Staff Response to the Evaluation by the Independent Evaluation Office of the IMF's Approach to Capital Account Liberalization

Executive Board Meeting
May 11, 2005

1. *The IEO report (SM/05/142) highlights the difficulties and complexities the Fund faces in providing advice on capital account issues.* The two main recommendations put forward in the report are: the need for (i) greater clarity in the scope of the Fund's policy advice on capital account issues to its membership, and (ii) greater attention to supply-side factors of international capital flows with a view to minimizing their volatility. This statement elaborates on some of the report's analytical underpinnings. The report is timely in view of the ongoing work on the Fund's strategic priorities.

2. *The staff considers the sample underlying the report's evaluation of our advice on capital account issues a fair representation of the diverse membership, although it believes that a finer distinction among these countries would have been useful.* The staff appreciates the considerable work that was involved in evaluating 27 countries, and finds the description of the cases broadly accurate. However, in discussing the staff's policy advice, the report could have made a useful distinction between three cases: countries with an actual or potential balance of payments or banking crisis; countries facing a major capital inflow; and those under "normal" conditions but with some remaining capital controls. This distinction would help to clarify and nuance the staff's advice on capital account liberalization and imposition of temporary capital controls.

3. *Relatedly, the report's finding of some apparent inconsistencies in the Fund's advice on capital account liberalization across countries needs to be more nuanced.* The Fund is sometimes criticized as being a monolithic institution following a "one-size-fits-all" approach. In contrast, the IEO concludes that its evidence suggests no "one-size-fits-all" approach by the Fund staff. Indeed, the staff has used its own professional judgment in approaching capital account liberalization in individual countries, and there was active debate on the issue within the staff. In its assessment, however, the report seems critical of this discretion, and calls for greater consistency in country work and institutional approach. The apparent lack of consistency in the Fund's advice to its members may have a number of causes, as acknowledged in the report, including the tailoring of policy advice to country-specific circumstances or the absence of an official position in the Fund on capital account issues. While we do not disagree with the report's finding that the latter could have contributed to some variation in policy advice across the membership, the report could have gone further into explaining the different country circumstances that would warrant differentiated advice. Indeed, a detailed case study approach of the sampled countries would have perhaps made a more convincing analysis.

4. *The staff largely concurs with the evaluation's two key findings on the Fund's policy advice to its member countries on capital account issues (Chapters III and IV).* The IEO report finds that the Fund staff has been quite accommodating of the authorities' policy choices when they involved a gradual approach to capital account liberalization or temporary use of capital controls. Moreover, in no case did the Fund require capital account liberalization as formal conditionality for use of its resources. In particular, the Fund has not pressured member countries—certainly not the emerging market countries sampled—to liberalize their capital accounts or to move faster than they wanted to go. In terms of advice on the temporary use of capital controls, the IEO concludes that the Fund staff seldom challenged the authorities' decisions and even supported market-based controls in some cases as a second-best option. It notes that the staff pointed out the risks inherent in an open capital account as well as the need for a sound financial system, even in the early 1990s. However, the IEO considers that these risks were insufficiently highlighted and did not translate into operational advice until later in the 1990s. We would

stress that the IEO sees recent improvements in this area. Indeed, substantial analytical work has been carried out by the Monetary and Financial Systems Department (MFD), the International Capital Markets Department (ICM), Research Department (RES), and area departments.

5. *The report does not do justice to the role played by external forces in promoting capital account liberalization.* While it acknowledges the presence of exogenous factors, the country cases do not fully reflect their role. In particular, free trade agreements (FTAs) and multilateral trade liberalization through the World Trade Organization have covered significant components of the capital account related to financial services and investment chapters. In addition, recent bilateral investment treaties (BITs) frequently cover a broad range of instruments (including portfolio investments, inter-bank transactions, and sovereign debt) with no balance of payments safeguards; that is, signatories, to a point, cannot impose capital controls even during times of macroeconomic or financial stress. Moreover, a major source of pressure for liberalization is often a country's own commercial sector, which may be looking for sources of competitive financing. All in all, the policy choices of emerging markets may have reflected these external factors at least as much as Fund policy advice.

6. *The report proposes two main recommendations in light of the Fund's experience with capital account issues.* As discussed below, the Fund is already implementing some aspects and plans to address these issues further in its future work program and in the strategic priorities review.

7. *Recommendation 1 is that more clarity is needed on the Fund's approach to capital account issues.* There are three aspects to this proposed recommendation, which are discussed in turn.

- *The report suggests that the place of capital account issues in Fund surveillance could be clarified, and there would be value if the Executive Board were to clarify formally the scope of Fund surveillance on capital account issues.* The Board and the Fund staff have recognized that capital account developments and vulnerabilities constitute an increasingly important focus of the Fund's work on promoting stability, and the process of clarifying the scope of Fund surveillance to include capital account issues is already underway. The Executive Board noted in the context of recent Biennial Surveillance Reviews (2002, 2004) that Fund surveillance needed to adapt to "a changing global environment, most notably to the rapid expansion of international capital flows." This adaptation would imply a broadening of the coverage of surveillance "from a relatively narrow focus on fiscal, monetary and exchange rate policies, to a broader purview encompassing external vulnerability assessments, external debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies that have an impact on macroeconomic conditions" (SUR/02/81). The Board has also highlighted the risks of opening the capital accounts before floating the exchange rate, and especially the risks of sudden outflows (PIN No. 04/141). More recently, in the context of the discussion of the "Fund's Medium-Term Strategy—Framework and Initial Reflections" (BUFF/05/60), the Board has called for additional work on capital account issues.

- *Relatedly, the report proposes that the Executive Board could issue a statement clarifying the common elements of agreement on capital account liberalization.* While this is an issue for the Executive Board to decide, the staff agrees that it would be useful to have some clear operational guidance that lays out the broad principles that Fund staff needs to follow in its policy advice across countries and that the outline of these principles in the IEO report is a useful starting point for such guidance. Indeed, staff (especially MFD) has already undertaken policy research and operational work on various aspects of capital account issues (including capital account liberalization and financial sector reform, country experiences with use and subsequent liberalization of capital controls, and sequencing), in the context of FSAPs and technical assistance. We would, however, caution that there is no single "right" approach. Our advice needs to take into account the different situations confronting our members. It also must recognize that for many members full capital account liberalization is an aspiration that will likely take substantial time to achieve.

- *Against this backdrop, the Fund's future work on capital account issues should seek to buttress efforts to promote financial stability, while helping ensure that controls are not used to impede adjustment.* An approach would be to build on the existing Fund expertise in this area, and to ensure that policy advice on capital account issues is fully incorporated into the mainstream of bilateral and multilateral surveillance, with analytic work being used to strengthen the basis for policy advice and technical assistance. This strategy would imply a measured approach to liberalization to facilitate countries' integration into global economy while maintaining stability, rather than promoting liberalization, per se.

- *The report also suggests that the Fund could sharpen its advice on capital account issues, based on solid analysis of the particular situation and risks facing specific countries.* The staff endorses this recommendation, which is in line with best practice and longstanding general guidance on Fund surveillance. In its policy advice to countries the staff will continue to draw on all existing analytical work as well as any future findings that may arise from staff studies that have been requested by the Board, or from other sources. Further, technical assistance provided by the Fund on operational issues provides hands-on advice to countries on how to proceed with capital account issues. We also note that MFD is reviewing, for the upcoming Biennial Review of Exchange Arrangement, Restrictions and Markets, the role of capital controls during financial stress and issues relating to financial liberalization and capital account regulations. However, the IEO's suggestion that the Fund should provide some quantitative gauge of the benefits, costs, and risks of moving at different speeds is likely to prove difficult to put into practice, given the conflicting theoretical and empirical evidence on the subject and the political and economic complexities that capital account issues typically involve.

8. *Recommendation 2 is that the Fund's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and what can be done to minimize the volatility of capital movements*. Staff agrees with the crux of this recommendation, although given the large number of staff studies already completed (and more under way), we are not sure what other specific actions, if any, the IEO may have in mind. We agree with the report's assessment that this is a difficult topic on which little professional consensus exists. That said, past work and current initiatives demonstrate that the staff recognizes that reducing volatility and cyclicality in the supply of capital are critical to achieving capital markets stability.

- *To strengthen Fund surveillance in this regard, several research initiatives have been under way.* ICM has aimed to focus on global financial market linkages, financial and risk-related flows, and global asset allocation decisions of institutional investors. Recent *Global Financial Stability Reports* (*GFSRs*) have focused on the volatility of private capital flows to emerging markets (September 2003), and provided analysis of the institutional investor base in emerging markets (March 2004). The next *GFSR* will include studies of home bias and global diversification, and financial stability considerations of regulatory and accounting policies. Further, a considerable number of studies by IMF staff (appearing in both Fund documents and outside journals) have in recent years examined supply-side aspects, including: the potential impact of interest rates and risk appetite in advanced countries on emerging market spreads; herding behavior, contagion, and the possible role of institutional investors and hedge funds in this regard. The Fund has also delved into deepening domestic capital markets by examining ways in which local securities and derivative markets can be developed to tap on a more stable segment of the investor base.

- *The Fund is undertaking a number of initiatives at the country level.* Through the Financial Sector Assessment Program (FSAP) initiative, the Fund is also contributing to identifying potential vulnerabilities and risks in the financial systems, particularly of systemically important countries, whose vulnerabilities may spill over to other countries owing to strong ties in the financial sector. Further, by way of the Reports on Observance of Standards and Codes (ROSC), Special Data Dissemination Standards (SDDS), General Data Dissemination System (GDDS), and technical assistance, the Fund is helping to improve information flow to investors, which in turn contributes to greater stability. In addition, the Fund has developed operational guidance to assist in maintaining the soundness of relatively large and complex banking organizations, with a view to creating stability in domestic and international financial sectors.

- *Several broader initiatives have also been undertaken by the Fund.* The Capital Markets Consultative Group (CMCG), established in July 2000 by the IMF's Managing Director, provides a forum for informal dialogue between participants in international capital markets and the IMF. More generally, the IMF is working on improving its understanding of recent trends in and future prospects of foreign direct investment (FDI) in emerging market countries (EMCs), the investment strategies of large multinational companies, and the determinants of FDI in EMCs. The Fund has also played a leading role in discussions about the possibility of a statutory sovereign debt restructuring mechanism (SDRM) for orderly debt workouts, and has encouraged the use of collective action clauses (CACs) to strengthen crisis resolution and reduce uncertainty associated with debt restructuring. As indicated in the report, the staff comments on the proposed New Basel Capital Accord (Basel II) have highlighted that using credit ratings to set capital charges could increase volatility and procyclicality.

- *With so many initiatives under way at the Fund, we are puzzled by the report's finding that the Fund pays too little attention to supply-side risks.* The past and current work, noted above, shows that the Fund staff has been at the forefront of the analysis and policy debate in this area. However, staff recognizes that it cannot rest here, and it will strive to enhance further its understanding of supply-side factors and their implications for our membership. However, it would have been more helpful if the IEO had proposed specific actions that could be taken on the supply-side to minimize volatility and cyclicality.
- *Beyond the present list of activities within the Fund to deal with the supply-side risks of capital flows, the staff emphasizes that additional internationally coordinated efforts could help give these issues higher priority among policymakers in advanced economies*. In this regard, the Financial Stability Forum (FSF), established in 1999 and, in whose work the Fund participates, works as a conduit for promoting international financial stability, improving the functioning of financial markets, and reducing systemic risks. Further, the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets, a private-sector-led initiative with the support of a number of emerging market country issuers, are also aimed at improving the engagement between sovereign debtors and their creditors, with a view to promoting global financial stability.