THE IMF'S JOURNEY ON CAPITAL CONTROLS: WHAT IS THE DESTINATION?

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Keynes's vision of capital account regulations

- "Loose funds may sweep around the world, disorganizing all business. Nothing is more certain than that the movement of capital funds must be regulated—which, in itself, will involve far-reaching departures from laissez-faire arrangements."

  John Maynard Keynes (1941)

  - Three years before Bretton Woods conference, Keynes provided a vision that would end up being embodied in IMF charter
  - Part of Keynes's vision to ensure: satisfactory level of aggregate demand & full employment; open international trading system
  - Very different from vision in the interwar period: Genoa Monetary Conference, 1922: "Capital controls are futile and mischievous"
  - Why the change? Experience of interwar period showed that macro policy autonomy required restrictions on international capital movements: completely relevant today!

Unfettered capital flows wreak havoc

- "Loans from creditor countries…are likely to be made in exceptionally large amounts toward the culminating stage of upswing, and…with the advent of crisis, they are at once cut down sharply or even cease entirely."

  Frank Taussig (1928)

  - Even for a large country like the US, ensuring prosperity and stability under free capital mobility was a challenge: US experienced several boom-bust cycles in 1920s and 1930s, including in the midst of the Great Depression

"Since the inflows complicate the problem of achieving and sustaining a prosperous stability and have nothing to do with foreign trade or the international division of labor, there appears to be a clear case for adopting measures designed to deter the growth of foreign capital holdings in our markets."

Mariner Eccles, Chair of the Federal Reserve (1937)

Keynes-White vision Embodied in IMF Charter

- Charter gives wide latitude to countries on capital controls:
  - "Members may exercise such controls as are necessary to regulate international capital movements" (Article V1 (3))
- Except to engage in beggar-thy-neighbor behavior
  - "Each member shall … avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage" (Article IV (1))

Vision Held Sway for three decades

- Vision suited the leading economic powers of the time
  - Pervasive capital controls in US, Europe, Britain (except for 1947 dash to convertibility), and Japan
  - In fact, advanced economies more restrictive than emerging market economies in these decades
  - IMF charter and vision very different from OECD with its liberalization code (1961 version which excluded short-term capital flows; and later version which included them (late 1980s)

US Position changed in 70s

- Why? Opportunistic move to engineer ER adjustment
  - Dollar overvalued but Europe and Japan did not want to accept revaluations through negotiation
  - US view: we can get what we want on dollar adjustment by unilaterally dismantling capital controls faster than through negotiation over parities
  - 1973 Economic Report of the President (p. 128): ‘capital controls need to be eliminated if they perpetuate misaligned exchange rates’

US Position During 1978 Amendment

- US pushed to insert language in Article IV of IMF Charter that the fundamental purpose of the IMS is to facilitate free trade in goods <u>and capital</u>
  - Completely at odds with the original version of Article IV
  - Indeed the original version saw a tension between capital mobility and free trade, and prioritized the latter over the former
- Europe, Japan still using capital controls in the 1970s, but evolution over next decade
- France switched camp: tournant de la rigueur under Mitterrand; EC directive for free capital mobility under Delors; UK, Thatcher dismantles controls; Washington Consensus; Summers arguing that free capital movements discipline economic policies
- EMs swept up in this: dismantled longstanding prudential controls and faced very damaging crises summarized in Diaz-Alejandro: ‘good-bye financial repression, hello financial crash’

No discernible leadership by IMF until 1990s

- IMF doesn't try and defend Article VI of its charter and say: the flexibility in the charter for EMs to manage capital flows should be used by EMs. This is kind of shocking
- IMF begins to provide leadership in the mid-1990s, but not to defend the charter, but instead to gut it
  - Camdessus believes capital controls ineffective & distortive: "Capital controls insulate a country only for a very short time…circumvented within 6 months…effective only against the poor…you cannot trust controls over the long term" (Michel Camdessus)
- Camdessus decides to seek jurisdiction to amend charter: goal is to prohibit imposition of capital controls without IMF approval and to promote removal of existing restrictions
- IMF Madrid declaration: "We welcome the growing trend toward currency convertibility and encourage member countries to remove impediments to the free flow of capital" (October 2, 1994)
- Only fails because of Asian Financial Crisis: US Congress pulls plug

Fund persists as before but with no legal basis

- Fund believes, and proceeds as if, Article VI is irrelevant:
  - Does not take up the issue of how to manage volatile capital flows: even though that is the most pressing and obvious issue
- IMF's Independent Evaluation Office critical of this failure. Notes that in practice, IMF invariably advises countries facing inflows (& outflows) to tighten fiscal policy and allow exchange rate to float; no active management of capital flow volatility is recommended (capital controls last resort)
- MD Rodrigo de Rato follows in Camdessus' footsteps: "I can think of no conditions under which capital controls would be beneficial for the country that imposes them" (2007)
- **From 1944 to 2008, IMF either provides no leadership on capital flow management or, when it does, pushes for a system of unregulated capital flows (with or without legal backing)**

Sea-Change in Leadership during GFC

- Another MD takes over during GFC
  - DSK realized that institutional position under Camdessus and de Rato is untenable given challenges facing EMs
  - Receptive to EM view that QE-centered policy mix was creating monetary tsunami for EMs, who were justified in seeking IMF blessing for broader toolkit. Existing toolkit is simply worn out
  - Directs IMF research department to revisit the toolkit and make some recommendations. Resulting papers (Ostry et al., 2010, 2011) form analytical backbone to IMF Institutional View (2012)
- Board paper has the potential to be responsive to EM demands, but implementation disappoints: capital controls remain a last resort and, if used, are stigmatized by IMF

EMs Prescient about Implementation

- EM chairs suspicious that IMF plan was more to restrict use of capital controls than to destigmatize them
  - By delineating a set of restrictive preconditions under which capital flows could be managed by EMs, IV entrenches stigma
- Revised IV in 2022 sought to remedy this, allowing for preemptive controls in some circumstances, but falls well short of the latitude permitted under the IMF's charter, and thus a missed opportunity to say: capital flow management is a legitimate tool unless goes against Article IV (Keynes)
- IMF position retains stigma of controls in many circumstances, including if capital flows are managed for social reasons (e.g., housing affordability). Fails to take up pressing issue of outflow controls (Argentina) or the distributional consequences of capital mobility (while endorsing growth benefits blindly)

Tentative Takeaways

- Keynes-White vision largely ignored after the 1970s
  - Despite continued relevance of that vision today, reflecting conflict between unmanaged capital mobility and macro policy autonomy, IMF has not adhered to the spirit of its charter
- Institutional leadership on capital account regulations lacking for a half century, except when goal was to push for a legal mandate to outlaw capital controls, or to ignore the IMF's charter altogether by stigmatizing controls
- Over the past decade, attempts to destigmatize capital controls really amount to a set of restrictions on their use
- Likely drivers of IMF position are ideological bias against regulating capital flows (despite the IMF's charter) & structure of voting power in the institution (AE vs. EM)