



Full length article

Regulating capital flows in emerging markets: The IMF and the global financial crisis[☆]

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Abstract

In the wake of the financial crisis the International Monetary Fund (IMF) began to publicly express support for what have traditionally been referred to as ‘capital controls’. This paper empirically examines the extent to which the change in IMF discourse on these matters has resulted in significant changes in actual IMF policy advice. By creating and analyzing a database of IMF Article IV reports, we examine whether the financial crisis had an independent impact on IMF support for capital controls. We find that the IMF’s level of support for capital controls has increased as a result of the crisis and as the vulnerabilities associated with capital flows accentuate.

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1. Introduction

Sometimes financial crises make policy-makers stop and rethink whether they know what they think they know about how economies work and what the proper economic policy responses should be to prevent and mitigate such crises. Was this time different? It has been well established that the International Monetary Fund (IMF) was generally skeptical for the regulation of cross-border financial flows from the 1980s to the run up to the global financial crisis (Abdelal, 2007; Chweiroth, 2009; Moschella, 2010; Gallagher, 2015).

In the wake of the crisis the IMF surprised many observers by openly embracing capital controls to both prevent and mitigate financial crises. The IMF supported the use of capital controls on inflows in a number of countries such as Brazil and South Korea (Gallagher, 2015). Most surprising to many was the IMF’s outright advocacy for the use of capital controls on outflows in

Iceland as part of that country’s post crisis stand-by-agreement (Sigurgeirsdottir and Wade, 2015).

In some ways, advocating for the appropriate use of capital controls is new policy at the IMF. In 2012, the IMF adopted a ‘new institutional view’ on capital account liberalization and controls that states that capital account liberalization is not always optimal and that under certain conditions capital controls on inflows and outflows can be appropriate to prevent and mitigate financial instability (IMF, 2012). This shift has received a significant amount of attention, however there is yet to be a rigorous account of whether the IMF has put its new words into action. This paper sets out to do just that.

2. The IMF and the capital account: a literature review

A burgeoning literature has emerged on the role the crisis played in the shift of discourse at the IMF on this matter (Grabel, 2011; Chweiroth, 2013; Gallagher, 2015). It is clear that the crisis played an independent part in at least accelerating an incremental level of ideational change at the fund on this issue, though the seeds of change were planted after the wave of crises that ended the century. This paper takes such analyses one step further by analyzing the extent to which such changes in discourse related to the crisis were also associated with changes in official IMF advice on managing capital flows.

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A strand of theory in the international political economy literature postulates that during episodes of financial crises, firmly held ideas can be challenged by a rival set of ideas about how economies work and should be managed. Under the uncertainty that is rife in such episodes, certain key agents can be open to alternative ideas that help manage such uncertainty. The conduits for such change can be ‘norm entrepreneurs’ that cultivate ‘pervasive struggles’ to legitimize previously unaccepted views (Blyth, 2002; Seabrooke, 2007; Schmidt, 2008; Widmaier et al., 2007). In the global uncertainty following the global financial crisis a significant amount of research demonstrates that the IMF changed the way it talked about global capital flows and their benefits and risks.

In the 1990s the IMF underwent a paradigm shift and began to see capital account liberalization as an optimal policy for all countries, and thus saw capital controls as an inadvisable policy. Indeed, in the 1990s the IMF went so far as to introduce a formal change to its Articles of Agreement that would have mandated open capital accounts for its membership. As a result of the financial crises of the 1990s, and actions by the United States Congress, that proposal did not come to fruition. Subsequently, the IMF became more tolerant of the gradual liberalization of the capital account and of temporary, price-based capital controls as a last resort for emerging market and developing countries (Independent Evaluation Office, 2005; Abdelal, 2007; Chweroth, 2009; Moschella, 2010).

A significant shift in mainstream economic thinking regarding the regulation of capital flows occurred around the time of the crisis as well. Mainstream economic thought generally saw capital account liberalization as an optimal policy in the long run for all countries and saw the regulation of capital flows as inherently distortionary from that optimum. Certain strands of economics from the Keynes, Minsky, and Lewis traditions had long seen the regulation of capital as necessary for maintaining monetary policy autonomy, preventing financial fragility, and as levers for structural transformation. These perspectives had fallen out of the mainstream by the 1980s (Gallagher, 2015).

Around the time of the global financial crisis a consensus among mainstream began to emerge on both the theory and the econometric evidence related to capital account liberalization and the regulation of capital flows. A number of theorists began to question the extent to which capital account liberalization is optimal, especially in the presence of information externalities. According to this research, externalities are generated by capital flows because individual investors and borrowers do not know (or ignore) what the effects of their financial decisions will be on the level of financial stability in a particular nation. This is a classic market failure argument and calls for a Pigouvian tax that will correct for the market failure and make markets work more efficiently.

These theoretical breakthroughs were further substantiated given that the vast majority of econometric analyses of capital account liberalization find no rigorous link between capital account liberalization and growth in emerging market and developing countries. Indeed, the consensus is that liberalization is often linked to banking crises (Jeanne et al., 2012). Finally, meta-reviews of the literature on the effectiveness as capital controls

found that capital controls consistently had the desired effects of their policy-makers (Magud et al., 2011; Jeanne et al., 2012). An authoritative review of the literature on these matters concluded the following:

“The international community should not seek to promote totally free trade in assets—even over the long run—because (as we show in this book) free capital mobility seems to have little benefit in terms of long-run growth and because there is a good case to be made for prudential and other non-distortive capital controls.” (Jeanne et al., 2012: 5).

The IMF took an even larger step in accepting gradual capital account liberalization and the use of capital controls in the wake of the global financial crisis of 2008. First, it is important to note that the crisis was associated with significant surges and sudden stops in cross-border capital flows as Fig. 1 shows, there was a sudden stop in capital flows to emerging market and developing countries as a result of the crisis—with investors flocking to the ‘safety’ of industrialized markets.

However, as nations such as the United States engaged in expansionary monetary policy, investment again began to surge into emerging markets. It is under this turbulent period that then managing director Dominique Strauss Kahn ignited a sense of new thinking within the Fund in hopes that it would revive interest in the IMF, given that global regard for the institution had waned significantly. Norm entrepreneurs within the research department seized that moment and published articles that found that those countries that deployed capital controls going into the crisis were among the least hard hit (Ostry et al., 2010). These findings were supported and promoted by the managing director and led to an eventual official re-evaluation of the IMF position on capital account liberalization and capital controls.

This re-evaluation was hotly contested within the board of the IMF, with the BRICS countries leading efforts to grant the most policy space possible for emerging markets to regulate capital flows (Chweroth, 2014; Gallagher, 2015). In December 2012, IMF adopted a ‘New Institutional View’ on capital flow management (IMF, 2012). In the new view, the IMF now recognizes that capital flows carry risks and that the liberalization of capital flows before nations reach a certain threshold of financial and institutional development can accentuate those risks. The IMF also now acknowledges that under certain circumstances, cross-border capital flows should be regulated to avoid the worst effects of capital flow surges and sudden stops—and rebrands capital controls as ‘capital flow management measures’ (CFMs). These tenets were incorporated into a Staff Guidance note in 2013 and since that time are intended to guide official IMF policy advice on the matter (Gabel, 2011; Chweroth, 2014; Gallagher, 2015).

While there is an emerging literature on the extent to which the IMF has changed its policy and discourse with respect to managing capital flows, there is yet systematic research that quantitatively examines the extent to which the IMF has actually changed its policy advice. There is a significant literature that attempts to quantify the extent to which the IMF has changed its behavior in other issues. Vreeland (2003), Pop-Eleches (2008), Thacker (1999), Bird and Rowlands (2009), and Presbitero and Zazzaro (2012) have all examined the quantitative determinants

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