EXECUTIVE BOARD MEETING

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To: Members of the Executive Board

From: The Secretary

Subject: **Independent Evaluation Office—IMF Advice on Capital Flows—IMF Advice on Crisis-Driven Capital Controls in Europe**

Board Action:	The attached corrections to SM/20/138, Sup. 10 (8/20/20) have been provided by the IEO.
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 1, 2, 3, 4, 9, 10, 11, 12, 13, 15, 17, 23, 24**
Questions:	Mr. Loungani, IEO (ext. 37043) Ms. Batini, IEO (ext. 35763)

I. OVERVIEW

1. The three cases of use of capital flow controls examined here (Iceland, Cyprus, and Ukraine) primarily involve emergency controls on outflows introduced at times of economic, financial, or security crisis in the context of IMF-supported stabilization programs.[1] In the key episodes, the introduction of controls was, at the time, generally considered to be inevitable and sensible. Nevertheless, the cases differ sharply in their objectives, their outcomes—both for the economy at large and for the wealth holders whose export of capital was blocked or delayed—and the likely counterfactual if the controls had not been put in place.

2. The main goal of Iceland's 2008 controls was to halt the depreciation of the local currency when the banking system collapsed. Those trapped by the restrictions in Iceland included foreign investors in Icelandic securities, as well as creditors of the estates of the failed banks. Some were able to repatriate their funds only after a long interval (about eight years) and after payment of a significant exit tax in the form of a "stability contribution."

3. Cyprus introduced controls in March 2013 in the context of a substantial "bail-in" of deposits at the two largest banks, which had both failed. In this case, there was little danger of exchange rate change because Cyprus is part of the euro area (indeed it is less clear that controls were advantageous for Cyprus or for the euro area) but any alternative would have required the vigorous support of the European partners in the Troika. Since Cyprus was in a Troika-negotiated program and since the largest bank~~s~~ had been recapitalized through the bail-in, and the second largest bank was wound down, the euro system could have chosen to finance any outflows, albeit assuming a degree of credit risk, given that the prior measures should have been sufficient to limit that risk.[2] Financing by the euro system would have removed the need for restrictions and perhaps accelerated the economic recovery. On the other hand, the controls were operated ~~rather loosely~~ with numerous ~~exceptions~~exemptions and they were progressively liberalized on a more rapid schedule than Iceland's.

4. Ukraine's emergency measures of February 2015 were much more successful than its earlier attempts to maintain stability through capital controls. They succeeded in their aim of protecting the level of foreign exchange reserves and stabilizing the exchange rate in the midst of an economic and security panic. Domestic wealth holders were arguably protected from the capital losses that would have hit them had outflows caused an overshooting depreciation of the

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[1] Some inflow restrictions were introduced in Iceland in 2016 and are mentioned below. In both Iceland and Cyprus, a period of strong, reversible inflows preceded a crisis; should capital inflow controls have been considered at that time? This possibility is not examined here. The Iceland inflows, which are likely to have been accentuated by the high interest rate policy that the Central Bank was pursuing before the global financial crisis, preceded 2008 and as such are outside the scope of this study. Capital inflow restriction in Cyprus would have been prohibited by EU rules on freedom of capital movements and thus incompatible with euro area membership.

[2] Earlier introduction of controls in Cyprus during 2012 would have allowed the bail-in of bank depositors to be spread over a wider set; large depositors who withdrew during 2012 received full value, whereas those who remained loyal to the troubled banks suffered haircuts which in some cases are expected to be higher than 90 percent.

local currency. To that extent, as with a "stop-loss" rule, each might have been protected from the externalities caused by a race to the exit.

5. Capital outflow restrictions in times of crisis are typically introduced suddenly and without much notice to anyone outside a narrow circle of decision makers and their advisors. Accordingly, the IMF staff was not in the driving seat for some of the major initial steps in these key episodes. Nevertheless, the staff broadly supported the approach taken in these three cases of emergency outflow restrictions. By contrast, it did not view favorably the measures that Ukraine maintained in earlier years, nor did it support the inflow measure that Iceland introduced in 2016. In each case, the Fund's stance can be seen as consistent with the Institutional View on the Liberalization and Management of Capital Flows (IV) (IMF, 2012a) (which was not issued until after the early measures).

6. The Fund staff provided what the national authorities considered to have been good technical advice on implementation of controls. It is possible that this advice helped limit the degree to which the measures were, through loopholes or leaks, vulnerable to abuse or corruption—an oft-mentioned hazard with such regimes—though this is inherently difficult to confirm. Significant loopholes that were detected in Iceland's 2008 regime were closed during 2009–10 (IMF, 2012b). The relatively ~~lax~~flexible implementation in Cyprus and lax approach (albeit in a quite different macroeconomic setting) in the earlier phase in Ukraine raises some questions as to how effective some of the measures were in limiting outflows.

7. As conditions stabilized, the Fund staff helped in the design of programs or roadmaps for phasing out restrictions, especially in Cyprus and Ukraine, where actions were conditions-based as recommended in the IV. In Iceland, too, the actions taken were conditions-based, but there the situation differed because of the need to deal with the trapped claims on the estates of the failed banks and other holdings. In all three cases, the timing and nature of the removal of controls remained firmly in the hands of the authorities and differed in significant respects from what the Fund had in mind at first.

8. All in all, discussions with officials in all three countries suggest that the introduction of the controls reflected in each case more an intuitive reaction to protect against extreme events than a thought-through strategy adopted with a clear endpoint in mind. The desire to limit exchange rate movements was clearly in play in two of the three cases. Such a goal could make sense where an overshoot of equilibrium rates is a serious threat.[3] Another goal could have been to provide time to design and implement debt restructuring, but it took a long time for such thinking to mature in Iceland, and in Cyprus there had already been a bail-in which should have been sufficient to avoid the need for further debt restructuring.

[3] In Ukraine, unwarranted adherence (through measures including lighter capital controls) to nominal exchange rate stability (at an overvalued rate) had been criticized by the Fund staff before the crisis of 2014. The severity of the 2014 crisis, clearly threatening an overshoot, displaced these concerns.

9. There is a widespread view that, even when they are introduced in response to an acute crisis, capital controls are hard to remove in a straightforward manner. That the removal of controls often takes years rather than months is evidenced from the experience recounted here. In each country, national authorities often wanted to liberalize more quickly than the Fund staff considered advisable. Nevertheless, all three countries were able to proceed to systematically and progressively remove controls and are (almost) completely free of controls at the time of writing.

10. There would be a case for the Fund to develop best-practice guidelines for the purpose and objectives, design, and roadmap for phasing out controls introduced in emergency situations. It is not clear that the IV (IMF, 2012a) or its implementation manual deliver what is needed here. While the IV provides a set of conditions that should be satisfied by such policies, it is not seen by practitioners as a constructive handbook for the development of a fully integrated suite of policy actions.

II. ICELAND: POLICY EVOLUTION

A. The 2008 Measures

11. It was the reckless expansion of the Icelandic banking system from 2004 that made Iceland so vulnerable to a sudden stop. The expansion was financed largely from abroad and much of it was used to buy foreign assets, though with a material spillover into the Icelandic economy. The sums involved were small relative to the international markets but vast in relation to Iceland's economic capacity. A spike in credit default swap (CDS) spreads for Icelandic banks in early 2006 signaled how fragile was the confidence of the international financial markets, which had financed the banks' buccaneering growth in the ample global liquidity conditions of those years. With the increasing tension in global financial markets in 2007–08, the banks faced increasing difficulties in accessing liquidity, with their CDS spreads soaring to more than 1000 basis points early in 2008.

12. In their response to increasingly stressed financial conditions during 2008, the authorities did seek additional support from other central banks but with limited success; they underestimated the scale of the external liquidity risk cliff-edge at which they were teetering. They managed to secure swap arrangements with three Nordic central banks, but for amounts totaling well under 1 percent of the banking system's liabilities. Their efforts to persuade the banks to downsize or to transfer their headquarters elsewhere were unsuccessful.

13. With the benefit of hindsight, the Fund might have urged more vigorous preemptive actions that might have allowed the banks' emerging insolvencies to be managed and contained in a more orderly manner (although it has to be acknowledged that by 2008 it was probably already too late to save much). Following a short ad hoc mission that the authorities requested in Spring 2008, an IMF Financial Sector Assessment Program (FSAP) team visited Iceland to conduct a financial sector assessment update in June 2008. The FSAP mission report (which was completed in mid-August but was not published until December) did express specific and well-founded concerns about the fragility of the banks, and it urged the authorities to prepare

promptly for the contingency of a sudden stop crisis, focusing mainly on how to deal with the potential for severe liquidity strains in the major institutions. But overall "the tone of the report was relatively reassuring" (IEO, 2011).[4] And, as noted by the downbeat Article IV report that was completed in early September 2008, the authorities' main focus of concern lay elsewhere and they remained insufficiently prepared for the failure of the entire banking system. While potential "debt-servicing difficulties" were mentioned in the Article IV report, there is no indication that introduction of capital flow restrictions was on the Fund's radar before the crisis.

14. When the crisis broke in September 2008, the Fund was not called ~~i~~on to provide financial assistance until after the authorities had launched the main crisis management actions. Relying on advice from investment banking consultants (J.P. Morgan), who pointed out that Iceland did not have the resources to credibly guarantee the banks' liabilities (with prospective losses amounting to a multiple of Iceland's GDP), the authorities allowed the main banks to fall into default and introduced legislative measures to protect domestic financial stability. Over a ten-day period from September 29, 2008, all three of the main banks failed. Replacement banks assumed local assets and liabilities, but the failure disrupted foreign payments because the replacement banks could not immediately establish international correspondent relationships for making payments.[5] For some weeks, foreign payments had to be conducted through the central bank, which sought to prioritize these through guidance and rationing.[6]

15. An IMF team arrived in Reykjavik on October 12, 2008 and within a few weeks a two-year Stand-By Arrangement (SBA) had been negotiated, providing for temporary maintenance of exchange controls with the intention of preventing a further sharp depreciation of the Icelandic krona (ISK). "All foreign exchange transactions unrelated to current transactions were prohibited with only limited exceptions" (IMF, 2012b).

16. The decision to formalize controls as a prior action of the program was at the initiative of the Fund. This was a striking departure from the Fund's usual position on capital controls at that time, and it came as a "bombshell" to the authorities, who had envisaged an early end to the

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[4] Pointing to specific areas in which the Central Bank of Iceland's stress tests missed evident vulnerabilities, the FSAP report specified ways in which more stringent tests were warranted given the "increasingly difficult conditions in global markets." Stressing that "[D]evelopment of contingency plans for a possible bank failure, particularly of one of the three large banks, is critically important," the team pointed out that "[t]he banks are so large that Iceland would have difficulties addressing significant cross-border stress alone. For that reason, a clear understanding on a shared diagnosis of the conditions of the banks is required and agreement on the allocation of responsibilities in the resolution of the banks is critical." Still, the Fund's concerns related more to liquidity issues than to issues of bank solvency.

[5] The access of depositors at branches of the failed banks in other European Economic Area countries to the Icelandic deposit guarantee system was removed by the emergency Icelandic legislation restructuring the banking system. This decision was challenged unsuccessfully at the European Free Trade Association Court by the governments of the Netherlands and the United Kingdom. In the end, the deposit insurance funds of both those countries fully recovered from the estates of the failed banks the outlays they had made to depositors.

[6] Notably, under initial Central Bank of Iceland guidelines, "non-resident holders of ISK assets were blocked and could not be converted into other currencies or transferred abroad" (IMF, 2012b).

appropriate in the face of a surge, and were not to be used preemptively to limit incipient inflows, it was seen by staff as relevant that Iceland's inflows in 2016 were rather small and certainly nowhere near what had been experienced before the crisis. Given that the measure was being introduced while outflow restrictions were still in place, it was arguable that Iceland should instead take advantage of the inflow to liberalize the outflows.

31. Today, the national authorities still regard the 2016 measure as having been effective in damping what could have become a serious obstacle to effective monetary restraint, and they arguably have a point in noting that it may be too late to introduce such restrictions when an inflow surge is fully under way.[16] Still, quite apart from matters of principle, the effectiveness of the measure to curb inflows can be questioned: in line with the experience of other countries, it did more to shift the composition of inflows into the—presumably safer—form of equity inflows than to reduce total capital inflows (Forbes, 2018),.[17] though this interpretation does not go unchallenged.

III. Cyprus: Policy Evolution

A. Banking Weaknesses

32. Severe balance sheet weaknesses in the Cypriot banking system were evident to the Fund staff in 2011 and became entangled with other pressures on the government's finances in the context of the fast-moving euro area crisis. The government began to encounter difficulties in market funding (and met some of its needs in 2011 by securing a bilateral loan from the Government of Russia). The combined difficulties, but especially the banking problems, led directly to the introduction in early 2013 of administrative controls on withdrawal of bank deposits and restrictions of international transfers, in the context of a Troika support package that drew on the Extended Arrangement under the Extended Fund Facility and the European Stability Mechanism (ESM). The sizable haircuts imposed on bank depositors—many of them non-residents—as part of the resolution of these banks were intimately entwined with the perceived need for capital flow measures as part of a package to stabilize the Cypriot economy. While depositor haircuts might trigger damaging outflows for fear they might be repeated, a steeper or earlier haircut could reduce the likelihood of a repeat being needed.

33. The two largest Cypriot banks, Bank of Cyprus and Laiki Bank, were struggling partly because of the sizable position that they had taken in Greek government debt not long before that debt was restructured in 2012. In addition, one of these banks was threatened by a large block of non-performing loans to the Greek private sector (including some associated with the Marfin Investment Group, a major shareholder of Laiki). Furthermore, the recession that took hold in 2012 exposed the poor underwriting of commercial and residential property loans in

[16] The reserve requirement was eventually reduced to zero.

[17] Similar permanent inflow management measures which helped lengthen maturities contributed to financial stability in other countries (see Everaert and Genberg, 2020).

Cyprus which overhung the entire banking system, following huge inflows from abroad until 2011.[18]

34. The Fund staff recognized the nature and scale of the problem and judged that a full bailout of the bank creditors by the Cypriot government would not be fiscally sustainable, because of the relatively large size of the Cypriot banking system in the economy (bank balance sheets totaling eight times GDP). It responded to belated approaches from Cypriot and European Union authorities from the middle of 2012 and engaged with the European Commission and the European Central Bank (as the Troika) with a view to finding a solution. While discussions continued, growing public awareness of the scale of the banking problem led to an acceleration of bank outflows.

35. With an estimated capital shortfall in the banking system of 50 percent to 60 percent of GDP, it became clear during these discussions that the government could not simultaneously meet such a requirement and maintain a sustainable debt profile. Under the circumstances, the Fund staff strongly advocated the use of direct recapitalization of the failing Cypriot banks by the new ESM. Although the idea of empowering the ESM to make such investments had been under discussion in the European Union and had been approved in principle in the EU leaders' Summit in June 2011, the EU was not willing to activate this mechanism.[19] Note, however, that activating the mechanism would have reduced the need for bail-in only if the ESM were prepared to make an investment with the expectation of losing a sizable part of it.[20]

B. Step-by-Step to a Program

36. Discussions between the parties were very protracted. This partly reflected different perspectives on the best way forward—participants recall that the staff of the European Commission and the European Central Bank were at first reluctant to endorse any bail-in of depositors—and partly a reluctance of the government to enter a program shortly before the elections that were scheduled for February 2013~~end-year 2012~~.[21] Contingency plans, including draft legislation to deal with a bank resolution, were prepared by the authorities in consultation with Troika staff. The idea of administrative controls to limit the outflow of banking funds was already being

[18] These inflows were associated with a current account deficit which peaked at 15 percent of GDP in 2008. From their peak in late 2008, real house prices had fallen by some 20 percent by mid-2012.

[19] EU legislation granting the European Stability Mechanism such powers has been in place since the end of 2014, but the powers have not yet been used.

[20] Still, an ESM capital injection sufficient to bring the restructured banks from zero to a capital adequacy ratio satisfying regulatory requirements would have reduced the scale of the needed haircut and avoided converting the ~~largest~~ uninsured depositors into shareholders of the restructured entity; it would have offered an adequate rate of return to the ESM's investment; and it would possibly have removed the need for administrative (including capital flow) measures.

[21] Michaelides (2014) and Orphanides (2014) are particularly critical of the delays in this period.

considered at this time, presenting unforeseen technical questions about the use of capital controls within a currency union.

37. Meanwhile, by mid-2012, the heavy bank withdrawals were making the Bank system ever more dependent on central bank financing; at the same time, the restructuring of Greek government debt and ratings downgrades eroded~~had exhausted~~ the two main banks' stock of collateral eligible for refinancing at the ECB. Furthermore, depletion of the two main banks' capital led to their losing the eligibility as counterparties in normal ECB refinancing operations. This meant that the run~~, which was mainly but not only from these two banks,~~ could now be fully financed only with the help of emergency liquidity assistance (ELA) from the Central Bank of Cyprus.[22] Under the prevailing circumstances, in practice this required a government guarantee to provide sufficient backing for the emergency lending. In that way the government's finances became further entangled in the bank failures even though the government had not given any guarantee to the depositors. The ELA that was provided—mainly to Laiki Bank which had lost one-third of its deposit base—came to about EUR 11 billion by early 2013.[23] The outflow of funds during this period escaped any haircut, ultimately leaving the remaining losses to be borne by the banks' remaining depositors, who suffered a worse haircut as a result.

38. The change of government following the election helped break the log-jam in discussions with official lenders.

C. Bank Depositor Bail-in and Administrative Restrictions

39. Unable to secure a further loan from Russia, the new government had to face the fact that the Fund would be legally precluded from lending to a member whose debt situation was unsustainable. If direct bank recapitalization by the European Stability Mechanism was not on the cards, that meant bail-in. The government discussed with EU (and, to a lesser extent, IMF) officials various options for bailing in the creditors of the banks. Observing that large depositors had enjoyed high interest rates (4–5 percent per year) in the previous years, the new government felt that the fairest and most effective approach would be to apply a "horizontal" levy on the deposits at all banks in the system (including deposits below the guarantee ceiling of EUR 100,000). The government calculated that a levy of 6.75 percent for deposits of less than EUR 100,000, and 9.9 percent for larger deposits, would be sufficient to fill the hole. Fears about how large non-resident depositors would react to a haircut in excess of 10 percent may have contributed to this plan.

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[22] Under Eurosystem procedures, ELA to a solvent but illiquid bank may be provided—at its own credit risk—by the national central bank unless the European Central Bank Governing Council objects.

[23] Much of the need for ELA in Laiki can be seen as resulting from the high loan-to-deposit ratio of the bank's Greek operations. These were previously run as a subsidiary, but became a branch of Laiki in early 2011, in a transaction that had the effect of greatly increasing the exposure of the Cyprus deposit guarantee system, inasmuch as Greek deposits previously covered by the Greek system would now be contingent liabilities of the Cyprus system.

40. Although the Fund made it clear that this was not its preferred approach, the plan was nevertheless endorsed in a late night Eurogroup meeting on March 16, breaking the deadlock that was threatening failure of the program negotiations.

41. A bank holiday was announced for all of the banks pending the introduction of the controversial "horizontal" depositor levy scheme. But the proposed scheme met with immediate and widespread criticism, both within Cyprus (especially from some banks that relied mainly on foreign deposits and that were not failing) and elsewhere (especially from parties who saw the proposed levy as undermining the credibility of the European deposit insurance regime in general (see Gulati and Bucheit, 2013; Wyplosz, 2013). Within days, the Parliament of Cyprus overwhelmingly rejected the proposal.

42. As a result, the "horizontal" approach, not distinguishing between failing banks and others, was quickly abandoned and replaced on March 25 by the resolution of the two largest commercial banks only. This was the approach that the Fund had advocated all along in case of bail-in. Insured deposits were now unaffected by levies, but large depositors suffered haircuts that were sizable enough to restore capital adequacy.[24] One of the two large failing banks (Laiki) was resolved immediately~~liquidated~~ and its restructured liabilities transferred to the other (Bank of Cyprus).[25] Depositors received equity stakes in the restructured bank.

43. Although the haircuts were sizable, they applied only to large deposits.[26] As a result, the aggregate amount of the haircut came to 15 percent and 25 percent of the total deposits in each of the two banks, respectively. Of this, two-thirds belonged to non-residents. Thus, haircuts on

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[24] The treatment of large deposits differed between the two banks. Those in legacy Laiki remained in the ~~liquidated~~ entity to be liquidated; recovery of only 5–6 cents per euro was being projected in 2019. Those in Bank of Cyprus received an initial haircut of 37.5 percent, with a further 22.5 percent frozen pending further clarification of the bank's finances; about half of these deposits were later released, making the final BOC haircut 47.5 percent, for which the depositors received equity in the resolved bank.

[25] ~~In an unusual maneuver carried out by the authorities at the instance of the Troika, the~~The three largest banks, including BOC and Laiki, sold the sizable assets and liabilities of their Greek branches, accounting for about a quarter of their balance sheets, to one of the largest Greek banks, Piraeus. Deposits in the Greek branches amounted to about EUR 15 billion (about 75 percent of Cyprus's GDP), of which only EUR 9 billion was insured by the Cypriot deposit insurance system. This transaction, which seems to have been developed by ECB staff and endorsed by Fund staff, was designed to ensure that the confidence of Greek depositors in Greek banks would not be damaged by a haircut being applied. It also served to protect the selling bank from Greek tail-risk. As is inevitable in such circumstances, the transaction was controversial in relation to the valuation of the assets. Although the acquiring bank Piraeus promptly recognized a valuation gain, reflecting the below-face-value price that it had paid, it subsequently had to take provisions against these assets. Even if the assets were fairly priced, though, it is worth noting that this transaction had the effect of protecting the large depositors in the Greek branches from haircut and of increasing the needed haircut on the remaining depositors. (Note that the European Court of Justice found in July 2018 that the sale of the Greek branches did not constitute an infringement of the right to property. See https://curia.europa.eu/jcms/upload/docs/application/pdf/2018-07/cp180108en.pdf). A somewhat similar ringfencing of the assets of the London branch of the failing Laiki was arranged by transferring its assets and liabilities to the London subsidiary of BOC.

[26] Unlike in the case of Greece, there was no restructuring of the sovereign debt of Cyprus.

Cypriot depositors amounted to about EUR 2 billion (a little more than 10 percent of GDP) spread over some 15,000 individuals and 4,000 corporates.[27]

44. Although the Fund staff would have preferred the Emergency Liquidity Assistance outstanding in Laiki Bank to be left as a claim of the Central Bank of Cyprus in the liquidation (and had argued for this in earlier discussions), this was not the solution adopted. Furthermore, the ELA was not haircut but was transferred to become a liability of the surviving large bank, Bank of Cyprus, after its restructuring. In that way the Central Bank was able over time to fully recover the amount that it had provided, thereby reducing the negative balance in its TARGET2 account vis-à-vis the remainder of the Eurosystem pro tanto. It was ~~more than five~~ almost four years after the program before the ELA was finally cleared.

45. Even though no new funds were injected into BOC, the bail-in had, by reducing the bank's liabilities, the effect of recapitalizing this bank.[28] Although the de facto recapitalization might have been thought sufficient to restore confidence among the remaining depositors, there were lingering concerns that further measures would be needed to stop the drain of deposits. The Fund staff felt that, absent commitment from the ECB to a sufficient liquidity backstop, an acceleration of outflows to an extent that undermined bank liquidity should prompt the introduction of administrative controls on deposit withdrawals and capital movements.

46. During the bank holiday that followed the levy announcement, the skeletal contingency plans for administrative controls and bank resolution that the authorities had been sketching out in collaboration with Troika staff were rushed to completion. When the bank holiday ended, the banking system (apart from the bailed-in deposits) was reopened, but with ceilings imposed on cash withdrawals from all banks in Cyprus and on transfers both within and outside Cyprus. As the measures restricted certain current international payments, they were considered by the Fund as not only capital flow management measures but as exchange restrictions (under Article VIII, Section 2(a)) (Box 1).

Box 1. Cyprus: ~~Nature of~~ Some of the Initial Restrictions Introduced in March 2013

- Cash withdrawals from banks by individuals were limited to EUR 300 per day, per person, per credit institution.~~9,000 per month.~~
- Export of bank notes abroad was limited to EUR ~~2~~1,000 per person per journey.
- ~~Transfers~~ Payments abroad via cards~~by individuals~~ were limited to EUR 5,000 per month. Otherwise, transfers abroad by individuals were subject to official approval.
- Individuals could make limited transfers ~~of less than EUR 3,000~~ to another domestic bank.
- Maturing time deposits were extended for one month.
- Ceilings for businesses were higher (initially EUR 5,000 per day, per account), and businesses (as well as individuals) could seek official approval for transfers above the ceilings.

[27] Depositors with loans were allowed to benefit from netting in the restructuring.

[28] Direct recapitalization (on a much smaller scale) was used for some smaller banks/credit cooperatives.

D. Liberalization

51. Soon, the restrictions began to be relaxed to avoid too harsh an impact on economic activity in Cyprus. In addition, most normal current payments above the unrestricted amounts were being permitted, and numerous exemptions were applied by the government. ~~It is reported that overall there was relatively lenient application of the controls that remained in place, provided that this did not threaten the liquidity position of BOC.[31]~~ Progressively, as confidence returned, the controls continued to be liberalized, though they were not finally removed in full until two years after their introduction.

52. In the end, depositors were able to access their (post-haircut) funds in full and in un-depreciated currency. This contrasts with the situation in Iceland, and indeed in many other countries where capital controls have coincided with substantial currency depreciations so that holders of domestic assets have lost value during the period in which their funds have been trapped by the controls. Nevertheless, being without access to their funds will have been costly to some of Cyprus's depositors inasmuch as they were unable to completed desired transactions during the period of administrative restrictions.

53. The progressive easing of the restrictions was somewhat faster than, though otherwise generally in line with, initial ideas that had been prepared in collaboration with the Fund and the other lenders. The Fund continued to caution against excessive speed in the liberalization: this caution reflected persistent doubts into 2014 about the adequacy of the recapitalization of BOC. These concerns were, however, qualified by the Fund's desire to see the economy return to normal. Cypriot authorities recall that the final removal was enacted, ahead of schedule, at national initiative.

54. Many observers concurred with the Fund's initial expectation that the adverse psychological and confidence impact of the haircut, the fiscal adjustments, and the period of administrative restrictions would combine to produce a steep and long-lasting decline in economic activity in Cyprus ("Cyprus's output loss is expected to be larger than most except Greece over the long run" (IMF, 2013). In the event, however, the economy recovered more quickly than forecast (Figure 2).[32]

~~[31] While this lenient approach may have helped limit economic damage to the economy from the controls, it may have introduced a degree of arbitrariness.~~

[32] The program documentation in early 2013 showed that the Fund staff's forecast for 2018 was for GDP to be 8 percent lower than in 2011, and the expectation was that GDP would not pass the 2011 mark until the mid-2020s. In reality GDP seems to have turned out at least 5 percent *higher* in 2018 than in 2011 (Figure 2).

sufficient collateral to be presented; central banks rarely lend unsecured even to a bank they consider well capitalized.

58. The Fund staff repeatedly but unsuccessfully called on the ECB to provide explicit assurance of open-ended financing of the Cypriot banks as a buffer for the liberalization of controls. Absent such a commitment, market uncertainty remained as to whether adequate liquidity would be provided, whether by the national central bank, or the ECB~~, or the ESM~~.[34]

IV. UKRAINE: POLICY EVOLUTION

59. The evolution of Ukraine's capital controls and the Fund's relationship with Ukraine on this and related matters over the past decade is complex and multi-phased. Broadly speaking, three phases can be identified. First is the collapse of Ukraine's banking system, whose weaknesses were acutely exposed by the global financial crisis in 2008–09. This led to a tightening of exchange controls. IMF programs were launched in 2008 and again in 2010 to support a recovery, but they lacked domestic ownership. Ukraine's monetary and foreign exchange policies were not kept on a sustainable and transparent path and, for this and other reasons, both programs soon went off track. Relations with the Fund were strained, with a lack of confidence about the authorities' administrative capacity and their policies. This was unsurprising, given the authorities' preference for a fixed exchange rate out of line with fundamentals, Central Bank funding of the public sector deficit, and unevenly enforced capital controls with some de facto discrimination against non-residents.

60. The second phase is the crisis of 2014–15. This period began with a political transition to a new administration that was determined to deliver market-oriented and "European" monetary and economic policies but was almost overwhelmed by the economic consequences of the Russia/Ukraine conflict, leading to a financial and balance of payments crisis. The IMF was called in again. The initial engagement was fraught, particularly when the security conditions deteriorated sharply, leading the authorities to introduce draconian and effective exchange controls in steps that had not been foreseen by the Fund staff. (The new controls were introduced suddenly in the interval between staff-level agreement and IMF Executive Board approval of a new program under the Extended Fund Facility.) Subsequently, however, relations between the Fund and the authorities improved significantly.

61. The third phase can be considered to have begun by 2016. Underpinned by the 2015 Extended Fund Facility Arrangement and a subsequent SBA, as well as a sovereign debt restructuring, it continues to the present. This phase has been marked by a constructive engagement, with the Fund staff helping to formulate a credible conditions-based road map towards full liberalization of the exchange controls and monetary policy now based on inflation

[34] At the time of the program negotiations, the European bank resolution legislation (Bank Recovery and Resolution Directive of May 2014) had not yet been formulated, nor had the Single Supervisory Mechanism been established. The resolution measures were adopted under Cypriot law and implemented by Cypriot authorities.

critical constraint, notably in the first abortive "horizontal" levy. In Ukraine, the draconian measures introduced in February 2015 came as a surprise to the Fund.

78. In all three cases, the design of the measures benefited significantly from important technical refinements stemming from Fund advice. The Fund staff was heavily involved in the design of capital account measures in all three countries, and then again was to the fore in helping design a roadmap for the progressive withdrawal of the measures. The staff was seen by the authorities in all three countries as a most useful sounding board and source of constructive advice on these matters.

79. When it came to liberalization, the national authorities remained largely in control of the timing, moving ahead of the Fund in Cyprus and Ukraine, and choosing a thoroughly homegrown approach to the package that allowed liberalization in Iceland.

80. The Fund staff did not neglect consideration of the alternatives to capital controls for moderating capital flows (e.g., monetary, fiscal, exchange rate, and macroprudential policies). While recognizing the need for controls to help stabilize the economy in the three key episodes, it also urged comprehensive policy reforms that would help make the progressive removal of capital controls possible and safe. Furthermore, it opposed controls where it felt other policies were preferable (for example, early on in the Ukraine case and the inflow measure in Iceland in 2016). Returning to a position of largely uncontrolled capital movements remained a goal throughout. Once it had endorsed the introduction of controls, though, the Fund staff tended to adopt a cautious, conditions-based, and phased approach to the process of liberalization—for example, pressing for sufficient foreign exchange reserve accumulation, fearing the disruption that might follow a premature liberalization that could unleash pent-up demand for foreign assets if investor confidence had not been sufficiently restored.

81. Possibly reflecting its long-standing lack of enthusiasm for capital account restrictions, the Fund was arguably somewhat slow to recognize the severity of the problems and the need for administrative measures to stem the outflows. Thus, even where it supported measures that were being introduced and reflected them in program design when providing financing, it had not fully recognized in advance that they would be necessary. This seems to have been the case in Iceland, recalling the experience with the Financial Sector Assessment Program just before the crisis broke, and in Ukraine, where the full extent of the security/geopolitical threat may not have been fully factored into the Fund's thinking in 2014.

82. In addition, some of the negotiations in which the Fund was involved were arguably concluded too slowly. In Iceland, the initial 2008 decisions were taken before the Fund was even invited (though in this case it was just a matter of days). In Ukraine, the 2014 negotiations took a long time, during which the situation deteriorated with outflows accelerating. In Cyprus, during the protracted pre-program discussions, both within the Troika and with the reluctant government, the economy shrank and sizable outflows were financed by (partly government-

guaranteed) emergency liquidity assistance borrowings from the Central Bank of Cyprus~~Eurosystem~~, thereby shifting the burden from exiting depositors to the national budget and the remaining depositors.

B. Clarity of Goals

83. It is not clear that the Fund always had a realistic and holistic view of the likely endgame with regard to capital controls in the different cases:

- In Ukraine in 2008–14, ineffective, leaky, and discriminatory controls operated against the background of incoherent monetary and fiscal policies and a de facto pegged exchange rate. They were opposed by the Fund, especially in the 2010 program, but both programs went off track. In contrast, more comprehensive and strictly enforced controls were endorsed by the Fund from 2015, taking into account the removal of the peg and the operation of more consistent macro policies. But were these controls really still needed after the first few months?

- The Iceland case was ultimately resolved with a substantial haircut on foreign claims. The Fund backed the controls from the outset, but there is no indication that the staff realized early on that, by trapping very large foreign holdings, the capital controls were creating the conditions which the authorities could, would, perhaps even should, subsequently exploit to leverage a haircut. Perhaps a quicker and cleaner solution to this overhang could have been found, had it been planned from the outset.

- In Cyprus, given the stance of the Troika partners, it was probably correct for the Fund to back a program that involved capital controls, but the fact remains that the program contained an unacknowledged inconsistency. If the bank recapitalization was sufficient, as it should have been, the European members of the Troika should have agreed with the Fund's hope that the ECB would finance further outflows while confidence was being restored, without the need for administrative controls. This would have been a more orderly way to limit the adverse effects on economic activity in Cyprus without material credit risk to the financiers.

C. Usefulness of the Institutional View

84. The IV provided a framework but not a roadmap. Though it has no legal force, interviewees mentioned the IV as a constraint within which they operated, and did not point to it as a practical basis for choosing among available policy options.

85. When Iceland introduced inflow restrictions to stem incipient inflows in 2016, the Fund staff argued that the IV did not provide a justification for preemptive measures—a line of reasoning that did not resonate in a country whose 2008 crisis had been enabled by a lack of restraint on pre-crisis inflows.