital flow liberalization. Capital flow liberalization should be covered, in particular, when the authorities are undertaking or considering liberalization measures, when in staff’s view the benefits of further liberalization relative to the costs have risen, or, conversely, when liberalization appears to have outpaced the economy’s capacity to safely handle capital flows. Operational issues likely to arise in this context include the following (Annex 3 provides further details on thresholds, pre-conditions, and sequencing):

<sup>13</sup> A limited exception to this principle is the Fund’s policy on non-accumulation, reduction or elimination of external payments arrears, including arrears evidencing capital restrictions.

- *Benefits and risks.* It is useful to take stock of the benefits of further openness to capital flows as well as the risks. As countries develop, they require more advanced financial systems, which usually go hand in hand with greater cross-border capital flows. In addition, capital flows can facilitate the transfer of technology and management practices (particularly through FDI), and financing of current account deficits for productive investment or smoothing consumption. They also have indirect benefits for intermediate objectives, such as financial sector development, macroeconomic policy discipline, and economic efficiency. Staff could assess the relevance of these factors for the case at hand. For example, staff could assess how freer capital flows could support a country's economic objectives, such as boosting growth-enhancing investment, lowering borrowing costs, providing funding to credit-constrained economic sectors, bringing in new technology, and lengthening maturities or improving liquidity in securities markets. At the same time, staff should be mindful of potential risks associated with capital flows. These risks include heightened macroeconomic volatility and vulnerability to crises, which are magnified when countries have yet to achieve sufficient financial and institutional development.<sup>14</sup> But capital flows can pose risks even for countries that have long been open, benefited from capital flows, and have highly developed financial markets. A key point for staff is, therefore, to take into account the adequacy of financial regulation and supervision to manage the risks associated with capital flows.<sup>15</sup>
- *Thresholds.* The benefits of capital flow liberalization are largest when countries have achieved certain levels ("thresholds") of financial and institutional development (Figure 1). The literature and country experiences do not, however, provide a uniform guide as to what levels of relevant variables are adequate for safe liberalization. Staff assessments of countries' readiness to move forward will, therefore, need to incorporate judgment based on country-specific circumstances, particularly on the soundness of financial systems, institutions, and fiscal, monetary, and exchange rate policies.<sup>16</sup> Exchange rate flexibility can help cushion the real economy against the effects of capital flow volatility. At the same time, a country could make progress toward greater capital flow liberalization before reaching all of the necessary thresholds for financial and institutional development, and indeed doing so may itself spur progress in these dimensions. But liberalization needs to be managed particularly cautiously in these circumstances as the risks are higher.
- *Liberalization direction.* Staff advice should not presume that full liberalization is an appropriate goal for all countries at all times. Instead, the appropriate degree of liberalization at any time would depend upon the country's circumstances and overall economic objectives. In particular, staff could discuss the rising benefits of capital flows relative to the risks in cases where countries have made significant progress with respect to the pre-conditions for liberalization, as several

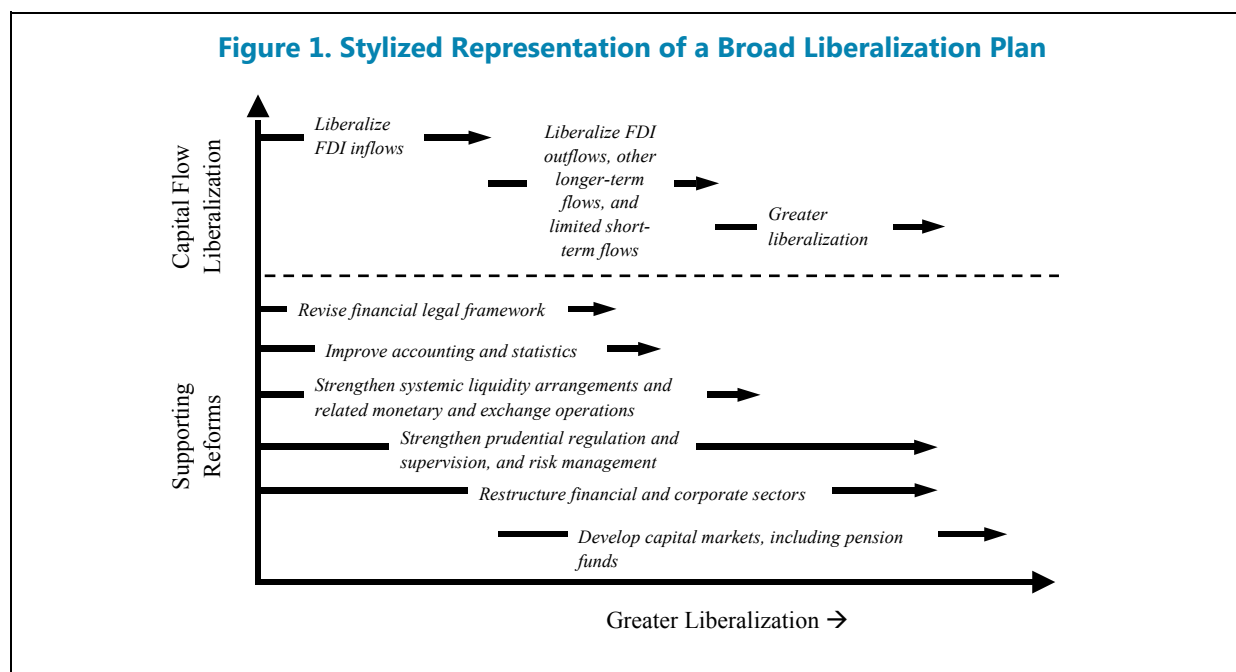
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<sup>14</sup> In addition, in light of the "impossible trinity", more liberal capital flows must involve less autonomy with respect to either monetary policy or the exchange rate.

<sup>15</sup> Staff reports generally already discuss financial sector supervision and regulation, which implicitly includes the ability to handle capital flows. These discussions are sometimes supported by FSSAs and ROSCs.

<sup>16</sup> In considering country-specific circumstances, staff could note that small states and LICs often have more shallow and less liquid capital markets. They may also face challenges in building regulatory and supervision capacity.

emerging economies with long-standing and extensive CFMs have done. The discussion could cover the strength of macroeconomic cushions (growth, price stability, foreign reserves), composition of external flows (such as a large share of equity and FDI in total flows); and trends in financial development, trade openness, and institutional quality.



- *Liberalization process.* For countries that choose to liberalize capital flows, staff should emphasize a systematic process and pace consistent with the country's institutional and financial development along the lines of the "integrated approach."<sup>17</sup> Teams should emphasize the need, and work with TA departments as relevant, for progressively deeper and broader supporting reforms to the financial and corporate frameworks. Staff advice should internalize recent financial and institutional assessments (for example, FSAPs, ROSCs) and cross-country examples. Where detailed recommendations are warranted, staff should draw upon expertise from MCM, which has provided TA on capital flow liberalization in several countries.
- *Re-imposition of CFMs.* A temporary re-imposition of CFMs under certain circumstances is consistent with an overall strategy of capital flow liberalization. In particular, if the authorities and staff assess that liberalization has outpaced the capacity of the economy to safely handle the resulting flows, the re-imposition of CFMs may be warranted until sufficient progress has been made with respect to the conditions that the integrated approach recommends. Input from relevant functional departments would be useful for forming staff views.

<sup>17</sup> Discussed in the Board paper, and for further background see [Ishii et al., 2002](#).

- *Spillovers.* Spillovers may have a significant impact on the effective operation of the IMS, particularly in the case of large, systemically important countries, and in such cases staff should assess the implications of liberalization measures for outward spillovers.

13. **Country experiences with liberalization are informative.** Chile, Korea, and Mexico are some examples where liberalization has corresponded in important respects with the integrated approach. In Chile, especially since the late 1990s, liberalization has been supported by strong macroeconomic frameworks, including fiscal policy and exchange rate flexibility, carefully calibrated and sequenced liberalization measures to manage risks, financial market development, and improvements in the regulatory framework that addressed in particular the issue of related lending and exposures and helped build financial sector resilience.<sup>18</sup> In Korea, also since the late 1990s liberalization has proceeded through a well-considered sequence of financial reforms in the context of sound macroeconomic policies and strong financial sector supervision. The experience also illustrates how long-term liberalization goals can be integrated with short-term use of CFMs and MPMs.<sup>19</sup> In recent years, Mexico's strong macroeconomic and prudential policy frameworks have allowed the country both to maintain an open capital account and weather severe external shocks. Resilience has been enhanced by improving the level and structure of public sector debt, the inflation targeting regime (including exchange rate flexibility), and a strong prudential framework.<sup>20</sup>

## IV. MANAGING CAPITAL FLOWS

14. **Operational use of institutional view for policies to manage capital flows.** Managing large and volatile capital flows will often pose a policy challenge for authorities, or have implications for domestic and balance of payments stability, and when they do, staff reports will need to cover and assess the issue sufficiently comprehensively and even-handedly. Staff should refer to the institutional view in such cases in order to ensure consistent advice based on country circumstances. In discussing with authorities their policy responses to capital flows, it is useful to ascertain as directly as possible the objectives of specific measures (for example, whether they are targeted at macroeconomic risks, financial stability risks, or some other objectives), which can help frame the policy advice.<sup>21</sup>

15. **Key elements.** Strengthening financial markets and supervision and regulation, as well as institutional capacity, would help improve countries' ability to absorb and handle capital flows. Capital flows generally warrant adjustments in macroeconomic variables, including the real exchange rate, and policies need to facilitate these adjustments. Volatile capital flows can give rise

<sup>18</sup> See [Chile 2012 Article IV Consultation](#), [Le Fort, 2005](#), and [Chile 2012 Selected Issues](#).

<sup>19</sup> [Republic of Korea 2006 Selected Issues](#), [Republic of Korea 2007 Article IV Consultation](#), [Republic of Korea 2011 Article IV Consultation](#) and [Republic of Korea 2012 Article IV Consultation](#).

<sup>20</sup> [Mexico 2011 Article IV Consultation](#).

<sup>21</sup> Useful references include [Ostry et al., 2010](#) and [Goyal et al., 2011](#) that discuss, respectively, the use of controls for financial stability risks and relevant instruments, as well as [Ostry et al., 2012](#) that discusses the multilateral aspects of various policies.

to stability risks, and macroeconomic and financial policies are a key part of the appropriate combination of policies for addressing these risks. CFMs are also a part of the toolkit under certain conditions (discussed below), but they should not substitute for warranted macroeconomic adjustment. When capital flows contribute to systemic financial risks, CFMs may in some circumstances help to safeguard financial stability.

16. **Even-handedness: source countries and push factors.** Push factors include monetary and prudential policies in systemically large economies and global risk appetite. They also include private liquidity generated by large cross-border financial intermediaries and liquidity-creating instruments. Staff should discuss with source countries, where relevant for surveillance, the role of the latter's policies in influencing capital flows to the rest of the world and ways to internalize the spillovers of such policies (such as whether alternative policies are feasible that have fewer spillovers).<sup>22</sup> Staff analysis should also seek to cover official flows related to reserve accumulation by central banks and foreign asset purchases by governments, including sovereign wealth funds. In assessing push factors, staff should draw on the Fund's multilateral and other surveillance products.

17. **Managing inflow surges.** A policy problem on which country teams often need to provide policy advice is how to respond to sudden surges of inflows, which can lead to macroeconomic and financial volatility, rapid currency appreciation, and build-ups in balance sheet and other vulnerabilities that can be followed by "sudden stops" or reversals of inflows. Operational issues likely to arise in this context include the following:

- *Identifying surges.* A surge can be understood as capital inflows exceeding their historical average over a relevant time frame, and identifying a surge is a matter of judgment.<sup>23</sup> In doing so, note that a rise in inflows relative to history could instead reflect a long-term structural increase, for example owing to a portfolio readjustment by investors that would warrant macroeconomic (including exchange rate) adjustment.<sup>24</sup> Staff should analyze the main drivers of capital flow surges, including pull and push factors. The Global Risk Assessment Matrix (G-RAM) is useful for assessing

<sup>22</sup> The concerns of recipient countries regarding specific risks can be raised during the review process and in the context of multilateral surveillance, such as spillover reports (see the [2012 Spillover Report](#) for example) and vulnerability exercises for advanced, emerging, and low income countries.

<sup>23</sup> In [Recent Experiences in Managing Capital Inflows – Cross-Cutting Themes and Possible Policy Framework](#), for example, a surge is identified a period when net inflows exceed the historical trend by one standard deviation and are larger than 1½ percent of GDP. [Ghosh et al., 2012](#) define a surge as an episode where net capital inflows to a country exceed the 30th percentile of the historical trend in the country, as well as in a cross-country sample. Gross inflows can also raise macroeconomic and financial sector stability risks, and should be a consideration in assessing surges.

<sup>24</sup> It can be difficult to assess whether capital inflows are driven by short-term cyclical factors or by structural factors. In practice, staff teams often analyze drivers of capital flows using empirical methods. These methods can be supplemented with market and anecdotal information. For example, structural changes may be indicated by increases in a country's sovereign credit rating over time so that it changes from non-investment grade to investment grade, and market intelligence suggests that investors are underweight exposure to the country. The portfolio rebalancing process could reasonably be expected to take time as countries' weights in benchmark indices are adjusted. Similarly, if a country were to discover recoverable energy resources that could attract sustained inflows drawn by expectations of higher growth, exports, and government revenue.

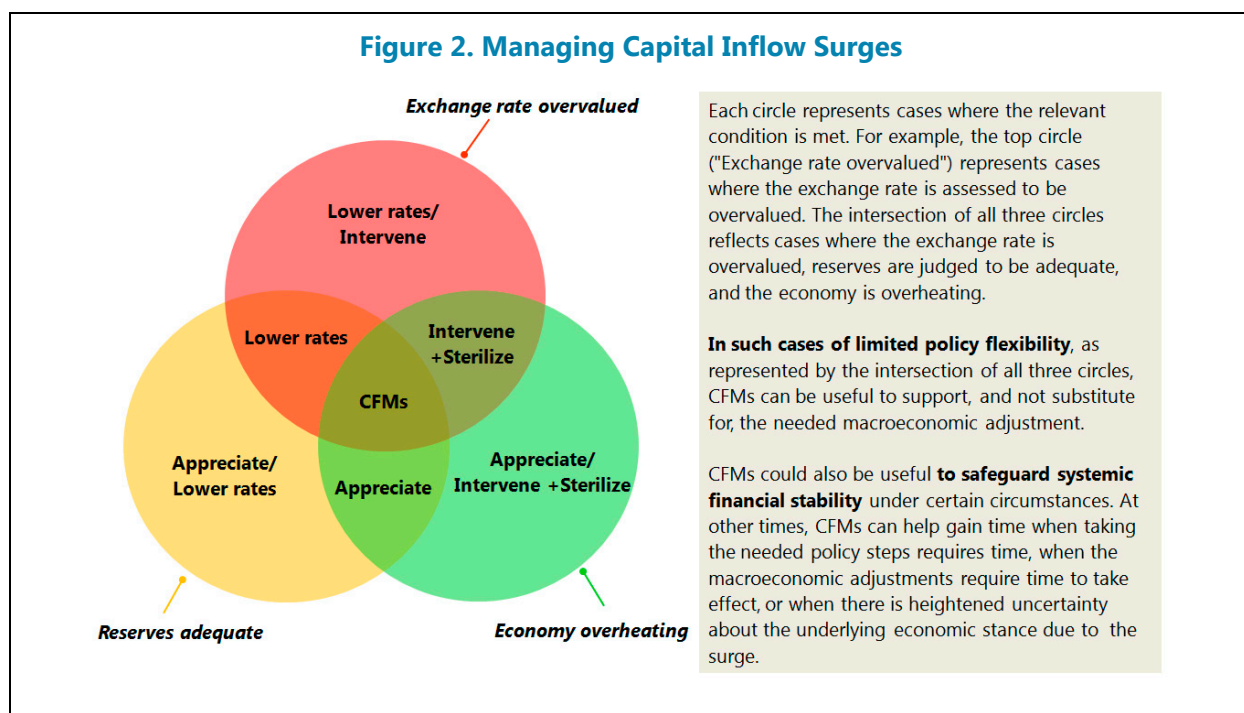
the global environment for capital flows and the risks for an individual country. Understanding the origins, characteristics and likely persistence of a surge can help determine the associated risks and craft an appropriate policy response.

- *Identifying macroeconomic and financial stability risks related to surges.* Staff should clearly lay out the key macroeconomic and financial stability risks to which surges may be leading. These risks could be summarized in the country Risk Assessment Matrix (RAM).
- *Policy mix: macroeconomic policies.* Staff should assess the appropriate policy mix for addressing the macroeconomic and financial stability risks, based on country-specific considerations. Appropriate policies include: lowering interest rates in the absence of overheating or asset price pressures, through monetary easing or fiscal tightening; allowing exchange rate appreciation if the currency is not overvalued (and some temporary overshooting relative to fundamentals may also not necessarily call for a policy response); and building foreign reserves if these are not more than adequate.<sup>25</sup> Staff reports already include staff's views with respect to overheating risks, macroeconomic policies, exchange rates, and reserves. They could draw upon these views to discuss the appropriate policy mix for responding to capital flows.<sup>26</sup>
- *CFMs.* In certain circumstances, introducing CFMs can be appropriate for supporting macroeconomic policy adjustment and safeguarding financial system stability. It is important to assess carefully the circumstances in which CFMs may be useful, which include the following:
  - i. *When the room is limited for adjusting macroeconomic policies:* for example if there are signs of overheating or asset bubbles, the exchange rate is overvalued, or reserves are more than adequate. These situations are illustrated in Figure 2.
  - ii. *When an inflow surge raises risks of financial system instability:* MPMs designed to limit these inflows (and therefore considered also to be CFMs) may be useful provided that they accompany needed macroeconomic policy adjustment and financial regulations.
  - iii. *When rapidly changing underlying conditions make the macroeconomic stance difficult to assess quickly, or when warranted policy adjustments take long to implement and take effect.* CFMs can be temporarily useful to gain time to make such assessments or while the necessary policies are being implemented. For example, when fiscal consolidation is being undertaken toward a sustainable position consistent with macroeconomic stability, introducing CFMs could be useful until the consolidation starts to affect the real economy

<sup>25</sup> Generally, recommended changes to the macroeconomic policy stance in response to capital inflows should not conflict with the primary objectives of the policy. For example, in a country with an inflation target, monetary easing would be appropriate only if inflation was projected to remain consistent with the authorities' target. As a separate point, the approach for determining appropriate policy responses is also relevant for "safe haven" countries. In practice, safe havens would need to rely principally on macroeconomic policies as they typically have well-developed financial sectors, which diminish the effectiveness of controls, and commitments to free capital flows.

<sup>26</sup> Standard surveillance tools that can help in assessing the underlying conditions include technical guidance on [assessing exchange rates and current accounts](#) and [assessing reserve adequacy](#).

and interest rates. These circumstances require judgment by country teams, and staff need to be able to explain them clearly, including whether necessary policy adjustments are being undertaken.



- *For illustrating policy responses, country experiences are informative.* In the Philippines, South Africa, and Turkey staff supported the authorities' reliance on macroeconomic policies, and in some cases outflow liberalization, for responding to the wave of capital inflows since 2010, based on an assessment of macroeconomic conditions and on the authorities' commitment to open capital flows. In the Philippines, there was scope for currency appreciation and the authorities also took the opportunity to liberalize outflows.<sup>27</sup> In South Africa, the rand was assessed as overvalued and policy interest rates were at historical lows, but reserves also were on the low side.<sup>28</sup> In Turkey, the lira was overvalued but there was scope to build reserves and to moderately tighten macroeconomic policies.<sup>29</sup> On the other hand, over the same period in Brazil CFMs provided breathing space for necessary fiscal consolidation.<sup>30</sup> More recently in Uruguay, CFMs provided breathing space for shifting to a more counter-cyclical macroeconomic policy stance in the face of an uncertain economic outlook. In 2010, Peru implemented prudential measures to restrict capital inflows, which

<sup>27</sup> [Philippines 2011 Article IV Consultation](#).

<sup>28</sup> [South Africa 2010 Article IV Consultation](#) and [South Africa 2011 Article IV Consultation](#).

<sup>29</sup> [Turkey 2011 Article IV Consultation](#).

<sup>30</sup> [Brazil 2012 Article IV Consultation](#).



coincided with a large terms of trade shock, sharp exchange rate movements, and a changing output gap that made underlying conditions particularly difficult to assess.<sup>31</sup>

- *CFMs are not always recommended, and only rarely would they be the sole response to an inflow surge.* In particular, CFMs should not substitute for macroeconomic policies that are warranted for macroeconomic adjustment, domestic stability, and effective operation of the IMS. For example, using CFMs to influence exchange rates in order to gain unfair competitive advantage would not be appropriate; it could also be inconsistent with countries' exchange rate obligations under Article IV.<sup>32</sup> Even when CFMs are desirable, a key consideration is their likely effectiveness, which is a matter of judgment and would depend on country-specific policy frameworks and institutional settings. For example, in larger economies with more developed financial markets, controls may be less effective than they are in other settings. CFMs may be precluded by a member's international commitments. Within the EU, for instance, full capital mobility is generally required.<sup>33</sup> For countries with well-established reputations for being open to capital flows, the reputational costs of CFMs may be relatively high and would need to be offset by commensurately higher benefits.
- *CFM design.* While the design of CFMs must be tailored to country circumstances in order to be effective, staff may bear in mind some broad principles from the institutional view. CFMs should be transparent, targeted, temporary, and preferably non-discriminatory. CFMs which *target* the instability as directly as possible may be the most effective and least costly.<sup>34</sup> When CFMs are adopted they should generally be *temporary*, being scaled back when capital inflow pressures abate (except in some circumstances, as discussed below).<sup>35</sup> For assessing whether capital flow pressures have abated sufficiently, staff would need to draw on the analysis of surges as well as judgment. CFMs should preferably be *non-discriminatory* between residents and non-residents, with the least discriminatory measure that is effective being preferred.<sup>36</sup> If, however, failure to discriminate between residents and non-residents would render the policy ineffective, this may justify using

<sup>31</sup> [Peru 2010 Article IV Consultation](#).

<sup>32</sup> See [Frequently Asked Questions: Observance of the Principles on Exchange Rate and Domestic Economic and Financial Policies](#) for a discussion on unfair competitive advantage.

<sup>33</sup> However, the [Treaty on the Functioning of the European Union](#) provides member countries with the authority to limit capital flows in crisis circumstances.

<sup>34</sup> Price-based measures are typically more *transparent* than quantity-based measures, although whether the CFM is price- or quantity-based appears not to significantly influence its *effectiveness* ([Habermeier et al., 2011](#)).

<sup>35</sup> Certain CFMs, including residency- or nationality-based measures, may be maintained over the longer term provided that they are imposed for reasons other than BOP purposes (such as financial stability or national security reasons) and, therefore, could not substitute for warranted macroeconomic adjustment and that no less discriminatory measure is available that is effective. As noted in Section III, if the surge reveals that liberalization has outpaced the capacity of the economy to safely handle the resulting flows, reforms to improve institutional and financial development may need to be implemented before CFMs can safely be lifted.

<sup>36</sup> For example, where currency-based measures are available and would be effective, they should be preferred to residency-based measures.



residency-based measures. The design of measures needs to be continuously reviewed as their efficacy can erode over time owing to incentives for circumvention.

- *CFMs and macro-prudential measures (MPMs).* When capital inflow surges contribute to financial stability risks, staff should draw on both the institutional view on capital flows and the policy toolkit for MPMs developed by Fund staff.<sup>37</sup> Some key principles, which are consistent between the institutional view and MPM toolkit, are to avoid using MPM/CFMs as a substitute for necessary macroeconomic adjustment and to seek to treat residents and non-residents in an even-handed manner.
- *Exit from inflow CFMs.* When inflows are no longer unduly large or volatile, CFMs could impose unnecessary costs or at best be ineffective. Some MPMs, on the other hand, may continue to be necessary for managing systemic financial risks. Their usefulness relative to their costs would need to be evaluated on an ongoing basis, including whether there are alternative ways to address the prudential concern that are not designed to limit capital flows.
- *Source countries.* Staff should encourage policymakers in all countries to take into account how their policies affect others. Source countries should better internalize the spillovers from their monetary and prudential policies, which are especially relevant for members with global systemically important financial institutions in their jurisdictions. While countries would not be expected to adopt policies that are less effective in meeting primary domestic objectives, such as stability, in discussions it is useful for staff to examine with authorities possible options to reduce policies' outward spillovers while maintaining effectiveness. Staff reports should include an assessment of outward spillovers that significantly influence the effective operation of the IMS, including spillovers transmitted via capital flows.
- *Official reserve related flows.* Staff should discuss capital flows related to official foreign asset accumulation by central banks and governments, including sovereign wealth funds.<sup>38</sup>
- *Spillovers from policies to manage capital flows.* Although such spillovers are empirically not well established, they should be discussed when they may potentially arise (Section II).

18. **Managing disruptive outflows.** Some capital outflows are a natural consequence of openness, but outflows that are large, sudden, or sustained can pose significant policy challenges. Operational issues for staff to take into account include the following:

- *Policy in non-crisis circumstances.* Outflows can sometimes pose challenges through their effects on exchange rates, external financing, and interest rates. When there is no immediate threat of a crisis, there would usually be scope to adjust macroeconomic and financial policies to address

<sup>37</sup> See [Macprudential Policy: An Organizing Framework](#).

<sup>38</sup> See [Reserve Accumulation and International Monetary Stability](#).

the implications of outflows and facilitate external adjustment, as for example Korea, Russia, and South Africa have done in recent years.

- *Policy in crisis-type circumstances.* Disruptive outflows are usually associated with economic crises, when they can lead to reserve depletion, currency collapse, financial system stress, and output losses. In crisis situations, or when a crisis may be imminent, there could be a temporary role for the introduction of CFMs on outflows.<sup>39</sup> In a crisis, CFMs may help to prevent a free fall of the exchange rate and depletion of international reserves and provide breathing space while fundamental policy adjustment is implemented. When a crisis is considered imminent, CFMs may be desirable if they can help to prevent a full-blown crisis.
- *Role of CFMs.* In these crisis-type circumstances, staff should ensure that if CFMs are used they form part of a broader policy package and are not used as a substitute for warranted policy adjustment, such as fiscal and exchange rate adjustment in response to a classic balance of payments crisis. Like inflow CFMs, CFMs on outflows should be transparent, temporary, and seek to be non-discriminatory (although it is recognized that residency-based measures may be hard to avoid in crisis-type situations).<sup>40</sup> Unlike inflow CFMs, which are targeted, outflow CFMs generally need to be comprehensive in order to be effective. They need to be supported by a sound institutional and regulatory system and to be adjusted on an ongoing basis.<sup>41</sup> The challenges associated with ensuring a smooth and timely exit in the future should be kept in mind (discussed below). CFMs should avoid leading to external payment arrears or default, particularly on sovereign debt, which can undermine relations with creditors and damage the international trade and payments system.
- *Assessing crisis or imminent crisis.* The determination of when “crisis” or “imminent crisis” circumstances are said to exist will require a measure of judgment from staff, based also on authorities’ views and country-specific circumstances, rather than a mechanical approach. Currency collapse, debt sustainability pressures, corporate and financial stress, sharp interest rate increases, and severe output contractions are common features of crises.<sup>42</sup> In assessing crisis risks, teams should leverage the Fund’s multilateral surveillance, including the early warning and vulnerability exercises.

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<sup>39</sup> A different phenomenon would be the use of restrictions on outflows by authorities for prudential reasons; for example, limits on the ability of domestic financial institutions to extend credit to international borrowers whom the regulatory authority deems to be risky.

<sup>40</sup> For example, if restrictions on non-residents’ access to local-currency funding are needed to make currency speculation more difficult.

<sup>41</sup> Iceland provides a good example of outflow CFMs in practice since 2008. Iceland’s success owes in part, however, to the effective enforcement of controls, which may be more challenging in larger and more complex financial systems. In addition, Iceland now faces the challenges associated with a smooth and timely exit from CFMs.

<sup>42</sup> Even in such circumstances, it turns out that few countries have introduced outflow CFMs over the past decade or so to address disruptive outflows (Argentina, Iceland, Ukraine).

- *Exiting from outflow CFMs.* Exiting from outflow CFMs involves a separate set of operational considerations, with respect to both timing and strategy. The right time to lift outflow CFMs will depend on specific country circumstances—in particular, on conditions rather than on a calendar date. In general, outflow CFMs should be lifted when macroeconomic stability, particularly with respect to the exchange rate, debt sustainability, and financial stability are restored, market access prospects improve, and reserves climb above critical levels. The exit strategy will need to carefully formulate several key aspects, including design and incentives, communication, and sequencing to deal with country-specific challenges.
- *Country experiences with exiting from outflow CFMs highlight a few issues:*
  - i. *Malaysia* was able to start lifting the outflow CFMs imposed in 1998 relatively quickly. The authorities replaced a blanket prohibition on non-residents' repatriation of assets with an exit tax, which was progressively lowered as macroeconomic and financial stability was restored. Residents were gradually allowed to invest abroad, though a key consideration was to limit access to credit from the domestic financial system for this purpose in order to preserve domestic financial stability. Malaysia was able to move early and continue liberalizing progressively because the authorities made progress on restoring macroeconomic and financial stability, including recapitalization of the banking system, and clearly communicated that the measures were in response to extraordinary circumstances and strictly temporary.<sup>43</sup> In addition, by the time the controls were imposed the worst of the crisis was over and significant outflows had already taken place. The early removal of some controls and gradual liberalization of the rest also helped to minimize the impact on investor sentiment and the country risk premium.
  - ii. *Ukraine* was also able to lift outflow CFMs gradually and without major disruptions once its crisis had abated.
  - iii. *Iceland's* case offers ongoing lessons. The imposition of CFMs was timely in preventing large-scale capital outflows at a time of crisis. The consequence has been to lock in a large volume of offshore krona liquidity that may leave abruptly once controls are lifted, presenting a challenge for designing the exit from CFMs. The lifting of CFMs is proceeding in a phased manner that focuses on, first, reducing the liquidity overhang, and, second, gradually lifting restrictions on capital account transactions.

19. **International Coordination.** Cross-border policy coordination among recipient countries, and between source and recipient countries, can help to mitigate undesired spillover effects of policy and promote globally efficient outcomes.<sup>44</sup> Points for staff to note are the following:

- If CFMs or other policies amplify macroeconomic or financial stability risks in other countries, and it is costly for those other countries to take counter-measures to manage those risks,

<sup>43</sup> See [Hood, 1999, Malaysian Capital Controls](#).

<sup>44</sup> [Ostry et al., 2012](#), provides a useful analytical framework for assessing the multilateral aspects of capital flow management.

coordination may be desirable whereby countries partially internalize the spillovers from their policies. This may require source countries to better internalize the spillovers from their monetary and prudential policies, as well as recipient countries to moderate their use of CFMs if these lead to costly spillovers (such as deflection of flows) to other recipient countries. In practice, this coordination could take place in several forms, including: during surveillance discussions with source countries (including through the spillover reports); among source and recipient countries in regional fora (like the European Bank Coordination (Vienna) Initiative); and among recipients in multilateral and regional fora. Staff (in both area and functional departments) could identify opportunities for coordination through surveillance tools, including the multilateral surveillance products. Where appropriate, staff can play a catalytic role in promoting coordination, for example, by organizing “working groups” with key stakeholders (which could include country authorities, international organizations and the private sector).

- Similarly, in the financial sector, staff should encourage dialogue with partners on cooperation in supervision and regulation (for example, supervisory colleges); consultation on the impact of the implementation of financial supervision and regulation (for example, building on such innovations as the Vienna Initiative); data sharing (for example, the G-20 Data Gaps Initiative); and the need to complete implementation of internationally agreed financial sector reform plans.

## Annex 1. Terminology: The Institutional View on the Liberalization and Management of Capital Flows

### Capital Flow Management Measures (CFMs)

1. **For the purposes of the institutional view, the term capital flow management measures (CFMs) is used to refer to measures that are designed to limit capital flows.**<sup>1</sup> CFMs comprise:

- *Residency-based CFMs*, which encompass a variety of measures (including taxes and regulations) affecting cross-border financial activity that discriminate on the basis of residency. These measures are also generally referred to as *capital controls*;<sup>2</sup> and
- *Other CFMs*, which do not discriminate on the basis of residency, but are nonetheless designed to limit capital flows. These *other CFMs* typically include measures, such as some prudential measures, that differentiate transactions on the basis of currency as well as other measures (for example, minimum holding periods) that typically are applied to the non-financial sector.

2. **Based on this definition, if a measure is not considered to be designed to limit capital flows it would not fall under the CFM nomenclature.** These measures that are not designed to influence capital flows are neutral in their application in that they do not discriminate according to residency and do not, typically, differentiate by currency. Prudential measures such as capital-adequacy requirements, loan-to-value ratios, and limits on net open foreign exchange positions, that are not designed to limit capital flows but rather to ensure the resilience and soundness of the financial system are not CFMs. Macroeconomic policies, similarly, would not normally be CFMs and nor would structural and other policies that, while they may directly or indirectly inhibit capital flows, are not designed to limit capital flows.

3. **In practice, the classification of a particular measure as a CFM would require judgment as to whether the measure is, in fact, designed to limit capital flows.** The key consideration in making the determination whether a measure is designed to limit capital flows is whether the measure, by virtue of its design: (i) treats international capital transactions<sup>3</sup> (and/or associated payments or transfers) less favorably than domestic capital transactions (and/or associated payments or transfer), or (ii) applies only to international capital transactions (and/or associated

<sup>1</sup> This definition is taken from Annex 2 of the Board paper on the institutional view.

<sup>2</sup> The term *capital controls* is used interchangeably with the term *restrictions*.

<sup>3</sup> For purposes of determining whether a measure is a CFM under the institutional view, international capital transactions generally are capital transactions, i.e., transactions that are not current transactions as defined in Article XXX(d) which have an impact on a member's balance of payment. Nonetheless, transactions associated with certain payments identified in Article XXX(d), namely, normal short-term banking and credit facilities, and payments of moderate amount for amortization of loans or for depreciation of direct investments, that have such an impact are also considered capital transactions for the purposes of the institutional view.

payments or transfers) and either imposes or intensifies a limitation on such transactions (and/or associated payments or transfers). An example would be measures that discriminate between residents and non-residents, which are always considered as CFMs. However, there may be cases where, even though the measure is not a CFM by virtue of its own design, but is nevertheless judged to be designed to limit capital flows based on an evaluation of the context in which it was introduced and the totality of the country-specific circumstances. Such an evaluation could take into account, for example, whether the measure was adopted during a period of surges in inflows or disruptive outflows. The determination whether a measure is a CFM should be guided by the above considerations regardless of the stated intent or motivation behind the adoption of the measure (for example, to promote price or financial stability, social policy, or national security reasons).

**4. To illustrate further, a measure could be designed to limit capital flows if any of the following are observed:**

- It explicitly discriminates on the basis of residency (for example, restrictions on non-resident investments or residents' access to foreign financing);
- It directly targets a cross-border capital flow (for example, a blanket tightening of domestic financial institutions' net open foreign exchange position when the on-shore foreign exchange interbank market is small relative to external sources of finance).

However, measures that are designed to deal with the financial sector risks of increased liquidity arising from capital flows, but not to limit the flows themselves, would not be considered CFMs. Such measures include, for example, increasing liquidity and capital requirements for financial institutions that rely on short-term wholesale offshore financing, or instituting tax and other fiscal measures that do not differentiate between residents and non-residents in order to address potential bubbles in asset prices such as housing.

### **Use of terminology**

**5. For transparency and even-handedness, CFMs and MPMs should be identified as such in staff reports and other papers.** (In some instances, staff reports have, for example, identified as "MPM" measures that are in fact "CFM" or "CFM/MPM.") If the classification is unclear, or the staff and authorities have different interpretations, the staff report can simply note the lack of clarity or difference in interpretation. At the same time, staff should focus in the discussions on the policy context and appropriateness of particular measures and avoid attaching any sense of stigma or preference to one term or other.

**6. The terminology is intended for use only in the context of the institutional view and its application in the Fund's advice and assessments.** The terminology is not intended to supplant terms used in other contexts, such as in other international, multilateral, or bilateral agreements. In addition to the CFM terminology, this intention applies also to concepts like capital flow liberalization. In the institutional view, "capital flow liberalization" is understood as the removal of CFMs, but the understanding can differ in other international frameworks. For example, the OECD

concept of liberalization applies only to the elimination of measures that discriminate between residents and nonresidents, while the obligations with respect to capital flow liberalization in the Treaty on the Functioning of the European Union generally prohibit all restrictions on capital flows even if they do not discriminate based on residency (both among EU members and between members and third countries).<sup>4</sup> Staff do not have to assess consistency of CFMs/MPMs measures with these other frameworks.

## MPMs and CFMs

7. **MPMs and CFMs are often perceived as similar, but their primary objectives do not always overlap.** While CFMs aim to contain the scale or influence the composition of capital flows, MPMs are prudential tools that are primarily designed to limit systemic financial risk and maintain financial system stability irrespective of whether the origin of the risk is domestic or cross-border. For example, a tax on specific cross-border inflows is a CFM and may only indirectly affect financial stability. On the other hand, a capital surcharge on systemically important financial institutions or counter-cyclical provisioning is an MPM that has only an indirect impact on capital flows.

8. **In some instances, however, CFMs and MPMs can overlap.** To the extent that capital flows are the source of systemic financial sector risks, the tools used to address those risks can be seen as both CFMs and MPMs. An example could be when capital inflows into the banking sector contribute to a boom in domestic credit and asset prices. A restriction on financial institutions' foreign borrowing, for example through a levy on their foreign exchange inflows or required reserves on financial institutions' foreign exchange liabilities would aim to limit capital inflows, slow down domestic credit and asset price increases, and reduce liquidity and exchange rate risks (see also paragraph 4 of this Annex on net open foreign exchange position). In such cases, the measures are designed to limit capital inflows as well as reduce systemic financial risk and would be considered both CFMs and MPMs.

## Source and recipient countries

9. **The terms source countries and recipient countries are based on gross flows.** For operational purposes, source countries can generally be understood as countries from which significant gross flows originate, while recipient countries are countries that receive gross flows on a scale that is substantial relative to the domestic economy. Push and pull factors accordingly originate from source and recipient countries, respectively.

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<sup>4</sup> See [OECD Code of Liberalization of Capital Movements](#) and the [Treaty on the Functioning of the European Union](#), in particular [Article 63](#).

Selected Capital Flow Management Measures<sup>1</sup>

	<b>Measures designed to limit inflows</b>	<b>Relevant features</b>
Brazil	2009 - Introduction of a 2 percent tax on portfolio equity and debt inflows.	Tax directly on inflows.
Indonesia	2011 - Imposition of (1) a six-month holding period on central bank bonds and (2) a limit on short-term foreign borrowing by banks to 30 percent of capital.	Directly targets a capital flow and will reduce demand for foreign capital
Korea	2011 - Restoration of a 14 percent withholding tax on interest income on nonresident purchases of treasury and monetary stabilization bonds (in addition to a 20 percent capital gains tax), leading to equal treatment of both foreign and domestic investors. Nonresident investors based in countries with double taxation treaties with Korea are subject to reduced rates based on these treaties and official investors are exempt.	Increased the tax rate for foreign investors with the stated intention of reducing capital inflows (even though it led to equal treatment).
Peru	2010 - Increase of fee on nonresident purchases of central bank paper to 400 basis points (from 10 basis points).	Discriminates on the basis of residency and is intended to limit capital flows.
Thailand	2010 - Restoration of a 15 percent withholding tax on nonresidents' interest earnings and capital gains on new purchases of state bonds.	Increased the tax rate for foreign investors with the stated intention of reducing capital inflows (even though it led to equal treatment).
	<b>Measures designed to limit outflows</b>	<b>Relevant features</b>
Argentina	2001 - Establishment of <i>Corralito</i> , which limited bank withdrawals and imposed restrictions on transfers and loans in foreign currency.	Direct restrictions on capital flows.
Iceland	2008 - Stop of convertibility of domestic currency accounts for capital transactions.	Direct restrictions on capital flows.
Malaysia	1998 - Imposition of 12-month waiting period for nonresidents to convert proceeds from the sale of Malaysian securities	Discriminates on the basis of residency to limit outflows.
Ukraine	2008 - Introduction of a 5-day waiting period for nonresidents to convert local currency proceeds from investment transaction to foreign currency.	Discriminates on the basis of residency to limit outflows.
Thailand	1997 - Imposition of limits on forward transactions and introduction of export surrender requirements.	Restricts foreign exchange transactions to limit capital outflows.

<sup>1</sup>This table provides illustrative examples of adopted measures that are assessed to be CFMs. It is not comprehensive and does not assess appropriateness or effectiveness.



## Annex 2. Liberalization and Management of Capital Flows in Staff Reports: Some Relevant Examples

Several staff reports in recent years have discussed the liberalization and management of capital flows in ways that represent useful examples with respect to particular issues. The examples below are not, however, an exhaustive list and are provided for illustrative purposes.

### Liberalizing Capital Flows

*China (2011 Article IV Consultation).* Discusses sequencing of liberalization. Key elements of discussion: staged approach to liberalization, including at the outset financial sector reforms and a focus on removing restrictions on more stable, long-term sources of financing such as FDI; full liberalization—including short-term flows—waiting until the bulk of financial sector reforms have been implemented; the risk that liberalizing interest rates could raise rates in a way that leads to potentially destabilizing capital inflows; and allowing the exchange rate to appreciate would help reduce these pressures.

*Korea (2006 Article IV Consultation).* Discusses role of financial development for handling capital flows. Key elements of discussion: authorities' policies to further develop the financial sector, including the proposed removal of remaining restrictions on the capital account; and priority areas for further financial development, especially an active money market to provide a pricing mechanism for forward transactions in foreign exchange.

### Managing Capital Inflow Surges

*Brazil (2012 Article IV Consultation).* Discusses appropriate policy mix, including CFMs. Key elements of discussion: drivers of inflows and outflows, as well as pressures from inflows on the already overvalued real; fiscal policy tightness as part of policy mix conducive to a reduction in net capital inflows; usefulness of CFMs (the IOF tax on portfolio inflows) as part of the policy toolkit; costs of CFMs and the need to address the underlying causes of Brazil's structurally high interest rates—a key pull factor; and importance of increasing the financial sector's absorptive capacity.

*South Africa (2011 Article IV Consultation).* Discusses appropriate policy mix, relying on macroeconomic policies. Key elements of discussion: the authorities' responses to capital inflow episodes, including exchange rate appreciation while building international reserves, accommodative monetary policy, and further liberalizing capital outflows; medium-term scope to build up reserves further and to tighten fiscal policy to create more room for monetary policy to manage the impact of capital flows; the case for CFMs in the near-term given little short-term policy space and overvalued rand, and the conclusion that their use was not warranted owing to their potential costs and low effectiveness.

*Philippines (2009 Article IV Consultation).* Discusses appropriate policy mix, relying on macroeconomic policies. Key elements of discussion: the authorities' policy mix for managing inflows—higher reserves, exchange rate appreciation, modification of prudential regulations, and further

liberalization of capital outflows; scope for greater exchange rate flexibility to manage additional inflows, given that reserves assessed to be adequate and exchange rate broadly in line with medium-term fundamentals; and scope for further financial market development to boost absorptive capacity.

### **Managing Disruptive Capital Outflows**

*Iceland ([2008 SBA Request](#), [2012 Second Post-Program Monitoring Report](#)). Discusses appropriate policy mix to manage disruptive outflows, including role of CFMs. Key elements of discussion: need for tighter monetary policy and maintenance of recently introduced exchange controls to prevent an exit of large non-resident krona holdings and preserve exchange rate stability after collapse of oversized banking sector left private sector debt at over 450 percent of GDP by end-2008. Need for liberalization strategy to lift these controls to be appropriately sequenced and paced to avoid disorderly capital outflows that would put the krona under pressure.*

*Ukraine ([2008 SBA request](#), [2011 Ex Post Evaluation](#)). Discusses appropriate policy mix to manage disruptive outflows, including role of CFMs. Key elements of discussion: need for recently introduced outflow CFMs to be a temporary response to large capital outflows and sharp currency depreciation, being removed as confidence returned; and importance of: (i) tight fiscal and monetary policy; (ii) flexible exchange rate, while avoiding excessive depreciation; and (iii) restoring confidence in the banking system. (Under the 2010 IMF-supported program, most controls were in fact removed, and the Ex Post Evaluation in 2011 concluded that they had not been generally effective.)*

## Annex 3. Liberalization: Thresholds, Pre-Conditions, Sequencing, and Other Operational Considerations

**When assessing liberalization plans, staff should analyze whether they are consistent with safe liberalization that allows reaping the benefits of greater openness while managing the risks. Staff could take into consideration the following aspects:**

1. **The extent to which the preconditions for safe liberalization are in place.**<sup>1</sup> Such preconditions include the following, and in examining them peer comparisons may also be helpful based on comparable economies with liberalized capital flows.
  - *Stable macroeconomic and financial conditions that also support flexibility.* A credible exchange rate arrangement supported by adequate reserves can reduce the risks related to increased capital flow volatility. A flexible exchange rate arrangement facilitates absorbing external shocks, as could a credible peg combined with fiscal and labor market flexibility. Low and stable inflation reduces the risk of capital inflow surges that can stem from carry trade and capital flight caused by depreciation expectations. Building and maintaining macroeconomic and financial sector buffers can also serve to reduce the risks. A sustainable fiscal position and manageable public sector and external debt reduce the likelihood of adverse macroeconomic effects of capital flow retrenchment, while providing room for private sector outflows. The absence of potential credit and asset price bubbles also reduces the financial stability risks.
  - *Financial sector capacity to absorb inflows.* Active and deep domestic money and foreign exchange markets facilitate the absorption of capital flow volatility, as well as the implementation of an effective monetary policy. Development of equity and bond markets helps reduce the risk of residents' reliance on foreign assets and the corporate sector's resort to foreign funding, by providing alternative investment and funding opportunities. Moreover, the development of an adequate yield curve is necessary to ensure the availability of hedging instruments.
  - *Ability of financial sector to deal with increased capital flow volatility.* Liberalizing and developing the financial sector, and ensuring sound governance and risk management in financial institutions, helps to strengthen its ability to deal with capital flows. Evaluating the resilience of banks' balance sheets to larger capital flows generally requires attention to the following factors: (i) Relatively high reliance on deposits, in particular from institutional investors who may rebalance portfolios when outward capital transactions are liberalized; (ii) Adequacy of net open foreign exchange position limits or exchange rate risk management practices; (iii) Credit risk associated with exchange rate depreciation, due to a large share of foreign exchange-denominated loans or inflation-linked loans (especially in high exchange rate pass-through countries); (iv) High levels of NPLs.

<sup>1</sup> These conditions need not be taken as given over time, and staff advice should aim to strengthen these conditions for managing capital flows safely and beneficially.

- *High standards of governance and disclosure.* Adherence to international accounting, transparency and shareholder protection standards facilitates the liberalization of FDI and portfolio flows and allows proper pricing of stocks and securities. Adequate governance standards reduce the vulnerability of the financial and nonfinancial corporate sectors to risks related to greater openness.
- *Strong financial sector regulatory standards and effective supervisory framework.* Adequate micro and macroprudential regulations can significantly contribute to containing the risks of greater openness. Cooperation agreements with supervisory authorities of other countries, particularly countries that are important as sources or destinations of capital flows, can facilitate the detection and management of financial stability risks. An adequate deposit guarantee framework can help local banks retain residents' deposits. Proper crisis preparedness and resolution frameworks gain importance in a context of increased capital flow volatility and potential contagion. Adequate prudential regulations need to be in place on institutional investors' foreign investments before liberalizing capital outflows. Reforms also need to address the risk that operations through the informal financial sector can undermine the effectiveness of the prudential framework in the formal financial sector.
- *Strong policy track record.* A track record of implementing sound policies, which provides a credible basis for the necessary reforms underpinning liberalization, can facilitate managing its risks.

2. **Rely on a range of available sources of relevant information.** The macroeconomic assessment should be based on the analysis for bilateral and multilateral surveillance (see [surveillance guidance note](#)). Staff should also draw on examples of other similarly situated countries that have liberalized successfully.

3. **Assess the risks that removal of the CFMs would pose to macroeconomic and financial stability.** Staff should identify those CFMs that are effective and assess the risks their liberalization would pose to the economy and the financial sector. Subsequently, reforms can be designed to support liberalization by eliminating or reducing these risks.

4. **Plan the sequencing of liberalizing reforms to match the achievement of preconditions and thresholds to reduce risks.** Broadly, sequencing reforms in the integrated approach can be summarized as “long term before short term, FDI and other non-debt before debt, and inflows before outflows.” In addition, the currency composition of financial assets can have implications for stability that may warrant caution. The sequence needs to be calibrated to country-specific circumstances and to entail a measure of flexibility and judgment, taking into account the dialogue between the authorities and staff, the preconditions, and expertise from MCM and others. The following general approach to sequencing could provide a reference point to be adapted to each country:

- *Liberalize FDI inflows and certain short-term bank-related flows* needed to facilitate trade and financial transactions for clients of financial institutions (for example, trade finance and allowing banks to open accounts with correspondent banks abroad).

- *Liberalize FDI outflows and inflows into traded securities* (for example, listed bonds and equities). Liberalizing inflows into equities may present fewer complications than bonds, given equities' potential for both greater risk-sharing and market-deepening. Nevertheless, the development of bond markets could also benefit from foreign participation enlarging the investor base. Some countries have taken advantage of liberalizing inflows into traded securities to lengthen maturities (for example, initially allowing inflows only for long maturities). In this stage, prudential controls on banks' open positions will need to continue, especially to limit the large-scale use of short-term foreign currency borrowing to fund domestic currency lending, along with prudential rules on domestic lending in foreign exchange.
- *Progressively lift controls on outflows, and allow greater participation of foreign investors in other assets.*

5. **Evaluate whether the current stage of liberalization is appropriate, considering benefits and risks associated with the existing preconditions.** If liberalization has outpaced the capacity of the economy to safely handle the resulting flows, the re-imposition of CFMs may be warranted until sufficient progress has been made with respect to the macroeconomic, financial, and governance policies and the level of market development that the integrated approach recommends. If CFMs are re-introduced, the least discriminatory measure that is effective should be preferred.

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