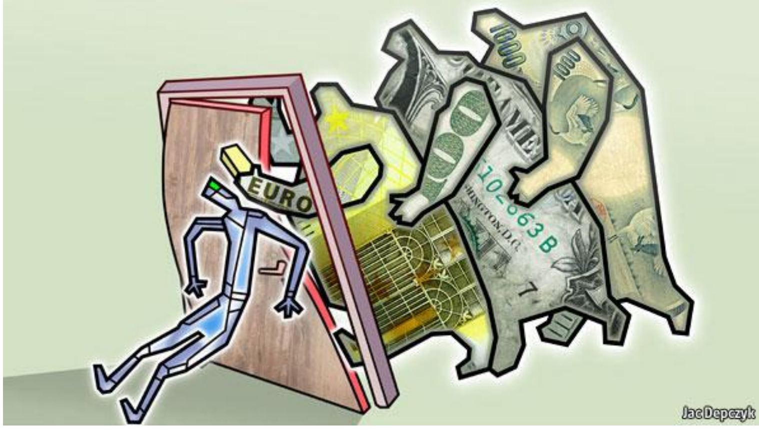
A disjointed attempt by the IMF to refine its thinking on capital controls
***The Economist*, Apr 7th 2011**



FOREIGN capital fled the emerging world in the throes of the economic crisis. Now, lured by their better growth prospects and repelled by rich countries' low interest rates, money has gushed back into countries like Brazil, Peru, South Africa and Turkey. Paulo Nogueira Batista, Brazil's executive director at the fund, calls it an "international monetary tsunami".

Usually emerging markets welcome foreign capital, which can help finance much-needed investment. But the recent surge has them worried, partly because of its speed and fears of an equally rapid reversal. The IMF reckons that gross inflows have risen to 6% of emerging-world GDP in about a quarter of the time taken for a similar spike before the crisis. Policymakers also fear that this flood of capital could lead to asset-price bubbles and overvalued currencies. Many have implemented measures to stem the tide, from Brazil's tax on portfolio inflows to Peru's higher charge on non-residents' purchases of central-bank paper.

Such policies—particularly capital controls that apply specifically to foreign investors or treat them differently from nationals—have long been controversial. Countries that use them are often accused of doing so to keep their currencies artificially undervalued. Critics reckon that with their prospects improving emerging markets should just let their currencies rise. But emerging economies retort that the reason capital is flooding their way may have less to do with their long-term prospects than with temporary factors such as unusually loose rich-world monetary policy, over which they have no control. Adding to the confusion is the absence of any internationally accepted guidelines about what is acceptable when it comes to managing capital flows.

The IMF is the natural arbiter of such issues. It has already stepped back a little from its historical antipathy to capital controls. In February 2010 a research paper by a team of economists at the fund led by Jonathan Ostry cautiously endorsed the use of controls in situations where a country facing a capital surge had a currency that was appropriately valued, had already built up enough reserves and had no further room to tighten fiscal policy. The fund now reckons these conditions are not all that rare. It finds that 9 out of 39 emerging markets studied would have been justified, as of late 2010, in resorting to such controls because they had exhausted other options. There is a need, therefore, for more clarity on which measures are justified, and when.

On April 5th the IMF released two documents designed to achieve just that. The first, a "framework" for policy advice that is approved by the fund's board, lays out the institution's official thinking. The other, by Mr Ostry and his colleagues, provides the analytical backing for the framework paper and explains the conditions under which various kinds of policy instruments might help manage capital flows. The two papers aim to ensure that the advice the IMF gives member countries is consistent. But several curious differences between them suggest that the fund's own thinking on managing capital flows is far from settled. In at least two respects the new paper by Mr Ostry's team marks a further evolution of the fund's position on capital controls. But the board-endorsed policy framework seems less inclined to budge.

Earlier IMF papers emphasised that capital controls should be imposed only in the face of temporary surges in inflows, arguing that the exchange rate should adjust when it came to permanent shocks. But Mr Ostry's team now points out that persistent inflows might be even more dangerous in terms of asset-price bubbles. It concedes that controls may be useful to target inflows that are expected to endure, because of the threat to financial stability. The framework paper is much more conservative, arguing that capital-flow measures "are most appropriate to handle inflows driven by temporary or cyclical factors".

The IMF has historically been more favourably disposed towards "prudential" measures, which are designed to stop inflows from destabilising financial systems and do not explicitly discriminate between residents and foreigners, than towards capital controls, which erect barriers designed to stop the exchange rate from rising. Mr Ostry and his colleagues point out that some prudential measures distinguish between local-currency and foreign-currency transactions. This makes them more like capital controls since most foreign-currency liabilities are likely to be owed to foreigners. It may thus make sense to treat such prudential measures and capital controls similarly. The framework paper, however, maintains that countries should "give precedence to capital-flow measures that do not discriminate on the basis of residency (such as currency-based prudential measures)" over those that do. The disconnect is glaring and confusing.

It wasn't us

The fund's attempts to flesh out what countries threatened by a surge of capital should do come up against a more fundamental problem, too. Many emerging economies argue that the IMF is focusing on the wrong players. Mr Nogueira Batista told a Brazilian newspaper that he objected to "countries that adopt ultra-expansive monetary policy to get over the crisis [and] provoke an expansion of liquidity on a global scale", and which then insist on guidelines about how recipients should behave. (Indeed, emerging economies were firmly opposed to the fund's original plan to refer to what is now a "framework" for policy advice as the more prescriptive-sounding "guidelines".) The fund acknowledges that these "push factors" are important, and should be addressed. Its own analysis suggests that American interest rates have a larger effect on flows to emerging economies than those economies' own growth performance.

A fund insider says that negotiations around the new framework on capital-flow measures were "the most contentious that any staffer can remember". It shows.