International Cooperation and Cross-Border Capital Movements

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In recent years, cross-border financial transactions have become an enormous part of the global economy. This has been facilitated by widespread liberalization of domestic rules relating to inward and outward capital movements and by various regional and bilateral international agreements regarding cross-border capital flows.

Both source and recipient states obtain benefits from liberalizing rules affecting capital movements. In theory, free movement of capital should promote efficient allocation of financial resources. As the recent global financial crisis reveals, however, there are also costs and potential pitfalls to increasing capital flows. Failure to manage capital inflows can increase a national economy's vulnerability to external pressures. And the inability to control rapid outflows can, in some circumstances, exacerbate or spur an acute financial crisis. Cross-border capital flows are now undoubtedly “the principal conduit for the transmission of global shocks.” Thus, some countries that resisted full liberalization of rules affecting capital movements in the years before the crisis avoided some of the dramatic problems experienced in countries that embraced such policies during that same period.

The current landscape of regulation of capital movements is essentially a patchwork of agreements liberalizing flows among large economies and pervasive capital controls in low-income economies. The existing agreements to liberalize flows tend to be inflexible to the kinds of controls that can preserve and restore financial stability. Perhaps more worrying, national policies affecting capital flows can have significant and unexpected collateral effects on other economies, causing instability elsewhere even if not at home. Policies that promote outward capital flows from source countries, for example, can lead to vulnerability in recipient countries; such vulnerability can lead to instability that transmits back to the source country. Furthermore, capital controls adopted in one country to avert financial crisis can impact similarly situated countries by, perhaps, diverting capital flows to the them or creating concern among market participants that the other countries will adopt similar policies. In other words, regulation of capital flows is a multilateral issue requiring international coordination.

This paper explores the efforts of the International Monetary Fund since the crisis to improve national policymaking affecting capital flows and to facilitate international coordination of such policies. The Fund has some, but limited, jurisdiction to engage

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its members on this topic. The Fund’s Articles of Agreement, a treaty of near-universal application, expressly allows members broad freedom to adopt policies affecting capital movements. The Fund has found, however, that this authority is limited by some of members’ other obligations under the Articles, especially the obligation to collaborate in promoting systemic financial and economic stability.

After a period study and internal discussion, IMF staff has proposed an “institutional view” on its members’ “liberalization and management of capital flows.” Building on previous staff positions and advice to members over the years, this view generally embraces liberalization of capital flows if carefully sequenced with other “financial and institutional development” and recognizes that “capital flow management measures” are sometimes useful and should generally not be foreclosed. The Board has formally endorsed the institutional view.

This institutional view is an interesting case study in global governance. While recognizing its members’ obligations, its own authority, and the need for greater international coordination regarding the treatment capital flows, the Fund has thus far eschewed taking formal steps in this area. It has not issued a formal decision and has not articulated any formal principles on the topic. Yet this view clearly informs and directs the content of advice that the Fund’s staff and its Board provide to members in the course of bilateral and multilateral surveillance. The Fund is thus attempting to promote international coordination by consultation and persuasion, its primary modes of governance. It remains to be seen whether this current approach will have a meaningful impact on its members’ policymaking and whether more formal actions, such as amending the Articles to effectively provide universal agreement on treatment of capital flows, would have a greater impact.

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2 See IMF, Articles of Agreement, Article VI, section 3 (authorizing members to exercise capital controls that are “necessary to regulate international capital movements.”)
