The IMF's View of Capital Controls: A Pendulum Swing?

William R. Cline and Arvind Subramanian assess a new IMF finding on capital controls, concluding that the Fund has shifted over time toward the consensus that controls are sometimes necessary.

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Steve Weisman: Whether capital flows have a beneficial affect on the world's economy and different countries in the world is a matter of some debate. Recently the International Monetary Fund issued a new "institutional view"on the advisability of capital flows, especially to developing countries. William R. Cline and Arvind Subramanian are here with me, Steve Weisman, at the Peterson Institute to discuss that. Bill, let me start with you. Please summarize what the IMF has concluded. Is this a significant step?

Bill Cline: I think essentially what it does is to codify what has become a recent IMF practice. It's important to realize that it's in a pendular swing from when the Bretton Woods institutions were first set up. There was a presumption that basically capital controls were part of life, that too much capital sloshing around had contributed to the Great Depression, etc. There was a huge swing, too. By 1997, the IMF was proposing to amend its articles to have capital have the same status as trade, [and that] there should be free flows of capital.

Then you had the East Asian Crisis [of the late 1990s] and there's been sort of a long walking back away from that pure capital markets. The state of the art is essentially a sense that clearly capital openness does tend to benefit growth for direct investment. This report reinforces that, that it's more ambiguous for debt, and that volatility in debt flows by implication can cause problems. What they did here is to set the ground rules for what is internationally acceptable or desirable practice. Those ground rules say explicitly that totally open capital markets are not always right for all countries at all times.

You could say, "Ah, they reversed their position." Well, maybe against the sort of a pure standard that was never really reached, but might have been talked about in the late '90s. They emphasized that when you're going to have measures to restrict capital flows, that they should be temporary, that they should not be a substitute for correct macroeconomic policies, that if your problem is that you've got too much capital coming in, that you first want to make sure that you don't have too high an interest rate. You should reduce the attraction to those inflows. You should make sure that you have an appropriately valued exchange rate – in the first instance, appropriate to appreciate your exchange rate. Basically, they relate the treatment of impediments that you might put up if you've got them—the macro polices right, if you still have too much capital coming in, causing problems.

They, I think, reiterate the principle view that outward capital controls are a bad thing. They do have an allowance for a sort of a very temporary set of controls, even on outward flows. But they argue that under those circumstances it should always be temporary and it should always be linked to corrective macro measures.

They do have a couple of sort of foot-in-the-door sections. There's a footnote on page 30 that suggests that we might crank up this article for surveillance and if you're using capital controls to get a competitive advantage in an unfair way -- that might be cheating.

The whole thing seems to be reasonable rules of the road for capital controls. It's very much a get-your-policies-right [approach]. It does not condone permanent restrictions on capital outflows by countries like China, where that's been part of their economic strategy. I think it's meant mainly to clarify what they've in practice been saying in recent years.

Steve Weisman: Arvind Subramanian, do you agree that this was a reasonable walking back for the IMF. Did they go too far -- or not go far enough?

Arvind Subramanian: I agree with Bill that there's nothing radical in this. They're basically codifying the kind of gradual change in intellectual consensus that's been happening over the last 15 years, ever since the Asian financial crisis. But I would say two things. One, nevertheless, it is noteworthy for the IMF to come up institutionally and say, "Look some countries are entitled to impose capital controls in some situations." Why is that important? It's important because of what I would say has been a foreign finance fetish that gripped the world economy. The impact of that was when countries like Brazil had to use capital inflows to check excess volatility and excess flows, they ran this risk of being seen as bad boys because, how can you tamper with the market? Because we were in the thrall of this foreign finance fetish? Hence in 2009, when they actually needed to impose much bigger controls, they retreated because they were scared of being seen as pariahs.

So in some sense, this is important because it says if you do these things and do them sensibly, you're not a pariah. It's completely consistent. So that's a sense in which I think it's useful to have this even if it's mere codification.

But I think that, in my view, obviously doesn't go far enough. In the book that Olivier Jeanne, John Williamson and I wrote [*Who Needs to Open the Capital Account* http://bookstore.piie.com/book-store/5119.html]. I think it doesn't go far enough in two respects. First, on the inflow side, even this paper, as Bill rightly said, basically says use this as a last resort. I'm exaggerating slightly, but that's what it is. Do everything else. That's because there is still this residual stigma that if you enforce controls, you're being a bad boy and going against the market. In our book we say, "No, there are good reasons to believe that you may want to use this, not as a last resort, but sometimes as the preferred instrument of choice in some situations." The second sense in which it doesn't go far enough is—actually what Bill alluded to it as well—that in our book what we say is that just as you need some rules on imposing too many controls on capital—or too fewo—just as there should be rules to legitimize the use of some controls, we should also have rules to delegitimize excessive use of capital controls when it's being used to gain unfair competitive advantage, as in the Chinese case. And this thing doesn't go remotely far enough in that direction.

Steve Weisman: Bill Cline, shouldn't the IMF have been a little bit more assertive in calling balls and strikes on the world scene with players who are behaving badly?

Bill Cline: You know, in this context the question of whether China in particular has been undervaluing its exchange rate and getting an unfair advantage, this paper wasn't really about that. As I say, it hinted at it in a footnote. I think what they're trying to do is write a general bible, as it were, that is always applicable. They can't really get bogged down very much in, well, this country really screwed up at a certain time and that country…. If for no other reason that those folks are sitting on the Board of the Fund.

But let me come back to the question of whether Brazil was unduly restrained. If you think about the Brazilian case, a lot of their problem has been that they have had these domestic interest rates on the order of 10-12 percent. My interpretation of the IMF—in 2009 anyway— [is that] they've succeeded just within the last year or so to bring those down. They've done the right thing on domestic interest rates. I think that you could find, within this report, indications that there were needed changes in the macro policy and that perhaps the capital controls were not the best place to start. Since Arvind did mention his book, let me mention the single number that came out of my book back in 2010 [*Financial Globalization, Economic Growth, and the Crisis of 2007-09* http://bookstore.piie.com/book-store/4990.html] which is that if you put all of these econometric studies together, and you do a metastatistical analysis on them, it says if you go from total closure of capital to total openness, it gives about a a half a percent per year extra growth over the long term and that this is sufficiently powerful.

But then if you look at the increase in the statistical probability that you're going to have a crisis by being open because there's too much capital sloshing in and you get over extended, even after allowing for that, you're way ahead of the game in terms of welfare to be open rather than be closed. After making that calculus, there are much larger gains. And that flavor I think is sort of in here. I'm glad to see them sticking to that. In a sense, I would take a slightly different perception from Arvind. I don't think what they're saying is you've got to be good boys and you're going to be bad boys for the international system if you control. I think the story is rather more, what's going to be in the interest of your own people? What's going to be in the interest of the growth of the economy? By and large it's going to be openness, if certain thresholds are met. That's by implication if you have a domestic financial system that's a total mess and very vulnerable, you may not be ready. But I think it reinforces that broad picture. But Arvind is certainly right. They do not go after this other issue, which is unfair competitive advantage.

Steve Weisman: Arvind, you agree that openness in principle is a good idea, except when it's not?

Arvind Subramanian: I guess Bill and I slightly disagree on the evidence. I don't think in our work—we can discuss this ad nauseum, and this is also supported by some other work I've done—that there's [any] evidence that open capital accounts contribute to long run growth. There is a difference between what Jagdish Bhagwati once wrote in his famous essay, "The Capital Myth," that trading bridges and trading capital are too completely different things, and one shouldn't expect all the benefits that you had from trading goods transferred over to trading in capital because that's inherently different.

So I have a different reading of the evidence. I think the IMF people is much more consistent with Bill's reading of the evidence, and so we should say that that's true. That's why I feel that it doesn't go far enough on that side.

On the China case, I'm not arguing that the IMF should have come out and said that China is a bad boy. I'm just saying that if you're going to treat capital controls, you want to have some rules with capital controls, you have to cover both the cases where sometimes it's good to have controls and isolate those situations when it's actually not just bad for yourself. Remember, the difference in restrictions on inflows has less to do with what it does to the rest of the world. That's a view about whether these are good or bad for your own economy. But when it comes to too many restrictions on capital like the Chinese

case, there is actually a negative externality being imposed on the rest of the world because nondivided exchanges means you export more and others export less.

So in that sense, I would argue that there is an even greater responsibility on an international institution to define rules for situations which have these spillover effects, and the IMF has been deficient on that score.

Steve Weisman: Bill, a final word?

Bill Cline: Just to point out that the IMF is now trying to make an effort to identify whether countries are overvalued or undervalued. They have came out with a thing called the Pilot External Sector Report. In some sense, I think they're trying to move in this direction and they do find that, for example, China is undervalued. But it's early days yet in that refinement of that process.

Arvind Subramanian: One last thing I want to say about the report is that I think the view in the IMF over the years —which has carried over into this report—is that it's a bit like saying—look, as Bill rightly said, it's not good to have controls everywhere in all times and all places, but—

Bill Cline: Openness.

Arvind Subramanian: Or openness and the converse that you shouldn't have controls indiscriminately. But the view has always been that if you have good institutions, then you can have openness. But it never goes so far as to say, "Well, if you don't have the prerequisites, then you should be entitled in post capital controls." They always say, "Well get your prerequisites in order and then you can enjoy the benefits of openness." So there is a subtle distinction which always kind of betrays the priors of even such august an institution as the IMF.

Steve Weisman: Thank you both very much.