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The IMF and the Capital Account

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The legal foundation of the international monetary system—the IMF's Articles of Agreement—should not be amended to give the IMF jurisdiction over the capital accounts of its members. As a matter of practice the Fund has adopted the correct policy stance with regard to capital account liberalization: Since the international financial crises of 1997 and 1998, the IMF has become cautious about promoting liberalization and frequently warns member countries of the risks involved. Although the IMF still should improve its surveillance and advice, the Fund's practices and the laws governing them are essentially appropriate.

It may seem uncontroversial to argue in favor of the status quo; unfortunately it is not. The current state of affairs—a cautious Fund without jurisdiction over the capital account—is what the founding members and authors of the Articles intended when the organization was first established. During the 1990s, when the IMF became an enthusiastic proponent of capital account liberalization and Fund management sought to amend the Articles, the status quo was seen as anachronistic and naive. Then, devastating financial crises in Asia, Latin America, and eastern Europe led many scholars and policymakers to question the new orthodoxy favoring the liberalization of capital movements in the absence of the domestic institutional foundations of sound financial systems.

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The Fund's lack of jurisdiction over the capital account should not be understood exclusively as a matter of intellectual principle. Jurisdiction is a matter of international politics. Edwin M. Truman in chapter 2 of this volume argues forcefully that a rehabilitation of the IMF's reputation and influence will require consensus among its members. The current absence of a political consensus in favor of a capital account amendment necessarily means that IMF management should not be pursuing one. Even in the spring of 1997, when support was at its highest, debates within the Executive Board revealed no more than 65 percent of the weighted votes in favor of the proposed amendment.[1] Since then support among member countries and on the board has declined dramatically. Now hardly seems a propitious moment for developed countries to push forward an amendment that many developing countries viewed with alarm and suspicion even before the financial crises of 1997 and 1998.

In the rest of this chapter I evaluate in greater detail the appropriate relationship between the IMF and the capital accounts of its members as a matter of law and practice.

The Capital Account and Articles of Agreement

Article I endows the Fund with six purposes, which are supposed to guide all of the Fund's policies and decisions. Several of those purposes deal with the promotion of trade and the elimination of members' current account restrictions. None deals with members' capital account restrictions. The Fund therefore may not, without violating its own Articles, require a member to remove controls on capital movements as a condition for the use of its resources.[2]

Instead, Article VI, Section 3 specifies that members "may exercise such controls as are necessary to regulate international capital movements." During the 1950s some Fund staff members debated how the organization's authority over the capital account was circumscribed by the Articles. In 1956 the Executive Board offered this definitive interpretation: "Members are free to adopt a policy of regulating capital movements for any reason . . . without approval of the Fund."[3]

1. Three-fifths of Fund members, having 85 percent of the total voting power, must accept any proposed amendment. A thorough analysis of the 1997 episode can be found in Abdelal (forthcoming, chapter 6).

2. The IMF can only impose conditionality consistent with the purposes of the Fund's Articles (IEO 2005, 8). The IMF's legal department subjected the issue to a sustained analysis, the documents of which are in the organization's archives (Abdelal, forthcoming, chapter 6). A review article published by a member of the Fund's legal staff clarifying the legal status of capital account liberalization in conditionality is Leckow (1999).

3. See Decision No. 541-(56/39), taken on July 25, 1956, by the Executive Board of the IMF. On the Fund's limited jurisdiction over members' regulation of international capital movements, see also Gold (1977).

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The authors of the Articles and the representatives of the 44 founding members reserved for members the right to control capital movements as a matter of principle. This was not an accidental omission; there was no unfinished work left by the founders. Capital transactions, as Fund historian Margaret Garritsen de Vries (1969, 224) writes, were "deliberately left out." Accompanying the legal right of members to control capital movements was the collective expectation that capital controls would be normal and legitimate for the foreseeable future. John Maynard Keynes (Moggridge 1980) in a 1944 speech to the House of Lords explained: "Not merely as a feature of the transition, but as a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements. What used to be a heresy is now endorsed as orthodox."

The central principle was that governments should be autonomous from financial markets.[4] The markets were to be preserved by taming their social consequences, thereby preempting societal demands to destroy them altogether. This was, in the words of John Gerard Ruggie, the compromise of embedded liberalism: Markets were to be embedded in social and political relations, rather than exist beyond them. Capital controls were understood to be essential to the success of embedded liberalism.[5] Only in this way, it was thought, could governments' social priorities be reconciled with the critical task of rebuilding a vibrant world economy.

Policymakers sought to encourage long-term, productive capital and regulate tightly short-term, "speculative" capital. Short-term capital movements not only constrained the autonomy of governments but tended, in the policy idiom of the time, to be "disequilibrating" and "self-aggravating." (Today policymakers and economists, respectively, speak of financial markets' "overshooting" and "self-fulfilling" crises.) Thus, not all capital movements were suspect. Policymakers worried primarily about "hot money" (short-term capital flows) and the financial crises it could cause even in countries without problematic fundamentals. Of even greater concern was the possibility that these crises would undermine political support for an open trading system.

4. Thus, the reconciliation of the so-called impossible trinity—the impossibility of simultaneously pursuing a fixed exchange rate, free capital movements, and autonomous monetary policy—was only one of the principles of the system and, among them, it was perhaps the least important.

5. The scholarly literature on the principles of the postwar system is large. Excellent overviews of these arguments can be found in Helleiner (1994, 33–38); Eichengreen (1996, 3–4 and 93–94); James (1996, 37–39); and Kirshner (1999). On the compromise of "embedded liberalism," see Ruggie (1982, 1998).

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Surveillance, the Capital Account, and Purpose of the System

In the late 1970s, after the breakdown of the par value system, the Fund became involved in capital account issues through bilateral surveillance of members' exchange rate policies. In 1977 the Executive Board, anticipating an amendment to the Articles, decided that capital flows would systematically be incorporated into discussions with members about their exchange rate policies, particularly in the new era of increasing private international financial flows. The decision was neutral in its language: The Fund would favor neither liberalization nor regulation. Of equal concern, for example, was "abnormal encouragement or discouragement to capital flows" pursued "for balance of payments purposes" (Pauly 1997, 105–11; IEO 2005, 29–30).

In 1978 the second amendment to the Fund's articles offered language that explicitly welcomed international capital flows. The preamble of Article IV reads: "The essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries." Still, the facilitation of the exchange of capital was a purpose not of the Fund, but of the system itself, so the organization was not given a new mandate to promote capital account liberalization.

Proposal to Amend the Articles

Locating the origins of the proposal to amend the Articles of Agreement is a difficult task. The first discussion of which I am aware is a late 1993 meeting in which Managing Director Michel Camdessus proposed the idea to Philippe Maystadt, chairman of the Interim Committee.

The Executive Board discussed the proposal several times in 1994 but only in 1995 did a thorough analysis and lively debate begin. The board held serious deliberations in the summer of 1995 but did not reach a consensus during these initial discussions. At the time only six executive directors (representing approximately 38 percent of the weighted votes) expressed support for the proposal. Seven executive directors (with 25 percent of the weighted votes) argued that it was unnecessary, and another six (with 14 percent of the votes) were against. Five executive directors (with 23 percent of the votes) called for further work.[6]

The Interim Committee involved itself officially in the process in September 1996 by asking the board to examine a possible change to the Arti-

6. These numbers are from my analysis of the minutes of a meeting of the Executive Board in July 1995; see Abdelal (forthcoming, chapter 6).

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cles. Then, in February 1997, the proposed amendment began to take shape.

The Fund was to be endowed with a new purpose: to promote the liberalization of capital flows. This purpose was to be codified in a rewritten Article I.[7] This change in the Articles would have enabled the Fund, for the first time in its history, to include capital liberalization in the conditions attached to its loans. The Fund would not necessarily use this new authority systematically to promote liberalization in borrowing countries. Discretion about its use would have rested with management.

The IMF also was to assume jurisdiction over the capital account regulations of its members. This new jurisdiction involved rewriting Article VI along the following lines: "Members shall not, without the approval of the Fund, impose restrictions on the making of payments and transfers for capital international transactions."[8] Members' right to control capital movements—long enshrined in Article VI, Section 3—would be rescinded. Whereas the legal presumption of the Articles as written in 1944 was that capital controls were allowed unless otherwise specified, the amendment would mean that capital controls were prohibited unless specifically approved by the Fund. Under the amended Article VI, the onus would be on members to justify deviations from openness.

In April 1997 the executive directors again failed to reach a consensus, although the proposal enjoyed significantly more support on the board. Fourteen executive directors (65 percent) favored the amendment, and seven (25 percent) opposed it. Three executive directors (10 percent) supported amending Article I but not Article VI—that is, they supported a new purpose for the Fund without accompanying jurisdiction over the capital account (Abdelal, forthcoming, chapter 6).

During the summer of 1997, when it was clear that support for the amendment would not reach 85 percent of the weighted votes, a tentative compromise was reached. One of the most difficult issues was foreign direct investment with all of its political sensitivities. Foreign direct investment, the executive directors agreed, would be excluded altogether from

7. For a clear statement, although it came after the Hong Kong meetings, see "Concluding Remarks by the Acting Chairman of Liberalization of Capital Movements under an Amendment of the Articles," 2, Executive Board Meeting, April 2, 1998, BUFF/98/41, in the IMF archives.

8. An alternative, giving broader jurisdiction: "Members shall not, without the approval of the Fund, impose restrictions on capital international transactions and related payments and transfers." This was most clearly articulated in "Capital Account Convertibility and the Role of the Fund—Review of Experience and Consideration of a Possible Amendment of the Articles," 30–31, prepared by the Legal, Monetary and Exchange Affairs, and Policy Development and Review Departments, February 5, 1997, SM/97/32, in the IMF archives. Some observers thought that Article VI, Section 3, was to be unaffected by the amendment; see Eichengreen (2000, 190). I am not aware of any alternate proposals that did not involve rewriting Article VI, Section 3.

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the Fund's jurisdiction. Thus, even if the amendment were successful, the Fund would have been left with jurisdiction only over shorter-term flows—the hot money that had worried the founding members.

By the time the 49th meeting of the Interim Committee began in Hong Kong on September 21, 1997, the financial crisis that would eventually sweep through Asia already was under way. The Interim Committee's call to amend the Articles was self-consciously "bold in its vision, but cautious in implementation" (Interim Committee 1997). And its timing was, for supporters, remarkably unfortunate, much of the work on the proposal having been done before the crisis hit Thailand in July. Even before the crisis, the board had not been close to the required consensus, and a series of devastating financial crises did little to endear the liberal amendment to executive directors and member countries. Although the Interim Committee renewed its request to the board in the spring of 1998, the proposed amendment would die a quiet death before the summer. The politics of the proposal both within and outside the Fund were decisive.

Politics of the Amendment

The required consensus in favor of the amendment never existed on the Executive Board. A number of executive directors from developing countries opposed the amendment for fear of ceding policy autonomy to the Fund. Although Fund management and staff sought to reassure directors and member countries that flexible approval policies would be put in place, developing countries recognized that they were being asked to trust the sound judgment of the Fund on capital account issues. That trust was lacking, as concerns were raised that the Fund would rigidly enforce members' obligations (see, for example, Polak 1998). Potentially the most significant operational change would be the board's requiring capital account liberalization as a condition of using Fund resources. In the developing world, conditionality already was hotly contested and frequently resented, and the prospect of Fund involvement in countries' capital account policies worried many policymakers. Although the Fund may not have employed conditionality to promote capital account liberalization, the mere fact of this authority worried some policymakers, who did not understand why Fund management sought power it did not intend to use.

Most successful policy initiatives within the Fund emerge from the Group of Seven (G-7). On the issue of the amendment, however, not even the G-7 could reach a consensus. From the beginning, the Canadian executive director, Thomas Bernes, following the lead of Finance Minister Paul Martin, spearheaded the opposition to the amendment as a matter of intellectual and legal principle (Kirton 1999). In May 1997, after a change of government in London, the United Kingdom withdrew its support for the proposal as well.

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Although the US executive director, Karin Lissakers, supported the proposal, senior officials within the US Department of the Treasury were indifferent at best. According to former treasury secretary Lawrence Summers, "For the Fund it was a bureaucratic imperative. The proposal was less about sound economic policy and more about Fund turf" (Abdelal, forthcoming, chapter 6). To the Treasury Department, which enjoyed a central role in the international financial system, it seemed that the Fund's management sought to make the organization more relevant in an era of highly internationalized financial flows. This view was consistent with the fact that many European executive directors and finance ministers who expressed enthusiasm for the amendment argued that the lack of IMF jurisdiction would lead to global discussions being held in the World Trade Organization, thus shifting capital movements from the domain of finance ministries into that of trade ministries.

IMF management did not initially consult with the private financial community. Perhaps IMF policymakers assumed that Wall Street financial firms would support the liberal initiative. When the world's most influential bankers and investors learned of the proposal in 1997, however, they reacted with alarm and quickly came to oppose the amendment.[9] While developing-country leaders worried that the Fund would use its new purpose and jurisdiction to delegitimize capital controls, the private financial community expressed concern that those controls that the Fund did approve would be thereby legitimized. Private bankers and investors also worried that the Fund would be overly enthusiastic about liberalizing markets about which those bankers and investors cared little but that could be prone to crises that would spread elsewhere. Finally, like the US Treasury Department, the private financial community interpreted the proposal as the Fund's grab for power.

The decisive blow against the proposal was struck by powerful Democrats in the US House of Representatives. In the spring of 1998, as the House debated a significant increase in US funding for the IMF, Richard Gephardt, then the minority leader of the House, and his colleagues learned of the initiative to amend the Articles. Gephardt and several powerful Democrats, including Representatives David Bonior, Nancy Pelosi, Barney Frank, Maxine Waters, and Esteban Torres, all deeply skeptical of financial globalization, sent a strongly worded letter dated May 1, 1998, to Treasury Secretary Robert Rubin warning that any further US support for the amendment would jeopardize the funding increase. The US Treasury immediately withdrew its already modest support for the proposal.

9. This position was taken by the Institute of International Finance and can be found in the institute's internal documents compiled between 1997 and 1999 (reviewed in Abdelal [forthcoming, chapter 6]). Public statements can be found in the September 1, 1997, issue of *The Banker* and in the Charles A. Dallara letter to Minister Philippe Maystadt, chairman of the Interim Committee, dated April 8, 1998.

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The proposed amendment has been portrayed—incorrectly—as an initiative of Wall Street, the US Treasury, and the US Congress (Bhagwati 1998, 12; Wade and Veneroso 1998, 35–39). IMF management conceived the proposed amendment, and it was supported most by a handful of European executive directors. The proposal's opponents were not limited to the radical Left or developing-country leaders. The amendment enjoyed only modest support even among US policymakers, support that has since diminished further.

Evolution of the IMF's Approach to the Capital Account

Until 1987, under the leadership of Managing Director Jacques de Larosière, Fund management intended that the organization stand apart from the process of financial internationalization. "We had our catechism," explained de Larosière. "Thou must give freedom to current payments, but thou must not necessarily give freedom to capital" (Abdelal 2006).

During the late 1980s and early 1990s the Fund's new management, and particularly its new managing director, Michel Camdessus, embraced and came to promote capital account liberalization as a matter of practice. The Fund promoted liberalization through two primary mechanisms: surveillance over members' exchange rate policies and technical advice. For promoting capital liberalization in the absence of a formal mandate, the Fund courted many critics (Bhagwati 1998, Wade and Veneroso 1998, Kirshner 2003, Stiglitz 2004).

The Independent Evaluation Office recently conducted a thorough evaluation of the Fund's approach to capital account liberalization (IEO 2005). Several of the IEO's findings should be reiterated in the context of a debate on IMF reform. First, IMF management embraced liberalization in the absence of a professional consensus about the appropriate pace and sequencing of countries' movements toward open capital accounts.[10] Some members of the Fund staff argued that rather than waiting for the institutional foundations of sound financial systems to emerge as a precondition for liberalization, capital account opening would lead countries, via the discipline of financial markets, to adopt those institutions. Other members of staff and management regularly argued that capital controls did not work and, thus, members ought to liberalize. The Fund often highlighted the benefits of capital account liberalization in discussions with members but offered fewer insights into the risks. There was a great deal of inconsistency in country work: Sometimes Fund staff offered

10. The empirical evidence of the benefits of capital account liberalization for developing-country members is still wanting (Eichengreen 2001, 360; Prasad et al. 2003). An excellent recent evaluation of the role of institutions and policies in determining capital flows is Alfaro, Kalemli-Ozcan, and Volosovych (forthcoming).

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advice on sequencing and institutional preconditions of liberalization, but at other times Fund staff did not (IEO 2005).

Still, the IMF did not literally force liberalization upon developing countries, and the Articles prevented the board from systematically making comprehensive capital account liberalization a condition of the use of Fund resources. Fund staff and management also did not encourage liberalization indiscriminately or systematically; instead they took developing countries on a case-by-case basis (IEO 2005).

The financial crises of 1997 and 1998 tempered the enthusiasm for capital account liberalization within the Fund, thus suggesting that the organization learned as time passed (IEO 2005, 10, 95). In the early years of the new century, Fund staff has tended to be extremely cautious about capital account liberalization. Much more attention is paid to the potential risks (IEO 2005, 7). The staff places greater emphasis on gradualism and sequencing (IEO 2005, 8, 36–37, 57–58). Indeed, the IMF is now often more cautious than country authorities (IEO 2005, 9).

My reading of the evidence is that the Fund deserved much, but not all, of the criticism it received for embracing capital account liberalization as a matter of doctrine, practice, and, with respect to the proposal to amend the Articles, law. Those days are gone, however. Fund staff since then may even have become overly cautious, presenting countries primarily with a laundry list of all of the things that may go wrong during the process of capital account liberalization. The intellectual distance between Bretton Woods and 19th Street, widest perhaps in September 1997, has since narrowed considerably. The Fund is now cautious about capital account liberalization, much as its founders, fresh from their own devastating financial crises, had intended. This caution is the appropriate stance.

Conclusions and Recommendations

The proposal to amend the Articles of Agreement failed, and rightly so. The proposal was often portrayed by Fund management and the Interim Committee as a "new chapter" for the Articles, finishing the work left undone at Bretton Woods. The intellectual history of the place of the capital account in the Fund's Articles reveals, in contrast, that to amend the Articles would not fulfill the original vision of the Fund. The IMF was supposed to be cautious about capital account liberalization, and members were to retain their right to regulate capital flows across their borders without Fund approval.

The Fund's Articles therefore should not be amended unless its members reach a new consensus in favor of endowing the IMF with a new purpose and jurisdiction. That consensus did not exist in 1997, and it does not exist now. An amendment would place even greater power in the hands of Fund management and staff. Fund management and staff have argued

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that developing countries should trust them to use that power prudently. That trust is not there, however; and it cannot be conjured up. Pressing for an amendment in the absence of trust can hardly help to create it.

Nor has a professional consensus about the appropriate path to capital account liberalization emerged outside of the Fund. In the spring of 1998 Stanley Fischer (1998, 8), who was then first deputy managing director, argued forcefully in favor of the proposed amendment by referring to our pressing need to know more: "The difference between the analytic understanding of capital versus current account restrictions is striking." He continued: "The economics profession knows a great deal about current account liberalization, its desirability, and effective ways of liberalizing. It knows far less about capital account liberalization. It is time to bring order to both thinking and policy on the capital account."

Following Fischer's reasoning, I am inclined to reach the opposite conclusion: In the absence of a professional consensus, presumably based on a more sophisticated and complete analytic understanding, the Fund should not be endowed with the purpose of promoting capital account liberalization or given jurisdiction over members' capital account regulations. The Fund should not be given power in advance of its articulating a theory of how to use such power effectively. And a legal change in the Articles cannot cause an improvement in our understanding of international financial markets.

Even if there were such a professional consensus, which at the moment appears less rather than more likely, it is a tactical error for the Fund's management to push for a capital account amendment that was unpopular in the developing world and on Wall Street before the crisis and unpopular in Washington after the crisis. It would be imprudent to risk the IMF's already scarce political capital to pursue a legal reform for which international political support is lacking.

The Fund also should not informally adopt a mandate for capital account liberalization, as it seemed to have done during the 1990s. It is simply poor governance for an international organization to appropriate a mandate on the basis of a bureaucracy's interpretation of the true value of the arguments instead of on the basis of the organization's legal authority (Pauly 1999, Barnett and Finnemore 2004). Fund management and staff should not decide to pursue an agenda that is at odds with the spirit and letter of the laws upon which members have agreed.

Indeed, if another major financial crisis were to be attributed—rightly or wrongly—to the Fund's enthusiasm for capital account liberalization, the outcome could easily be worse than the status quo for both the system and the organization. The Fund's original mission to promote current account convertibility remains, and a crisis that reduced trade openness would undermine that important mission. Members might also circumscribe the Fund's current legal authority if the organization were seen to have caused financial instability.

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The Fund is still obliged, of course, to consider capital account issues in its multilateral and bilateral surveillance and technical advice. The Fund operates, according to the lingo, in a "capital account world." The world today is substantially different from the world that Keynes and others envisioned more than 50 years ago. Whether the Fund promotes it or not, capital account liberalization will likely continue to proceed throughout the world. Most governments want their countries to benefit from the opportunities presented by large, increasingly integrated financial markets. The rules of the Organization for Economic Cooperation and Development and the European Union, unwritten at the time of the Bretton Woods conference, promote capital account liberalization, and a great deal of de facto liberalization already has taken place.

The question is, how should the IMF respond to this challenge without having an explicit mandate in the Articles? There is in fact much the Fund can do to contribute to a stable international financial system without amending the articles.

Some supporters of the amendment argued that the Fund should be the primary locus of expertise on the capital account. I agree, and recent research on capital account policies emerging from the Fund is outstanding. There is nothing in the articles that would prevent the Fund's staff from becoming known as the world's experts on capital flows and regulations, and certainly they may do so without an amendment.

The Fund must continue to be neutral with regard to the capital account. The prevailing mood of caution is warranted, as is the Fund's current focus on sequencing and on institutional foundations in the Financial Sector Assessment Program.

The IMF also must recognize that there is a variety of reasons that members employ capital controls, the legitimacy of which is beyond the legal competence of the IMF to evaluate. Barry Eichengreen (2000, 187–88) argues that the IMF should adopt a role "not as advocate of capital account liberalization but as adviser on prudent regulation of the capital account and guardian against avoidable financial crises." The IMF should help countries to implement capital controls in the least distortionary and most effective ways, just as it should advise governments that wish to liberalize on how to mitigate the risks. The IMF should become the repository of knowledge on the best practices of capital account regulations, which increasingly appear to be taxlike rather than quantitative restrictions. A recent evaluation of capital flows to emerging markets by John Williamson (2005, 111) concludes that "if an emerging-market country is serious about controlling the boom-bust cycle, it needs to retain the possibility of resorting to capital controls in certain situations." That possibility is in part a function of their legal rights as IMF members, and the Fund can best help protect emerging markets by acting as their adviser within the existing legal framework.

Finally, I second the advice of the IEO (2005, 13) that the IMF should focus, especially in its multilateral surveillance, much more attention on

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the supply-side dynamics of international financial markets and, perhaps, even recommend policies that could be put in place by countries, particularly in the developed world, that are the source of the vast majority of cross-border investment flows. Volatility and contagious financial crises are not just the result of problematic policies in the developing countries that experience them. The international financial markets that developed countries have unleashed are their responsibility as well.

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