Controlling Capital after the Crisis of 2007-2009: The IMF and New Norms of Financial Governance

Jeffrey M. Chwieroth
Senior Lecturer in International Political Economy
London School of Economics
Department of International Relations
Houghton Street
London WC2A 2AE
Tel: [+44] (0) 20 7955 7209
Fax: [+44] (0) 20 7955 7446
Homepage: http://personal.lse.ac.uk/Chwierot/

In the midst and recovery from the 2007-2009 crisis, the IMF has offered qualified endorsement of capital controls, which some observers have depicted as a dramatic shift in the organization's long-held stance against such measures. However, the change in IMF thinking has been more evolutionary than revolutionary, since many inside the organization have been sympathetic to controls for some time. Yet for an organization long perceived, though often wrongly, to offer unequivocal opposition to capital controls, its recent pronouncements have offered a more far-reaching and explicit legitimating of their use. This clarification of the IMF's orientation could have significant implications for multilateral governance. This paper explores these implications and seeks to understand the reasons for this clarification. It offers an explanation that synthesizes arguments stressing external and internal determinants of organizational behaviour. On the external side, it focuses on recent changes to the power and preferences of some of the Fund's leading member states, while on the internal side it examines adaptation, the uptake of new ideas from the economics profession, and internal advocacy.

Paper prepared for presentation at the conference on Myth or Reality? The Promise of Economic Multilateralism, Leonard Davis Institute for International Relations, Hebrew University, Jerusalem, Israel, 20 – 21 December 2010.

During the worst of the 2007-2009, which intensified and spread following the collapse of Lehman Brothers in September 2008, a number of emerging markets imposed capital controls in response to destabilizing capital outflows. Now, with most developed countries pursuing ultra-loose monetary policies and exceptional liquidity support to combat sluggish growth and employment, capital is flooding back into emerging markets where growth prospects appear much brighter.[1] Notwithstanding the benefits of these inflows, many emerging market governments, concerned that the current flood could generate macroeconomic and financial instability, introduced measures to restrict them.

In midst and recovery from the financial crisis, these measures have received a qualified endorsement from the International Monetary Fund (hereafter IMF or Fund). Several prominent observers, such as Ronald McKinnon (cited in Rappeport 2010) and Dani Rodrik (2010), have depicted the Fund's recent pronouncements on controls as a dramatic shift in the organization's long-held stance against such measures. Yet this depiction mischaracterizes the Fund's pre-crisis position on controls and in doing so exaggerates the extent of transformation within the organization.

Contrary to popular depiction, the IMF never uniformly or indiscriminately advocated the abolition of capital controls (Chwieroth 2010). To be sure, by the mid-1980s a consensus had emerged within the IMF that liberalization was desirable, but the Fund was never unequivocally and unconditionally opposed to capital controls. Instead much of the 1980s and 1990s was a period of vigorous debate within the Fund about how the world should proceed toward greater capital freedom. This debate pitted "gradualists" versus supporters of the "big-bang." While big-bang proponents pressed for a rapid move to openness, gradualists argued for a slower transition, ensuring that certain pre-conditions were met before additional

[1] Net private capital flows to emerging markets reached a record high of $1.28 trillion in 2007, then plummeted to less than $600 billion in 2008 and 2009, and are now projected to reach $825 billion in 2010 (Institute of International Finance 2010).

liberalization was undertaken. In addition, although both groups generally agreed that controls on outflows were inappropriate, gradualists offered sympathy, even encouragement, for temporary limits on inflows in some circumstances, whereas big-bang proponents ruled out even selective restraints on capital mobility. As a result, though the staff collectively shared a belief in the long-run desirability of liberalization, they often offered conflicting analyses and recommendations on how to proceed toward it.

By the mid-1990s big-bang proponents had gained the upper hand. But the wave of financial instability in emerging markets in the late 1990s swung the debate decisively in favour of the gradualists. Gradualism became widely accepted within the IMF and the organization spent the decade following the Asian financial crisis elaborating its orientation. From this empirical vantage point, the Fund's recent qualified endorsement of controls can be seen as more evolutionary than revolutionary. What is notable is not so much the content of the Fund's recent pronouncements, but rather the clarity with which they provide a more far-reaching and explicit legitimation of controls.

For an organization long perceived, though often wrongly, to offer unequivocal opposition to controls, this clarification has significant implications for multilateral governance. In helping to shift the norms of financial governance, the IMF has helped to increase the policy space for emerging markets and developing countries. By appealing to the interests and experiences of these countries, the IMF has potentially helped contribute to the on-going efforts to address its legitimacy problems.

Notwithstanding its benefits, this enhanced policy space increases the scope for unilateral actions that could have adverse multilateral implications. In addition to undercutting the long-term benefits of financial globalization and diverting capital to countries less able to absorb it, widespread unilateral imposition of controls could potentially undermine the legitimacy and effectiveness of multilateral governance and delay reforms that

are necessary to create more balanced and sustainable economic growth. Yet the potential for such adverse implications also creates an opportunity for enhancing multilateral governance through the development, for instance, of a new code of conduct for the use of capital controls. This paper analyzes these implications.

Before doing so, it situates the Fund's recent clarification in empirical context by tracing the evolution of the Fund's orientation prior to the 2007-2009 crisis. Emphasis is place on the ascendance of gradualism within the IMF. The paper then turns to examining the factors driving the Fund's recent pronouncements. The explanation I offer synthesizes arguments that stress external and internal determinants of organizational behaviour.[2] On the external side, it focuses on recent changes to the power and preferences of some of the Fund's leading member states, while on the internal side it examines organizational adaptation, the uptake of new ideas from the economics profession, and internal advocacy.

Controlling Capital before the Crisis of 2007-2009

Capital controls were the norm in most economies for much of the early post-war era (Helleiner 1994). At the Bretton Woods the right of governments to use capital controls was institutionalized in the IMF's Articles of Agreement. In the early post-war era, most policymakers and academic economists viewed controls as essential and legitimate policy tools to enhance macroeconomic policy autonomy, promote financial and currency stability, and support industrial policy measures aimed at allocating credit to favoured sectors and firms and protecting them from foreign competition.

In a more fundamental way, it was scepticism about the efficiency of free market finance that lent controls important legitimacy. The experience with destabilizing capital flows in the 1930s and the ascendance of Keynesian ideas convinced many policymakers and

[2] External determinants of the behaviour of international organizations are typically stressed by principal-agent theorists (Hawkins et al. 2006), while constructivists usually emphasize internal determinants (Barnett and Finnemore 2004). Thus far, only a few studies have sought to synthesize these approaches, see Chwieroth (2010) and Nielson et al. (2006).

academic economists to see permanent restraints on capital mobility as necessary to keep the animal spirits of investors in check. For Keynesians, investors, constrained by uncertainty, came to rely on conventions to make investment decisions. However, these conventions could take on a life of their own, leaving economies vulnerable to wide swings in market sentiment that could trigger manias, panics, and crashes. Hence, the need to permanent controls on capital flows.

Within the IMF, the legitimacy of controls rested on two bases of support; one external to the organization, the other internal. On the external side, IMF member states, most of whom extensively utilized controls, endorsed their use. The United States, though it refrained from using controls for much of the post-war era and viewed them more sceptically than most of the IMF membership, for the most part accommodated their use.

On the internal side, professionalization and recruitment patterns shaped the views of the IMF staff. Most of the staff recruited to the IMF in the 1940s and 1950s was brought from the delegations to the Bretton Woods conference and various Keynesian-minded academic departments. A large number of these staff would serve in senior positions until the 1980s. When these formed policy judgements, the Keynesian content of their training, along with the experience of the 1930s, helped ensure that the legitimacy of controls would be upheld, even when it later contradicted the preferences of some powerful member states.

There was little comprehensive shift in the Fund's orientation toward controls until the mid-1980s. It was then that a new informal orientation emerged among the staff that identified freeing capital flows as desirable, at least in the long-run, but interestingly, until the mid-1990s, there were no formal instructions from member states to encourage liberalization and no change in the IMF's formal rules giving member states the right to use controls. Prior to the mid-1980s, staff reports revealed a Keynesian emphasis on uncertainty and convention-driven behaviour. Yet increasingly in the 1980s the staff came to view investment decisions

as a rational and efficient response to fundamentals, a view more closely aligned with neoliberalism (see below).

Beginning in the mid-1980s and continuing until the Asian financial crisis, the general orientation of the staff was to oppose controls. Rather than being essential policy instruments, controls were said to harm economic performance, generate severe distortions, delay adjustment, and send negative signals to market actors. An underlying faith in market rationality and efficiency also led the staff to overlook the potential usefulness of tightening regulation aimed at investors based in the financial centres of developed countries; a prescription consistent with an alternative view, more closely aligned with Keynesianism and often advocated by emerging market and developing country officials, that stresses factors intrinsic to the operation of international capital markets as contributing to macroeconomic and financial instability. Instead, the Fund placed the burden on emerging markets and developing countries to adjust their polices in response to financial instability.

What triggered this profound organizational change? Contrary to popular views, the U.S. was not wholly responsible. While the staff likely could not have encouraged liberalization without U.S. support for the principle of capital freedom, there is, remarkably, little evidence to support the argument that the staff orientation was dictated by the influence of member states alone (Chwieroth 2010). In short, though the Fund's new orientation benefitted long-term U.S. interests, it was not a direct result of them.

By the early 1990s, the Group of Seven (G-7) leading developed countries had reached a consensus on the desirability of greater capital freedom. The result was a lessening of the degree of preference heterogeneity among the IMF membership. Yet, importantly, this new preference configuration did not develop until after the staff orientation had shifted. It should also be noted that while their influence and representation within the IMF did not match that of the G-7, many emerging market and developing controls had misgivings about

the desirability of liberalization. The staff were certainly aware of these preferences, and the views of the G-7 in particular, but they were not the primary source of their orientation.

In the context preference heterogeneity among the G-7 (at least until the early 1990s), the staff enjoyed significant autonomy to develop their orientation independently. This autonomy permitted the staff to rely on their own judgment and initiative to determine whether liberalization should be encouraged informally in a given case. Internally, professionalization and administrative recruitment were critical in shifting the staff's orientation. In the mid-1980s, senior staff that had joined the IMF in the 1940s and 1950s retired in large numbers and were replaced by staff that had received their professional training in the 1960s and 1970s. Without this personnel realignment in the 1980s, the Fund's opposition to controls would have been, in all likelihood, delayed, more incremental, and less coherent than it was.

These new senior staff had markedly different beliefs than their predecessors about the legitimacy of controls due in large part to differences their experiences and professional training. With the emergence of monetarism and the neoclassical synthesis in the 1960s, academic economists increasingly began to question the legitimacy of controls. Although these schools of thought disagreed about the desirability and efficacy of government intervention, they essentially converged on a view that that the invisible hand of the market could become paralyzed in the short run described by Keynes, but in the long-run it behaved as neoclassicals suggested. Although neoclassical synthesis proponents focused on short-run market errors, while monetarists on lags and adaptive expectations, both schools of thought shared an underlying faith in market rationality.

This consensus was a far cry from the deep Keynesian scepticism of market efficiency (Best 2005; Leijonhufvud 1968; Skidelsky 2009). For neoclassical synthesis proponents and their intellectual heirs the New Keynesians, markets could be left unfettered in the long-run,

though in the short run there was a case for temporary intervention and the use of controls based on standard "second-best" reasoning. Monetarists went even further, claiming that all controls are counterproductive. Taken together, these professional developments meant that beginning in the early 1960s few academic economists doubted the *long-run* desirability of liberalizing capital controls.

In the 1970s, the emergence of new classical economics based on rational expectations and efficient markets theory heightened academic opposition to controls. In rational expectations models, there is no uncertainty, only risk. Systematic errors such as asset bubbles busts are impossible since all investors perfectly understand the complex workings of the economy. These and other insights were later formalized in Dynamic Stochastic General Equilibrium (DSGE) models, which became the new bedrock of macroeconomics. In the new field of financial economics, the efficient markets hypothesis suggested that since financial markets are "efficient" in employing all available information in determining asset prices, prices reflect the true state of the economy based on fundamentals, and markets could be left alone to make Pareto-efficient decisions and to supervise themselves.

Within the economics profession a broad neoliberal consensus emerged. Although academic economists offered different views on the desirability and efficacy of government intervention and the behaviour of markets, this neoliberal consensus meant that the vast majority of academic economists drew to some extent on neoclassical-informed assumptions and models and shared the view that unfettered capital mobility was desirable in the *long-run*.

To be sure, there remained debate among academic economists. But, until the late 1990s, this debate focused more on differences of degree than of kind. Debates persisted within the profession over sequencing and temporary controls, but few questioned the long-run desirability of freeing capital movements. As Jean Tirole (2002:ix) observes: "[A] wide

consensus had emerged among economists, capital account liberalization – allowing capital to move freely in and out of countries without restrictions – was unambiguously good." In short, the Keynesian consensus that endorsed controls had been replaced by a neoliberal consensus that stigmatized their use.

In the 1980s and 1990s, in addition to the personnel realignment, learning via country experiences helped alter the orientation of the Fund. Many staff saw the transition to openness within the European Union as providing important evidence in support of liberalization. Other staff saw the case of Indonesia, which was notable for liberalizing earlier even than most developed economies, as providing evidence of the benefits of liberalization for emerging markets and developing countries. Staff research studies also provided evidence that seemed to invalidate many of the traditional arguments for controls.

These experiences and evidence helped foster among the staff a comprehensive reappraisal of organizational goals. Old organizational ideologies, norms, language, and routines were largely discarded, and new ones took their place. Rather than adapting through simply adding new agendas or policy instruments to existing organizational practice, the staff experienced a deeper shift in their beliefs about desirable goals.

By helping to create an internal ideational configuration that made it more acceptable within the Fund to analyze controls from a more critical perspective, the personnel alignment of the 1980s played an important part in creating an environment conducive for learning. In the Bayesian framework, an accumulation of evidence tends to result in a gradual and uneven process of belief change, particularly when prior beliefs are strongly held. In a similar fashion, for sociologists, prior beliefs channel the lessons that emerge from experience, inhibiting learning by narrowly defining the kind of information that is considered relevant and filtering this information in such a manner as to match these prior beliefs (Meseguer 2005). As a result, most belief change tends to be gradual rather than revolutionary; new

agendas or policy instruments may be added to organizational practice but without the deeper shift in staff beliefs about desirable goals. In the absence of the aforementioned personnel realignment, the cognitive difficulties associated with learning likely would have limited the extent to which it occurred.

The vigorous debate between gradualists and big-bang proponents during the 1980s and 1990s belies the popular depiction of the IMF as unequivocally and unconditionally opposed to controls. Gradualists and big-bang proponents offered conflicting analyses and recommendations on how to proceed toward openness. This internal debate was very much a reflection of a similar intellectual battle occurring within the economics profession. While professionalization and administrative recruitment fostered a shift in the general orientation of the Fund, it also created subcultures within the organization, as new recruits brought contrasting beliefs associated with unsettled debates within the economics profession. Intra-disciplinary debates about sequencing and allowances for selective capital controls provided an ideational basis for internal bureaucratic struggles within the IMF.

The neoclassical synthesis and New Keynesianism provided the theoretical point of departure for gradualism. Gradualists saw liberalization as desirable in the long-run, but viewed selective controls as sometimes necessary to combat distortions or correct short-run market errors. In part, the gradualist position was also a reaction to the financial crisis in Chile in the 1980s, which some within the IMF attributed to liberalization in the absence of critical supporting policies and institutions, such as robust prudential financial regulations. Initial gradualist sympathy for controls was based on seeing them as second-best measures to insulate weak and poorly regulated financial systems from capital flow volatility. Rather than enabling policymakers to avoid adjustment, gradualists saw controls as providing them with the breathing space to do so.

But by the mid-1990s big-bang proponents had gained the upper hand within the organization. These internal advocates argued that the effectiveness of controls made sequencing irrelevant and that gradualism was a political economy recipe for vested interests to resist liberalization. Downplaying the need for prudential regulation prior to liberalization, big-bang proponents argued that openness would enable market discipline to operate and ensure that policymakers stepped up their reform efforts.

The overlap of its arguments with existing IMF principles and bureaucratic organization aided the ascendency of the big-bang approach. In the 1990s, the Fund, in line with the broad contours of the Washington Consensus, tended to be biased toward any liberalization, regardless of its sequence, as better than no liberalization at all. While capital account liberalization was not formally part of the Washington Consensus, the efforts of big-bang advocates to downplay sequencing fit with its emphasis at the time on “getting the policies right” without due regard to the institutional environment in which these policies were situated. Following the end of the Cold War, there was also a general enthusiasm for “shock therapy” approaches to market reform that also gave little regard to sequencing. Arguments for sequencing based on second-best reasoning also did not fit well in organization with a culture that prioritizes “first-best” policy prescriptions.

In terms of bureaucratic organization, until 1992 the IMF separated expertise and responsibility for monetary systems and exchange restrictions in different departments. Although staff in each department were aware of the links between domestic financial and international financial liberalization, there did not exist a strong organizational capacity to explore systematically how it might be coordinated. When organizational expertise and responsibility for monetary systems and exchange restrictions was finally merged, it took some time for the staff in the new department to develop any specific conclusions about sequencing, which tended to aid advocates of the big-bang approach.

Temporary market-based controls on inflows, such as those used in Chile for much of the 1990s, were a major point of controversy between gradualists and big-bang advocates. Big-bang advocates attacked such measures for prolonging unsound policies, creating severe distortions, and failing to substitute for adjustment. Their initial evaluation suggested the effectiveness of such controls would prove short-lived, forcing the introduction of additional restrictions to maintain the same level of control and thus introducing further distortions. Their initial empirical analysis of the measures found no evidence that they slowed down the volume of capital flows, permitted greater monetary independence, or prevented real exchange rate appreciation.

But gradualists saw the Chilean controls, and similar measures such as those used in Colombia, as helping to insulate the underdeveloped and poorly regulated domestic financial system from capital flow volatility. Some prominent academic economists also began to raise similar arguments (Eichengreen and Wyplosz 1996). But this prescription did not fit well with the big-bang framing of such measures or with the IMF's cultural emphasis on first-best policy prescriptions. As a result, gradualists developed a strategy to re-frame the measures as "prudential measures" to safeguard the domestic financial system.

Although big-bang supporters initially proved resistant to this framing, the Mexican peso crisis in 1994-1995, by providing a vivid demonstration for many within the Fund of the need to coordinate financial sector development, prudential supervision, and capital account liberalization, added some momentum to gradualist advocacy. In the aftermath of the Mexican crisis, there was greater awareness of the risks of inadequate sequencing, enhanced receptivity to arguments stressing a need for prudential regulation, and heightened sympathy for temporary market-based controls.

The Mexican crisis also helped the gradualists to undermine the big-bang framing of the Chilean controls. As a result, the staff for the first time turned their attention toward

evidence suggesting the controls had lengthened the maturity structure of inflows, thus minimizing vulnerabilities to the domestic financial sector. Although the general orientation of the Fund was to oppose controls on outflows, particularly when they were introduced in liberalized economies, and to view even market-based controls on inflows as distortionary, waning in effectiveness over time, and as a poor substitute for policy adjustment, there began to be greater sympathy for justifying such measures on prudential grounds and on a temporary basis. But a big division opened up within the organization at all levels, even management, where the Fund's second-highest ranking official appeared more open than the head of the organization to the use of temporary market-based controls. Interestingly, in some countries, the staff from various departments within the Fund clashed in the advice they offered directly to country officials.

The latter half of the 1990s witnessed within the Fund both the high-water mark and demise of enthusiasm for greater capital freedom. An initiative emerged that sought to amend the IMF Articles to give the Fund the formal mandate to promote liberalization as well as fuller jurisdiction over the capital account policies of its members. In granting the Fund fuller jurisdiction over the capital account, the initiative would have prohibited governments from imposing virtually all types of controls without Fund approval and would have committed governments to liberalizing existing controls. In short, the amendment would have formally stigmatized capital controls. The amendment also would have enabled the IMF, for the first time in its history, to include capital account liberalization as a condition for accessing its financial resources.

IMF management and European governments embraced the initiative enthusiastically, but U.S. officials, while supporting the principle of greater freedom for capital movements, offered weaker support (Chwieroth 2010, chapter 8; Abdelal 2007). The amendment also faced opposition from emerging markets and developing countries who wanted to retain the

autonomy to impose controls in crisis situations without IMF approval. They were also concerned that the IMF staff would become overly enthusiastic in advocating liberalization. Breaking from norm of G-7 consensus, Canada also opposed the initiative, stressing a need for greater understanding about preconditions and sequencing as well as legal aspects of amending the Articles before moving ahead.

Between April and October 1997, efforts to amend the Articles reached their peak. Consensus on the amendment, however, proved elusive. As the crisis and criticism of the Fund's response to it intensified, support for the initiative evaporated.

In responding to the crisis, the IMF, backed by the G-7, insisted upon policy adjustment and structural reforms in crisis-afflicted countries. Yet in focusing largely on "home grown" causes the IMF's narrative of the crisis downplayed the impact of incompletely informed market actors driven by conventions toward "herding behaviour." Some prominent economists offered an alternative Keynesian-inspired narrative of the crisis, arguing that it was more an international financial panic driven by negative externalities from the financial centres of developed countries than the result of "home grown" policy and institutional errors (Sachs 1997; Stiglitz 1998).

By the autumn of 1998, the climate of opinion among academic economists had shifted toward a genuine reappraisal of pre-crisis beliefs. Academic economists began to devote greater attention to factors intrinsic to operation of capital markets that could trigger herding behaviour and market panic (Bhagwati 1998). In applying this perspective, many academic economists, like many emerging market and developing country officials, pointed to China and India as examples where the maintenance of extensive controls had enabled these economies to escape the worst effects of the crisis. A number of academic economists also began to offer support for restraints on capital mobility, with some – most notably Paul

Krugman (1998) – even offering support for controls on outflows as a tool for crisis management.

Inside the Fund a similar reappraisal of prevailing beliefs took place. The Asian financial crisis opened up space for those IMF staff that had long harboured reservations about liberalization to begin to press their beliefs more forcefully. In the minds of some staff, the problems of domestic distortions and factors intrinsic to the operation of financial markets, most notably information asymmetries, that can give rise to wide swings in market sentiment and, in the extreme, financial crisis, created an argument for permanent market-oriented restraints on inflows (Eichengreen and Mussa 1998).

However, even these staff continued to identify capital freedom as a desirable long-run goal, which in turn channelled how beliefs were updated and adapted. Rather than implicating capital account openness per se as responsible for the crisis, the prior belief in the long-run desirability of liberalization led the staff to identify poorly sequenced liberalization, such as South Korea's decision to liberalize short-term but restrict long-term inflows, as a principal culprit in triggering the Asian financial crisis. Although this interpretation undermined virtually all support for the big-bang approach and translated into greater sympathy for temporary market-based controls on inflows, it failed to induce reconsideration of the long-run desirability of capital freedom.

The stigma attached to controls on outflows also lessened somewhat, partly as a result of growing acceptance of the potential for herding behaviour and partly due to the Malaysian experience. When Malaysia imposed controls on outflows to manage contagion from the crisis, the IMF subjected it to severe condemnation. The Fund staff argued that the controls would prove ineffective, harmful to growth, and damaging to Malaysia's reputation in global financial markets.

But when these expectations were not fully met, a number of staff members reconsidered their prior beliefs. By 1999, the staff became much more accommodating of Malaysia's decision and concluded the controls had been effective in creating temporary "breathing room" that government officials used to adjust policies. Yet within the IMF and the economics profession the jury remains out as to whether the controls functioned as fully intended. Nevertheless, for many inside the Fund and the economics profession the experience of Malaysia demonstrated that controls on outflows could prove effective in crisis situations, if only under a limited set of conditions. The IMF subsequently became more accommodating of their selective use.

In the decade between the Asian financial crisis and the financial crisis of 2007-2009, the staff elaborated and refined the gradualist consensus that had emerged (Chwieroth 2010, chapter 9). IMF staff research increasingly showed that reaping the benefits of openness required certain institutional prerequisites and that controls on inflows had some utility for macroeconomic and financial stability (Ariyoshi et al. 2000; IMF 2007a). While not disputing the long-run desirability of liberalization, in the wake of the Asian financial crisis the staff were much more cautious in encouraging it and were much more open to selective limitations on capital mobility. Still, controls were cast as legitimate only in select circumstance that were not precisely stated, and even then the staff tended to offer strong reservations (IMF 2007b).

However, this did not prevent the staff from accommodating or even encouraging their controls, especially when liberalization and inflows threatened to expose countries with weak and poorly regulated financial systems to greater risk. Accommodation was even extended to controls on outflows, such as those introduced by Venezuela in 2003 to minimize capital flight during a crisis. What is particularly noteworthy about this particular case is that

less than a decade earlier, when Venezuela had introduced similar measures during a crisis, the staff had subjected this decision to severe criticism.

Following the Asian financial crisis, the academic literature also reinforced the case for gradualism and greater acceptance of controls. Academic economists increasingly emphasized institutions as a critical determinant of economic performance (Acemoglu et al. 2001). Within the IMF the uneven performance of many Latin American economies in the 1990s showed that even if countries liberalized, they often failed to achieve sustainable strong economic performance because of weak institutions. It thus became clear to many IMF staff members that policy reforms needed to be embedded in solid institutions even if it meant slowing down the pace of liberalization (Singh et al. 2005). The enhancement of the Washington Consensus thus helped to foster a more cautious approach to liberalization.

The empirical literature on capital controls saw significant advances in the decade that followed the Asian financial crisis.[3] The centre of gravity within the economics profession shifted away from strong doubt about the effectiveness of controls to a conditional acceptance of their utility, particularly those that were temporary, market-based, and targeted at inflows. The evidence for the effectiveness of controls on outflows for the most part remained inconclusive.

Despite this greater receptiveness to controls, the IMF continued to view crises as "home grown" phenomenon and to insist on policy adjustment and structural reform as the legitimate response. Private market actors, most of who were based in financial centres in developed economies, were relieved of most of the blame for financial instability in emerging markets in the late 1990s and were not subject to tighter regulation. On the contrary, faith in markets led governments over the next decade to assign to private market actors an increasingly significant role in the regulation and supervision of financial markets.

[3] For a review, see Magud and Reinhart (2006).

The IMF and the G-7 sought to correct errors and deficiencies in crisis-afflicted economies by encouraging them to adopt various international financial standards and codes, most of which were informed by the interests and experiences of G-7 countries, and in particular the Anglo-American regulatory approach, and virtually excluded emerging markets and developing economies from much input into their design. To be sure, the Fund developed an increasingly sophisticated understanding and appreciation of factors intrinsic to the operation of financial markets that can trigger financial instability, but the IMF showed little willingness to entertain regulatory measures aimed at reducing negative externalities emanating from financial market actors in developed countries.

On the external side, one reason for this was the preferences of leading member states, which opposed taking regulatory action. Although emerging market officials, particularly in East Asia, objected to this view, they lacked sufficient influence and representation within the IMF and standard-setting bodies to affect significant change in the policy discourse. In addition to the preferences of leading member states, on the internal side the beliefs of the IMF staff still prioritized their attention toward fundamentals and institutions in emerging markets as the primary source of instability in the international financial system. Finally, the IMF lacked the institutional tools to provide equivalent leverage over developed economies.

Clarifying Controls and the 2007-2009 Crisis

In the early stages of the 2007-2009 financial crisis, some countries, such as Argentina, Iceland, Indonesia, Latvia, Russia, and Ukraine, imposed controls on outflows as a way of managing contagion from the crisis. Instead of criticism, the IMF greeted these measures with either tacit acceptance and accommodation or plain silence. In the case of Iceland, Latvia, and the Ukraine, the IMF (2009a) endorsed these measures as part of its lending programs, though the staff went to great lengths to emphasize the controls were envisioned to be temporary and lifted as soon as possible. IMF staff reports, while taking

note of the use of controls on outflows in several countries, were noticeably silent on whether there measures were desirable or would prove effective (IMF 2009b; World Bank-IMF 2009).

This tacit acceptance, accommodation and silence reflect a gradual evolution of organizational beliefs since the Asian financial crisis. Just as it was for much of the decade after the Asian financial crisis, the Fund appears open to accommodating controls on outflows in some circumstances, but sceptical about their effectiveness, wary of their costs, and opposed to encouraging their widespread use. "Regardless of the possible merits of capital controls in typical capital account crises," during the recent crisis some staff saw controls on outflows, "to be much less appropriate in a global deleveraging scenario where more EMEs (emerging market economies) are facing a slowdown of capital inflows rather than investors seeking to flee the currency" (Ghosh et al. 2009:8).

The general preference within the Fund remains for crisis-afflicted countries to adjust their policies, but also receptive to the possibility that controls on outflows could serve as a "last resort" to provide possible breathing space necessary for reforms to be pursued, though with "significant risks and long-term costs," (Ghosh et al. 2009:9).[4] As one recent IMF (2009a:33) report notes, "Capital controls were needed to stabilize market conditions in some cases" and to permit reforms to proceed.

In Latvia, for instance, the IMF program permitted the continuation of exchange restrictions arising from a partial deposit freeze at the country's largest domestic bank to support the government's bank restructuring strategy. Similarly, an IMF (2009c:9; 11fn9) staff report finds that controls in some low-income countries helped to limit the impact of sudden liquidity withdrawals on their banking systems. However, this tacit acceptance of controls on outflows as exceptional measures has thus far been different from the recent

[4] See also World Bank-IMF (2009:65-66).

response to controls on inflows, the reaction to which has been increasingly explicit and far-reaching legitimating of their use, albeit under a set of circumstances that have become increasingly precise.

Since the onset of the recent crisis, the Fund has started to specify in a more fine-grained fashion the circumstances under which controls on inflows constitute legitimate policy tools. Of course, since the 1980s gradualists had sought to legitimize the selective use of controls on inflows; an orientation that became increasingly practiced within the Fund in the wake of the Asian financial crisis. Yet until recently the Fund had yet to delineate in an explicit fashion the specific conditions under which it would sanction their use. Although far from revolutionary, the Fund's recent steps to clarify its views represent an important evolutionary step in its orientation.

Initially, the Fund's continued with its post-Asian financial crisis orientation of sanctioning controls on inflows in select circumstances, while still offering strong reservations about their effectiveness and failing to elaborate in a precise fashion the circumstances under which such restrictions might be a reasonable and pragmatic policy response. The Fund's response to Brazil's introduction on new restrictions on inflows in October 2009 provides a good illustration of this tendency.

The Brazilian restrictions introduced a two percent tax on portfolio investment to curtail pressures for exchange rate appreciation stemming from a surge of capital inflows unleashed by exceptional monetary easing and liquidity measures taken in the developed world to combat the crisis and by the prospect of stronger economic performance in emerging markets. The restrictions were intentionally crafted as modest, temporary, and market-oriented. In line with the orientation it had developed since the Asian financial crisis, the Fund's initial reaction was sympathetic, while stressing its preference for policy adjustment and underscoring the likelihood of evasion.

Dominique Strauss-Kahn, the IMF managing director, stated "I have no ideology on this;" capital controls were "not something that come from hell" (quoted in Guha 2009). The IMF chief said that the Fund recognized that "there is no reason to believe that no kind of control is always the best kind of situation". Strauss-Kahn indicated he was sympathetic toward policymakers facing surges in capital inflows and were worried about asset bubbles. "We do not have a lot of tools to avoid this happening," he stated, especially when a standard IMF prescription to limit bubbles – exchange rate appreciation – proved difficult when export competitors such as China did not follow suit.

But Strauss-Kahn and other IMF officials indicated the Fund would not recommend controls as a standard prescription either – as they carried costs and were usually ineffective.[5] "The problem," according to the IMF chief, "is that most of the time it does not work." This sentiment was echoed by the head of the Fund's Western Hemisphere Department, the unit within the Fund responsible for relations with Brazil. "These kinds of taxes provide some room for manoeuvre, but it's not very much, so governments should not be tempted to postpone other more fundamental adjustments," he stated. "Second, it is very complex to implement those kinds of taxes, because they have to be applied to every possible financial instrument [to avoid evasion]," he added then (quoted in Reuters 2009).[6]

As capital flows continued to surge into emerging markets, other governments, including Taiwan, Indonesia, South Korea, and Thailand, facing similar pressure on asset prices, inflation, and exchange rates, also implemented restrictions on inflows (Brazil has tightened its controls several times since introducing them). In addition, a number of officials from other emerging markets, such as India, have let it be known publicly that the

---

[5] An IMF (2010e) study later found the evidence to be mixed as to whether the Brazilian tax on inflows was effective in reducing the volume of inflows, despite having an impact on the composition of flows.
[6] Interestingly, following the IMF's clarification its orientation in spring 2010, the head of the Western Hemisphere, in an October 2010 seminar, suggested the Colombia consider imposing controls on inflows to curb appreciation of its currency. The head of the central bank has ruled out such measures at least for the moment. See Crowe (2010).

introduction of new controls on inflows was under consideration (Goyal 2009; Lamont 2010). The response from the IMF has been one of tacit approval.

In February 2010, this approval became more explicit and far-reaching. A well-publicized report (Ostry et al. 2010) was released that clarified the circumstances under which controls on inflows would form a legitimate part of the policy toolkit.[7] For an organization that has long been perceived as emphasizing the distortions controls create, this clarification is significant. In line the evolution of organizational beliefs, the February 2010 report picks up on the earlier gradualist framing of controls on inflows by identifying them as an important policy instrument for "macro-prudential" regulation of the financial system.

Macro-prudential regulation aims to limit the build of systemic risk and the macroeconomic costs of financial instability. The 2007-2009 crisis has clearly demonstrated to policymakers and economists the need to strengthen this orientation by developing new counter-cyclical regulatory tools designed to "lean against the wind" (Brunnermeier et al. 2009; de Larosiere Group 2009; Financial Services Authority 2009). In line with this orientation, the February 2010 argues that controls can form part of the policy arsenal against future crises, especially the build-up of asset bubbles, by helping to counter-cyclically restrict credit growth and leverage caused by capital inflows. Free-flowing capital can threaten emerging economies because surges of inflows can create shocks, causing currencies to rapidly appreciate and asset prices to soar, the report argued. "For both macroeconomic and prudential reasons," the report (Ostry et al. 2010:15) explicitly stated, "there may be circumstances in which capital controls are a legitimate component of the policy response to surges in capital inflows." The report then identified in a more explicit and precise fashion the circumstances under which such macro-prudential considerations would support the use

[7] See also IMF (2010d; 2010e).

of controls: when the economy is operating near potential, the level of reserves is adequate, the exchange rate is not undervalued, and if the flows are likely to be transitory.

In line with the macro-prudential framing fixed to controls, the report uncovered evidence that controls that reduced risky liability structures by altering the maturity and composition of inflows had been useful in reducing fragility during the 2007-2009 crisis. It added that countries such as China and India, where extensive controls had been in place prior to the crisis, experienced better growth performances. The report also revealed concern about herding behaviour, bouts of excessive optimism and pessimism, and the possibility of collateral damage from asset bubbles and busts, even when the flows are fundamentally sound. Still, the report did caution that the circumstances under which controls were likely to prove effective were limited, and their effectiveness would likely prove mainly to be on the composition of flows rather than the aggregate volume. Despite this caveat, the report (Ostry et al. 2010:5) noted that controls "can retain potency if investors devise strategies to bypass them…the cost of circumvention strategies acts as 'sand in the wheels."

The recent clarification, while significant, does not imply that the IMF now supports more permanent restraints on capital flows. On the contrary, it continues to view controls as a temporary measure needed to restrain inflow surges at particular moments in the macroeconomic cycle under a precise set of circumstances. In a series of public statements, IMF management has stressed that controls should only be used to combat temporary surges and must not become permanent (Oliver 2010; Lipsky 2010). Surges of a long-term nature would indicate, according to IMF management, the need for adjusting policies and institutions.

The Fund's continued opposition to the Tobin tax, a permanent global tax on financial transactions, nicely illustrates this orientation. While constituting a restraint on inflows, the Tobin tax is analytically different from the macro-prudential restrictions recently endorsed by

the Fund because it would be applied permanently to all flows regardless of the state of the macroeconomic cycle. In September 2009, the G-20 instructed the IMF to provide a report that would examine how banks could contribute to the cost of the crisis, explicitly identifying the Tobin tax as one of several options the staff should consider. When the report was released in April 2010, the Fund rejected financial transaction taxes (FTT) as poorly suited for raising revenue and addressing the core sources of financial instability (IMF 2010c).[8] The Fund report was also skeptical as to whether an FTT would improve financial market performance. A FTT, the report argued, could some eliminate "desirable" contrarian short-term trading. The report was also doubtful as to whether higher transactions costs imposed by a FTT would limit cyclical asset price volatility, and it emphasized a number of potential distortions it could introduce.

The above discussion makes clear that the IMF's recent pronouncements on capital controls are more evolutionary than revolutionary. Nonetheless, perceptions about the IMF's orientation may matter more than its actual orientation, particularly at a time when the organization is actively seeking to strengthen its credibility and legitimacy in the eyes of emerging markets and developing country officials. Thus, for an organization that has long been perceived, though wrongly, as unequivocally opposed to capital controls, the recent clarification in its orientation is significant. What accounts for this recent clarification?

On the external side, there have been important shifts to the power and preferences of leading IMF members. In the decade following the Asian financial crisis, the G-7 continued to support the principle of capital freedom. There were, however, important differences in emphasis. In its trade and investment agreements, such as those with Chile, Singapore, and South Korea, U.S. officials insisted upon limitations for the use of capital controls. This position contrasted with the agreements with EU nations, Canada, and Japan, which

[8] See also Claessens et al. (2010).

permitted the use of controls either fully or as a safeguard during a crisis (Gallagher 2010). While embracing the principle of capital freedom, France, Germany, and Japan and, to a lesser extent, Canada have been traditionally more sceptical of free market finance and self-regulatory norms of financial governance than the U.S. and Britain.

The 2007-2009 crisis heightened their scepticism of free market finance and severely discredited the pre-crisis norm of self-regulation upon which the Anglo-American model and much of the international standards and codes had been based (Financial Services Authority 2009). French and German officials have been particularly outspoken critics of this model, pointing out that the crisis had vindicated their earlier scepticism. With the 2010 crisis in Greece and the Eurozone heightening the scepticism, French and German officials have pressed for consideration of a FTT as a way of dampening speculation and providing resources for future financial rescues.

A FTT has also attracted the interest of British officials, though given their traditional opposition to such measures and to Franco-German efforts to tighten EU regulation over the City of London, it remains to be seen how much their position has shifted, especially since the Labour government had backed a FTT was voted out of office in May 2010. U.S. officials, though prompted by the severity of the crisis and enormous popular pressure to tighten financial crisis, have remained steadfast in their long-held opposition to a FTT.

The crisis has weakened U.S. normative authority and leadership, but it has not prevented it from making its preferences heard at the IMF. Indeed, some observers (Gallagher 2010) suggest the U.S. remains the principal obstacle to capital controls securing greater legitimacy as policy instruments. Partly out of recognition of long-held U.S. opposition to a FTT, the IMF managing director made public statements in October 2009 that appeared to rule out the idea of an FTT and thus pre-empt the findings of IMF work on

recouping the costs of the financial rescue before it had been carried out (IMF 2009c). (He then later backtracked and emphasized that an FTT was one proposal being explored).

In addition to the heightened skepticism of free market finance, there has been a shift in the way that financial crises are understood. In contrast to the period following the Asian financial crisis, in the current reform debate there is a strong consensus that the same private market actors who over the past decade had been permitted to self-regulate were responsible for triggering the crisis. Crises are now not seen largely as "home grown" phenomenon in emerging markets but also the result of negative externalities emanating from financial centres in developed countries. As a result the IMF has overhauled it lending to make it easier for countries to borrow with fewer and sometimes no conditions attached.

Finally, the G-7's policy response to the crisis has effectively re-written the orthodoxy on crisis management. Over the past decade the G-7 had lectured crisis-afflicted countries on the need to restore confidence by closing insolvent financial institutions, strengthening fiscal discipline, and raising interest rates. Then, when faced with a crisis in their financial systems, they pursued precisely the opposite policies.

In addition to damage done to Anglo-American intellectual hegemony and leadership, the crisis has also accelerated the gradual shift in financial wealth and geopolitical clout away from the G-7 to new emerging powers. Indeed, there was great symbolism in the decision to convene the Group of Twenty (G-20) leading developed and emerging market economies, rather than the G-7, to set the reform agenda and act as the steering committee for the world economy. The decade since the Asian financial crisis has seen a fundamental shift in finance, with emerging markets accumulating massive stockpiles of foreign reserves. The past decade has also seen the rise of emerging market sovereign wealth funds whose investment US and European officials enthusiastically welcomed to support their distressed financial institutions in 2007-2008. The crisis has underscored the growing financial clout of China, whose banks,

insurance firms, and stock market now rank among the largest in the world. With its large dollar reserve-holdings, China (and other emerging markets) has become increasingly assertive in questioning U.S. fiscal policy and calling into question the dollar's reserve as the principal international currency.

Reserve accumulation and stronger policy frameworks and fundamentals have provided many emerging markets with the capacity to chart a course that is increasingly independent of IMF influence. The Fund emerged from the Asian financial crisis a significantly weakened institution. In addition to criticism of the IMF's response to that crisis, its outdated governance structure, which failed provide emerging markets with influence and representation congruent with their enhanced economic weight, raised serious questions about the organization's legitimacy. Prior to the onset of the 2007-2009 crisis, those governments that could do so pursued measures, such as reserve accumulation, regional liquidity arrangements, and early repayment of outstanding debts to the IMF, to escape the organization's influence. As a result the IMF loan portfolio shrunk to a historic low, forcing it to downsize its staff and develop a new income model.

But, in April 2009, with the crisis heightening demand for IMF assistance, the G-20 reaffirmed the organization's relevance in crisis management and agreed to a significant boost in its financial resources, namely $500 billion to be delivered through borrowing from select member states. Although pleased by the commitment to increase IMF resources, officials in emerging markets, particularly large reserve-holding countries, such as Brazil, Russia, India, and China—the so-called BRICs—feared that there would be pressure to contribute ad hoc increases now against promises of governance reform in the future. They therefore insisted that the IMF for the first time float bonds to member states so that they could maintain pressure for governance reform.

At the time of writing, China has committed to purchase $50 billion, while Brazil, Russia, South Korea and India has each committed to $10 billion, and Chile and Singapore at least $1.5 billion. Thus in a clear reflection of the new balance of economic power and clout, nearly one-fifth of new IMF resource commitments have come from countries that have historically had less influence and representation within the organization. Indeed, many of the aforementioned new creditors were at one time borrowers.

In October 2010, the G-20 agreed to boost IMF resources again, this time doubling from $340 billion the standing pool of IMF resources known as quotas. In a further reflection of the shift in economic power and clout, the G-20 also has agreed to a landmark reform of IMF voting weights to give a bigger voice to emerging markets. Over six percent of IMF voting power will be transferred to underrepresented countries at the IMF, with China becoming the country with third-largest share of votes. After the changes take effect, Brazil, Russia, and India will be all included in the fund's 10 biggest shareholders.

Many emerging markets and developing country officials traditionally have had serious misgivings about the desirability of free market finance. Yet their lack of significant influence and representation within the IMF prevented them from asserting this view forcefully. The prospect of potentially borrowing from the organization also perhaps moderated emerging market opposition to ensure support from IMF officials if it became necessary.

But the shift in power outlined above has altered this state of affairs. Many emerging markets no longer have a serious prospect of borrowing from IMF; on the contrary, it is now the IMF that faces the prospect of borrowing from them. Because of this and the growing influence and representation of emerging markets within the organization, IMF officials may have become more receptive to their preferences as way of gaining greater legitimacy and currying political support. Indeed, with their enhanced clout and the damage done to Anglo-

American normative hegemony and leadership, some emerging market officials have been emboldened to call on the IMF and the G-20 to provide greater support for the use of capital controls (Subbarao 2010).

Prior to the onset of the crisis, staff members, even if they were more sceptical of free market finance, would have found it difficult to advocate more far-reaching and explicit support of controls because such actions would have run contrary to the preferences of its leading member states, particularly the United States and Britain. But the shift in member state preferences and power has made it easier for the IMF staff to develop a more critical perspective on free market finance and to offer a more explicit and far-reaching acceptance of selective restraints on capital mobility.

Yet these external factors alone cannot account for the IMF's orientation. To be sure, the Fund's recent clarification seems to have been beneficial to the long-term interests some member states, notably emerging markets and developing countries, and to a lesser extent those traditional skeptical of free market finance among developed countries, but these interests alone were not the sole reason for it. In fact, the crisis has served to increase the dispersion of power and preferences within the IMF, which in turn has likely provided the organization with autonomy to develop its position independently. IMF management, whom some scholars see as an agent of member state interests, also appears to have exercised little leadership. The apparent initial equivocation in IMF management's views on capital controls likely meant that the staff faced weak organizational incentives to conform to a particular view.

This line of argument suggests a need to turn to internal factors, which have proven to be an important influence as well. Adaptation, the uptake of new ideas from the economics profession, and internal advocacy has proven to be critical in shaping the IMF's orientation. As outlined earlier, prior to the 2007-2009 crisis the staff continued to adapt their beliefs.

This adaptation led them to become increasingly convinced that reaping the benefits of financial globalization required countries meeting specific institutional thresholds and, that restraints on capital inflows could provide some important benefits in terms of macroeconomic and financial stability.

In the wake of the Asian financial crisis, the staff also developed a much greater knowledge and appreciation for factors intrinsic to the operation of financial markets that can give rise to financial instability. Staff reports began highlighting more forcefully the risks inherent in international financial integration, the limitations of economic models based on assumptions of rational and efficient markets, as well as the potential for negative externalities emanating from the financial centres of developed economies. In the decade following the Asian financial crisis staff reports analyzed herding behaviour in international capital markets, the "feast and famine" dynamics and the "boom-and-bust pattern and volatility" of capital flows to emerging markets, the relationship between financial market returns in developed countries and capital flows to emerging markets, the investor base of emerging market financing, and "spillovers" from developed countries to emerging markets (Chwieroth 2010, chapter 9). The staff had also become increasingly aware of the importance of macro-prudential regulation, though it took the 2007-2009 crisis to make this insight register with sufficient intensity and uniformity throughout the organization.

As suggested, in the wake of the Asian financial crisis the academic literature had progressed toward greater consensus that controls could provide some utility. It is notable that IMF staff studies, while acknowledging conflicting findings among empirical researchers, began increasingly to acknowledge the work on the effectiveness of controls by academic economists. After the onset of the 2007-2009 crisis some prominent academic economists began calling on the G-20 to offer greater support for controls on inflows to be used to protect weak or poorly regulated financial systems (Rodrik and Subramanian 2008;

Buiter 2008) and the use of controls on outflows to offset "sudden stops" in capital flows (Calvo 2008).

For most academic economists as well as policymakers, regulators, and IMF officials, the 2007-2009 crisis exposed the intellectual deficiencies in policies based on beliefs that held markets to be rational and efficient. The crisis, according to highly publicized report from the IMF's chief economists, had exposed serious flaws in the pre-crisis orthodoxy in macroeconomics (Blanchard et al. 2009). Belying the pre-crisis orthodoxy, among other things the crisis had shown that macroeconomic fragilities could arise when inflation was stable and that regulation was not macroeconomically neutral. The implication for policy, according to the report, was to give policymakers cyclical regulatory tools to manage the build-up of leverage and risk in the system.

There has also been a rethink of the pre-crisis orthodoxy with financial economics. Even prior to the crisis some economists had become increasingly attracted to the insights of behavioural economists. Harkening back to Keynes, behavioral economists stress the limitations of market rationality and efficiency and use social, cognitive, and emotional factors to understand how market actors make economic decisions (Akerloff and Shiller, 2009). Although interest in behavioral economics had been growing for some time, the 2007-2009 crisis has proven to be a boon for its proponents.

The rethink on macroeconomics and financial economics fit well with the emerging consensus on the need to strengthen macro-prudential regulation. Although not initially framed in this manner, capital controls began to feature in arguments from academic economists about policy tools for macro-prudential regulation (Subramanian, 2009a; Subramanian and Williamson, 2009). It is now increasingly accepted among academic economists that controls on inflows should be used for this purpose.

Prior to the release of the February 2010 staff report, it had become increasingly accepted wisdom within the Fund that restraints could lengthen the maturity structure of inflows even if there were doubts about their effectiveness in reducing the volume of flows and pressures for real exchange rate appreciation. Nonetheless, like crises before it, it seems apparent that the 2007-2009 crisis has had the effect of emboldening those staff economists who had long-held reservations about free market finance to advocate their views more forcefully within the IMF. It is therefore not surprising that many of the authors of the February 2010 report had been writing sympathetically about restraints on capital mobility for some years prior to the 2007-2009 crisis. In addition, like earlier crises, the crisis of 2007-2009 heightened the receptiveness of the organization as a whole toward taking a more critical view of capital freedom and a more supportive view of controls.

To summarize, external and internal factors have combined to produce the recent notable clarification in the IMF's orientation toward capital controls. On the external side, the shift in preferences and power among the IMF's leading member have made it easier for staff members to take more critical view of free market finance and a more supportive view of capital controls. On the internal side, it is clear that this orientation had been developing within the IMF for some time, though it was not as explicit and far-reaching as it is now. While far from being revolutionary, the recent clarification stands as important evolutionary shift in the IMF's orientation. Staff research drove the IMF to adapt its views. This adaptation was reinforced by the uptake of ideas from the economics profession and internal advocacy. These internal advocates, many of whom had long-standing reservations about free market finance and were sympathetic to controls, found that the crisis, along with the accompanying shift in member state preferences and power, to offer an opportunity to press their views more forcefully.

Conclusion

The IMF's recent clarification, driven by external and internal factors, stands as an important evolutionary step. For an organization long perceived, though often wrongly, to offer unequivocal opposition to capital controls, this clarification will likely prove significant in changing perceptions about whose interests and experiences the IMF serves. By offering a more explicit and far-reaching acceptance of capital controls the IMF has gone some way toward convincing emerging markets and developing countries, who generally perceive the Fund's past support for liberalization to have reflected the beliefs of developed countries and the interests of their financial sector, that it is representing and taking into account their interests and experiences. It thus could contribute to the on-going efforts to address its legitimacy problems.

Yet this new orientation poses a risk to multilateral governance. The Fund's new orientation may help to create and sustain a contagion effect of sorts. Even with the IMF's growing conditional acceptance of selective of restraints on inflows in the wake of the Asian financial crisis, most emerging market officials were often tentative and timid in taking measures to restrict capital flows out of fear of triggering an adverse reaction from the IMF, global financial markets, and credit rating agencies. However, as each government introduces controls with little adverse reaction from the IMF and other international organizations,[9] global financial markets and credit rating agencies, it may have become easier for governments elsewhere to do the same (Grabel 2010).

While this may provide greater policy space for emerging markets and developing countries, it also increases the scope for unilateral action that could have adverse multilateral consequences. With the current failure of multilateral institutions to resolve the dispute over claims that U.S. monetary policy is driving destabilizing inflows into emerging markets and that Chinese exchange rate intervention is creating large and protracted imbalances, many

[9] Other international organizations, including the Asian Development Bank, the United Nations, and the World Bank, have confirmed the empirical findings of the IMF and academic economists and increasingly have endorsed capital controls.

emerging market officials have taken matters into their hands by imposing controls. Such unilateral action, while partly a consequence of the failure of multilateral governance, could also quickly become a cause for its failure as governments lose faith in it and instead pursue policies, such as capital controls, tailored more to their interest.

The risk, then, is not only damage to the legitimacy and effectiveness of multilateral governance, but also a prolonged delay in macroeconomic adjustment in emerging market economies where reforms are necessary to encourage a rebalancing of global demand away from developed economies. This is most notably the case in those emerging markets where capital controls are used to sustain undervalued currencies. Widespread adoption of capital controls could also undercut the long-term impact of financial globalization and divert capital to countries less able to absorb it.

However, it should also be noted that by curtailing short-term flows and risky liability structures, greater use of controls could limit the demand for reserves by emerging markets and thus contribute to reducing global imbalances. To its credit, the IMF staff are aware of some of these important multilateral implications, which have led some within the Fund to suggest development of a new multilateral code of conduct governing the use of controls as part of the organization's ongoing mandate review (Ostry et al. 2010). There is thus a potential opportunity for enhancing multilateral governance. In fact, some within the Fund have raised the idea once again of revising the IMF's Articles to provide it with a new mandate to oversee the capital account policies of its members (IMF 2010a; 2010b).

The recent clarification has made it easier for the staff to begin engaging with the practical question of how to design controls so that they might prove effective and provide the greatest benefit and inflict the least harm. Indeed, as part of its mandate review, some staff are proposing strengthening surveillance so as to help members design and implement controls, ensuring that negative spillovers are avoided and that broader goals are taken into

account. Proposals to develop a code of conduct and to engage in work on how to design controls would appear to be important first steps in combating the potential adverse multilateral implications from the IMF's recent clarification.

References

Abdelal, Rawi. 2007. *Capital Rules: The Construction of Global Finance*. Harvard: Harvard University Press.

Acemoglu, Daron, Simon Johnson, and James A. Robison. 2001. The Colonial Origins of Comparative Development: An Empirical Investigation, *American Economic Review*, 91 (5): 1369-1401.

Akerlof, George A., and Robert J. Shiller. 2009. *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism* (Princeton: Princeton University Press)

Ariyoshi, Akira, Karl Habermeier, Bernard Laurens, Inci Otker-Robe, Jorge Ivan Canales-Kriljenko, and Andrei Kirilenko. 2000. *Capital Controls: Country Experiences with their Use and Liberalization*, IMF Occasional Paper No. 190 (Washington, DC: IMF).

Barnett, Michael, and Martha Finnemore. 2004. *Rules for the World: International Organizations in Global Politics*. Ithaca, NY: Cornell University Press.

Best, Jacqueline. 2005. The Limits of Transparency: Ambiguity and the History of International Finance. Ithaca: Cornell University Press.

Bhagwati, Jagdish. 1998. The Capital Myth: The Difference between Trade in Widgets and Dollars, *Foreign Affairs*, 77 (3):7–12.

Blanchard, Oliver, Giovanni Dell' Ariccia, and Paolo Mauro. 2009. *Rethinking Macroeconomic Policy*, Staff Position Note SPN/10/03 (Washington, DC: IMF).

Brender, Anton and Florence Pisani. 2010. *Global Imbalances and the Collapse of Globalized Finance*. Brussels: Centre for European Policy Studies.

Brunnermeier, Markus K., Andrew Crockett, Charles A. Goodhart, Avinash Persaud, Hyun Song Shin. 2009. *The Fundamental Principles of Financial Regulation*, Geneva Report on the World Economy 11. Geneva: International Center for Monetary and Banking Studies.

Buiter, Willem H. 2008. Some Suggestions for the G20 on November 15th, in *What G20 Leaders Must Do to Stabilise Our Economy and Fix the Financial System*, ed. Barry Eichengreen and Richard Baldwin, 17-20 (London: Vox.Org Publication).

Calvo, Guillermo. 2008. The New Bretton Woods Agreement, in *What G20 Leaders Must Do to Stabilise Our Economy and Fix the Financial System*, ed. Barry Eichengreen and Richard Baldwin, 53-55 (London: Vox.Org Publication).

Chwieroth, Jeffrey M. 2010. *Capital Ideas: The IMF and the Rise of Financial Liberalization* (Princeton: Princeton University Press).

Claessens, Stijn, Michael Keen, and Ceyla Pazarbasioglu. 2010. *Financial Sector Taxation: The IMF's Report to the G-20 and Background Material* (Washington, DC: IMF).

Crowe, Darcy. 2010. Colombia Central Bank Chairman: Controls Not Justified, Dow Jones Newswires, 19 October.

De Larosiere Group. 2009. *Report of the High-Level Group on Financial Supervision in the EU*. Brussels: European Union.

Eichengreen, Barry, and Michael Mussa. 1998. Capital Account Liberalization: Theoretical and Practical Aspects, IMF Occasional Paper No. 172 (Washington, D.C.: IMF)

Eichengreen, Barry and Charles Wyplosz. 1996. Taxing International Financial Transactions to Enhance the Operation of the International Monetary System, in Mahbub ul Haq, Inge Kaul, and Isabelle Grunberg, ed., *The Tobin Tax: Coping with Financial Volatility*, 15-41 (Oxford: Oxford University Press).

Financial Services Authority. 2009. *The Turner Review: A Regulatory Response to the Global Banking Crisis* (London: FSA).

Gallagher, Kevin P. 2010. *Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements*, G-24 Discussion Paper Series No. 58 (New York: United Nations).

Ghosh, Atish R., Marcos Chamon, Christopher W. Crowe, Jun Il Kim, and Jonathan David Ostry. 2009. *Coping with the Crisis: Policy Options for Emerging Market Countries*, Staff Position Note 2009/09 (Washington, DC: IMF).

Goyal, Kartick, 2009. India May Take Measures if Capital Inflows Surge, Chawla Says, Bloomberg, 19 November.

Guha, Krishna. 2009. IMF Refuses to Rule Out Use of Capital Controls, *Financial Times*, 3 November.

Grabel, Ilene. 2010. Not Your Grandfather's IMF: Global Crisis, 'Productive Incoherence' and Developmental Policy Space, University of Massachusetts Amherst Political Economy Research Institute Working Paper Number 214 (Amherst: University of Massachusetts).

Haggard, Stephan and Sylvia Maxfield. 1996. The Political Economy of Financial Internationalization in the Developing World, *International Organization*, 50 (1):35-68.

Hawkins, Darren G., David A. Lake, Daniel L. Nielson, and Michael J. Tierney, eds. 2006. *Delegation and Agency in International Organizations* (Cambridge: Cambridge University Press).

Helleiner, Eric. 1994. *States and the Reemergence of Global Finance: From Bretton Woods to the 1990s*. Ithaca: Cornell University Press.

H.M. Treasury. 2009. *Risk, Reward, and Responsibility: The Financial Sector and Society* (London: H.M. Treasury).

Institute of International Finance. 2010. Capital Flows to Emerging Market Economies, IIF Research Note. (Washington, DC: IIF).

International Monetary Fund. 2007a. *Reaping the Benefits of Financial Globalization* (Washington, DC: IMF).

-------. 2007b. *World Economic Outlook* [October edition], (Washington, DC: IMF).

-------. 2009a. *Review of Recent Crisis Programs* (Washington, DC: IMF).

-------. 2009b. *Annual Report on Exchange Rate Arrangements and Exchange Restrictions* (Washington, DC: IMF).

-------. 2009c. Transcript of a Press Conference by International Monetary Fund Managing Director Dominique Strauss-Kahn with First Deputy Managing Director John Lipsky and External Relations Director Caroline Atkinson, 2 October 2009, Available at http://www.imf.org/external/np/tr/2009/tr100209.htm.

-------. 2010a. The Fund's Mandate – An Overview (Washington, DC: IMF).

-------. 2010b. The Fund's Mandate – The Legal Framework (Washington, DC: IMF).

-------. 2010c. *A Fair and Substantial Contribution by the Financial Sector: Final Report to the G-20* (Washington, DC: IMF).

-------. 2010d. *Global Financial Stability Report* [April edition] (Washington, DC: IMF).

-------. 2010e. *Global Financial Stability Report* [October edition] (Washington, DC: IMF).

Krugman, Paul. 1998. Saving Asia: It's Time to Get Radical, *Fortune*, 138 (5):74–80.

Lamont, James, 2010. Strong Rupee Could Spur Controls on Capital, *Financial Times*, 21 April.

Leijonhufvud, Axel. 1968. *On Keynesian Economics and the Economics of Keynes: A Study in Monetary Theory* (New York: Oxford University Press).

Lipsky, John. 2010. The Road Ahead for Central Banks: Meeting New Challenges to Financial Stability, 18 June, Available at http://www.imf.org/external/np/speeches/2010/061810.htm.

Magud, Nicholas and Carmen Reinhart. 2006. Capital Controls: An Evaluation, NBER Working Paper 11973 (Cambridge: NBER).

Meseguer, Covadonga. 2005. Policy Learning, Policy Diffusion, and the Making of a New Order, *The Annals of the American Academy of Political and Social Science* 598:67-82.

Nielson, Daniel, Michael Tierney, and Catherine Weaver. 2006. Bridging the Rationalist-Constructivist Divide: Engineering Change at the World Bank, *Journal of International Relations and Development*, 9 (2):107-139.

Oliver, Christian, 2010. IMF Warns on Emerging Market Currency Controls, *Financial Times* (11 July).

Ostry, Jonathan D., Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reinhardt, Capital Inflows: The Role of Controls, IMF Staff Position Note SPN/10/04 (Washington, DC: IMF, 2009).

Rappeport, Alan. 2010. IMF Reconsiders Capital Controls Opposition, *Financial Times*, 22 February.

Reuters. 2009. IMF says Capital Tax Not Enough on Its Own, 23 October.

Rodrik, Dani. 2010. The End of an Era in Finance, Project Syndicate, 11 March, Available at http://www.project-syndicate.org/commentary/rodrik41/English.

-------., and Arvind Subramanian, 2008. We Must Curb International Flows of Capital, *Financial Times* (25 February).

Sachs, Jeffrey. 1997. Power unto Itself, *Financial Times* (11 December).

Skidelsky, Robert. 2009. *Keynes: The Return of the Master* (London: Allen Lane).

Steinbruck, Peter. 2009. Tax Trades to Share the Costs of the Crisis, *Financial Times* (24 September).

Stiglitz, Joseph. 1998. What Caused Asia's Crash? Bad Private Sector Decisions, *Wall Street Journal* (4 February).

Subbarao, Duvvuri. 2010. Volatility in Capital Flows: Some Perspectives, Comments at the High-level Conference on The International Monetary System, Swiss National Bank / IMF, Zurich, Switzerland (11 May).

Subramanian, Arvind, and John Williamson. 2009. The Fund Should Help Brazil to Tackle Capital Inflows, *Financial Times* (25 October).

Subramanian, Arvind. 2009b. The IMF Beyond Instanbul, *Business Standard* (30 September 2009).

Tirole, Jean. 2002. *Financial Crises, Liquidity, and the International Monetary System*. Princeton: Princeton University Press.

Turner, Adair. 2009. How to Tame Global Finance, *Prospect*, Issue 162 (27 August).

World Bank – International Monetary Fund. 2009. *Global Monitoring Report 2009: A Development Emergency* (Washington, DC: World Bank – IMF).