UPDATE 1-IMF endorses capital controls as temporary measure

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(Recasts with details from conference call)

By Lesley Wroughton

WASHINGTON, Feb 19 (Reuters) - The International Monetary Fund sees capital controls as one way to curb sudden surges in money flowing into emerging market economies but believes they should be only a temporary measure, it said a study released on Friday.

Analysts said the move was a shift in the IMF's long-held view that capital controls are ineffective.

Jonathan Ostry, the IMF's deputy director of research, said since the Asian financial crisis in 1997-98 the IMF has become more accommodating of capital controls, which restrict the free movement of capital.

"What I would say is that this paper doesn't represent a shift in the IMF's view (but) a clarification of the circumstances under which capital controls could form a legitimate part of the toolkit," he told a conference call.

Quoting from a 2005 report from the IMF's internal watchdog, the Internal Evaluation Office, Ostry said the IMF had "displayed sympathy with some countries in the use of capital controls and had even suggested market-based measures could be introduced as a prudential measure."

The shift comes as the IMF grows increasingly wary of the rapid flow of money into emerging markets. The fund said in January it was concerned about asset prices overheating and said policy makers could not afford to be complacent.

The IMF's latest paper said there was no one-size-fits-all solution to deal with the impact of potentially destabilizing short-term capital flows and the best response would be multi-faceted.

Such a response should include traditional methods such as allowing a currency to appreciate, accumulating more reserves, changing fiscal and monetary policy, or strengthening rules to prevent excessive risk in the financial system.

"There may be circumstances in which capital controls are a legitimate component of the policy response to surges in capital inflows," the paper said.

Eswar Prasad, a senior fellow at the Brookings Institution in Washington, D.C., said the paper represented a "marked change" in the IMF's advice to emerging market economies.

"While it is one thing to argue for slower capital account liberalization, making the case that imposition of capital controls is a useful part of emerging market policy makers' toolkits is a dramatic shift," said Prasad, who is also a Cornell University professor and a former IMF official.

BUBBLE TROUBLE

Emerging market economies are now the main source of global growth and attract money from slower-growing economies in the developed world.

Emerging market economies like Brazil have imposed taxes on investment to try to slow the flow of capital.

One of the biggest concerns is that such "hot money" could lead to asset prices overheating and cause dangerous market bubbles. A burst in an asset bubble could throw the world economy back into recession.

The IMF said: "If the economy is operating near potential, if the level of reserves is adequate, if the exchange rate is not undervalued, and if the flows are likely to be transitory, then use of capital controls...is justified as part of the policy tool kit to manage inflows."

The IMF examined past cases of capital controls and said they have a bigger impact on the composition of capital flows than on volume.

For example, in Chile, Colombia and Brazil, which all imposed restrictions in the 1990s, capital controls had no significant impact on total money flows, the IMF said. During the period, exchange rates appreciated by about 5 and 4 percent annually in Brazil and Chile, respectively.

In Thailand, its currency appreciated within a week after controls on short-term flows were imposed in late 2006.

Meanwhile, in Chile controls appeared to have an impact in altering the composition of the capital.

The paper cautioned that the impact of controls could spill over into other countries and governments toying with the idea should consider the global effect, especially as economies recover from the recent global turmoil.

It said controls in one country could force capital to flow into countries less able to absorb it. (Reporting by Lesley Wroughton; Editing by Kazunori Takada and Leslie Adler)