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Congress Should Query IMF Support for Capital Controls

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The International Monetary Fund (IMF) recently weakened its long-held institutional support for the free flow of capital across national borders. The IMF's new view, described most clearly in a document entitled "The Liberalization and Management of Capital Flows: An Institutional View,"[1] which was endorsed by the IMF governors in December 2012, is that temporary capital controls can sometimes be beneficial.

Regrettably, many governments are likely to interpret this as legitimizing longer-term capital controls as well, undermining the open-market policies that are critical to ensuring dynamic growth of the global economy.

Since the global financial turmoil in late 2008, increased attention has focused on the role of the IMF in the rapidly changing international monetary system and the future of U.S. support for the fund. The IMF's recent institutional endorsement of capital controls should be a major concern for Congress in its consideration of President Obama's request for a $63 billion increase in the U.S. funding for the organization.

The Morphing of the IMF. The IMF's activities have evolved over the years in response to changes in the international economic system. Its new "institutional view" of capital controls is the latest example of this evolution.

One of the IMF's six institutional purposes outlined in the Articles of Agreement is to assist "in the elimination of foreign exchange restrictions."[2] Throughout the 1990s and 2000s, for example, the IMF supported capital account liberalization in developing and emerging markets, particularly in the post-Soviet states. In the midst of the 1997–1998 Asian financial crisis, the IMF spoke out against capital controls and even proposed to amend its Articles of Agreement concerning measures related to regulating capital movements in the mid-1990s.[3]

The IMF's strong stance against capital controls no doubt contributed to the explosive growth of international capital transactions that has played such a large role in sustaining the globalization of trade and the vast increase in world prosperity that has followed.

The international financial crisis of 2008–2009, however, generated increased concern about the volatility and risks that accompany cross-border capital movements. That such concern came primarily from countries seeking to avoid necessary macro-economic adjustments to make their economies more competitive did not restrain some IMF staffers from producing research papers that challenged the fund's long-held position against capital controls. In fact, this theoretical groundwork coincided with a shift in the fund's day-to-day policies. During Iceland's financial crisis in 2008, capital controls were adopted as a pillar of Iceland's stand-by arrangement with the IMF, setting an obvious precedent for a policy change.[4]

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Now the IMF has endorsed the use of "targeted, transparent, and generally temporary" capital controls. This language leaves a great deal of room for countries to retain broad capital controls. Reflecting the policy shift, Christine Lagarde, managing director of the IMF, remarked in her speech to the Malaysia Economic Association:

> Economic management is the key. If the flows are coming through the banking system, then macro-prudential tools make sense—such as tightening conditions for housing loans or having banks hold more capital. In other circumstances, temporary capital controls might prove useful. I should point out that Malaysia was ahead of the curve in this area.[5]

Malaysia, which had previously been regarded as something of a financial pariah for its imposition of strict capital controls, is now apparently regarded by the IMF as a policy innovator.

Policy Implications. The IMF's new position on capital controls encourages countries to use direct controls as a politically convenient excuse to put off necessary economic reforms that are critical to enhancing efficiency and productivity. More notably, the IMF's recent promotion of capital controls in sovereign bailouts threatens to leave a permanent trail of capital restrictions.

For example, although they were billed as "temporary and limited in scope," the Icelandic capital controls are still firmly in place half a decade after they were installed. Despite the fact that the controls have been holding back Iceland's economic recovery, the Icelandic authorities are openly talking about continuing the capital controls for decades to come.[6]

To its credit, the Obama Administration seems to have been cautious about the IMF's support for capital controls. Lael Brainard, U.S. Under Secretary of the Treasury for International Affairs, pointed out the negative impact of capital controls in a recent speech, noting that "in the aftermath of the crisis…some G-20 members still run tightly managed exchange rate regimes with extensive capital controls…. [These regimes] intensify the risk of inflation and asset bubbles…and put an undue burden on emerging economies with market exchange rates."[7]

Issues for Congress. Congressional interest in IMF activities has sharpened in recent months in light of the Administration's request to shift $63 billion from an IMF crisis fund to the fund's general accounts.[8]

This proposed increase in funding is part of larger IMF governance reforms that have been under consideration since 2010. These reforms would double IMF quotas and give more voting rights to emerging economies such as China. The Administration argues that it is in Washington's interest to increase its IMF funding in order to maintain its influence in the global lender.[9] This is true, however, only if American influence is used to improve IMF policies.

1. International Monetary Fund, "Liberalization and Management of Capital Flows: An Institutional View," November 14, 2012, http://www.imf.org/external/np/pp/eng/2012/111412.pdf (accessed May 21, 2012).
2. International Monetary Fund, "Articles of Agreement of the International Monetary Fund," Article 1, http://www.imf.org/external/pubs/ft/aa/#art1 (accessed May 13, 2013).
3. International Monetary Fund, "The Fund's Role Regarding Cross-Border Capital Flows," November 15, 2010, p. 4, http://www.imf.org/external/np/pp/eng/2010/111510.pdf (accessed May 13, 2013).
4. International Monetary Fund, "Iceland: Request for Stand-By Agreement Staff Report," November 2008, http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf (accessed May 13, 2013).
5. Christine Lagarde, managing director, International Monetary Fund, "Asia and the Promise of Economic Cooperation at Malaysia Economic Association," Kuala Lumpur, Malaysia, November 14, 2012, http://www.imf.org/external/np/speeches/2012/111412.htm (accessed May 13, 2013).
6. Jon Danielsson, "The Capital Controls in Cyprus and the Icelandic Experience," Vox, March 28, 2013, http://www.voxeu.org/article/capital-controls-cyprus-and-icelandic-experience (accessed May 13, 2013).
7. Lael Brainard, Under Secretary of the Treasury for International Affairs, remarks at the 2013 Annual Economic Policy Conference of the National Association for Business Economics, March 5, 2013, http://www.treasury.gov/press-center/press-releases/Pages/jl1870.aspx (accessed May 13, 2013).
8. Reuters, "U.S. Treasury's Lew Presses Congress on IMF Funding," April 24, 2013, http://www.reuters.com/article/2013/04/24/usa-imf-lew-idUSL2N0DA2MC20130424 (accessed May 13, 2013).
9. Ibid.

Given the IMF's recent endorsement of the use of capital controls, as well as the Administration's budget request for increasing U.S. funding to the IMF, Congress should:

- Hold hearings on the IMF's newly adopted institutional endorsement of capital controls. In particular, Congress should request that Treasury Secretary Jacob Lew, as the top U.S. representative to the IMF, explicitly reject capital controls.
- Make sure that future American support for the IMF is conditional on the fund's advocacy for sound, market-oriented reforms that advance economic freedom.
- Ensure that the U.S. Trade Representative and the U.S. State Department strongly advocate free capital movements in any future free trade agreements or bilateral investment treaties.

Patchy Record. The record of capital controls proves that the effectiveness of such restrictions is patchy at best.[10] With the international economy sputtering through slow growth and struggling for solid traction, it is vital to advance policies that sustain open markets and greater economic freedom.

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10. Lina Saigol, "Patchy Record of Capital Controls," *Financial Times*, March 25, 2013, http://www.ft.com/intl/cms/s/0/b443cfcc-9551-11e2-a4fa-00144feabdc0.html#axzz2SpK6um57 (accessed May 13, 2013).