Capital Account Liberalization and the Fund[1]
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It is a pleasure to be here for this seminar on the International Monetary Fund and capital account liberalization. The issue is an oldy but a goody. When I was Senior Policy Advisor at the Fund in 1998, I was already asked to author a paper on theoretical and practical aspects of this issue for the Executive Board. Seven years later, the questions remain the same. But those questions are especially timely now, since we are in the tightening phase of the financial cycle. After a long period of low interest rates, the ECB has joined the Fed in tightening, and the Bank of Japan has signaled its intention of doing likewise as soon as it is convinced that Japan has finally exited from deflation. We know that increases in interest rates in the financial centers can create problems for capital flows to emerging markets. The question is whether emerging markets are suitably prepared, whether the IMF is suitably prepared, and whether the Fund is giving and taking suitable advice on how to manage the associated problems.

The fact that we are still discussing these issues nearly a decade after the Asian crisis, which was the event that brought the dilemmas of capital account liberalization to head, might be taken as a sign of lack of intellectual progress. It is tempting to read the report of the Independent Evaluation Office this way.[2] When you turn to recommendations, it says two things. First, "There is a need for clarity on the IMF's approach to capital account issues…The place of capital account issues in IMF surveillance could be clarified." Second, "The IMF's analysis and surveillance should give greater attention to the supply side factors of international capital flows and what can be done to minimize the volatility of capital movements." This is not very helpful. Saying that more clarity is required without being specific about exactly what advice should be conveyed is not an operational guide to policy. Saying that it would be nice were capital flows less volatile is similarly not very helpful in the absence of concrete initiatives to help bring this about.

A more charitable assessment is that this ambiguity reflects an important reality about which there has been a good deal of learning in the course of the last decade. This reality is that capital account liberalization is a particular aspect of the larger process of economic and financial development. We have learned that the regulation of capital flows in and out of a country is only one aspect of the larger task of economic and financial regulation, and that the regulation of financial markets is only one part of the broader process of economic and financial development. Capital account liberalization can occur naturally in the course of economic and financial development. The most obvious indication of this is that all of today's advanced economies have open capital accounts. But premature capital account liberalization, initiated before the development of domestic financial markets is sufficiently advanced, can be dangerous and

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[2] IMF (2005).

counterproductive. Because financial development is complex, policy toward the capital account is complex. Inevitably, the search for simple answers will be frustrated.

From this flow four additional points.

- First, capital account liberalization is a continuous process rather than a dichotomous, on-off variable. It is likely to be gradual because financial development is likely to be gradual. The relaxation of prohibitions on capital flows in and out of a country should probably start relatively early in the development process, but full capital account convertibility should only come relatively late.

- Second, because the development of financial markets proceeds differently in different countries, one-size-fits-all advice regarding capital account liberalization is unlikely to be productive. In some countries financial markets develop early in the industrialization process, while in other countries they emerge only toward its end. In some countries financial markets are bank based, while in others they are more heavily market led. Given this heterogeneity, it would be imprudent to attempt to apply to all these cases the same advice regarding the structure and sequencing of policies toward the capital account.

- Third, these observations do not relieve the IMF of the need to develop a coherent approach to the problem. What is needed is a taxonomy of cases – say, six paths to financial development – and six corresponding sets of policy recommendations for managing capital account liberalization.

- Fourth, the IMF's advice regarding capital account liberalization should be integrated with its advice on financial and economic development more generally. One of the lessons of the Asian crisis is that the Fund needs to worry about prudential supervision, corporate governance, and all the other institutional arrangements that influence the stability and efficiency of the financial sector. This implies a broad agenda for IMF surveillance. It is important to acknowledge that this is incompatible with "Kohler-nomics."[3] In other words, there is no way around the fact that the IMF will become involved in a wide range of issues related to the development and governance of financial markets. Unavoidably, therefore, IMF surveillance and conditionality will be invasive. The Fund cannot avoid recommending to countries how to regulate their financial markets, reform their bankruptcy and insolvency codes, strengthen their corporate governance, and so forth. Inevitably, this means meddling in a variety of delicate national decisions about the design of social institutions. And in turn, for this kind of socially invasive policy advice to be politically acceptable, the entity extending it must be adequately accountable to its members. So the debate over capital account liberalization leads, as all roads seem to do these days, to the need to reform governance and representation in the Fund.

[3] That is, with Horst Kohler's vision of a focused Fund that concentrates narrowly on monetary and fiscal polices.

It is a common observation that the success of the IMF is not related to the institution's success in reinventing itself – in adapting its mission to changing circumstances. When the institution was created in 1944, not just international capital flows but financial markets generally were heavily regulated and controlled. Exchange rates, on which IMF surveillance focused, were mainly driven by trade flows and official finance. It followed that the Fund could maintain a posture of studied indifference toward liberalization of capital accounts. With the deregulation of domestic financial markets and transactions in member countries in the second half of the 20th century, there then arose a tension between inherited attitudes toward capital account management and new economic and financial realities. The IMF's ambiguous attitude toward the merits of capital account liberalization is indicative of this fact. In the 1990s Michel Camdessus, a smart man who was also an ambitious bureaucrat, saw making the pursuit of capital account liberalization a mandate of the Fund as a way of raising the profile of the institution. He saw amending the Articles of Agreement to make capital account convertibility an obligation of IMF members as a way of giving the Fund more oversight over international capital markets and thus as a way of reinventing the institution for the 21st century.

These bureaucratic ambitions help to explain a fact that would otherwise be hard to understand given the historical context, namely that the IMF was quite gung ho on capital account liberalization in the first half of the 1990s. Here I think the report of the Independent Evaluation Office leaves something of a misimpression. It argues that IMF advice regarding capital account liberalization was always nuanced. Fund staff and management always understood, it tells us, that capital account liberalization was a two-edged sword. Perhaps so, but it remains my impression that these nuances largely dropped from sight in the mid-1990s.

Why then was this the case?

- One reason was political expediency. As I have just argued, pushing for capital account liberalization was a way of expanding the political and bureaucratic mandate of the Fund.

- Another reason was that emerging markets, in Latin America and the former Eastern bloc in particular, were just emerging from a period when their economies had been heavily regulated and distorted. This created an instinctual tendency on the part of economists to carry over to financial markets about the merits of liberalization that were so obviously valid for product and labor markets and to overlook the greater prevalence of information asymmetries in the financial sphere.

- Third, there was the Treasury-Wall Street complex. In the mid-1990s, not only the IMF but also the U.S. Treasury under Robert Rubin pushed with excessive

> zeal for capital account liberalization.[4] I interpret this as policy informed by "the view from Wall Street." Individuals responsible for helping to shape IMF policy in the U.S. government, the Fund's single most influential shareholder, saw financial markets as part of the solution, not part of the problem. They didn't necessarily believe that the markets always got it right – so Mr. Rubin emphasizes in his book.[5] They didn't push mindlessly for capital account liberalization. Still, their background and familiarity with the markets may have led high U.S. and perhaps also IMF officials to push with excessive enthusiasm for the removal of capital controls.

There has been progress subsequently – more perhaps in the corridors of the IMF than the U.S. Treasury. We see this in the advice currently being tendered to China. The U.S. Treasury continues to press China to liberalize its capital account, although whether it is doing so in order to facilitate the access of U.S. banks into the Chinese market or in the belief that opening the capital account will facilitate the flow of capital into the country and intensify the pressure for revaluation of the renminbi is unclear. In contrast, IMF advice has been broadly sensible. A recent paper by Eswar Prasad, the Fund's chief economist for China, and colleagues on the sequencing of capital account liberalization and exchange rate flexibilization in China argues, quite rightly, that China should slow capital account liberalization until it makes further progress in strengthening its financial markets and moving toward a more flexible exchange rate.[6] This is the right advice. It is confirmation that the IMF is a learning institution.

Indeed, the Chinese authorities are much in need of sensible advice. They argue that they cannot move to a significantly more flexible exchange rate until they have made more progress in liberalizing the capital account. In fact, this is exactly the wrong way of thinking about the problem. A pegged exchange rate and an open capital account are an explosive combination – together they are a recipe for disaster. Countries need to move first to a more flexible exchange rate in order to introduce two-way bets into financial markets and avoid being overwhelmed by one-way flows. As it continues opening the capital account while maintaining what is in practice a relatively rigid exchange rate, China is exposing itself to precisely this danger. In any case, it is not necessary to have a fully open capital account in order to have a more flexible exchange rate. India has a more flexible exchange rate despite its maintenance of significant capital controls. Brazil has a more flexible exchange rate despite the fact that it still has significant restrictions on capital flows. What these countries have in comparison with China are stronger banking and financial systems. In other words, what China needs in order to be able to operate a more flexible exchange rate is stronger domestic financial markets, not a more open capital account. These are different things. Here IMF advice is right on the mark.

Let me conclude by reiterating and elaborating three points that I alluded to at the beginning.

[4] For discussion, see DeLong and Eichengreen (2002).
[5] See Rubin (2004).
[6] See Prasad, Rumbaugh and Wang (2005).

First, there is still a need for good ideas for regulating the supply side of international capital markets. All of the problems having to do with the operation of international capital markets are not created by borrowing countries. Capital flows remain disturbingly procyclical. In good times, emerging markets are swamped with liquidity, which then dries up precisely when it is needed most. This issue has been on the IMF's agenda for some time, but there has been little progress in addressing it. Indeed one can argue that the Basle II reforms will only make the problem worse by heightening the sensitivity of capital requirements on loans to emerging markets to the creditworthiness of the borrowers, something that depends in procyclical fashion on the volume of lending itself.[7]

Second, there is still a need for the Fund to develop a taxonomy of cases for coordinating capital account liberalization and other policies for financial development. It is fine and good to say that the Fund must avoid one-size-fits-all advice and that recommendations for capital account liberalization should be sensitive to the economic and financial circumstances of the individual member. But conclusions at this level of generality are a license for giving absolutely any advice at all. The Fund needs to develop a specific set of guidelines for what different patterns of financial development imply for the sequencing of capital account liberalization. A start would be for IMF staff to distinguish a handful of models of financial development and to articulate the role and timing of capital account liberalization in each. This is needed if we are to have appropriate discipline on and accountability regarding Fund advice instead of a license for saying that anything goes.

Finally, if we acknowledge that capital account liberalization is connected to the broader process of economic and financial development, then this means that the Fund will have to continue giving advice and setting conditions not just on exchange rate and capital account-related policies narrowly defined but on a whole host of issues related to the development and operation of financial markets. How should countries regulate their banking systems? How much financial disclosure should be required of market participants? What kind of bankruptcy and insolvency procedures should they adopt? What kind of corporate governance mechanisms should they install? These are delicate questions intimately connected to the structure of domestic institutions. They affect not only financial markets but domestic politics and society generally. It is intrinsic to the process of integration – to the fact that national markets are being integrated internationally – that the Fund will have to intrude deeply into these delicate questions of national policy. How it does so should be shaped in good part by the preferences of its members. And when it does so badly, its management should be held accountable by that same membership. Unavoidably, then, discussions of capital account liberalization point to the urgency of dealing with long-standing problems of representation, voice and accountability in the institution. They remind us that rapidly growing Asian countries are underrepresented in the Fund, and that Europe is overrepresented. They remind us that not all members of the Executive Board are created equal. We will not make durable progress on these capital account issues until we also take steps to reform the governance of the Fund.

[7] For discussion see Reisen (2003).

References

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