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MANAGING CAPITAL OUTFLOWS—FURTHER OPERATIONAL CONSIDERATIONS

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INTRODUCTION

1. The *Guidance Note for the Liberalization and Management of Capital Flows* (IMF 2013a) provides operational guidance to staff on the use of the Fund’s institutional view on the liberalization and management of capital flows (Box 1). It discusses appropriate policies with respect to the liberalization of capital flows and the management of disruptive capital inflows and outflows. With respect to capital outflows, the institutional view considers that capital flow management measures (CFMs) may be appropriate in crisis-type circumstances¹ or, in the context of capital flow liberalization, if countries find that they have liberalized prematurely and are unable to handle the resulting capital flows. In non-crisis-type circumstances, the guidance considers outflows as being appropriately handled by macroeconomic, financial, and structural policies. It is intended to mirror the policy advice with respect to capital inflows. The guidance is, however, relatively brief and would benefit from some elaboration to lay out the possible configurations of policies in the context of the institutional view. This note seeks to provide such an elaboration, which is particularly relevant as capital outflows are becoming a more relevant policy challenge.²

CONTEXT

2. **Some capital outflows are a natural consequence of openness, and would not necessarily require policy action.** As discussed in IMF 2012a and IMF 2013a, capital outflows can reflect outward investment opportunities, increased liberalization, and financial integration. Implementing timely structural reforms to deepen financial markets, strengthen balance sheets, and build sound institutions and policy frameworks are crucial for withstanding shocks and managing outflows safely.

3. **At the same time, outflows that are large, sustained, or sudden can pose significant policy challenges even in the absence of a crisis.** Domestic vulnerabilities, as well as international factors such as global risk sentiment and liquidity, can drive sudden and disruptive capital outflows. Such instances could also arise due to contagion through trade and financial linkages. Even short of crisis, large or sudden outflows can pose challenges through their effects on exchange rates (disruptive currency movements), interest rates, credit, and output.³

¹ See IMF (2013a), p. 18, for examples of “crisis” or “imminent crisis” situations.

² The guidance encompasses the cases of all exchange rate regimes, but unless it says otherwise it refers to regimes in which the exchange rate can act as a shock absorber (i.e., either floats or can be adjusted).

³ A sudden reduction of capital inflows, including so-called “sudden stops” that end an inflow surge, could have similar effects as capital outflows on macroeconomic and financial stability.

Box 1. Institutional View and Guidance on Managing Capital Outflows: Key Elements

This box summarizes the main elements of the institutional view and guidance note on capital flow management, with respect to outflows.

Managing capital outflows

- Countries can better absorb capital flows and reap their benefits by implementing sound macroeconomic policies, deepening financial markets, strengthening financial regulation and supervision, and improving institutional capacity.
- Large, sustained, or sudden outflows can give rise to macroeconomic and financial stability risks. In order to manage these risks, a key role needs to be played by macroeconomic policies, including monetary, fiscal, and exchange rate policies, as well as by sound financial supervision and regulation and strong institutions.
- CFMs should not be used to substitute for or avoid warranted macroeconomic adjustment. In certain circumstances, introducing CFMs can be useful for supporting macroeconomic policy adjustment and safeguarding financial system stability. CFMs should seek to avoid discrimination based on residency, and the least discriminatory measure that is effective should be preferred.
- In practice, policy advice on CFMs in response to managing disruptive outflows would mainly apply to CFMs introduced to previously open portions of the capital account.

Role of CFMs in crisis-type circumstances. When responding to disruptive outflows, CFMs should generally be used only in crisis situations or when a crisis is considered to be imminent. When there is no immediate threat of a crisis, there would usually be scope to adjust macroeconomic and financial policies to address the implications of outflows. 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. CFMs are more effective when they are implemented as part of a broad policy package that includes sound macroeconomic policies and institutional and regulatory system. Like inflow CFMs, CFMs on outflows should be transparent, temporary, being lifted once crisis conditions abate, and seek to be non-discriminatory ^{1/}. Unlike inflow CFMs, which should generally be targeted, outflow CFMs generally need to be comprehensive and be adjusted on an ongoing basis in order to avoid circumvention and remain effective. The challenges associated with ensuring a smooth and timely exit in the future should be kept in mind. 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.

Assessment of crisis or imminent crisis. The determination of when “crisis” or “imminent crisis” circumstances are considered to exist will require a measure of judgment from staff, based also on the 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 main features of crisis. In assessing crisis risks, teams should leverage the Fund’s multilateral surveillance, including the early warning and vulnerability exercises.

International coordination. If CFMs or other policies amplify macroeconomic or financial stability risks in other countries, and it is costly for those countries to take counter-measures to manage those risks, cross-border policy coordination may be desirable whereby countries partially internalize the spillovers from their policies. Although domestic stability considerations are not subordinated to spillover considerations, staff should encourage countries to consider whether an alternative policy configuration could achieve the same objective with lower adverse spillovers.

^{1/} It is recognized, however, that sometimes residency-based measures may be hard to avoid in crisis-type situations.

POLICY RESPONSE

4. **Capital outflows should be handled primarily with macroeconomic, structural, and financial sector policies.** The macroeconomic policy response should address the domestic triggers and implications of outflows and foster orderly external adjustment, if warranted, through exchange rate depreciation, monetary policy, and possible use of reserves. The combination of policies would be based on macroeconomic conditions, taking into consideration financial stability risks including balance sheet foreign exchange exposures, and any need for the adjustment of policies that may have contributed to outflows in the first place. Fiscal policy may need to be adjusted based on considerations of macroeconomic stability, financing constraints, or policy credibility. Liquidity provision may be required to support orderly financial conditions. Prudential measures following a graduated approach can be appropriate in order to prevent de-capitalization of banks and avoid confidence problems or deposit runs. In addition, relaxing inflow CFMs that were introduced or tightened to address inflow surges may be useful in some circumstances.⁴ In relaxing inflow CFMs that are also macroprudential measures (MPMs) the judgment would also depend on what actions best safeguard systemic financial stability, taking into account the need to stay above regulatory standards and to maintain confidence in the financial system.⁵

5. **The re-imposition of CFMs on outflows can be appropriate and consistent with an overall strategy of capital flow liberalization.** This could be necessary, even in non-crisis-type circumstances, if premature or improperly sequenced liberalization or the inadvertent effects of complementary policies such as interest rate liberalization or changes in the exchange rate regime have outpaced the capacity of the economy to safely handle the resulting flows. Such use of CFMs should be limited and temporary while sufficient progress is being made with respect to financial sector and macroeconomic policies, with clear communication being critical to avoid a perception of a permanent policy reversal.

6. **The appropriate policy mix to manage outflows would take into account country-specific considerations and would depend on macroeconomic circumstances, financial sector conditions and specific risks, and the nature and size of the shock** (Figure 1). Relevant macroeconomic and financial sector policies would include:

- *Allowing the exchange rate to be a shock absorber.* Flexible exchange rates serve as an equilibrating mechanism in response to shocks. In the case of outflows, if the currency is not undervalued, some depreciation would be appropriate. A certain degree of exchange rate volatility is normal and may occur without generating disorderly conditions. However, excessive

⁴ Countries have responded in a variety of ways to outflows during the “taper tantrum” of summer 2013. Some countries where CFMs on inflows have been used actively in recent years eased those CFMs, echoing steps taken earlier by some countries to liberalize outflows in response to surges in inflows (IMF 2013a). For a discussion of circumstances under which inflow CFMs should be scaled back, see IMF (2013a), p. 17.

⁵ See the IMF (2013b) paper on macroprudential policy principles. Experience with adjusting macroprudential policies during outflow phases is limited, and a thorough case-by-case analysis is needed in applying these principles.

movements in the exchange rate (for example, changes that lead to balance-sheet effects and heightened counterparty risk and domestic spillovers to other markets from investors seeking to reduce risk, including through proxy trades) can cause it to lose its role as a shock absorber and instead to amplify financial and macroeconomic disruptions.⁶ In assessing the risk that exchange rate changes can contribute to disorderly market conditions, important considerations include exchange rate valuation, depth of foreign exchange and related markets, and balance sheet exposures to currency risk. To prevent or mitigate such conditions, foreign exchange intervention may be appropriate.

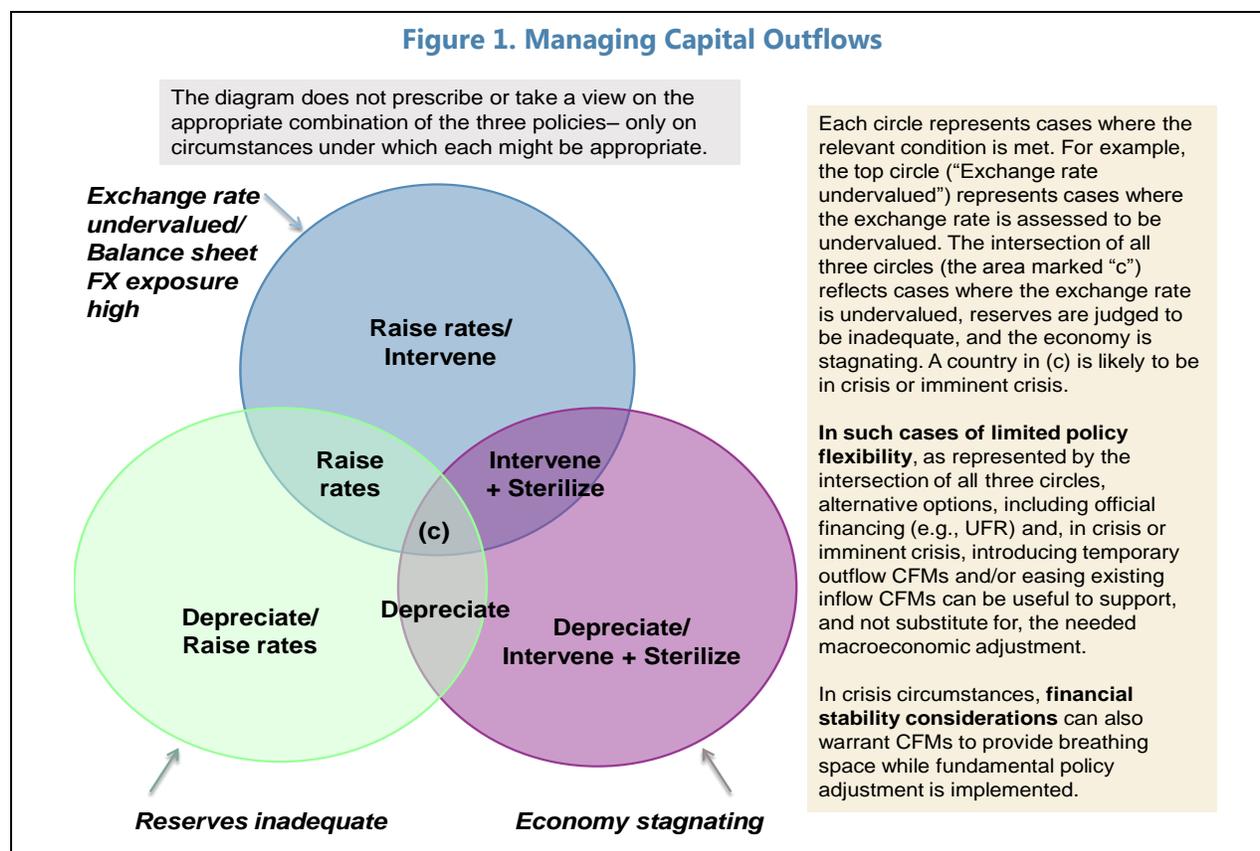
- *Intervening in the foreign exchange market, provided that doing so would not cause reserves to fall to inadequate levels* as determined by appropriate metrics.⁷ The use of intervention should weigh the costs on the credibility of the policy framework against its benefits in terms of dampening shocks. Sterilizing the intervention can help avoid any unwarranted tightening of monetary policy.⁸ Unsterilized intervention can be appropriate in other circumstances, particularly if initial monetary conditions are too loose or the intervention is conducted under a fixed exchange rate regime. Clear communication can help emphasize the purpose of intervention or that it is temporary.
- *Adjusting monetary policy, as necessary and feasible to maintain price stability.* The appropriate monetary policy response depends on the nature of the shock, macroeconomic conditions, and countries' circumstances, including the pass-through effect of exchange rate changes on inflation and balance sheet vulnerabilities. If outflows are fueled by country-specific factors, such as macroeconomic imbalances or vulnerabilities, tighter monetary policy may have to be part of the policy response. The degree of monetary tightening required is likely to depend importantly on the credibility of the monetary policy framework.

⁶ In the case of large, systemically important, economies, a large or sudden exchange rate change could also have global spillovers, with potential spillbacks to the source economy.

⁷ A member country "should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized *inter alia* by disruptive short-term movements in the exchange rate of its currency" (IMF 2012b). For a discussion of appropriate metrics, see the IMF (2015) paper on reserve adequacy.

⁸ The evidence for emerging countries suggests that sterilized intervention has temporary but significant effects on the exchange rate level and volatility, and can dampen the effect of the global financial cycle. Sterilized intervention appears more effective when shallow or inefficient markets, less open capital account, deviations of exchange rate from equilibrium, and consistency with monetary policy are present.

Figure 1. Managing Capital Outflows



- *Role for fiscal policy.* Fiscal policy should be based on public debt sustainability and cyclical considerations, the latter conditional on policy space and availability of financing. A broadly neutral fiscal stance that allows automatic stabilizers to work is generally appropriate, provided that fiscal sustainability and financing constraints are not binding.⁹ If, however, policy space or credibility has been eroded, or financing constraints are binding, steps to rebuild fiscal buffers may be needed to regain policy credibility and restore market confidence.
- *Graduated approach for financial sector policies.* Policy action needs to be commensurate with specific risks, including whether they are associated with individual institutions or the whole banking system.¹⁰ In this regard, a ‘stop-loss’ approach whereby authorities determine ex-ante what conditions would trigger an intensification of policies would be a useful framework, and may also help with coordination among host supervisors in the midst of a fast-evolving situation (teams should encourage supervisors to discuss and inform each other of pending decisions).

⁹ The case for an active fiscal stimulus may exist but as an operational matter it is unlikely to be supported by external financing conditions in circumstances featuring large capital outflows.

¹⁰ If prospective pressures from withdrawals by parent institutions were a concern, a graduated approach may, for example, call for high-frequency reporting requirements first (daily or intra-day on bank liquidity), which could be strengthened if concerns intensified to include such measures as pre-notification requirements for material transactions.

7. **It is important but challenging to distinguish between short-term and long-term trends in capital flows.** A long-term reversal of capital flows would require an adjustment in the exchange rate, while short-term reversals (volatility) need not imply a long-term change in the exchange rate. In a flexible exchange rate regime, the exchange rate should be used to absorb capital flow fluctuations, combined with foreign exchange intervention if necessary to maintain orderly market conditions, provided that reserves are adequate and macroeconomic policies are sound, as discussed in the previous paragraphs. In practice, it is difficult to ascertain in real time the extent to which capital flows in either direction are permanent or temporary, and staff advice will require judgment that should take into account the Fund’s multilateral analysis (including the WEO, GFSR, ESR) and be explained in the Policy Note and staff reports where relevant.¹¹

8. **In countries with fixed exchange rates, intervention is integral to the exchange rate arrangement, and macroeconomic policies need to ensure consistency with the peg.** In such countries, the scope for exchange rate changes is smaller than in countries with more flexible regimes, and accordingly more of the burden of adjustment has to be borne by macroeconomic and structural policies. Foreign exchange intervention to deal with outflows under a peg should typically be unsterilized. In cases in which a shock requires a significant real exchange rate adjustment, a realignment of the peg or crawling arrangement may be needed. Such realignment should consider the effects on the credibility of the peg. Intervention and realignment should not substitute for macroeconomic adjustment that is necessary to ensure consistency with the regime.

¹¹ The institution’s view on the temporariness or permanence of swings in capital flows would, likewise, benefit from the perspectives of country teams.

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