EXECUTIVE BOARD MEETING

SM/20/138
Supplement 2
Correction 1

September 28, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Independent Evaluation Office—IMF Advice on Capital Flows—How Well is it Supported by Empirical Evidence?**

Board Action:	The attached correction to SM/20/138, Sup. 2 (8/20/20) has been provided by the IEO.
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Page 6**
Questions:	Mr. Loungani, IEO (ext. 37043) Ms. Batini, IEO (ext. 35763)

16. This view was based in part on the benefits that capital account liberalization theoretically offered to developing countries in terms of increased access to external capital, in part on the perception that current account convertibility in developing countries, a larger presence of multinational firms in those countries, and the ongoing capital account liberalization in the advanced economies, had all combined to make restrictions on capital flows in developing countries less effective, and in part on the perception that the costs of restrictions could be large (see Mathieson and Rojas-Suarez, 1993, as well as Quirk and Evans, 1995).[8] Doubts on effectiveness were based partly on empirical research both inside and outside the Fund.[9] It is clear that during this time the Fund generally viewed *de jure* capital account restrictions in middle-income developing countries unfavorably. Indeed, the issue of amending the Articles to give the Fund a mandate in this area was actively discussed at the time, including at the 1998 Annual Meetings in Hong Kong SAR.[10]

III. Emergence of the "Institutional View"

17. This perspective is in contrast to what later emerged as the IV. What changed, and what role did empirical evidence play in the change? This section considers this question from the perspective of the three components of the IV: capital account liberalization (the removal of longstanding and comprehensive restrictions on capital flows, or "walls" in the terminology of Klein (2012)); the imposition of temporary restrictions as stabilization tools ("gates"); and the conditions under which it might be appropriate to deploy "gates."

A. Benefits and Costs of Capital Account Liberalization

Pre-IV professional evidence

18. While tests of the effectiveness of capital account restrictions could frequently be found in the professional literature by the middle of the 1990s, somewhat surprisingly empirical tests of the various benefits suggested by theory from the removal of such restrictions are hard to find before this time.[11] This changed with the obvious challenges that increased capital mobility posed in the form of the dramatic outflows associated with the UK's sudden exit in 1992 from the European Exchange Rate Mechanism and with the 1994 Mexican crisis, as well as of large inflows

[8] Perceived costs included the postponement of needed reforms, administrative costs, encouragement of rent-seeking activities, and the possibility that evasion effects could spill over into other activities, expanding the size of the informal economy.

[9] Some of the relevant work on the effectiveness of controls is cited in Mathieson and Rojas-Suarez (1993). See also Johnston and Ryan (1994) and the survey by Dooley (1995). The perceived costs of restrictions, by contrast, were not documented empirically—at least not in any systematic way—but were rather reasoned to be likely to exist on *a priori* grounds.

[10] See Quirk and Evans (1995), as well as Fischer and others (1998).

[11] As mentioned above, Alesina, Grilli, and Milesi-Ferretti (1994) was one of the first papers to investigate the real effects of capital account restrictions/liberalization.