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IMF Draft Guidelines Endorse Capital Controls as Last Resort for Inflows

By Sandrine Rastello - Mar 31, 2011

Nations should be able to use capital controls as a last resort to manage inflows of money that threaten their financial stability, according to draft guidelines discussed last week by the board of the International Monetary Fund.

Such controls should be applied only after countries strengthen their banking systems and adopt economic measures such as building up reserves, tightening fiscal policies and lowering central bank interest rates, according to the draft guidelines, obtained by Bloomberg News.

"In the past, capital controls were not in our toolkit," IMF Managing Director Dominique Strauss-Kahn said separately in a statement posted on the fund's website. "Today, we see them more as part of the toolkit, although only in specific circumstances and not, of course, as a substitute for good macroeconomic policies."

Countries from Brazil to South Africa are striving to manage inflows of overseas capital that put upward pressure on their currencies, making exports less competitive, and threaten to create asset bubbles. Dealing with such capital flows will be discussed by Group of 20 finance ministers meeting today in Nanjing, China.

'Stability Risks'

"While inflows are typically beneficial for receiving countries, inflow surges can carry macroeconomic and financial stability risks," IMF staff wrote in the report. "Choosing appropriate responses can be challenging given the uncertainties associated with the causes and effects of the inflows and with possible policy reactions."

IMF spokesman William Murray declined to comment on the contents of the report. "We will be publishing the complete set of documents related to the March 21 executive board discussion on these important issues," he said.

The Washington-based fund, founded in the aftermath of World War II to help ensure the stability of the global monetary system, is considering guidelines on capital controls for the first time.

"The paper tries to strike a careful balance between being sensitive to the policy needs of emerging markets and pointing out the very difficult cost-benefit tradeoff of imposing capital controls," said Eswar Prasad, a senior fellow at the Brookings Institution in Washington and head of the fund's Financial Studies Division from 2005 to 2006.

'Lukewarm Endorsement'

"The lukewarm endorsement of a surgical approach to capital controls, while warning of the many risks, is the compromise position that may leave countries on both sides of the capital-controls debate unhappy, but is probably the best the IMF can do to balance the disparate views of its major shareholders," said Prasad, who has seen drafts of the report.

The fund has traditionally insisted on maintaining unrestricted flows of money across borders as it led bailouts during crises in Latin America and Asia in the 1990s.

"This is a new approach," said Bessma Momani, a professor in the department of political science at the University of Waterloo in Canada. In the 1990s through the middle of last decade, "you could not say the words 'capital controls' " at the IMF because "it was considered very taboo."

She said the shift has been "in response to pressure from rising powers within the fund," such as Brazil and India, which have gained voting clout as their share of the world economy has grown.

The report reviews how nations cope with inflows of capital drawn by relatively higher interest rates and the faster pace of economic growth in emerging markets. It focuses on seven of them, including Brazil, South Korea and Turkey, and warns that some nations may be tempted to use capital controls "to avoid appreciation of undervalued currencies."

'Growth Prospects'

"Improved fundamentals and growth prospects" in emerging economies and "loose monetary policies in" richer counterparts "are among the main pull and push factors behind the recent acceleration of capital flows from advanced to emerging economies," according to the report.

The IMF started to shift its opposition to capital controls with a research paper in February 2010, which said they could be a "legitimate" tool in some cases.

The guidelines suggest that measures should only be used if a currency isn't undervalued, reserves are above precautionary levels, and the economy is overheating, making lower interest rates impossible.

The report also says “prudential” steps that strengthen the ability of economies to absorb overseas capital, such as measures to develop local bond markets, can be used at “any time.” Such steps also include reserve requirements for local- currency deposits adopted by Turkey and Brazil.

Capital-management measures that do not discriminate based on residency can come as a “second line of defense,” according to the report, which cites South Korea’s levy on banks’ non- deposit foreign liabilities as an example.

Measures “that discriminate based on residency could be considered when other options have already been deployed or are infeasible,” staff wrote. That would include Brazil’s tax on equity and bond flows, according to the report.

Taxes Increased

Brazilian President Dilma Rousseff on March 29 increased taxes on corporate loans and debt sales abroad by banks in a bid to stem gains in the real.

Brazil imposed a tax of 6 percent on international bond sales and loans with an average minimum maturity of up to 360 days, according to a decree published today in the Official Gazette. Companies had paid a 5.38 percent tax on loans up to 90 days and zero tax when the operation exceeded three months.

Brazil received net inflows of $10.5 billion in foreign currency flows from trade and financial investments this month through March 25, compared with $7.4 billion for all of February, according to the central bank.

Net private capital flows to developing countries expanded 44 percent in 2010 to about $753 billion, according to the World Bank. The nine countries that attracted the bulk of capital flows were Brazil, China, India, Indonesia, Malaysia, Mexico, South Africa, Thailand and Turkey, the bank said in January.

Brazil’s real has jumped 42 percent against the dollar since the beginning of 2009. The Indonesian rupiah has gained 25 percent, while the South Korean won is up 14 percent.

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