1. This supplement provides further information on some of the issues covered in *Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework* that have been highlighted in staff’s informal discussions with Directors. These include the role of supply-side factors behind the surge in capital flows and the nature of the framework pertaining to the use of capital flow management measures (CFMs).

**Role of supply-side factors**

2. Supply-side factors, including advanced economy monetary policies and global risk aversion, can have important consequences for capital flows to emerging market countries (EMs). The empirical work in *Recent Experiences in Managing Capital Inflows—Cross-Cutting Themes and Possible Policy Framework* (Section II.B “Push and Pull Factors”) seeks to bring out the role of both global and country-specific factors behind capital flows to EMs. In particular, a 50 basis point fall in the yield on the 10-year US Treasury bond is estimated to be associated with a 13 percent increase in gross inflows in EMs, although the estimated relationship explains only part of the observed variation in capital flows and the effect would depend on global economic conditions. The role of supply-side factors has also been highlighted in other recent Board papers, including *Understanding Financial Interconnectedness* and *The Fund’s Role Regarding Cross-Border Capital Flows*, as well as the *April 2010 GFSR*. Further discussion of this issue will be provided in the forthcoming WEO and GFSR.

3. The focus of the present paper—on dealing with capital inflows in countries with mostly open capital accounts—is only one part of a broader agenda covering the entire Fund membership. Ongoing and planned work by staff also encompasses analysis and policy guidance for: (a) the countries at the source of cross-border capital flows; (b) multilateral considerations to be taken into account in designing policies related to capital flows; (c) capital account liberalization; and (d) dealing with outflows. Regarding the analysis of issues related to the source of global capital flows and related policy implications, key upcoming outputs include Chapter 4 of the forthcoming Spring WEO, which discusses the extent to which policies in advanced countries influence capital inflows to EMs;
spillovers reports on the five most systemic economies, in particular the one on the United States, which will examine the impact of QE2 on capital flows to EMs, among other issues; work on macroprudential policy frameworks (beyond the issues covered in the forthcoming Board paper on *Macroprudential Policy: An Organizing Framework*) as well as multilateral aspects of policies related to capital flows, which could help support the effectiveness of CFMs; and work on global liquidity—how to measure it and assess its adequacy—which should provide useful context to discussions on dealing with inflows in recipient countries. With the exception of the Spring WEO chapter, already issued, this work is expected to come on stream between the Spring Meetings and the Fall.

**Nature of framework**

4. **The framework set forth in the staff paper seeks to highlight the circumstances under which it would be appropriate to deploy CFMs—it is not intended to suggest a predetermined sequence of policy instruments.** Receiving countries may face a myriad of economic circumstances at the onset of an episode of capital inflows. The framework suggests that so long as appropriate macroeconomic policies are in place, it is reasonable for recipient countries to deploy CFMs, where inflows give rise to significant economic or financial stability concerns. Similarly, in choosing the right kind of CFM to address such risks, the proposed framework is meant to identify a general preference among a menu of possible measures, with due regard to country-specific factors in its application, rather than an endorsement of a particular sequence of measures.

5. **The proposed policy framework also recognizes that while residency-based CFMs are less preferable from a multilateral perspective, they are appropriate under certain circumstances.** The key motivation for the Fund to have a preference against such measures is institutional. Since such measures directly discriminate against nonresidents, they run counter to the international cooperative spirit of participation in the Fund, particularly given the Fund’s role in respect of the international monetary system, and are also more likely to have multilateral effects or lead to a proliferation of such measures. That said, the approach proposed in the paper recognizes that, under certain circumstances, residency-based CFMs may be appropriate. Indeed, there may be circumstances where CFMs that target a specific prudential risk may be less effective than those targeting residency, or where a narrowly-targeted residency-based CFM is less distortive than a broad prudential measure targeting all foreign currency transactions.

**Use of framework**

6. **The framework proposed by staff would provide a basis for policy advice to members facing capital inflows.** The staff paper was partly motivated by the fact that a number of our members currently have to cope with large capital inflows. Indeed the issue has come up in several recent Article IV consultation discussions, and a clear analytical framework is therefore needed to weigh the effects of alternative policies to manage inflows.
The institutional view implied by Board endorsement of the framework would facilitate provision of policy advice to members having to manage large inflows, including in the context of Article IV surveillance. However, it is not proposed or contemplated that this policy framework would provide guidance on the scope of members’ obligations under Article IV, as was foreshadowed last December in the context of *The Fund’s Role Regarding Cross-Border Capital Flows*. If there is broad support, consideration could be given to using the framework for these purposes at a later stage such as, for example, when similar frameworks have been provided on other aspects of capital flows as summarized above.

7. **A key intended goal of the framework is to help achieve consistency and evenhandedness in Fund policy advice to countries in similar circumstances.** In the absence of a guiding framework, the Fund is at risk of providing ad hoc advice. This would undermine the Fund’s credibility in an important area of international discussion. The framework would allow the Fund to publicly support members that are appropriately using CFMs—many of the country cases considered in the paper—while explaining the basis for this support. At the same time, the framework is sufficiently flexible that it would give due regard to country-specific considerations in its application.