“Capital Flows Management Measures and Systemic Risk”

<u>Transcript of the comments by Paulo Nogueira Batista, Executive Director Brazil, International Monetary Fund</u>

IMF debates on capital account management: an insider’s account

Thank you Stephany, let me first of all thank CAFRAL and IPD for inviting me to participate in this conference. It is a pleasure to be here in this panel chaired by Stephany with Kevin Gallagher, Jose Antonio and Yu Yongding. It is the first time that I come to India, but I have, since I joined the IMF Executive Board in 2007, worked quite closely with a number of Indian officials not only in the IMF itself but in the context of the G20 and BRICS. I have come to admire the competence and the seriousness with which Indian officials have contributed to the discussions in recent years.

I think the most useful contribution I can perhaps make in this discussion is to present to you what I could call an insider’s view of the evolution of the debate on capital account issues and capital account management in the IMF. At the outset I must say that although I am an IMF official, Executive Director for Brazil and ten other countries, I speak on my own behalf and neither on behalf of the IMF nor the countries that have elected me to the Board as their Executive Director.

Well, the IMF assessment on capital flows and capital flow measures has undoubtedly evolved considerably since the crisis, since 2008. A number of you will remember that not so long ago, in the late 1990s, the US together with other advanced countries was spearheading an effort in the Fund to promote full capital account convertibility as an obligation of IMF members. This would have involved an amendment to the Articles of Agreement, requiring a supermajority of 85 per cent of weighted voting power. In the end, this effort that seemed quite strong at the time was aborted by the East Asian crisis in 1997. Fifteen years later, the IMF recognized, as was mentioned by Stephany, that capital flow measures including capital controls can be useful in certain circumstances. I will try to explain to you why I think that this is not as big a change as it may seem. We did not have a sea change but some adaptations.

The revision started in 2010, some two years after the crisis broke out in the US and Western Europe. Between the end of 2010 and the end of 2012, there were a series of papers prepared by staff for the Executive Board’s discussions. I must tell you that these discussions were often marked by controversies and even acrimonious; sometimes the Directors from emerging markets felt that they were being railroaded by the Fund’s Management. We had suspicions about what the true intentions of these discussions were. Was the intention to gradually extend the IMF’s jurisdiction to the capital account under the pretext of endorsing the resort to capital account management in limited circumstances? We tried to bend the debates our way, discussions were sometimes very unpleasant --- something, by the way, you cannot perceive by looking at the documents because everything that comes out of the Fund is carefully doctored to moderate the extent to which internal controversies and disagreements are portrayed. I don't think this is good practice on the part of Fund because it does not give the outside world an idea of the extent to which debates occur in fact in the institution. Nevertheless, that is the culture of the institution, it is very difficult to modify. In any case, these discussions led in the end, towards the end of 2012, to the approval by the Board of an institutional view on capital account liberalization and management.

After this institutional view was published, Paul Krugman, for example, came out with a comment saying that he found that the IMF had shown surprising intellectual flexibility, and even Stephany yesterday when she was presenting me to an Indian colleague told her that I have been working very hard to get capital controls accepted in the Fund again, with some success she said. I wonder how much success I did have. You know, when I hear these positive assessments as we heard this morning from Joseph Stiglitz and my friend Stephany on the evolution of the Fund, I sometimes think, well is that really true? When I hear from inside the Fund, outside assessments of what we have done, of things I participated directly in, I sometimes feel a certain disconnect between what people are saying and what I believe really happened. It reminds me of something that happened to AJP Taylor, the British historian. He was once giving a conference on some intricate, delicate diplomatic crisis that occurred if I remember correctly in the run up to the first world war, and in the audience there was a high level official who had intensely and directly participated in that diplomatic crisis. After the talk was over he came to AJP Taylor and said: "Congratulations, I had never realized that it had been quite like that". That is how I sometimes feel when I hear about the Fund, outside the Fund. But any way, I do not want to be too pessimistic.

I think what is clear, to me at least, is that no change in the Fund would have happened without the international financial crisis. It really shook up the status quo in many areas of the world. It's what Rakesh Mohan appropriately prefers to call --- Rakesh Mohan is my Indian colleague on the Board of the IMF ---, the North Atlantic financial crisis. I very much doubt whether any change in the IMF's stance would have been possible without this crisis. Not only on this matter, also, for example, on fiscal policy, or on the creation of the Flexible Credit Line in 2009 without ex-post conditionality or on the changes that did occur in terms of distribution of voting power, limited but not irrelevant --- all this was very much the product of the extraordinary crisis. Now, I should also mention the role of some persons, for example, of Olivier Blanchard and the research department of the Fund in this discussion on capital flows, and the role of emerging market chairs. I would say, if you allow me to be a little immodest, notably the Indian and Brazilian chairs; in the capital account management discussion, we had to grapple with considerable resistance to change and intellectual inflexibility on the part of departments of the Fund and from advanced country chairs, especially the US and European chairs. The US plus Europe, Japan and Canada have more than 50 per cent of the voting power in the skewed distribution of votes in the institution. And, under the rules, something like the institutional view, provided that it does not involve an amendment to the Articles of Agreement, can be approved by a simple majority of weighted voting power. So this whole discussion was carried out in the shadow of this skewed distribution of voting power. And, I believe that if you look at the results carefully, you notice it. That is why I am a bit reluctant to exaggerate what we managed to achieve. The basic reason for my dissatisfaction with what we achieved, and I will try to summarize the institutional view later on, is that in my opinion we cannot settle for partial adaptations. Given the extent of the damage that has been inflicted on several economies by large and volatile capital movements, a more fundamental revision is required.

But, of course the dark age, let's say, has passed. When I arrived in the Fund in 2007 and even later up to more or less 2009, the views in the institution on capital account flows and policies were remarkably simplistic. For countries facing large inflows, the IMF's mantra up to 2009 amounted to essentially two things. First, adopt a contractionary fiscal policy, and second allow your exchange rate to appreciate. That was basically it. Even international reserve accumulation was frowned upon. Needless to say, this sort of recommendation was not persuasive for emerging market countries that had ample experience with massive international capital inflows, exchange rate overvaluation, high current account deficits and sudden reversals of flows. We were fully aware of the fact that fiscal policy was too slow to respond to large and volatile and capital movements, that it is a clumsy instrument to deploy against fast moving capital flows. It is always subject to political constraints and depends largely on legislative approvals. In short, until recently, until about 3 years ago, what the IMF had to offer on this topic was meagre and of doubtful value to countries facing challenges associated with large and unstable flows.

Well compared to this rather low pre-crisis standard, the new institutional view represents some progress. For example, measures on inflows and outflows are now seen as advisable in certain circumstances, and the institutional view of the IMF explicitly states that there is no presumption that full capital account liberalization is an appropriate goal for all countries at all times. I think that's quite a significant step forward. Observe that the IMF also recognizes controls on outflows as potentially important in a crisis situation, in crisis prevention and in crisis management. This recognition was encouraged by the Fund's experience since 2008 with Iceland for example, an advanced country, that under a Fund supported program used controls on outflows extensively, and quite successfully, I would say. Ironically the experience of Iceland, an economy that was considered in the past a model of the benefits of liberalization, is now used by the Fund as a reference for the benefits of control of outflows.

This is pretty much as far as the Fund's intellectual flexibility goes. The recognition of the role of capital account management is qualified by a number of statements that effectively downplay the role that these measures can have. For example, capital flow measures are referred to as temporary, implying that they should be used for short periods. They are also presented as mere complements to macroeconomic policies, the ones that should play the key role, according to the IMF. Capital flow measures can be useful, according to the institutional view, provided they are not substitutes for warranted economic adjustments. These papers are available in the Fund's website; many of you have examined them. If you go through them, you will perhaps notice that the IMF's approach suffers from lack of balance in at least three major respects.

First, the Fund emphasizes the benefits of capital flows for recipient countries, with insufficient consideration of their costs and risks. Whatever recognition of cost and risks you do find in the institutional view was inserted mostly after great insistence from some emerging market directors in the teeth of heavy resistance. Second, the institutional view of the Fund has a focus on recipient countries with much less attention to source countries; the so-called push factors are not sufficiently dealt with, in my opinion. Third, there is a lingering overall bias against capital flow measures, especially capital controls. They are admitted in the tool kit, so to speak, but with many hesitations and restrictions.

So allow me to address briefly these three shortcomings. First, on benefits versus costs of capital flows. IMF staff has recognized that empirical evidence on the benefits and costs of liberalization of capital movements is mixed --- and indeed this morning I believe some of the papers that recognize this were mentioned. Indeed, many studies do not find a positive relation between capital account liberalization and growth. But this is not completely reflected in the Fund's institutional view. The prominence given to capital flow liberalization is, I believe, symptomatic of a pro-liberalization bias that still prevails in the Fund and is very much a part of the institution's culture and basic mind set. I believe that the on-going crisis has yet to have a full impact on the way the IMF perceives these issues. The destruction that large and volatile capital flows can cause to recipient countries has not been fully factored in, and yet the experiences of, for example, emerging markets in eastern Europe and Iceland, in the run up to the crisis are glaring examples of the risks associated with capital flows as well as the need for capital flow management. In the Euro area, Spain, Cyprus, Ireland are also striking illustrations of the dangers and destruction that can result from large scale and unrestricted capital movements and oversized financial institutions that are too big to manage and too big to save.

The second shortcoming or imbalance of the view of the Fund comes from the fact that the institution is reluctant, for political economy reasons that you can readily imagine, to explore the effects of advanced country policies on capital flows, so-called push factors. The supply side is down played; there is a lack of even-handedness. If you go to the documents, what recommendations do you find for the countries that are sources of capital flows? You will see that they are rather vague. The IMF, I think, mostly tends to underestimate the responsibility of major advanced countries for destabilizing surges in capital flows. During the discussions I often approached the Management of the Fund and asked them: "Where is the institutional view for the source countries?". The focus is still mostly on recipient countries and mostly on emerging markets that are recipient countries. I will give you another example: the discussion of global liquidity and global liquidity indicators. Despite repeated calls from many quarters to have more work on this, little progress has been made. You can imagine why. The US and other advanced economies are dead set against deepening this discussion.

Lastly, the institutional view of the Fund shows an unjustified preference for capital flow measures that treat residents and non-residents uniformly. This relates to a point that Stiglitz was making this morning. One of the key elements of this institutional view is a recommendation to avoid capital flow measures based on residency, usually referred to as capital controls. There is however considerable research that shows that the behaviour of residents and non-residents is systematically different, a point that also Amar Bhattacharya has often made. If that is true, country authorities would be well advised to distinguish between the two groups, residents and non-residents, when designing, when defining their capital account policies. More broadly, the institutional view still carries a considerable amount of negative references to capital account management. I believe that this is not necessarily because the IMF staff believes fully in this, but perhaps because they feel the need to cater to the preconceptions and prejudices of the major shareholders. In any case, they are there. Numerous caveats qualifying or restricting the use of capital flow measures have the effect of downplaying their role. For example, repeated use of words like “short term measures” or “temporary measures” conveys the impression that we should apply them only for short periods, but you know, in practice, temporary may mean several years. To mention Iceland again: wide ranging capital controls were instituted in late 2008 and they are still largely in place, though so many years have gone by. Moreover, the use of the “temporary” or “short-term” ignores another dimension of the problem: countries, in my opinion, are well advised to have CFMs as permanent instruments in their frameworks. This is the case of Brazil, for example. Brazil has a regulatory tax on financial operations. It is a permanent component of the tax system and can be used by executive order at varying rates and incidences to regulate capital movements. And indeed this was a major instrument used by Brazil in recent years to control capital inflows.

In conclusion, let me say that after almost 7 years in the Fund, I could not fail to notice that the institution is often eager to carve roles for itself. I think this is typical of international bureaucracies. And this tendency to seek roles/carve roles is sometimes leading to the adoption of normative approaches that are premature or half baked. The Fund wishes to advise countries on how to liberalise and how to manage capital flows. However, the institution’s track record, knowledge and expertise are often insufficient for that purpose.

One should not lose sight of the fact that the IMF’s credibility has been tarnished over the last decade by its propensity to endorse or encourage capital account liberalisation, and this makes the institution co-responsible for many crises triggered by large and unstable capital flows. So the IMF should have been, I believe, in a learning mode, instead of offering institutional views/advice; the Fund could benefit more from the humility that was called for this morning for our conference and listen to policymakers, listen to financial sector practitioners, who are often better placed to understand capital flows and capital flow measures in a complex financial environment. Again, there has been some progress compared to previous work. I do not deny that progress occurred, and I would not be inclined to do so because we did make a substantial effort in the Fund to produce something. But I think it is fair to say that the IMF has so far has failed to deliver convincing results. In the last Executive Board discussion on this matter, in late 2012, I stated that I was not ready to endorse the institutional view as it stood. I hope that further work and revisions and deeper analysis will lead to a more balanced approach. And I hope that we won’t be needing another large scale international financial crisis to make more progress. Thank you.