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Evaluating the Implementation of the IMF's Institutional View on Capital Flows

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ABSTRACT

The International Monetary Fund (IMF) Institutional View on *The Liberalization and Management of Capital Flows (IV)*, formally adopted in 2012, marked a significant shift in the Fund's official position on capital account liberalization by expressing support for capital flow management measures (CFMs) under certain circumstances. Through a content analysis of the IMF surveillance documents between 2004 and 2012 as well as 2013 and 2019, before and after the IV was operationalized, this paper examines the impact of the IV on the frequency of country-level discussions and advice on measures related to CFMs. Results highlight that, while overall countries experienced less capital flow volatility in the years after the IV, there was a slight increase in discussions of CFMs. Still, its application is uneven amongst the membership, with capital flow volatility experienced by specific countries not predicting a higher frequency of discussions on CFMs in Article IV Country reports assessments.

Keywords: Capital controls, International Monetary Fund, Capital Flow Management Measures, Content analysis

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INTRODUCTION

The onset of the COVID-19 pandemic triggered a sudden reversal in global capital flows, compounding the fallout from the pandemic for emerging market and developing economies. Between mid-January and mid-March 2020 alone, the Organization for Economic Co-operation and Development (OECD) estimated outflows from these countries at $103 billion (OECD 2020). The consequences of such sudden stops or flight of capital can be severe, including exchange rate depreciation, increasing debt levels, tighter financial conditions, a decline in asset prices, falling investment and a reduction in aggregate demand (Calvo 1998; Eichengreen and Gupta 2016; Ocampo 2017).

COVID-19 is just the latest episode of capital volatility that countries have experienced since the Global Financial Crisis. The 2013 Taper Tantrum triggered by the US Federal Reserve reversing its accommodative monetary stance, the 2015 Chinese stock market sell-off and a broad sell-off of emerging market assets in 2018 all injected volatility into the global economy (Batini, Borensztein and Ocampo 2020; Reinhart, Reinhart and Trebesch 2020; OECD 2020). Now, as countries work to recover and rebuild from the pandemic, there has been a reemergence in the discussion of capital controls as an effective tool for a country to establish financial stability, and the International Monetary Fund (IMF) is revisiting its Institutional View (IV) on capital flows in mid-March 2022.

Prior to the Global Financial Crisis, the mainstream economic consensus within the IMF and economic literature favored capital flow liberalization and opposed capital controls. This consensus began to shift in the aftermath of the 2007-08 financial crisis (Gallagher 2015; Gallagher and Tian 2017). IMF research recognized the merits of capital controls in the crisis response and showed countries that implemented them were the least affected (Ostry et al. 2010). A synthesis of advances in the literature, published in an IMF journal, finds prudential capital controls to be a desirable policy since individual investors are focused on their returns and not overall financial stability (Korinek 2011). A 2012 meta-review of the econometric analysis found no link between capital account liberalization and growth, recognizing their effectiveness in promoting stability (Jeanne, Subramanian and Williamson 2012). The advancement of economic theory around the issue of capital controls is also corroborated by a survey of the literature from Erten, Korinek and Ocampo (2021).

The departure from viewing a fully open capital account as an optimal policy culminated in the IMF adopting its IV on "The *Liberalization and Management of Capital Flows"* in 2012 that recognized the merits of capital controls, now rebranded as capital flow management measures (CFMs), as a policy response in certain circumstances (IMF 2012), but stopped short of a full endorsement.

After implementing the IV, several IMF documents have examined how advice aligns with it through case studies and analysis of advice given to specific countries in this area (IMF 2016, 2018, 2020). However, there has been no robust analysis of the scale at which CFMs are discussed among its entire membership as a policy tool and what country level circumstances prompt the considerations outlined in the IV.

To that end, this paper evaluates IMF Article IV consultations, the assessments conducted for member countries on an almost yearly basis to identify risks and make policy recommendations, to examine whether the IV is consistently implemented by IMF staff when discussing issues around capital flows. It analyzes the frequency with which IMF staff assess CFMs as a policy tool, taking into account capital account volatility experienced by each country.

The IMF's Institutional View: Adoption and Implementation

Throughout the 1980s and 1990s, as documented by Joyce and Noy (2008), the IMF was one of the leading promoters of capital account liberalization. Countries with an IMF program were significantly more likely to open their capital accounts. At the time, the IMF argued that capital controls "harm economic performance, create severe distortions and delay policy adjustments needed to eliminate the balance of payments disequilibria" (Chwieroth 2010). These perspectives were consistent with the mainstream view on capital controls amongst economists at the time (Gallagher 2015).

In the 1990s, the IMF attempted to push for an amendment to its Articles of Agreement to mandate an open capital account as a condition for membership. This would have resulted in a revision of the IMF Articles of Agreement that, in their current form, explicitly allow countries the use of capital controls if deemed necessary. According to an IMF staff report, "the impetus for such liberalization was largely provided by the frameworks of the OECD Code and the European Union Directives" (Evens and Quirk 1995). The proposal faced opposition and never materialized, as events such as the Asian Financial Crisis shed light on the relationship between capital account liberalization and financial instability (IEO 2005).

The adoption of the IV in 2012 marked a significant departure for the IMF from this stance stance on the use of CFMs. The IV put in place a framework for more consistent advice and assessments on the risks related to capital account liberalizations and the need for CFMs. The IMF put forth a set of circumstances that warrant the introduction of CFMs, which are still mostly considered a temporary measure to respond to a crisis or buy time to implement other types of adjustments. CFMs are also recommended when sudden inflows or outflows pose challenges to financial stability. The IV states other macroprudential measures should take precedence over CFMs that must not be used to avoid adjustments.

The first Guidance Note for staff on implementing the IV was published in 2013 and instructed staff to "take account of capital flows, particularly their size and sustainability" and "discuss this development and policies" when such flows significantly impact domestic or balance of payment stability (IMF 2013). Since the IV was adopted, the IMF has conducted several evaluations on its implementation, mainly focusing on the consistency of advice and discussion around CFMs received by countries (IMF 2020, 2018).

In 2015, an update to the Guidance Note was released, clarifying that even in disruptive outflows or volatility, CFMs should only be used if a crisis is eminent (IMF 2015). Some examples of the IMF endorsing and advising the use of capital controls are in Iceland, where a set of policies were implemented during an IMF program, and in Brazil, wherein the IMF stated that CFMs have helped manage cyclical capital flow pressures and avoided extreme volatility in the exchange rate (IMF 2008, 2012).

The IMF's Internal Evaluation Office (IEO) released the most comprehensive review in 2020 containing 28 country case studies. The IEO's report praised the IV as a milestone but expressed concerns that the IMF's actions on CFMs remained relatively timid and restrictive. The IEO recommended CFMs be used more proactively and be more permanent rather than a temporary last resort action. They also noted that the Fund's IV position on CFMs as a crisis measure only did "not seem justified in light of recent theoretical work and lack of firm empirical support." However, the IEO does not address the issue of when, for what countries and under what circumstances are CFMs discussed, and if the consistency extends to discussing capital flows for all members that experience capital account volatility.

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DATA AND METHODOLOGY

To assess the impact of the IV discussing the implications of capital account liberalization, capital flow volatility and considerations of CFMs, we perform a textual analysis of Article IVs between 2004 and 2019. The results are used to construct an index on the IMF and Capital Flow Management (CFM Index), comparing the attention received by these issues before and after the implementation of the IV. We then evaluate the results of the CFM Index against a benchmark that we establish to measure capital flow volatility.

Constructing the IMF Capital Flow Management Index

The Index is constructed based on searching for a corpus of terms related to CFMs through 1,828 IMF country reports published between January 1, 2004 and December 31, 2019. Twenty-five documents had an error and could not be analyzed. After generating our sample, we created the CFM Index for IMF Article IV documents. We follow the standard textual analysis methods deployed in papers, such as Mihalyi and Mate (2019); Ramos et al. (2021), Bloom et al. (2020) and Hollander et al. (2020). The methodology for creating the CFM Index has five steps:

- First, as is standard in the literature, we design a corpus of search terms. A corpus is a list of relevant words and synonyms about a particular topic. The corpus identified for this project is listed in Annex 1 and was drawn from IMF (2013) and bi-grams synonyms.
- Second, we calculate the frequency of search terms from the corpus as they appear in the Article IV reports from our sample. These search terms are bi-grams, two-word combinations or more such as capital control and capital flow management. We then calculate search term frequency per document. Annex 2 details these search terms and frequency per group.
- Third, we apply the Natural Language Toolkit (NLTK) library to remove "stop words" and screen out irrelevant words in each country report (Yogish et al. 2019). Stop words include articles, prepositions and pronouns that can be safely removed without sacrificing the sentence's meaning. We also excluded page numbers, web pages and emails.
- Fourth, to construct the CFM Index, we sum the number of occurrences of CFM-related search terms from the corpus in a particular document as a ratio of the total pool of words in each record.
- Fifth, we scale the calculation in Step 4 to an index that ranges from 0 to 1. A higher score reflects a higher level of attention to CFMs per publication in the sample over the specified period.

This analysis shows that the terms appear with the most frequencies for Iceland, South Africa and China. The disproportional number of times in the case of Iceland makes it a clear outlier; thus, we remove Iceland from the high-income country group and analyze it separately. Table 1 summarizes the results for the CFM Index per income group, before and after the 2012 Institutional View.

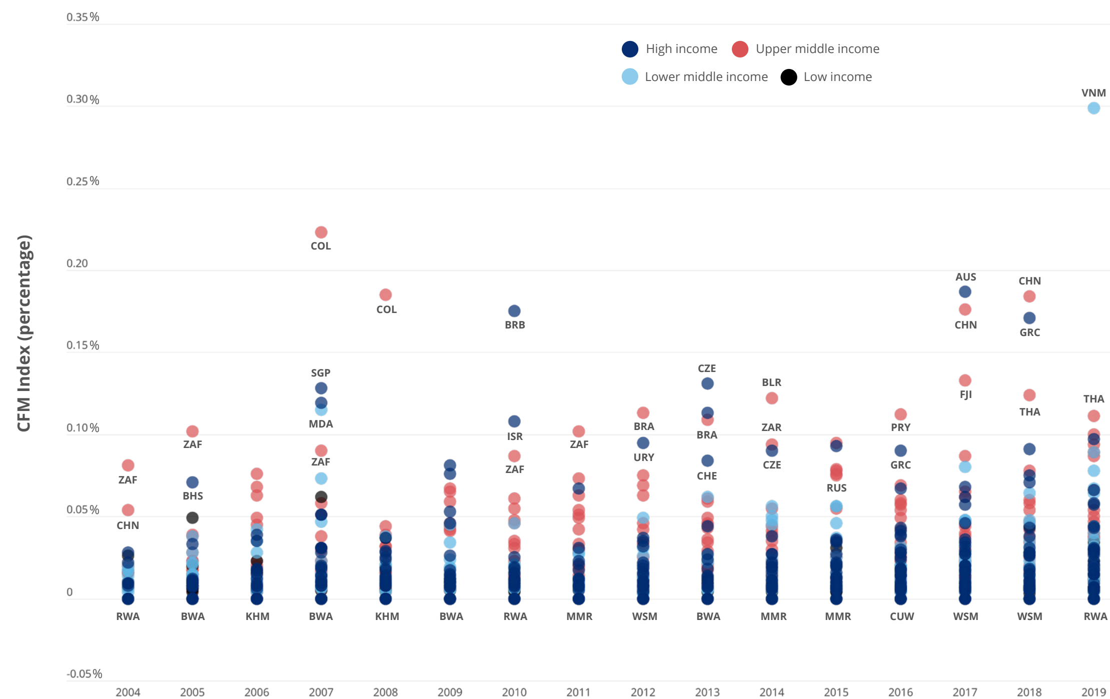
As illustrated in Table 1, the 2012 IV slightly impacted the IMF's engagement with issues around CFMs. We observe an increase in the average and median values for the CFM Index between these two periods in all income groups. However, there is also an increase in the standard deviations for each group, which means a greater dispersion and uneven discussions among individual country reports.

Table 1: CFM Index Scores in Percentage: Statistical Analysis by Income Group and Period

	High Income		High Income without Iceland		Upper-middle countries		Lower middle Income		Low income	
	2004-2012	2013-2019	2004-2012	2013-2019	2004-2012	2013-2019	2004-2012	2013-2019	2004-2012	2013-2019
Median	0.000%	0.007%	0.000%	0.007%	0.007%	0.012%	0.000%	0.006%	0.000%	0.004%
Average	0.009%	0.019%	0.008%	0.014%	0.017%	0.024%	0.007%	0.014%	0.005%	0.007%
STDEV	0.025%	0.046%	0.019%	0.024%	0.032%	0.028%	0.013%	0.027%	0.010%	0.010%

Source: Authors' own elaboration.

Figure 1: CFM Index from 2004-2019 by Country, without Iceland



Source: Authors' own elaboration.

Figure 1 shows the CFM Index scores for all countries by income groups. The greater dispersion between countries after the IV can also be observed here, with more countries registering values that distinguish them from other countries in their income group.

Proxy for the Financial Flows Volatility

Next, we look at whether the dispersion in the CFM Index results is related to the levels of capital account volatility experienced by individual countries. Large swings in cross-border capital flows can affect domestic stability, are a channel for transmitting shocks and spillovers among economies (European Central Bank 2016) and appear to be a significant "driver" of recessions in emerging markets (Canuto and Ghosh 2013). Following the IV, IMF staff were instructed to pay particular attention to cases where capital flow volatility poses risks to financial and balance-of-payment stability (IMF 2013).

To verify if this is the case, we estimate a volatility proxy based on the yearly variation of the standard deviation of the financial account. The results for this proxy, in each time period and by income group, are summarized in Table 2.

Table 2: Financial Account Volatility: Statistical Analysis by Income Group and Period

	High Income		High Income without Iceland		Upper-middle countries		Lower middle Income		Low income	
	2004-2012	2013-2019	2004-2012	2013-2019	2004-2012	2013-2019	2004-2012	2013-2019	2004-2012	2013-2019
Median	1.868	1.728	1.726	1.844	1.614	1.01	2.219	.923	3.743	.604
Average	3.362	2.816	2.789	3.257	13.349	6.017	6.342	1.875	3.756	1.442
STDEV	4.565	2.67	3.074	4.507	51.529	21.309	13.604	2.029	2.118	1.591

Source: Authors' own elaboration.

Overall, countries experienced less capital flow volatility between 2013 and 2019 compared to 2004 and 2012. The only exception is amongst high-income countries when Iceland is excluded, which experienced slightly more volatility in the latter period. At the country level, results show that Dominica and Tonga experienced the highest fluctuations in capital flows. Within Group of 20 (G20) countries, China, Russia and Turkey had the highest volatility.

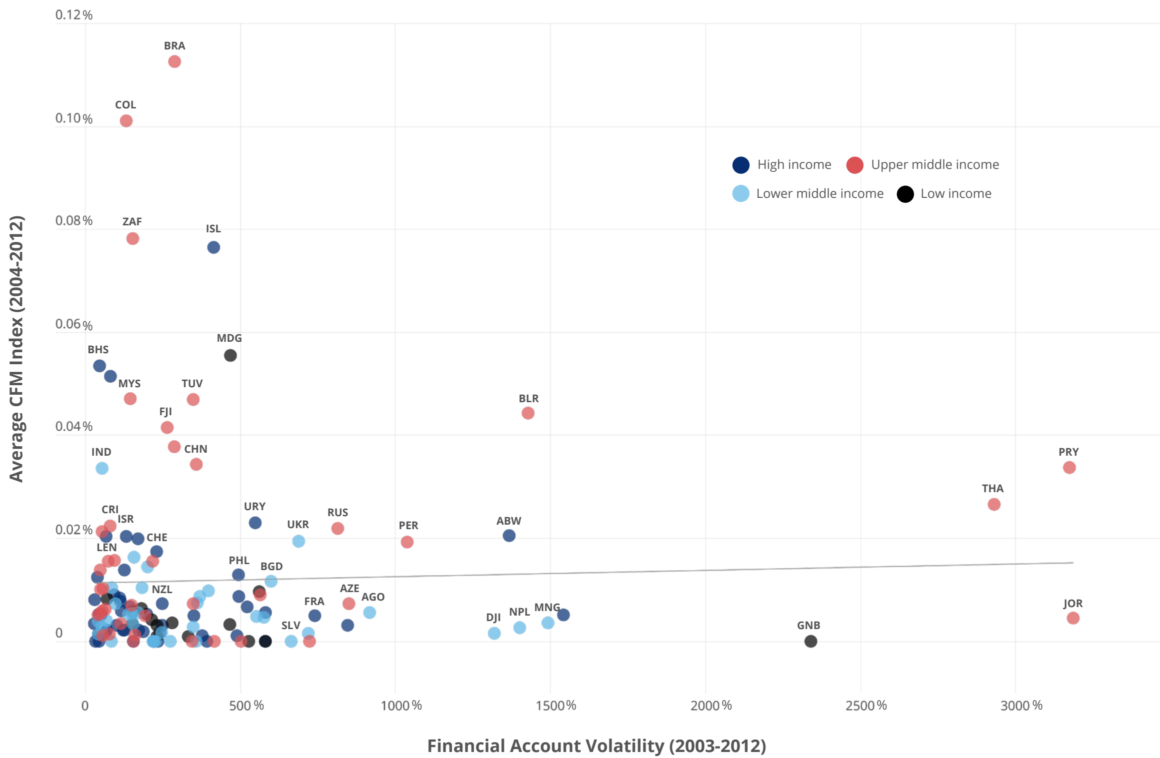
IMF CFM Index Against Volatility Benchmark

The next step is to compare the results of the CFM Index against the proxy for volatility to assess whether it explains the dispersion in results from the CFM Index. We compare the results pre-IV and after to see how the IV impacted attention paid to CFMs based on the volatility experienced by countries. The results are shown in Figures 2 and 3.

Both Figures 2 and 3 illustrate that capital flow volatility experienced by countries is not a good predictor of whether IMF staff will assess and discuss policies around capital flows in country reports. Looking at Figure 3, it becomes clear that even after the IV instructed staff to pay attention to risks surrounding capital flows, in some countries that experienced a high level of volatility, such as St. Lucia, Hungry, Poland and Finland, CFMs were not discussed.

This comparison shows that while in the aftermath of the IV, overall discussions around CFMs increased, the application of the IV was uneven and not based on the risks and circumstances of specific countries.

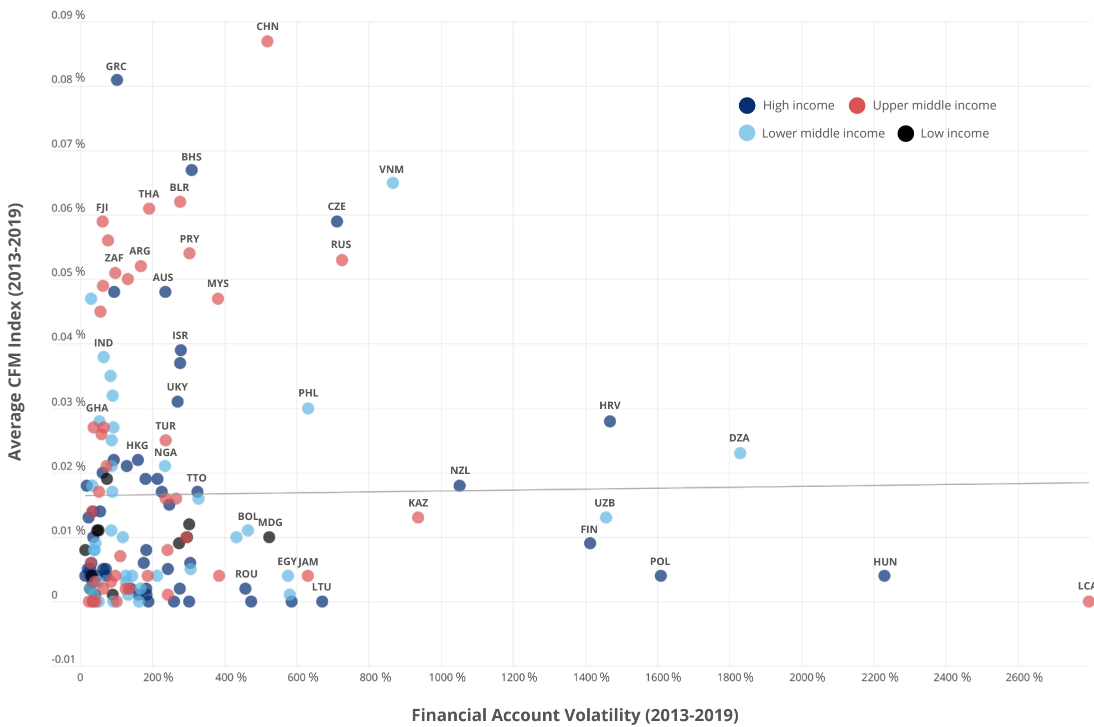
Figure 2: Financial Account Volatility versus CFM Index Average before Institutional View[1]



Source: Authors' own elaboration.

[1]Benin, Tonga and Sri Lanka were outliers excluded from the visualization.

Figure 3: Financial Account Volatility versus CFM Index Average after Institutional View[2]



Source: Authors' own elaboration.

[2]Dominica and Iceland were outliers excluded from the visualization.

CONCLUSION

This paper addressed the consistency with which the IMF followed the guidance of its 2012 IV on capital flow management when looking at the advice given to its entire membership. While assessments from the IMF have found that advice on CFMs was mostly consistent with the IV, our findings demonstrate that there is still a large discrepancy among members when it comes to whether the merits of CFMs are discussed at all within individual member states. Many countries that face significant capital flow volatility risks were systematically ignored, with little or no discussion around policy tools available to address that volatility.

The analysis in this paper was limited to the frequency and scale with which the IMF discussed issues around CFMs following the IV, without evaluating the type of advice given to countries. Nonetheless, as noted by the IEO's evaluation on the IV implementation, the IMF should reassess the framework and advice beyond implementation issues and update it to incorporate mounting evidence on the benefits of CFMs as a precautionary measure and outside the context of crisis (IEO 2020).

As the IMF prepares an update of its overall guidance on surveillance in general and the IV in particular, it must include clear guidance on this matter. The IMF must reassess both the recommendations on CFMs from the IV and introduce clear criteria to ensure the view is mainstreamed by IMF staff and evenly implemented across all countries.

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ANNEX 1

Table 1A: Capital Flow Management Corpus

capital account control; capital account management; capital account regulation; capital account restriction; capital control; capital flow control; capital flow management; cfm, capital flow restriction; capital management technique; capital regulation; capital restriction; contain capital; contain outflow; controls on capital account; controls on capital flow; controls on inflow; controls on outflow; controls over capital; exchange control; foreign currency regulation; forex regulation; fx intervention; foreign exchange intervention; FX-related prudential measure; limit capital; limit inflow; limit outflow; limits on capital; limits on outflow; manage capital flow; manage capital inflow; manage inflow; manage volatile capital flow; management of capital; discouragement to capital; discourage capital; restrictions on capital; inhibit capital; targets a capital; reducing capital; reducing inflow; reducing outflow; reduce capital flow; reduce inflow; reduce outflow; managing capital flow; managing capital inflow; managing capital outflow; managing inflow; managing volatile capital flow; outflow control; outflow restriction; regulate capital; regulation of FX transaction; restrict capital; restriction on capital

Source: Authors' own elaboration.

ANNEX 2

Table 2A: Top-20 Most Mentioned Search-term per group

Search Term	Emerging	Other	Total
fx intervention	227	559	786
capital control	230	517	747
cfm	154	520	674
foreign exchange intervention	185	460	645
exchange control	127	231	358
capital flow management	96	135	231
restrictions on capital	14	48	62
capital account restriction	10	31	41
management of capital	10	30	40
capital regulation	7	33	40
reducing capital	6	28	34
foreign currency regulation	5	29	34
limit capital	9	14	23
reduce capital flow	6	11	17
managing capital flow	12	3	15
managing capital inflow	7	4	11
contain capital	1	9	10
outflow control	1	7	8
manage capital inflow	5	2	7
discourage capital	1	6	7

Source: Authors' own elaboration.

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