The IMF's half step

By Kevin Gallagher
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"What used to be heresy is now endorsed as orthodox," John Maynard Keynes remarked in 1944, after helping to convince world leaders that the newly established International Monetary Fund should allow the regulation of international financial flows to remain a core right of member states. By the 1970's, however, the IMF and Western powers began to dismantle the theory and practice of regulating global capital flows. In the 1990's, the Fund went so far as to try to change its Articles of Agreement to mandate deregulation of cross-border finance.

With much fanfare, the IMF recently embraced a new "institutional view" that seemingly endorses re-regulating global finance. While the Fund remains wedded to eventual financial liberalization, it now acknowledges that free movement of capital rests on a much weaker intellectual foundation than does the case for free trade.

In particular, the IMF now recognizes that capital-account liberalization requires countries to reach a certain threshold with respect to financial and governance institutions, and that many emerging-market and developing countries have not. More fundamentally, the Fund has accepted that there are risks as well as benefits to cross-border financial flows, particularly sharp inward surges followed by sudden stops, which can cause a great deal of economic instability.

What grabbed headlines was that the IMF now believes that countries could even use capital controls, renamed "capital flow management measures," if implemented alongside monetary and fiscal measures, accumulation of foreign-exchange reserves, and macroprudential financial regulations. Even under such circumstances, CFMMs should generally not discriminate on the basis of currency.

But has the IMF's reconsideration of financial globalization gone far enough? This month, the IMF's Independent Evaluation Office released an assessment of the Fund's policy on reserve accumulation that implies that a "one size fits all" approach to reserve accumulation continues to prevail within the organization. Many emerging-market policymakers view accumulation of foreign-exchange reserves during the 2000's as having insured their countries against exchange-rate volatility and loss of export competitiveness. Yet the IMF pinned significant blame for global financial instability on this policy.

Not surprisingly, given their decades of experience with the management and mismanagement of capital flows, emerging-market policymakers have been watching the IMF's "rethink" on these issues very closely. From 2009 to 2011, with advanced economies pursuing near-zero interest rates and quantitative easing, yield-hungry investors flooded countries like South Korea and Brazil with hot money, fueling currency appreciation and inflating asset bubbles. When the eurozone panic ensued in July 2011, inflows came to a halt and fled to the "safety" of the United States, Switzerland, and beyond.

Unlike in the past, however, emerging and developing countries avoided the worst, precisely because they had learned to accumulate foreign reserves and regulate cross-border capital flows, and to ease such measures to prevent or mitigate sudden stops. And yet, despite abundant academic evidence and country experience to the contrary, the IMF remains stubbornly wedded to the idea of *eventual* capital-account liberalization.

In a new study that surveys and updates the economics literature, Arvind Subramanian, Olivier Jeanne, and John Williamson conclude

that "the international community should not seek to promote totally free trade in assets – even over the long run – because…free capital mobility seems to have little benefit in terms of long-run growth."

Thus, the IMF's recommendation to use capital controls only after exhausting interest-rate adjustment, reserve accumulation, and prudential regulation is out of step with the profession. Indeed, recent work in economic theory shows that capital controls can actually be the optimal policy choice. For example, the new welfare economics of capital controls views unstable capital flows as negative externalities on recipient countries, which implies that regulations on cross-border flows are the optimal tools to address market failures, improve market functioning, and enhance growth, not worsen it.

Indeed, the IMF's own research shows that countries that deployed capital controls first – or alongside a host of other macroprudential measures – were among the most resilient during the global financial crisis. In many cases, the controls were neither market-based nor temporary.

The IMF also fails to appreciate fully that capital flows should be regulated at "both ends," or at least that advanced-country regulations will not make matters worse. IMF research over the last year has outlined circumstances in which industrialized countries should also take part in regulating global capital flows. But the new view also highlights an important obstacle: many advanced countries' trade and investment treaties prohibit the regulation of cross-border finance.

The good news is that Article VI of the IMF Articles of Agreement still stands: "Members may exercise such controls as are necessary to regulate international capital movements." The IMF is making strides in the right direction, but emerging markets will have to remain in the lead. They have proven to be the best judges of their economic needs and priorities; as they consider the IMF's new stance on financial globalization, they should continue to heed their own counsel.

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