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## THE REBRANDING OF CAPITAL CONTROLS IN AN ERA OF PRODUCTIVE INCOHERENCE

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### Abstract

The rebranding of capital controls during the global crisis has widened the policy space in the financial arena to a greater, more consistent degree than following the Asian crisis. How are we to account for this extraordinary ideational and policy evolution? The paper highlights five factors that contribute to the evolving rebranding of capital controls. These include: (1) the rise of increasingly autonomous developing states, largely as a consequence of their successful response to the Asian crisis; (2) the increasing assertiveness of their policymakers in part as a consequence of their relative success in responding to the current crisis; (3) a pragmatic adjustment by the IMF to an altered global economy in which the geography of its influence has been severely restricted, and in which it has become financially dependent on former clients; (4) the need for capital controls by countries at the extremes, i.e. those that faced implosion, and also and more importantly by those that have fared "too well"; and (5) the evolution in the ideas of academic economists and IMF staff. The paper also explores tensions around the rebranding of capital controls as exemplified by efforts to "domesticate" their use via a code of conduct.

**Keywords:** Capital controls; IMF; global financial crisis; policy space for development; developing economies; policy and ideational change

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## 1. INTRODUCTION

There's a political cartoon that I have in mind these days when I think about recent changes in the international political economy of capital controls. Picture a sailboat in stiff winds on rough seas. The wind in the sails is labeled "Brazil, China, Iceland, or the Global South." The boat is labeled "S.S. Capital Controls." The International Monetary Fund's (IMF) Managing Director Christine Lagarde is at the tiller, and she barks at her worried shipmate—"No, don't trim the sails!" But we also see that the ship is trailing a heavy anchor, labeled "Neoliberalism."

This image captures well the conflict surrounding capital controls during the global financial crisis. Many extraordinary things have happened during the crisis, one of which is that capital controls have been successfully "rebranded." Formerly denigrated as a policy tool of choice of the weak and misguided, capital controls have now been normalized as a tool of prudential financial management, even within the corridors of the IMF. As with most rebranding exercises there is uncertainty about whether the framing will prove sufficiently sticky, especially in the context of tensions and countervailing impulses at the IMF and elsewhere.

Rebranding of capital controls has occurred against a broader backdrop of uncertainty and economic, political and ideational change. This state of affairs—which I have elsewhere termed "productive incoherence"—constitutes the broader environment in which thinking and practice on capital controls are evolving (Grabel, 2011). By productive incoherence I

refer to the proliferation of responses to the crisis by national governments, multilateral institutions, rating agencies and the economics profession that have not yet congealed into a consistent approach to capital controls. Instead, we find a proliferation of strategies that defy encapsulation in a unified narrative. The present incoherence is productive because it has widened the space around capital controls to a greater and more consistent degree than in the years following the East Asian crisis of 1997-98.<sup>1</sup>

How are we to account for this extraordinary ideational and policy evolution on capital controls?<sup>2</sup> In what follows I examine five factors that, in my view, must appear in any comprehensive account. These include: (1) the rise of increasingly autonomous developing states, largely as a consequence of their successful response to the Asian crisis; (2) the increasing confidence and assertiveness of their policymakers in part as a consequence of their relative success in responding to the current crisis at a time when many advanced economies have stumbled; (3) a pragmatic adjustment by the IMF to an altered global economy in which the geography of its influence has been severely restricted, and in which it has become financially dependent on its former clients; (4) the intensification of the need for capital controls by countries at the extremes—i.e., not just those that faced implosion and thereby threatened cross-national contagion, but also and more importantly by those that fared “too well” during the crisis; and (5) the evolution in the ideas of academic economists and IMF staff. I will conclude by exploring in passing important tensions that have emerged in conjunction with rebranding. Paramount in this regard are efforts by IMF

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<sup>1</sup> Best (2005) discusses the related issue of ambiguity in international monetary governance.

<sup>2</sup> Moschella (2013) argues (based on the Swiss case) that the crisis has also created space for foreign exchange intervention and exchange rate targeting.

staff and some academic economists to “domesticate” the discussion and use of capital controls, in part by the implementation of something akin to a capital controls “code of conduct.”

My discussion of the rebranding of capital controls highlights the complex interaction of economic realignments, tension, aperture and uncertainty in facilitating a powerful evolution in ideas about and the use of this instrument. The account resonates with analyses of ideational and policy change within constructivist international political economy, including those that focus on the way that exogenous shocks create opportunities for new ideas to gain traction, either rapidly or incrementally, and stick (Best, 2003; Blyth, 2002; Chwieroth, 2013a, 2013b; Moschella, 2010, 2012; Widmaier et al., 2007); those that focus on the interaction of ideas and external interests in driving ideational change (Blyth, 2003; Kirshner, 2003; Moschella, 2010); and those that focus on “stigma management” in transforming the international normative order (Chwieroth, 2013b). The account also resonates with constructivist work that traces the micro-processes by which norms and rules around capital controls change (or fail to do so). Here I refer to research that focuses on how leaders of international organizations have sought to rewrite formal rules around capital liberalization (Abdelal, 2007); research on informal processes of internal norm entrepreneurship within the IMF (Chwieroth, 2010) and related work on “layering” of new policies over old ones (Chwieroth, 2013a); research on the interaction between ideas and the larger political environment (Moschella, 2009); and research that highlights the pragmatism of actors in the IMF, who may abandon ideas around capital liberalization when they become less useful, such as during the current crisis (Nelson, 2013; Kirshner,

2003). The analysis is also consistent with work that highlights the monetary statecraft inherent in capital account policies (Gallagher, 2013) and the power and interests that they reflect (Wade and Veneroso, 1998).

## **2. THE ROOTS OF CHANGE: CAPITAL CONTROLS AND THE ASIAN CRISIS**

The crisis has achieved in a hurry something that Keynesian and other heterodox economists were unable to do for a quarter-century. As we will see, it has provoked policymakers in many developing countries to deploy capital controls as a means to protect domestic economies from the instability, currency pressures, and trade dislocation associated with uncontrolled international capital flows. What is perhaps more surprising is that today's IMF has legitimized controls in various ways. The credit rating agencies no longer flinch when new controls are announced, and private investors continue to flock to many of the economies using controls.

This reception contrasts sharply with the IMF and investor condemnation of Malaysia when it imposed stringent capital controls during the Asian crisis. At the time the IMF called these outflow controls a "step back" (Shamin and Kate, 2010), and a representative article in the international business press stated that "foreign investors in Malaysia have been expropriated, and the Malaysians will bear the cost of their distrust for years" (cited in Kaplan and Rodrik, 2001:11). Flagging the country's controls, Moody's, Standard and Poor's, and Fitch downgraded Malaysia's sovereign debt rating (Abdelal and Alfaro, 2003). More recently, controls in Thailand were reversed by the Central Bank within a few days after their implementation in December 2006 (following a coup) after they triggered massive capital flight (Shamin and Kate, 2010).

During the neo-liberal era of the last several decades, IMF staff and the economics profession were consistently intolerant of capital controls.<sup>3</sup> Thus, the reception that greeted Malaysia's controls was consistent with the view of the then dominant neo-liberal economists and policymakers. Indeed, up until the Asian crisis the IMF was poised to modify Article 6 of its Articles of Agreement to make the liberalization of all international private capital flows a central purpose of the Fund and to extend its jurisdiction to capital movements. Despite the neo-liberal tenor of the times, however, some developing countries nevertheless maintained controls. Moreover, even during the neo-liberal era, staff in different areas of the IMF held divergent views on controls. That said, IMF policy generally cohered around liberalization.

A subtle, uneven and inconsistent process of ideational change began to occur after the Asian crisis. IMF research staff started to change their views on capital controls modestly and cautiously. In the post-Asian crisis context, the center of gravity at the Fund and in the academic wing of the economics profession shifted away from an unequivocal, fundamentalist opposition to any interference with the free flow of capital to a tentative, conditional acceptance of the macroeconomic utility of some types of controls. Permissible controls were those that were temporary, "market-friendly," focused on inflows, and were introduced when the economy's fundamentals were mostly sound and the rest of the economy was liberalized (Prasad et al., 2003). Academic literature on capital controls after

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<sup>3</sup> The turn away from capital controls began at the IMF during the 1970s (Chwieroth, 2010). This was part of a broader intellectual transformation toward liberalism in economics in the same period (Blyth, 2002).

the Asian crisis reflected this gradually evolving view: cross-country empirical studies offered strong support for the macroeconomic achievements of inflow controls (Magud and Reinhart, 2006; Epstein, Grabel and Jomo, 2004; Chwieroth, 2010:ch.8; Gallagher, 2010a). While evidence supporting the achievements of outflow controls remains more scant, research on Malaysia by Kaplan and Rodrik (2001) finds strongly in their favor.

It bears mention that the IMF's treatment of inflow and outflow controls by countries in crisis was somewhat uneven during the neo-liberal era. This unevenness was highlighted in a 2005 study by the IMF's internal watchdog, the Independent Evaluation Office (IEO, 2005). The study covered the period of the Asian crisis to 2004. The IEO report (p. 48) finds that during and after the crisis the IMF "displayed sympathy with some countries in the use of capital controls and...even suggested that market-based measures could be introduced as a prudential measure." The report finds that the IMF supported the use of capital controls in 7 of the 12 countries it assisted, that in two of these countries (namely, Peru and Estonia) it advised policymakers to deploy controls as part of their overall reform recommendations, and that on balance its support for controls increased following the Asian crisis. That said, the report acknowledges (correctly) that there was a lack of consistency in the IMF's advice on this matter after the Asian crisis.

Although the seeds of intellectual evolution were planted after the Asian crisis, there was substantial push back in this same period from leading economists (e.g., Forbes, 2005; Edwards, 1999). In addition, there was disconnect between IMF research, on the one hand, and the creeping tolerance for controls by the institution's economists when they worked

with particular countries, on the other (as the IEO, 2005:48) acknowledges. This might be explained by the relative autonomy of different departments at the IMF, a lack of leadership from the top, and the internal entrepreneurship of mid-range staff when working in different contexts (Chwieroth, 2010, 2013a).<sup>4</sup>

Despite the modest intellectual progress on capital controls that began after the Asian crisis, controls remained an exceptional and contested measure that were thought to achieve desirable outcomes only when particular preconditions were in place. These qualifications begin to change, however, during the current crisis, when circumstances coalesce so as to legitimate controls to a far greater and more consistent degree. Today, scarcely 15 years down the road, controls on outflows and especially on inflows are not just tolerated, but are in many cases understood as a vital tool of prudent financial management. In academic and policy circles controls have achieved a renewed legitimacy—begrudging legitimacy in some camps, to be sure, but legitimacy nonetheless. The evolution in thinking and practice on capital controls represents an important turn in the direction of post-WWII support for the measure by the economics profession, government officials and the IMF (Crotty, 1983; Helleiner, 1994; Perez and Vernengo, 2012; Gallagher, 2012b).

### **3. ENABLING CAPITAL CONTROLS DURING THE GLOBAL FINANCIAL CRISIS**

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<sup>4</sup> Chwieroth (2010, 2013a) and Abdelal (2007) suggest that the process of change in a complex organization like the IMF is messy and uneven. I argue that “uneven, messy and contested” is an apt description of the evolving transformation around controls at the IMF and in the economics profession today.

A range of factors has facilitated the reemergence and legitimization of capital controls during the current crisis. For ease of exposition I will discuss them separately, though as will become clear I do not think of them as “independent variables” that can be summed up to give a full account. Instead, I see the factors as thoroughly interdependent and cumulative.

### **Emerging State Autonomy in the Developing World**

Precisely because of the constraints on policy space that followed the Asian crisis, the crisis created momentum behind the idea that developing countries had to pursue strategies to protect against future encroachments on their autonomy and sovereignty. The explicit goal was to escape the IMF’s orbit. Policymakers sought to accomplish this goal by relying on a diverse array of strategies, most important of which was self-insuring against future crises through the over-accumulation of reserves.<sup>5</sup> Reserve accumulation in rapidly growing developing countries, such as Brazil, China, Turkey, South Korea, Argentina, South Africa, and Russia, gave policymakers the material means to increase their policy autonomy and protect it in the face of future crises. That strategy was validated in the current crisis.

How extensive are the increases in foreign exchange reserves in the post-Asian crisis period? Emerging and developing countries (with reserves of US\$7.1 trillion in the third quarter of 2012) accounted for 72.5% of the increase in global reserves between 2000 and 2012 (IMF, COFER, 2012a). Reserve holdings relative to GDP have also increased dramatically over the last three decades. In the 1980s, reserves by developing countries

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<sup>5</sup> We might think of these strategies collectively as promoting resilience and even what Nassim Taleb (2012) refers to as “anti-fragility,” or the ability to thrive in periods of instability.

were equal to about 5% of their GDP. This figure has doubled every decade since then, reaching around 25% of GDP by 2010 (Ghosh, Ostry, and Tsangarides, 2012:3). These figures are in stark contrast to reserves in OECD countries, where reserves had grown to just US\$3.4 trillion, or 8.1% of GDP, by the start of 2011 (Dadush and Stancil, 2011). Reserves are highly concentrated among regions and particular countries in the developing world. Over 90% of developing country reserves are held by 20 countries (Dadush and Stancil, 2011). Reserve accumulation has been facilitated by a variety of circumstances, such as the boom in commodity prices. Though the hoarding of reserves enhances financial resilience and policy autonomy it nevertheless entails opportunity costs for reserve holding countries (as Rodrik (2006) and Gallagher and Shrestha (2012) argue).<sup>6</sup>

Data on official reserves do not provide a complete picture of the resources that expand policy autonomy. Developing countries with large reserves generally transfer a portion of their holdings to sovereign wealth funds (SWFs) to be managed separately so as to maximize the returns on these assets. At the end of 2010 (the last year for which these data are available) developing and emerging economy funds held the majority of SWF assets-- US\$3.5 trillion of the US\$4.3 trillion held globally in such funds (Griffith-Jones, 2011:8-9). Though the explicit function of SWFs is not to promote financial stability or policy autonomy, a speculative attack against a country's currency is less likely to occur when governments have signaled that reserves are so large as to justify cleaving off some of them to capitalize a fund.

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<sup>6</sup> Many have claimed that excess reserve accumulation poses other problems as well—namely, it can contribute to global financial instability insofar as global imbalances contribute to fragility.

In sum, considerable resources are available in both official reserves and SWFs held by developing countries. Together these funds contribute to an environment wherein policymakers now have the material means to enjoy increasing policy autonomy relative to the IMF. Not least, policymakers now have the ability to deploy capital controls without worrying about negative reactions by the IMF or investors. Indeed, controls have become necessary in some national contexts precisely because of the strong performance of some developing countries during the crisis (a matter to which we return below).

### **Increasing Assertiveness of Developing Country Policymakers**

Many developing country policy makers have demonstrated an eagerness to take advantage of the increased autonomy they now enjoy. I explore here three “indicators” of increasing assertiveness other than the increasing use of capital controls: the use of counter-cyclical macroeconomic policies; innovation in financial architecture; and new activism at the IMF.

#### *Counter-cyclical policies*

Those developing countries that have been able to maintain and even expand their autonomy during the crisis have used the resulting policy space to pursue a variety of counter-cyclical policies. This marks a sea change in the behavior of developing country policymakers from the past, when macroeconomic policy during crises was strongly pro-cyclical.

Ocampo et al. (2012) provides the most comprehensive survey of counter-cyclical policy responses to the crisis in the developing world. The study concludes that when we look across the developing world we find diverse, uneven counter-cyclical policy responses. Counter-cyclical policies tended to be more powerful in larger, less financially liberal economies (such as China, Brazil and India). Monetary policy in most developing countries was expansionary and involved diverse instruments. In addition, fiscal policy responses were counter-cyclical, though their magnitudes varied substantially. The most expansionary fiscal policies were in East Asia, followed closely by South Asian countries. China deployed the most ambitious counter-cyclical support—in 2009 and 2010 it was equivalent to around 14% of its GDP. Sub-Saharan African countries such as Kenya, Mauritius, South Africa, and Tanzania also adopted counter-cyclical fiscal policies. In Latin America, the picture was more mixed. Chile ran the clearest counter-cyclical fiscal policy; other countries in the region, such as Argentina, Costa Rica, and Paraguay, had more modest increases in public spending; while Bolivia and the Dominican Republic reduced spending.

The reserve accumulation and related growth in SWFs examined above enabled policymakers to pursue counter-cyclical and other protective policies that were unavailable during previous crises. Indeed, SWFs provided support to domestic banking systems and stock markets (Park and van der Hoorn, 2012).<sup>7</sup> The enabling effects of reserve and SWF

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<sup>7</sup> Some SWFs played a counter-cyclical role outside their borders. Some increased exposure to euro assets (Park et al., 2012). The SWFs of China, Singapore, and Middle Eastern countries provided US\$80 billion to recapitalize financial institutions in Europe and the USA in 2007-08 (BIS, 2009:153; Campanella, 2012:20). However, some SWF decisions have been destabilizing (Drezner, 2008:118). For instance, some exited overseas markets after losing value on international equities

accumulation are part of a larger set of supportive economic conditions (e.g., the reduction in external public debts) that gave policymakers the space to respond to the crisis with expansionary policies without fearing the reaction of investors and the IMF (Ocampo et al., 2012).

It bears noting that the ideational climate was supportive of protective national policy responses, particularly during the G-20's "Keynesian moment" in 2008-09. Monetary expansion in the USA and Japan helped normalize protective responses to the crisis, even after the G-20 switched to an austerity message in June 2010.<sup>8</sup> The G-20 did not address capital controls as a protective response until late in the crisis, namely at the Seoul Summit in late 2010 when it called on the IMF to examine the matter (Chwieroth, 2013a, 2013b). Capital flows figured more prominently on the G-20 agenda during France's leadership of the organization in early 2011, after which Germany and Brazil co-chaired a fractious committee on the subject in the same year (*ibid*).<sup>9</sup>

### *Innovation in financial architectures*

Another indicator of the increased appetite for autonomous action by developing country policymakers is given by the expansion of existing and the creation of new regional, bilateral and multilateral financial arrangements. The Asian crisis had earlier turned

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(Campanella, 2012). More broadly, there is debate on whether SWFs are developmental and stabilizing. See, e.g., Helleiner (2009) on SWFs and state financialization.

<sup>8</sup> The IMF's rhetorical attention to pro-poor spending during the crisis may also have legitimated counter-cyclical responses (Grabel, 2012). See Blyth (2013, preface and pp. 59-62) for discussion of the G-20's switch to an austerity message.

<sup>9</sup> Chwieroth (2013a, 2013b) suggests that the G-20's timid and late focus on capital flows reflects US policy preferences and influence. This contrasts to the almost immediate identification of unrestrained capital flows as a culprit in the Asian crisis. I thank Eric Helleiner for this point.

attention in the region to the creation of an institution--the Asian Monetary Fund--that would provide emergency financial support absent the IMF's conditions (Kirshner, 2006; Grimes, 2009). The proposal was eventually tabled in the wake of tensions between Japan and China, and strong opposition by the US (Grimes, 2009; Kirshner, 2006; Noble and Ravenhill, 2000). As with the Asian crisis, the current crisis has promoted interest in the creation of institutions that deliver liquidity support and which complement or even substitute for the IMF. These initiatives have been given life by the new economic environment in which many developing country policymakers find themselves. There are far too many of these initiatives to discuss comprehensively here (but see Grabel (2012) and Chin (2012)). In what follows I provide a few illustrative examples of these institutional innovations as suggestive evidence of the increasing assertiveness of developing country policymakers.

Central banks of the Association of Southeast Asian Nations, plus China, Japan and Korea, have expanded the scope of the Chiang Mai Initiative. This arrangement, now known as the Chiang Mai Initiative Multilateralisation (CMIM), is a regional reserve pooling arrangement. CMIM members have been prompted by the crisis to make some progress on long-standing governance issues involving the CMIM's relationship to the IMF. Indeed, decisions taken in May 2012 (to double the size of the CMIM reserve pool to US\$240 billion and to loosen its link to the IMF) underscore the way in which the global crisis is stimulating a broadening

and deepening of regional financial liquidity support arrangements despite political and historical obstacles to doing so.<sup>10</sup>

The re-emergence of more populist governments in Latin America and the success of large commodity exporters have stimulated a great deal of architectural innovation. One example involves the Latin American Reserve Fund (FLAR), an institution founded in 1978. Like CMIM, FLAR is a regional reserve pooling arrangement; its capitalization and the modalities by which it provides support to distressed countries have broadened during the crisis. At the same time, the Andean Development Corporation (founded in 1968) has taken on an increasingly active role in the region.

Since 2012 the BRICS countries (Brazil, Russia, India, China and South Africa) have been engaged in discussions, which have proven to be somewhat discordant and complicated, about the creation of a new development bank, a credit rating agency and a reserve pooling arrangement. There are also a variety of bilateral initiatives among developing countries, especially involving new currency swaps and mechanisms aimed at promoting trade settlement without using the US dollar as the vehicle currency (e.g., between Brazil and Argentina, and also among twelve Latin American nations). During the crisis national development banks (such as Brazil's National Development Bank and the China

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<sup>10</sup> See Grabel (2012) and Chin (2012) for discussion. See Grimes (2011) for a skeptical view of the likelihood that CMIM will operate independently of the IMF, and Wade (2013) for a strongly dismissive view of the matter.

Development Bank) have become more active lenders. China's banks have also become increasingly active outside its borders and region.<sup>11</sup>

Collectively, these innovations suggest that developing country governments have been stimulated by the crisis to pursue architectural initiatives that express an increasing self-confidence and a desire for autonomy from the Bretton Woods institutions. Some of these arrangements will no doubt fail to achieve their promise. But taken together they represent part of the messy landscape of aperture and change that has emerged during the crisis. Moreover, it is conceivable that recent changes in IMF views and practice on capital controls stem partly from attempts to protect the institution's franchise from actual or potential competition from these institutional innovations.<sup>12</sup>

#### *New roles, new pressures at the IMF*

The increasing assertiveness of developing countries is also given expression in the new role that they have taken on at the IMF. Developing countries have now twice been called upon to commit funds to the IMF. The new commitments reflect the power of rapidly growing economies and the IMF's evolving relationships with former clients. It is noteworthy in this connection that most of the new lenders are utilizing capital controls, and have pursued economic models that involve more broadly state mediation of financial flows.

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<sup>11</sup> Note that the activities of national (development) banks are driven as much by growth and trade objectives as they are by any crisis-stimulated appetite for innovation.

<sup>12</sup> There is anecdotal evidence that the Fund is beginning to face competition from other institutions, even the World Bank. For instance, Wade (2010:fn10) notes that the IMF is losing new business to the World Bank outside of the European rescues.

The first of the new commitments by developing countries to the IMF came about at the April 2009 G-20 meeting. For the first time in IMF history the institution issued its own bonds, and this provided the vehicle for unprecedented developing country financial support for the institution. China committed to purchase US\$50 billion while Brazil, Russia, South Korea and India each committed to purchase US\$10 billion. As the Eurozone crisis unfolded, the IMF's Lagarde began in late 2011 to call again on developing countries to step forward with a second tranche of commitments. Brazil's President Rousseff refused to announce the dollar amount of the country's new contribution until she was apprised of plans for IMF governance reform and until a later BRICS-wide conversation on the matter could take place. Never one to miss a chance to note historical ironies, Brazil's Finance Minister Mantega quipped during Lagarde's 2011 visit: "(i)t's a great satisfaction to us that this time the IMF did not come to Brazil to bring money like in the past but to ask us to lend money to developed nations" (Leahy, 2011). The new funding commitments were announced in June 2012 when BRICS leaders met informally at the G-20 Leaders' Summit. China committed US\$43 billion; Brazil, Russia and India each committed US\$10 billion, while South Africa pledged US\$2 billion. Even after this second recapitalization, Lagarde continued to seek support from developing countries. Indeed, during a visit to Colombia in December 2012 Lagarde noted "that (the country) is in a situation where it can offer support" (Stringer, 2012).

At the same time that developing countries have begun to contribute substantial funds to the IMF they have become more outspoken in demands for reform of the institution's

formal governance. The 2012 contributions by the BRICS countries were pointedly conditioned on reform. Brazil's Mantega stated the BRICS position clearly--the promise of additional funding was tied to "an understanding that the reforms of the Fund's quotas, which will result in a greater voting power for emerging countries, will be implemented according to the timetable agreed by the G20 in 2010" (Giles, 2012).<sup>13</sup> As of this writing, the US has not yet ratified the very modest 2010 agreement on governance reform, and the matter remains stalled at the IMF. The failure to move forward on governance reform makes it more likely that the BRICS will continue to explore new institutional initiatives that may in turn create more competition with the IMF in the coming years.

## **A Chastened IMF**

The IMF emerged from the Asian crisis a greatly weakened institution. Indeed, prior to the global crisis, demand for the institution's resources was at an historic low. From 2003 to 2007, the Fund's loan portfolio shrunk from US\$105 billion to less than US\$10 billion (Weisbrot et al., 2009a). After the loans associated with the Asian crisis were repaid, the Fund's loan portfolio contracted dramatically since those countries that could afford to do so deliberately turned away from the institution. This trend radically curtailed the geography of the IMF's influence. The decline in the IMF's loan portfolio indicates the degree to which these escapist strategies proved successful.

In the context of the current crisis, countries did their best to stay clear of IMF oversight.

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<sup>13</sup> This is not to say that all BRICS participants agree on all of the relevant issues, or that the BRICS represents a happy marriage of cooperating states (see, e.g., Ban and Blyth, 2013: fns1, 2). Indeed, it can better be described as a group of independent-minded states that occasionally have managed to overcome various tensions to reach tentative consensus on matters pertaining to financial governance.

Indeed, Korea would have been a good candidate for a new type of (precautionary) Flexible Credit Line with the Fund. But it did not apply for the credit line, because of its prior experience and to avoid the stigma of being once again an IMF client (Wade, 2010:fn10). Instead, it negotiated a reserve swap with the US Federal Reserve.

The crisis nevertheless rescued the IMF from its growing irrelevance. Even with reduced staffing the Fund still holds a monopoly position when it comes to experience in responding to financial distress. More directly, the IMF's rescue was facilitated by the decisions of G-20 and Eurozone leaders (Lütz and Kranke, 2013). Representatives at the April 2009 G-20 meeting gave the IMF pride of place in crisis response efforts. The meeting not only restored the IMF's mandate but also yielded massive funding commitments to the institution.<sup>14</sup>

In sum, then, the IMF has experienced conflicting developments. It has discovered new vitality as first-responder to distress while at the same time facing a substantially diminished territory over which it can dictate economic policy. It no longer enjoys wall-to-wall influence across the developing world. The geography of its influence is now significantly curtailed and transformed as a consequence of the rise of relatively autonomous and increasingly assertive states in the developing world, as well as its continuing involvement with the Eurozone. The Fund may also be facing potential competition from evolving and nascent financial arrangements in the developing world.

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<sup>14</sup>Wade and Sigurgeirsdottir (2013) argue that the IMF's more accommodative stance on capital controls was partly instrumental as the institution sought to rehabilitate the image that was so tarnished by the Asian crisis.

The institution's staff faces the challenges of restoring and protecting its newly resurrected franchise and image in an environment where many former client states are able to walk on their own (and are, in fact, now among its lenders). Hence, the IMF is forced to negotiate to retain the influence that, up until recently, it was able to take for granted. We see this negotiation in the domain of capital controls, where the IMF now often finds itself responding after the fact to decisions implemented unilaterally by assertive governments and central banks. Relatedly, even where it retains substantial authority, its economists are responding to the current crisis in some ways that diverge from past practice. We turn to these matters in what follows.

### **The Crisis, Winners and Losers**

The current crisis is marked by many firsts, such as developing country support to the IMF. Another departure from the old script is that some developing countries have emerged as (relative) winners. Most of the countries that have put capital controls in place did not face the usual problems of capital flight and attendant currency collapse. Rather, they faced “too much of a good thing”—namely, asset bubbles, inflationary pressures and currency appreciations induced by large international private capital inflows. The use of capital controls by winning economies has certainly figured into their acceptance by the IMF and international investment community. As each country deploys controls with no ill effects on investor sentiment and no finger wagging by the IMF, it becomes easier for policymakers elsewhere to deploy the controls they deem appropriate. And they are doing so with the consequent effect of de-stigmatizing this policy tool.

### *Capital controls in losing economies*

Some countries have used capital controls for the more usual reasons. In these cases, the IMF has tolerated outflow controls. Iceland's policymakers put outflow controls in place to slow the implosion of the economy before signing an IMF stand-by arrangement (SBA) in October 2008. The SBA with the Fund made a very strong case for the extension of these controls as means to restore stability and to protect the krona (IMF, 2012b; Wade and Sigurgeirsdottir, 2013).

Not surprisingly, given the IMF's long-held allergy to capital controls, the institution's staff was questioned repeatedly in news conferences on what seemed to be an abrupt about face. Fund staff repeatedly said that Iceland's outflow controls were crucial to prevent a free fall of the currency, that they were temporary, and that it was a priority to end all restrictions as soon as possible. These temporary outflow controls have turned out to have a long life span—indeed the central bank is not planning to phase out the 2008 controls until 2015 owing to the risks that the economy still confronts. Iceland's use of outflow controls continues to receive praise from many quarters. The IMF's Mission Chief in the country stated that "capital controls as part of an overall strategy worked very, very well" (Forelle, 2012). Moreover, the Deputy Managing Director of the Fund stated that "unconventional measures (as in Iceland) must not be shied away from when needed" (IMF, 2011e). And even rating agency, Fitch, praised the country's "unorthodox crisis policies" when it raised its credit rating to investment grade in February 2012

(Valdimarsson, 2012).<sup>15</sup>

The IMF's stance with respect to Iceland's outflow controls initially appeared anomalous. But it soon became clear that it marked a dramatic precedent and revealed a change in thinking about capital controls. For example, the SBA with Latvia in December 2008 allowed for the maintenance of pre-existing restrictions arising from a partial deposit freeze at the largest domestic bank (IMF, 2009c). Soon thereafter, a Fund report acknowledged that Iceland, Indonesia, the Russian Federation, Argentina and Ukraine all put outflow controls in place to "stop the bleeding" related to the crisis (IMF, 2009a). The report neither offers details on the nature of these controls nor commentary on their ultimate efficacy, something that suggests that controls—even and most notably on outflows—are being destigmatized by the context in which they are being used and the Fund's measured reaction to them. The IMF and the European Union (EU) also did not flinch when Cyprus put stringent outflow controls in place as its economy imploded in March 2013.<sup>16</sup>

### *Capital controls in winning economies*

Policymakers in a far larger set of developing countries have deployed controls to curb the fallout from their strong performance during the crisis. Brazil is a particularly interesting case since the government (particularly Finance Minister Mantega) has been such a strong

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<sup>15</sup> Krugman (2011) and Wade and Sigurgeirsdottir (2012) argue that Iceland broke the rules in other respects (e.g., by increasing public spending), though Wade and Sigurgeirsdottir (2013) later hedge on this issue. Neo-liberals in Iceland are not happy about its unorthodox response or the IMF's advice (Arnason and Danielsson, 2011).

<sup>16</sup> The credit rating agency Fitch downgraded Cyprus' Hellenic Bank, though this seems to reflect the oddly sudden realization that Russian money laundering bloated the country's banking system.

voice on policy space for capital controls. The IMF's changing stance regarding Brazil's controls also provides a window on the evolution and continued equivocation in the views of Fund staff. Chwieroth (2013b) argues that the country successfully "counter-stigmatized" controls.

In late October 2009, Brazil began to utilize capital controls by imposing a tax on portfolio investment. They were intended to slow the appreciation of the currency in the face of significant capital inflows. Brazil imposed a 2% tax on money entering the country to invest in equities and fixed-income investments and later a 1.5% tax on certain trades involving American Depository Receipts, while leaving foreign direct investment (FDI) untaxed.

The IMF's initial reaction to Brazil's inflow controls was ever so mildly disapproving. A senior official said: "These kinds of taxes provide some room for maneuver, but it is not very much, so governments should not be tempted to postpone other more fundamental adjustments. Second it is very complex to implement those kinds of taxes, because they have to be applied to every possible financial instrument," adding that such taxes have proven to be "porous" over time in a number of countries. In response, John Williamson and Arvind Subramanian indicted the IMF for its doctrinaire and wrong-headed position on the Brazilian controls, taking the institution to task for squandering the opportunity to think reasonably about capital controls (Subramanian and Williamson, 2009). A week later the IMF's Strauss-Kahn reframed the message on Brazil's controls. The new message was, in a word, stunning: "I have no ideology on this"; capital controls are "not something that come from hell" (cited in Guha, 2009).

The Brazilian government continued to strengthen and layer new controls over existing ones in 2010 and 2011. In 2010 the tax charged on foreign purchases of fixed-income bonds was tripled (from 2 to 6%). In March 2011 Brazil increased to 6 percent a tax on repatriated funds raised through international bond sales and loans with a maturity of up to two years, and in August 2011 placed a 1% tax on bets against the US dollar in futures markets. Despite this array of controls, in an August 2011 review of Brazil, IMF economists called its use of controls “appropriate” (Gill, 2011b).<sup>17</sup>

Like Brazil, many well performing developing countries implemented and adjusted controls on outflows and especially on inflows. Some strengthened existing controls, while others introduced new measures. For some countries (such as Argentina, Ecuador, Venezuela, China, and Taiwan) these measures are part of broader dirigiste or heterodox approaches to policy. For most other countries (e.g., Brazil, South Korea, Indonesia, Costa Rica, Uruguay, the Philippines, Peru, and Thailand), capital controls are part of a multi-pronged effort to respond to the challenges of attracting too much foreign investment and carry trade. I provide a sketch of some of these controls in what follows.

In December 2008 Ecuador doubled the tax on currency outflows, established a monthly tax on the funds and investments that firms kept overseas, discouraged firms from transferring US dollar holdings abroad by granting tax reductions to firms that re-invest their profits domestically, and established a reserve requirement tax (Tussie, 2010). In

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<sup>17</sup> In an example of the resilience of old views, in August 2010 Canadian Prime Minister Harper used some of his time in Brazil to lecture the government about dismantling controls (Mayeda, 2011).

October 2010, Argentina and Venezuela implemented outflow controls. Argentine controls involve stricter limits on US dollar purchases; Venezuelan controls involve new restrictions on access to foreign currency. Argentina's controls were strengthened in October 2011: all dollar purchases had to be authorized by tax authorities, and the country's oil and gas companies were required to repatriate all export proceeds and convert them to pesos (Webber, 2011). Unlike controls implemented elsewhere, Argentina's 2011 measures led to a ratings downgrade (on oil and gas companies by Moody's). However, this likely has far more to do with nationalization of Spanish oil company YPF and the on-going conflict with foreign investors and the IMF than with capital controls (Gill, 2011a).

Peru has imposed inflow controls since early 2008. The country's central bank raised the reserve requirement tax four times between June 2010 and May 2012. The May 2012 measures included a 60% reserve ratio on overseas financing of all loans with a maturity of up to three years (compared to two years previously) and curbs on the use of a particular derivative (Kwan, 2012). What is particularly interesting about Peru's measures is the way in which they are being branded by the central bank. In numerous public statements the Central Bank President maintains that the country does not need capital controls despite the fact that the reserve requirement tax in place since 2008 is one (Quigley, 2013)! We return to this linguistic sleight of hand below.

In August 2012, Uruguay imposed a reserve requirement tax of 40% on foreign investment in one type of short-term debt (Reuters, 2012). Like Peru, its bilateral agreement with the US could make this control potentially actionable. Currency pressures also induced Costa

Rica to use capital controls for the first time in twenty years. The country began to use controls in September 2011 when it imposed a 15% reserve requirement tax on short-term foreign loans received by banks and other financial institutions (LatinDADD-BWP, 2011). In January 2013, the Costa Rican President began to seek Congressional approval to raise the reserve requirement tax to 25%, while also seeking authorization to increase from 8% to 38% a levy on foreign investors transferring profits from capital inflows out of the country.

Numerous Asian countries deployed new or strengthened existing controls following the crisis. For instance, in November 2009 Taiwan imposed new inflow restrictions that preclude foreign investors from placing funds in time deposits. At the end of 2010 controls on currency holdings were strengthened twice (Gallagher, 2011a). In 2010, China added to its existing and largely quantitative inflow and outflow controls (Gallagher, 2011a). In June 2010, Indonesia announced what its officials termed a “quasi capital control” via a one-month holding period for central bank money market securities and new limits on the sales of central bank paper by investors and on the interest rate on funds deposited at the central bank. The awkward labeling of controls in Indonesia suggests that some governments are still afraid of the stigma and market-driven punishments that long attached to capital controls.

Thailand introduced a 15% withholding tax on capital gains and interest payments on foreign holdings of government and state-owned company bonds in October 2010. In December 2012, the Philippines announced limits on foreign currency forward positions by

banks and restrictions on foreign deposits (Aquino and Batino, 2012). Since October 2010, Korean regulators have audited lenders working with foreign currency derivatives; and since 2011 have levied a tax of up to .2% on holdings of short-term foreign debt by domestic banks, banned “naked” short selling, and reintroduced a tax on foreign investment in government bonds sold abroad (Lee, 2011).<sup>18</sup> In another sign of changing sentiments by the rating agencies, Moody’s recently recommended that South East Asian countries use controls to temper currency appreciation (Maqtulis, 2013).<sup>19</sup>

### *Similar pressures, divergent responses*

Not all policymakers responded to the pressures induced by capital inflows with capital controls, of course.<sup>20</sup> Indeed, Turkish, Chilean, Mexican and Colombian policymakers publicly rejected controls. Instead they have increased their purchases of dollars and used expansionary monetary policy. These divergent responses to similar pressures reflect many factors, not least of which are differing internal political economies, the continued sway of neo-liberal ideas, the long shadow cast by the belief that central banks must signal their commitment to neo-liberal strategies, and perhaps also pride associated with the problem of an excessively strong currency in countries that have so long faced the opposite problem.

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<sup>18</sup> See Chwieroth (2013b) on Korea’s reframing of these measures as macroprudential and not as capital controls.

<sup>19</sup> Policymakers in Brazil, Korea and China loosened or abandoned some controls during 2011 and 2012 as their economies slowed and investors reallocated assets to US markets.

<sup>20</sup> See Gallagher (2013) on divergent responses in Brazil, Korea, Chile and South Africa.

But we would be mistaken to reduce resistance to capital controls in all these countries to ideology—to vestigial neoliberal sentiments that preclude interference in markets. The fact is that some countries simply cannot introduce capital controls because of bi- or multilateral trade and investment treaties with the US, the EU, the Organization for Economic Cooperation and Development (OECD), or the World Trade Organization (WTO) (Gallagher, 2010a, 2011b, 2012a; Shadlen, 2005; Wade, 2003). Mead (1992) was prescient on this matter when writing about the chief effect of the North American Free Trade Agreement (NAFTA) in the 1990s. He argued that NAFTA was intended by its negotiators to impose external constraints on domestic Mexican politics by tying the hands of any future (populist) policymakers who might want to pursue state-directed economic development strategies. The same strategy has been pursued extensively since then. Like NAFTA, the majority of the US' 52 existing bi- and multilateral trade and investment treaties make capital controls an actionable offense or prohibit them (Anderson, 2011). The basic template for these treaties requires that all parties allow capital and all transfers related to an investment to move “freely and without delay.” The template also subjects governments that violate this commitment to dispute settlement mechanisms that allow investors to sue them after a “cooling off period” (of six months to one year) (Anderson, 2011).

Governments face other restrictions on controls from the obligations to liberalize financial services under the WTO (Gallagher, 2012a). Moreover, Article 63 of the Lisbon Treaty of the EU enforces open capital accounts across the union and requires that members not

restrict capital transactions with other countries.<sup>21</sup> (Cyprus' 2013 use of outflow controls, however, suggests that EU strictures can be less binding than is usually thought at least when countries avail themselves of the treaty's temporary safeguard measures.) Other restrictions appear in the OECD's Code of Liberalisation of Capital Movements, though since it is not a treaty the obligations are not actionable (Abdelal, 2007; Gallagher, 2012a).

At the time when many of these agreements were negotiated, their restrictions on capital controls no doubt seemed redundant since controls were effectively blocked by the effective constraints imposed by the IMF, rating agencies and investors. Today, however, in the face of reversals by the previous enforcers of neo-liberalism, the provisions are consequential. Chile's refusal to use controls during the current crisis may have as much to do with its 2004 trade agreement with the US as with neo-liberal ideology.<sup>22</sup> Recall that the country's central bank pioneered in the 1990s reserve requirement taxes of the sort used today in many countries (Grabel, 2003b). But the trade agreement exposes the country to lawsuits by investors who are able to demonstrate that they are harmed by controls. Mexico's situation is similar. Here neo-liberal views are backed up by the strictures in NAFTA that threaten to punish any change in its policy stance, just as Mead had predicted. Costa Rica may soon test the limits of its own policy space. Its policymakers recently introduced some controls, but it cannot go any further without risking retaliation under its bilateral treaties (LatinDADD-BWP, 2011). By contrast, Brazil is free to utilize controls

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<sup>21</sup> Lisbon Treaty obligations mean that countries on the European periphery have not been able to use controls during the crisis (with the exception noted above). Such countries enjoy less policy space than many developing countries.

<sup>22</sup> By contrast, Korea's free trade agreement with the US allows controls (Gallagher, 2013). Though it is an OECD member, Korea has been able so far to pursue capital controls without raising the ire of other members.

because it has not signed bilateral treaties with the US. Future research will take up the matter of why some countries' policymakers push against the limits of their agreements (as in Costa Rica), while others do not (e.g. Chile). Reframing controls as something other than controls seems to be one viable avenue in cases where policymakers do not have the appetite to push the limits of trade/investment agreements (as with Peru and Uruguay), or where they otherwise fear the anti-free market stigma. Hence, Indonesia's quasi-controls.<sup>23</sup>

### *Tearing up the rule book*

Notwithstanding some exceptions, the crisis marks a radical departure from the recent past. Since 2008 many developing countries have implemented controls without seeking permission from the IMF. For most of these countries, controls are a response to the costs of their relative economic success. It's hard to imagine that capital controls could have been rebranded as legitimate policy tools as quickly and deeply as has been the case had it not been for the divergent effects of the crisis across the globe, and the initiatives of many of the winners from the crisis to assert control over financial flows. Just as history is written by the victors, so may it be the case that the rebranding and re-legitimizing of a forbidden policy tool depends primarily on the practices and strategies of those countries whose success grants them the latitude and confidence, and the influence over other countries, not just to "cheat" in a policy domain but to tear up the rule book altogether.

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<sup>23</sup> In some cases, this reframing may be less instrumental than I suggest. Chwieroth (2013b) argues that Korean authorities see these measures as prudential and consistent with their acceptance of the norm of liberalization. I should add here that the re-normalization of capital controls may involve rebranding, the focus of this paper, and/or re-framing of capital controls as something other than capital controls. The former represents a more direct assault on the pre-existing neoliberal ideology, and is expected where states have achieved substantial policy autonomy. The latter amounts to "cheating" – attempting to use a strategy that is not permitted under the neoliberal rules of the game without admitting it. We should expect this strategy in cases where states have not achieved substantial policy autonomy.

Thus, it may turn out that whether the IMF and the economics profession have changed fundamentally on the matter of capital controls matters less than the context in which they are being utilized.

The rebranding of controls has also been facilitated by the fact that carry trade pressures caused central bankers in wealthy countries to reconsider their long-held opposition to currency interventions and even capital controls. For example, the Swiss National Bank (SNB) intervened aggressively and repeatedly to curb the Swiss franc's appreciation (Moschella, 2013). At that time, the head of the SNB, Thomas Jordan, announced that the Bank was even considering controls on foreign deposits, though to date these have not been used (Ross and Simonian, 2012). More surprisingly, a top Bundesbank official signaled a softening in its traditional position by stating that "limited use of controls could sometimes be appropriate" to counter currency pressures (Reuters, 2013).

Finally, outflow controls have also been legitimized by widespread acknowledgement of their success in Iceland and elsewhere. Outflow controls are still seen in a different light than inflow controls, but the crisis has catalyzed a degree of rethinking on this controversial instrument as well. We find evidence of this in the evaluation of Iceland's program by the IMF and the credit rating agencies, and (as we will see below) in recent IMF research and Executive Board statements regarding the circumstances under which outflow controls are warranted.

## **A New Pragmatism in the Economics Profession and at the IMF**

I have argued that the new pragmatism at the IMF regarding capital controls stems from the divergence in economic conditions around the globe, the institution's chastening by the Asian crisis, dependence on former clients, and transformed geography of influence. But there is also a deeper transformation underway—one operating at the ideational level.

Today IMF staff economists and leading academic (neoclassical) economists have taken steps toward elaborating a theoretical and empirical case for capital controls. The rapid succession of financial crises over the past two decades appears to be encouraging those economists at the IMF who have long had reservations about capital liberalization to give voice to their concerns and to assert themselves more effectively and consistently, particularly now that views on capital controls by prominent academic economists are evolving rather significantly. After all, economists at the Fund are not immune to the loss of confidence of many economists in the models, theories and policy tools that have long dominated professional practice. A recent statement by the IMF's Chief Economist, Olivier Blanchard, is instructive in this regard: "We have entered a brave new world. The economic crisis has put into question many of our beliefs. We have to accept the intellectual challenge" (Blanchard et al., 2012:225).

My arguments about ideational change around capital controls complement those advanced by constructivists. However, I do not intend in what follows to engage in process tracing. Instead, I intend to explore diverse forms of evidence of ideational evolution regarding controls in the economics profession and within many quarters of the IMF.

### *Neoclassical economics and capital controls*

Two views on capital controls predominated among neoclassical academic economists during the neoliberal era. The first was a minority view, associated with libertarian thought, which derided controls as violations of investor rights. This was a principled rather than a consequentialist opposition, and as such did not allow for renegotiation based on new evidence. In contrast, the majority (welfare consequentialist) view within neoclassical economics claimed that controls were imprudent and costly interventions in the market. In this view, controls raise the cost of capital, especially for small and medium-sized firms, and generate costly evasion strategies (Forbes, 2005; Edwards, 1999). In short, controls were seen to induce economic inefficiency and distributional disparities in countries that could hardly afford them.

In the context of the current crisis the first view lost some of its appeal, even though its most ardent defenders have not given up the ghost. For instance, Nobel Laureate Michael Spence has criticized the recent use of controls in many countries (Dobbs and Spence, 2011). Some neo-liberals have rebuked the IMF for its support of capital controls in Brazil and Iceland. Beyond the camp of holdouts, we find evidence within neoclassical thought of a new pragmatism. Recent research emphasizes the negative externalities associated with highly liberalized international financial flows. Liberalized short-term capital flows are now recognized to induce ambient risk that can destabilize economies. Capital controls are now theorized as a second-best strategy that can reduce risk and dampen instability. What were formerly recognized as unwarranted interventions into otherwise efficient capital markets have now been rebranded as prudential financial regulation.

There are two dimensions to the new academic research on controls by prominent neoclassical economists. The first of these strands, termed the “new welfare economics of capital controls,” assumes that in an environment of uncertainty, imperfect information and volatility, unstable capital flows have negative externalities on recipient economies (Korinek, 2011, 2012; Aizenman, 2009).<sup>24</sup> Contemporary Pigouvians argue that externalities are generated by capital flows because individual investors and borrowers do not know or find it advantageous to ignore the effects of their decisions on the aggregate level of stability in a particular nation. Inflow controls are therefore conceptualized as a Pigouvian tax that corrects for a market failure rather than as a cause of market distortions. Inflow controls induce borrowers to internalize the externalities of risky capital flows, and thereby promote macroeconomic stability and enhance welfare. In a related vein, Jeanne (2012) finds that it is optimal to tax debt inflows in a boom, and concludes that Brazil’s inflow taxes are consistent with the features of an optimal Pigouvian tax.

A second strand of new research is empirical and substantiates the theoretical claims of the welfarist approach. For example, Qureshi et al. (2011) find that capital controls and foreign currency-related prudential measures in 51 developing countries from 1995 to 2008 are associated with a lower proportion of foreign currency lending in total domestic bank credit and a lower proportion of portfolio debt in total external liabilities. The study concludes that capital controls and foreign-currency measures in place during the boom enhanced resilience during the bust of 2008. Even Forbes, a longstanding critic of controls,

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<sup>24</sup> That this work is marketed as “new” says much about the state of economics!

finds that Brazilian taxes on foreign purchases of fixed-income assets between 2006-11 achieved one of its key goals of reducing the purchase of Brazilian bonds (Forbes et al., 2011).

Another type of empirical work involves “meta analysis” of a large volume of existing studies. Magud and Reinhart (2006) find that inflow controls enhanced monetary policy independence, altered the composition of inflows, reduced real exchange rate pressures, and did not reduce the aggregate volume of net inflows. Magud and Reinhart (2011) find the same results over a larger number of studies, including some that focus on the current crisis. Finally, Jeanne, Subramanian, and Williamson (2012) show that free capital mobility has little benefit to long-run growth. On this basis, they conclude that the international community should not promote unrestricted free trade in financial assets. They tie this recommendation to welfare economics, and in doing so commend Brazil’s inflow controls. They conclude by calling for an international code of good practices for controls under the auspices of the IMF in coordination with the WTO.

### *The IMF and capital controls*

The evolution in thinking on capital controls by academic economists is reflected in and reinforced by developments at three over-lapping levels of practice at the IMF: research, official statements by key officials, and policy recommendations by its staff.<sup>25</sup> Indeed, the ideas of IMF economists on controls have evolved significantly (albeit unevenly) during the

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<sup>25</sup> We should of course not presume that developments at these three levels necessarily unfold in a lock-step manner. What is remarkable about the current conjuncture, however, is the degree to which there have been parallel developments on all three levels as concerns capital controls.

crisis, thereby contributing to their normalization. By now, many reports by IMF research staff have documented that under certain conditions capital controls are a legitimate part of the policy toolkit, and that they have generated positive macroeconomic outcomes in many countries.

Illustrations of changes and tensions in recent IMF research on capital controls abound. An IMF report drafted early in the crisis states that the impact of the crisis on banking systems in low-income countries has been modest insofar as “(t)he existence of capital controls in several countries...helped moderate the direct and indirect effects of the financial crisis” (IMF 2009b:9, fn9). A joint World Bank-IMF report concludes cautiously that “capital controls might need to be imposed *as a last resort* to help mitigate financial crisis or stabilize macroeconomic developments” (WB-IMF, 2009:65, emphasis added). And an Article IV report on Bangladesh credits the effective closure of its capital account with its ability to avoid the global “flight to safety” early in the crisis (IMF, 2010a).

In February 2010 a team of IMF economists writing in a Staff Position Note (Ostry et al., 2010) reached far beyond the Fund’s public statements or practice to date in regards to inflow controls. In a thorough survey of econometric evidence, Ostry et al. (2010) commend inflow controls for preventing crises and ultimately reducing the risk and severity of crisis-induced recessions, and for reducing fragility by lengthening the maturity structure of countries’ external liabilities and improving the composition of inflows. These findings pertain to controls that were in place prior to and after the Asian crisis, as well as during the current crisis. The report also indicates that ”such controls, moreover, can

retain their potency even if investors devise strategies to bypass them....the cost of circumvention strategies acts as ‘sand in the wheels’” (p. 5).

Other parts of Ostry et al. (2010) qualify this new acceptance of inflow controls, however.

The report hedges in the expected ways—identifying the restrictive conditions under which controls can work. But in comparison with earlier reports by the IMF the qualifications are just that---they are not offered as insuperable obstacles to the use of controls. And that, in itself, represents a major advance, as many observers have acknowledged. After Ostry et al. (2010) was released, prominent IMF watchers praised the Fund for finally embracing a sensible view of controls. For example, Ronald McKinnon stated “I am delighted that the IMF has recanted” (cited in Rappeport, 2010); former IMF official, Eswar Prasad states that the paper represented a “marked change” in the IMF’s advice (cited in Wroughton, 2010), and Dani Rodrik stated that the “the stigma on capital controls (is) gone,” and that the report “is a stunning reversal – as close as an institution can come to recanting without saying, ‘Sorry, we messed up’” (Rodrik, 2010). Rodrik also noted that “(j)ust as John Maynard Keynes said in 1945—capital controls are now orthodox” (Thomas, 2010). No less telling is the sharp rebuke to Ostry et al. (2010) by William Cline, which is illustrative of the discomfort that “true believers” in capital liberalization have with what they see as the Fund’s troubling, wrong-headed new embrace of controls (Cline, 2010).

Research on controls spilled out from various quarters of the IMF through 2011, 2012, and up to the present. These reports continue to illustrate the growing legitimization of controls,

while also giving us a window into the resilience of the discomfort around these views (IMF, 2011a, 2011c, IMF 2010b; Ostry et al., 2011, 2012; IMF, 2012c, 2012d; Chwieroth, 2013a).<sup>26</sup> The IMF's crisis-induced research on controls culminated in a December 2012 report of the Executive Board, which the IMF terms the "institutional view" (IMF, 2012c). This report was extended in an April 2013 "Guidance Note" (IMF, 2013). The institutional view report makes clear that inflow and outflow surges induce instability; that countries should not consider capital liberalization prematurely; that temporary inflow and even outflow controls may be warranted during turbulence; that countries retain the right under Article VI to put controls in place; and that the IMF's new, more permissive stance on controls may conflict with and be subsumed by trade and other agreements. Particularly notable is the fact that the report refrains from denigrating capital controls as a last resort measure—a theme that had recurred throughout IMF research in 2010 and 2011.

There is also clear evidence in the institutional view of the IMF's continued effort to "domesticate" the use of controls. The report states that controls should be targeted, transparent and temporary, and should not discriminate against foreign investors. Moreover, the arguments in the report continue to be guided by the view that capital liberalization is ultimately desirable, though claims to this effect are more nuanced than in the past. Not least, the report rejects the presumption that this is the right policy for all countries at all times. Tensions over these (and other) matters among members of the IMF's Executive Board were given an oblique airing in a Public Information Notice released

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<sup>26</sup> Even though they do not represent the IMF's official position (and do not require member state approval), Staff Position Notes (such as Ostry et al., 2011) are nevertheless authorized for distribution. Thus, they are important documents in tracking the evolution of thinking at the Fund. Indeed, Ostry et al. (2011, 2012) was authorized by no less than Olivier Blanchard.

by the Fund, and more directly in press accounts, many of which focused on criticisms of the report by Paulo Nogueira Batista, IMF Executive Director for Brazil and ten other countries (IMF, 2012e; Beattie, 2012). That said, the fact that the IMF has shifted the discussion of capital controls away from straight economics (i.e., evasion, macroeconomic costs) and toward the legal and institutional conditions required for their success is further evidence that the most stubborn form of resistance to controls on economic grounds has been overcome.<sup>27</sup>

Recent IMF reports, including those discussed above, refer to capital controls matter-of-factly as “capital flow management” techniques (Ostry et al., 2011; IMF, 2011a, 2012c). This rebranding of controls is significant. The new, entirely innocuous term is suggestive of a neutral, technocratic approach to a policy instrument that had long been discredited as a vestigial organ of wrong-headed, dirigistic economic meddling in otherwise efficient markets.<sup>28</sup>

Beyond the research, public statements by current and former officials at the Bretton Woods institutions beginning in 2009 further illustrate both the normalization of and lingering ambivalence around controls. For instance, former IMF First Deputy Managing Director, John Lipsky, acknowledged in a December 2009 speech that “(c)apital controls also represent an option for dealing with sudden surges in capital flows.” In the address he

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<sup>27</sup> Chwieroth (2013a) argues that the greater equivocation on controls in the institutional view reflects the fact that official documents require member state approval, whereas reports such as Staff Position Notes do not.

<sup>28</sup> Others have previously sought to rebrand controls. Epstein, Grabel and Jomo KS (2004) refer to controls as one among many “capital management techniques,” and Ocampo (2003, 2010) has long used the term “capital account regulations” to refer to a family of policies.

makes clear that controls should be used when capital inflow surges are temporary (though we have to wonder when sudden surges would not be temporary?), and he emphasizes that controls likewise should be temporary. Despite these caveats, he argues that “(a)bove all, we should be open-minded.” The IMF’s Strauss-Kahn stated in a July 2010 speech that “it is just fair that these (developing) countries would try to manage the inflows” as a last resort against inflow-induced asset bubbles (cited in Oliver, 2010); and he reiterated the new mantra that capital controls are a legitimate part of the toolkit in an October 2010 speech (Strauss-Kahn, 2010). In the same month the director of the Fund’s Western Hemispheric department made a case (unsuccessfully) for the utility of controls in Colombia owing to the appreciation of its currency (Crowe, 2010). The World Bank’s former President Robert Zoellick said of the reemergence of controls in Asia: “it’s not a silver bullet...they may help at the margin” (cited in Gallagher, 2010b).

Given the unevenness of the IMF’s position on capital controls after the Asian crisis, its recent research, policy advice and statements coming from key officials mark by its standards a minor revolution.<sup>29</sup> Change at the Fund has been uneven, to be sure, with one step back for every two steps forward. None of this should be surprising. We should expect that long-held ideas—especially those that have hardened to the level of ideologies and been codified in institutional practices—have very long half-lives (Grabel 2003a). The process of changing these ideas and practices is necessarily uneven and slow; moreover, progress will inevitably generate push back from within the institution and the economics profession itself. We should expect to find continuing evidence of tension and equivocation

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<sup>29</sup> For an opposing view, see Gabor (2012).

in research by academic economists and in future IMF reports and practice that preclude a clear and decisive verdict on capital controls. But for now, at least, welfarist arguments for controls have been embraced at the top of the profession, and this is apt to continue to cast a long shadow over the IMF and beyond. More importantly, and as I have argued throughout, change at the IMF and in the economics profession is only one of a larger set of factors that have normalized and legitimated capital controls.

#### **4. Conclusion: Domesticating Capital Controls?**

From late 2010 to the present the IMF and the G-20 have provided us with a vantage point from which to observe hesitant change and the messy international politics around controls. In several reports, the Fund notes that it is developing standards for the appropriate use of controls (IMF, 2010b, 2011c, 2011d; Ostry et al., 2011, 2012). The project to develop standards was also given life by the French government, which tried to use its leadership of the G-20 and G-8 in early 2011 to authorize the IMF to pursue this project (Hollinger and Giles, 2011).<sup>30</sup> This has since fallen off the G-20 agenda, perhaps because of the leadership change and perhaps also (per Chwieroth, 2013a, 2013b) due to the US' enduring influence.<sup>31</sup>

At the same time that the IMF was developing its institutional view, the G-20 approved an expansive statement on controls that reflected the work of the committee co-chaired by Germany and Brazil (G-20, 2011). The G-20 statement goes beyond the IMF's institutional

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<sup>30</sup> Managing capital controls through multilateral rules has long been a French preoccupation (Abdelal, 2007).

<sup>31</sup> See Gallagher (2013) on efforts to countervail US monetary power through capital controls.

view--it takes an unambiguous, firm stand against “one size fits all” approaches to controls, rejects the idea of developing a set of conditions for their use, and calls upon nations to develop their own approaches to their use. The IMF’s institutional view report includes the G-20 document as an appendix and notes the importance of building on it, though acknowledges that the G-20 document is non-binding and is the product of a “hard-won consensus” (read: conflict that most likely pitted the US, UK and Germany against Brazil and other developing country members).

The fact that the IMF continues via its 2012-13 institutional view to try to secure for itself a leading role in managing the use of controls is instructive. The IMF’s 2013 Guidance Note many times invokes a refrain along the lines of “this will require staff judgment” in connection with country policies. Equally instructive is the fact that Brazil and developing countries working through the G-24 have consistently unequivocally and publicly rejected such a role for the Fund (Wagsty, 2011; Reddy, 2011; G-24, 2011). Newly enjoying policy autonomy in this domain, these countries are not anxious to succumb to IMF codes, sanctions or guidance that could tie their hands in the face of destabilizing flows of hot money.

The ultimate outcome of this rethinking of capital controls by the IMF and the economics profession is uncertain, of course. It is possible that the pre-2008 view of controls may re-establish itself, not least because its advocates have proven remarkably adept at “paradigm maintenance” over the last three decades as Wade (1996), Mirowski (2010) and Hodgson (2009) have noted and as Polanyi (1944:143) suggested long ago. Others, such as Farrell

and Quiggin (2012), see the matter more subtly, arguing that the current state of the profession is best characterized as an open-ended “dissensus.”

At present it appears to be very unlikely that the pendulum will swing back in the direction of reifying capital liberalization. Whether the IMF’s new openness on capital controls fades with the crisis may not matter much insofar as the institution has been rendered less relevant as it faces increasingly autonomous and assertive developing country members—some of which are now among its lenders.<sup>32</sup> The fact that economies that are performing well during the crisis are utilizing controls successfully has certainly eliminated the stigma around the instrument (Chwieroth, 2013b). That the Fund has also acknowledged the utility of outflow controls in countries in crisis also makes it harder to envision a return to pre-2008 views.

In this environment of disruption, economic and institutional change, and intellectual aperture, we find a productive expansion of policy space for capital controls, something that may ultimately be among the most important legacies of the crisis. The change, messiness, and uncertainty exemplify what I see as the productive incoherence of the present environment (Grabel, 2012). Some developing countries today enjoy the means and the appetite to exercise a greater degree of policy autonomy than we have observed during past crises. Just as powerful states, financial interests, and a supportive ideational environment promoted capital liberalization in the neoliberal era, a new configuration of states, interests and ideas is enabling capital controls during the current crisis. In a similar

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<sup>32</sup> Another possibility is that conflict over controls has shifted from the economic to the legal arena as I suggested earlier.

vein, Mittleman (2013) uses the term “global bricolage” to describe the current environment of shifting relations among developing countries, institutional adaptation, and changing ideas. Helleiner (2010) relatedly speaks of the moment as an interregnum. While the matter remains unsettled, the crisis has shifted dramatically the political, economic and ideological terrain on which future battles will be fought.<sup>33</sup>

Just as liberalized capital accounts are associated with negative spillovers in the form of instability, controls in one country can certainly induce positive and negative spillovers abroad. For instance, one country’s inflow restrictions can overvalue other countries’ currency values, harming their export performance. And so it is not inappropriate that the IMF and economists drawing on the welfarist approach are raising the need for a framework for coordinating controls. But we must be certain not to go back toward a simple-minded regime—such as the neoliberal regime—that dictates identical policies for all countries and which also places the responsibilities for policy spillovers on developing countries while giving wealthy countries a pass. These forms of policy coherence ought to be rejected along with the neoliberal form that it took for the better part of a quarter century.

It is critical that efforts be made to maintain and expand the opportunity that has emerged in the crisis environment for national policymakers to experiment with controls. Hence, the pressing policy challenge today is to construct a regime that provides for substantial national policy autonomy while managing cross-border spillover effects (Rodrik, 2001,

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<sup>33</sup> This contrasts with Wade (2013), who while acknowledging some change, argues that signs of continuity are more significant than those of discontinuity.

2012). This certainly suggests abandoning the strictures on capital controls in bilateral and multilateral agreements. It is also critically important that such a regime place responsibilities on capital source and recipient countries (as Keynes and White acknowledged long ago), and incorporate a genuinely even-handed acknowledgement that monetary policies and capital controls have global spillover effects that can be positive and negative. In this regard, the same factors that have contributed to the rebranding of controls as prudent capital flow management techniques—the diminished influence and pragmatic adjustment of the IMF in the context of rising autonomy and confidence of leading developing countries, coupled with increased aperture and new research within economics—might also contribute to the construction of a viable, flexible and permissive capital controls regime that is consistent with the goals of managing instability, promoting development and maximizing policy space.

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