Historic moment for the IMF

By Kevin P. Gallagher, Stephany Griffith-Jones, and José Antonio Ocampo

This month the International Monetary Fund (IMF) can make history. The IMF is set to officially change its view on the regulation of cross-border finance. Preliminary work released by the IMF exhibits diligent research and deep soul searching, but falls short of being a comprehensive view on how and when to regulate capital flows. There is still time for the IMF to further sharpen its view.

In recent decades cross-border capital flows have increased massively; international asset positions now outstrip global economic output. Direct investment is essential for growth but some forms of international financial flows (such as short-term debt, carry trade, and related derivatives) have proven to be usually de-stabilizing. Even long-term capital flows are highly, even increasingly pro-cyclical, as IMF research has shown.

The IMF Articles of Agreement grants individual nations the leeway to regulate their cross-border capital flows and also enable north-South co-operation on such regulations. John Maynard Keynes and Harry Dexter White – the chief crafters of the Articles – agreed that the burden of regulating speculative capital should be at "both ends": not only on the recipients of capital inflows, but also on the source countries of that capital.

In the 1990s however, the IMF pushed to amend the IMF Articles and require that all nations liberalize their capital accounts and effectively deregulate global financial flows. Just as the IMF's effort was gaining momentum, capital account liberalization played a big role in the Mexican, Asian, and related financial crises of the 1990s. The attempt of the IMF to acquire authority over countries' capital account was rejected.

In any case, after their own crises, nations shunned IMF loans when they could, and instead "self-insured" by accumulating reserves and putting in place capital account regulations (traditionally referred to as capital controls). Interestingly, recent IMF research has shown that those nations that regulated cross-border finance in the run up to the global financial crisis were among the least hard hit.

In September 2011, cross-border capital flows reached their pre-crisis highs in many emerging economies, especially Latin America and east Asia. Then, when the eurozone crisis deepened toward the end of 2011, there was a sudden slowdown of capital flows to emerging markets and capital flew out of developing countries back to the "safety" of the United States market.

In this context, when France took the helm at the G-20, Nicholas Sarkozy called for a code of conduct on regulating cross-border finance and tasked the IMF to propose a set of guidelines for reform. The IMF produced a series of official papers, on capital account liberalization, on inflows and outflows of capital, and on the multilateral aspects of regulating cross-border capital. This summer they will officially release a comprehensive ‘institutional view’ on when and how nations should deploy capital account regulations.

It is clear that the IMF has done real soul searching and rigorous research in this effort. Based on the series of papers on the issue, the institution that pushed for global de-regulation of cross-border finance in the 1990s now says that: capital account liberalization is more of a long-run goal and is not for every country at all times; capital controls –which they re-term “capital flow management measures” to take away the stigma– on inflows (on a temporary basis and alongside other measures such as capital requirements and reserve accumulation) are permissible en route to liberalization; regulations on capital outflows are even permissible in or near financial crises. Moreover, they note that certain trade and investment treaties “do not provide appropriate safeguards” to allow for capital account regulations.

While the IMF should be applauded for taking a hard look at its view on regulating cross-border finance, we think further revision is needed in order for the Fund to have a policy that will truly be useful for nations to prevent and mitigate financial crises.

1. First, the IMF’s view should reflect the consensus in the economics literature that there is no clear association between capital account liberalization, economic growth, and financial stability. Such is the view of a new book published by Olivier Jeanne, Arvind Subramanian, and John Williamson. Cross-border finance should be regulated, indeed as any other form of finance. So, the view that all nations should eventually completely deregulate cross-border finance should be put to rest.
2. Second, regulations on cross-border inflows should be permanent, but applied in a counter-cyclical manner when excessive surges or sudden stops of capital flows occur.
3. Third, regulations on outflows from source countries are also useful to temper global capital account volatility and may be necessary to regulate finance on ‘both ends’, as Keynes and White suggested.
4. Finally, the IMF should make clear that their codes of conduct will not be binding, and that the management of the capital account should continue to be a prerogative of all members under the IMF Articles of Agreement.

During the 2011 G-20 summit in Cannes a set of “G20 Coherent Conclusions for the Management of Capital Flows Drawing on Country Experiences” was agreed. The document was endorsed by the G20 finance ministers and central bank governors, and the G20 leaders themselves. The G20′s conclusions say that “there is no ‘one-size fits all’ approach or rigid definition of conditions for the use of capital flow management measures”. The IMF’s final guidelines should reflect this sensibility and the most recent advances in economic thinking.

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