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Creating Policy Stigmas in Financial Governance: The International Monetary Fund and Capital Controls*

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Policy stigmas are an importance aspect of financial governance. Their prescriptions serve both to regulate behaviour and to identify what counts as "good" financial governance. Conformity with stigmas is thus an important part of signaling "good" financial citizenship. This paper explores the source, significance, and shortcomings of one particular policy stigma, that which has been attached to capital controls. Focusing on the International Monetary Fund, it empirically examines how the degree of approval fixed to controls has varied considerably across time and space and within the IMF itself. It analyzes the origin and impact of this stigma as well as the potential costs and risks it raises.

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The financial crisis that originated in developed economies in summer 2007 and that intensified and spread following the collapse of Lehman Brothers in September 2008 led to a destabilizing sharp, but temporary, reversal of capital inflows to emerging markets. Yet with many emerging markets now decoupling from the slow recovery in developed countries, capital inflows, attracted by significant interest-rate differentials, soon returned in abundance. Notwithstanding the benefits of these flows, many emerging markets are concerned that the recent surge could cause problems for their economies in terms of exchange rate volatility and financial instability. As a result, some governments have taken action to restrict capital flows.

But in imposing these restrictions many governments have tended to be timid in their actions, taking great effort to present them as small in magnitude, market-based in orientation, and temporary in duration while eschewing more intrusive and permanent measures that could be necessary for the restrictions to be effective. One important reason for this behavioural tendency is the perception of a stigma attached to use of capital controls. Policy stigmas are important, but understudied aspect, of financial governance. This paper seeks to strengthen our understanding of stigmas by exploring their impact on the use of capital controls. It provides an analysis of one source of this stigma, the International Monetary Fund (IMF), and the significance that variation in this stigma has had on policymaking.

This paper also seeks to address some shortcomings of stigmas. When a policy is stigmatized it generates significant costs, actual or perceived, on the government that implements it. These costs in turn place severe limits on the policy autonomy of governments. In some cases, this constraint may prove beneficial, imposing discipline on policies that are clearly suboptimal from the standpoint of economic theory and aggregate welfare. Yet rarely are stigmas derived from a theoretical consensus that provides a singular

truth about optimal policy. By raising the actual or perceived costs of a particular policy, stigmas may unintentionally encourage governments to pursue alternative policy choices that, while seemingly optimal given the constraints imposed by the stigma, may generate unanticipated suboptimal outcomes more severe than those that would have developed had the stigmatized policy been pursued. From a political economy standpoint, stigmas are also often associated with varying distributional consequences that are nonetheless cloaked behind the rhetoric of optimality.

1. Policy stigmas in financial governance: source, significance, and shortcomings

A policy stigma is severe social disapproval of a particular course of action that is perceived to be against prevailing standards of behaviour. Within the field of international political economy, policy stigmas are understood to result from constitutive and regulative norms (Abdelal *et al.*, 2010). Regulative norms specify the boundaries of legitimate practice and thus order and constrain behaviour, and in doing so constitute what counts as legitimate behaviour for actors with particular identities. For instance, the statement "Governments practicing 'good' financial governance do not use capital controls" contains both a regulative and constitutive element in that it places constraints on the range of legitimate social action and links it to an actor with a particular identity.

Policy stigmas exist in all areas of world politics, but they are likely to be particularly influential in finance because of the importance of confidence and credibility. Policies that are deemed illegitimate or lacking credibility cannot be sustained because of the response of market actors to such policies. Since policies require market confidence to in order to work, policy stigmas can have an overwhelming influence of the ability of governments to set policy. These stigmas, regardless of their truth value, define the possible and the feasible.

Stigmas define the meaning fixed to particular policies, shaping the way that actors interpret them. In game theoretic language, stigmas define the range of actions that an

audience will view favourably, thereby constructing and sustaining credibility and confidence. By sending a negative signal, governments that implement stigmatized policies expect to trigger an adverse market reaction. Nicely summarizing the constraints that stigmas can impose, one scholar of international political economy observes: "The astonishing result of this [stigmas] is that in a hypothetical menu of five economic policies, each of which was plausible from the standpoint of economy theory, if three were *perceived* to be illegitimate, they would not in face be sustainable, *solely for that reason*. (Kirshner, 2003, p. 13, emphasis in original)

Policy stigmas vary across time and space. What may be illegitimate for one type of actor (i.e. "developed countries") may not be illegitimate for another (i.e. "developing countries"). Moreover, a policy choice stigmatized at one particular moment may have been perfectly legitimate at another moment. For instance, as will be discussed in more detail, whereas in the early post-war era the use of capital controls during a crisis was conventional wisdom, by the mid-1980s such actions had become seen as sending a negative signal to market actors. Liberalizing controls during a crisis, on the other hand, was argued as necessary to send a positive signal to markets and to restore confidence (Bartolini and Drazen, 1997). Policies, like fashion, are thus subject to fads. But what is fashionable at one moment can later become passé. To paraphrase Keynes, what was once defined as orthodoxy often later becomes redefined as a heresy.

International organizations play an important role in fixing meanings, thus constituting the legitimate boundaries of policymaking (Barnett and Finnemore, 2004). In the area of financial governance, the IMF has been a key player in this regard. Through the authority delegated to it by its member states and its command of specialized knowledge, the IMF commands a degree of deference to its pronouncements on what counts as legitimate policy practice. The institutional tools available to the IMF – conditional lending,

surveillance, and its coordinating role with official creditors and private market actors - make it a highly influential actor in particular settings.

Notwithstanding recent events in the eurozone, most developed countries seem to have "graduated" from a history of serial default (Reinhart and Rogoff, 2008), which means they typically can borrow extensively in their own currencies and depend less on the IMF to provide them with a seal of approval. Historically, emerging markets and developing countries tend not to enjoy this luxury and thus often depend on the IMF to inspire and sustain market confidence.[1] Conditional lending and surveillance provide the IMF with two important in-house levers to encourage governments to avoid policies that it stigmatizes.

Equally significant is the coordinating role the IMF plays for official creditors and financial market actors. Progress in debt rescheduling via the Paris Club and the Highly Indebted Poor Countries Initiative is tied to IMF approval, as was progress for many Eastern European countries in their accession negotiations with the European Union (EU). Access for countries such as Greece to the newly created EU stabilization fund also partly depends on IMF approval. Private creditors and investors also often take their cues from the IMF. Although evidence on the magnitude and composition of the "catalytic" effect from the IMF seal of approval is mixed, there is much more definitive evidence suggesting the presence of "paralytic" effect from IMF disapproval (Edwards, 2005). In other words, financial market actors do not necessarily flock to countries meeting IMF approval, but they do tend to flee from countries meeting its disapproval.

[1] This distinction between developed countries, on the one hand, and emerging market and developing countries, on the other, is in a state of flux. The recent rapid increase in public debt and the deterioration of the fiscal positions that followed the financial crisis of 2007-2009 has significantly increased the perception of sovereign risk for some developed countries. Conversely, some emerging market countries, particularly those that had improved policy fundamentals and reduced vulnerabilities in the pre-crisis period, are generally better placed and likely to experience significantly better public debt and fiscal positions than most developed countries in the near future. Consequently, their "debt intolerance" may have decreased. In addition, many emerging markets have made significant efforts in the past decade to improve their ability to borrow in their own currencies, thus partly tackling the problem of "original sin."

Member states are an important influence on the policy beliefs of international organizations (IOs). Their preferences set the "outer structural constraint" in which the organization operates (Woods, 2006). Yet because IOs like the IMF have significant autonomy, it is necessary to explore intra-organizational process to understand the policy beliefs they espouse.

The policy beliefs the IMF espouses, like those of any organization, are linked to the beliefs that prevail within the profession from which it recruits (Chwieroth, 2010). Professions are major agents in the construction of policy beliefs, and because the IMF primarily recruits from the economics profession and maintains close links to it, this means many of the organization's beliefs originate from the academic community. Technical knowledge and normative conceptualizations originating from the economics profession offer the staff a lens through which to develop shared diagnoses and policy prescriptions. Fads and fashions in the economics profession can thus have an important influence on the content of the policy stigmas put forth by the Fund.

Organizational beliefs also change via experience through processes of adaptation and learning. Adaptation involves a change in beliefs about the desirability or possibility of using a given policy instrument or instrument setting without any corresponding change in beliefs about the desirability of a particular goal to which the instruments and settings are directed. It can entail changes in organizational language, structures, symbols, and small modifications of behaviour, but the organization's general goals and assumptions remain intact. Learning, on the other hand, involves a comprehensive change in beliefs about the possibility or desirability of a given goal. Organizational language, structures, and symbols are fundamentally altered.

Pre-existing beliefs impose an important constraint on the process of updating beliefs, channelling the lessons that emerge and raising barriers to change. Pre-existing beliefs will

tend to engender a confirmation bias in updating, thereby narrowing the kind of information that is considered relevant and filtering this information in such a manner as to match these beliefs. Consequently, when organizational staff encounter outcomes that fail to match up with their expectations, they tend to adapt rather than learn. Change through experience tends to be gradual rather than revolutionary; the exception being times of perceived crisis. In fact, learning is so cognitively difficult that it typically requires a realignment of personnel that enables alternative beliefs to be brought to bear on experience.

Change also comes through the strategic efforts of "norm entrepreneurs" within an organization. These actors operate from within organizations to change the meaning fixed to particular policies or events and to re-frame and construct what is feasible and legitimate. The success of these entrepreneurs typically depends on their ability to frame new initiatives so that they resonate with pre-existing organizational principles and practices.

In addition to understanding some of the sources and significance of stigmas, it is worth highlighting some of their potential shortcomings. Since economic theory rarely provides a definitive answer as to the optimal policy in every context, there will almost always remain a range of policy choices that are feasible or legitimate. Yet stigmas can skew the ways in which actors understand and react to problems, creating a powerful constraint on policymaking. By raising the actual or perceived costs of a particular policy, stigmas may unintentionally encourage governments to pursue alternative policy choices that, while seemingly optimal given the choice set constrained by the stigma, may entail costs and risks that are more severe than those that would have developed had the stigmatized policy been pursued. As a result, stigmas can unintentionally lead to unanticipated suboptimal outcomes.

From a political economy perspective it is important to note that while the aggregate consequences across the range of feasible policy choices may be similar, it is almost certainly

the case that they vary in terms of their distributional consequences despite typically being cloaked under the veil of efficiency and optimality. Policy stigmas are likely to introduce asymmetric costs and benefits to various countries and actors within and across economies. This is particularly problematic because policy stigmas, even those based on sound economic logic, necessarily limit the degree of "policy space" available to governments, thus artificially privileging some interests over others.[2] Desirable policy will often vary across economies depending on their social priorities and levels of development (Rodrik, 2009). The risk from policy stigmas is that they can become too general and uniform, thus rendering them unsuitable for particular local needs and contexts.

Finally, the effort to stigmatize policies runs the risk of converging on belief system that provides a poor quality template. It should be noted that this line of argument does not suggest an orientation of "anything goes." Rather, the argument is that economic theory often identifies a broader range of plausible policy options than stigmas permit, and that such stigmas can end up generating significant risks and negative consequences. Ultimately, as the experience of the IMF in the decade after the Asian financial crisis illustrates, these risks and consequences can feed into resentment and backlash on the part of some actors toward the organization promoting the stigma.

The following sections illustrate these arguments about stigmas by examining historical variation in the legitimacy the IMF fixed to capital controls.

2. Capital controlled: a creation without stigmas.

At the end of the Second World War, collectively shared Keynesian beliefs produced widespread support in the 1940s and 1950s for the view that unfettered capital mobility – particularly for short-term flows – was undesirable and that controls were essential. Rather

[2] *Artificial* here means not derived from any singular economic truth.

than being stigmatized, capital controls were the norm. Within the IMF, this norm had two bases of support (Chwieroth, 2010, ch. 4).

First, the IMF membership supported the legitimacy of controls. The United States, though it decided not to rely on controls and viewed them more sceptically than most of the IMF membership, generally accommodated their use. Other members of the IMF lent greater support, with a number of governments, particularly in Western Europe, fearing the disruptive effects of speculative capital flows.

From within the IMF the staff also provided a second important base of support for controls. Recruitment patterns proved to be a key influence on the staff approach. In the 1930s and 1940s, Keynesian-minded economists played an important role in helping to construct capital controls as a legitimate policy instrument. Some scholars suggest that support for controls was based on the belief that they were necessary to maintain exchange rate commitments and policy autonomy (Helleiner, 1994). Yet among most economists support for controls – particularly in the 1940s and 1950s – went deeper than reconciling elements of what would become the Mundell-Fleming model; it also rested on an understanding of market behaviour that suggested unfettered capital mobility was undesirable in itself.

This understanding of market behaviour rested of John Maynard Keynes's fundamental insight that market behaviour was not simply a rational reaction to an efficient use of information regarding fundamentals. Instead, for Keynes, market behaviour was plagued by a pervasive uncertainty that limited the ability of investors to make use of information efficiently. Constrained by uncertainty, incompletely informed investors came to rely on conventions to help them surmise what other actors might do. Prices were seen not as representing the "true value" of a financial asset, but rather what investors think others believe it is worth, each of whom is assigning value from the same point of view. But

conventions could become self-reinforcing and come to take on a life of their own, leaving governments subject to wide swings in market sentiment that were often unrelated to fundamentals. A system based on unfettered capital mobility was thus seen as prone to manias, crashes, and panics.

In more contemporary parlance, Keynes and his followers were united by the view that factors intrinsic to the operation of markets limit the extent to which actors use information efficiently; the result often being myopia, herding, momentum, and rationing, which manifests itself in capital inflow "bonanzas" followed by abrupt and "sudden stops" and reversals. Because these factors are intrinsic to the operation of markets and are difficult, if not impossible, to eliminate, controls were legitimated as an essential and permanent policy instrument.

Through their participation in the Bretton Woods delegations and the professionalization of their graduate students, Keynesian economists helped define the range of policy options that could be entertained by the Fund staff. When the staff members came to draw on their training to diagnose economic problems and to form policy judgments, the Keynesian content of this training helped ensure that the legitimacy of controls would be upheld, even when it later contradicted with the preferences of powerful member states. Many staff members recruited in the 1940s and 1950s would serve in senior positions until the 1980s.

The norm of capital control was formally institutionalized in the IMF's Articles of Agreement at the Bretton Woods Conference. As opposed to long-term flows – which were seen as "productive" and "legitimate" - short-term flows were seen as necessitating control. The Fund's Articles explicitly gave member states the right to use controls and formal policy encouraged the use of controls, rather than IMF resources, to manage capital outflows,

empowering the Fund to request governments employ controls and to declare them ineligible for IMF financing if they refused.

Despite widespread endorsement of the norm of capital control, there were developments in the early post-war period that foreshadowed the eventual stigmatization of capital controls. During a brief interval, 1945 to 1947, the United States sought to promote a return to neoclassical orthodoxy with Keynesian advocates losing favour within the new Truman administration and members of the private financial community emerging in prominent policymaking positions. Two significant events occurred during this interval: the failed attempt at sterling convertibility and an IMF board decision on the use of the organizations' resources (Chwieroth, 2010, ch. 4).

Delegates to the Bretton Woods Conference had sought to endow the IMF with the authority to mandate the use of cooperative capital controls to help strengthen their effectiveness. Although opposition from the private financial community succeeded in watering down this provision in the Articles, there remained an expectation that governments would offer their cooperation upon request. But when Britain and Western Europe, faced with massive capital flight to the U.S., turned to it for assistance, they found this expectation to be proven erroneous. Instead, the U.S. insisted that countries faced with capital flight adjust their policies. The U.S. refusal dealt a fatal blow to the expectation that cooperative controls would be a norm in financial governance.

A second key event was a 1946 IMF Board decision, implemented at U.S. insistence, which ruled out the use of IMF resources to finance capital account crises. The decision ensured that IMF resources could not employ to support countries with ineffective capital controls. By restricting governments from using IMF resources to finance capital account crises and refusing to implement cooperative controls, the U.S. placed the burden on countries to adjust.

However, the deepening of the crisis in Europe and the onset of the Cold War led to an end of this brief interval and fostered a change of views within the U.S. Reversing their earlier position, U.S. officials came to accommodate official financing as a support mechanism for ineffective controls. This financing took the form of the Marshall Plan.

After this brief internal, the U.S. became more accommodative, even encouraging, of the use of capital controls abroad. Perhaps the high point of this orientation was U.S. support for a 1956 IMF Board decision that reaffirmed that governments could employ controls "for any reason" and "without approval of the Fund" (as cited in Chwieroth 2010:114). This decision deepened the formal legitimacy of capital controls as a policy instrument.

3. The limits and hollowness of Keynesianism in the 1960s.

The 1960s were a decade of significant transition in the norms of financial governance emanating from academic economists. Monetarism would emerge as a formidable challenger to Keynesianism, but it was the development of the neoclassical synthesis that would have a far greater impact at this time. Proponents of the neoclassical synthesis sought to adapt Keynes's insights so that they could fit within the broad confines of neoclassical orthodoxy. Like Keynes, they rejected the neoclassical assumption that prices adjust instantaneously to clear markets; instead, arguing that it was possible for the economy to reach an equilibrium characterized by excess supply or insufficient demand. In such circumstances, government intervention was necessary.

But rather than point to conventions to account for investment volatility, as Keynes had, proponents of the neoclassical synthesis pointed to short-run market imperfections such as price and wage rigidities. Cast aside was the emphasis on uncertainty, replacing it was a focus on market errors that prevent actors from forming their expectations efficiently only in

the short run. This theoretical department induced what Jacqueline Best (2005) calls the "hollowing out" of Keynesianism.[3]

Although proponents of the neoclassical synthesis and monetarism disagreed over the desirability and efficacy of government intervention, they shared remarkably similar views about market behaviour. While the former focused on short-run market errors and the latter on lags and adaptive expectations, both shared an underlying faith in market rationality. The invisible hand of the market could become paralyzed in the short run described by Keynes, but in the long run it behaved as neoclassicals suggested.

For proponents of the neoclassical synthesis, their understanding of market behaviour suggested that while markets could be left unfettered in the long run, in the short run there was a case for intervention. This viewed inspired a series of "second-best" arguments that suggested that a government facing one clear distortion or market error could, in principle, improve welfare by introducing capital controls. However, because intervention was legitimate only so long as the distortion or market error paralyzed markets in the short run, it would necessarily be a *temporary*, rather than a *permanent*, measure and markets would be left unfettered in the long run. Permanent intervention would in the long run entail significant administrative costs, generate increasing distortions, and invite evasion and corruption. Monetarists went even further, claiming that all controls were counterproductive and making the case for floating exchange rates.

The emergence of these new understanding of market behaviour undermined the Keynesian standard of behaviour that controls should be an essential and permanent feature of financial governance. Adherents to the neoclassical synthesis such as Tobin treated speculative capital flows as something that could and should be managed via market-oriented measures, such as taxes and tax-like instruments. This view is therefore quite similar in an

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[3] See also Leijonhufvud (1968).

important respect to arguments for floating exchange rates. Neither approach seeks to *eliminate* speculation, as Keynes had, but rather seeks only to keep it within certain limits and transfer some of the costs to investors who engage in it. From a Keynesian perspective, the Tobin tax and similar proposals fail to confront the far more pervasive problems of uncertainty and convention-driven market behaviour. Taxes, tax-like instruments, and floating exchange rates increase the costs of international financial transactions but leave them otherwise unfettered. The emergence of the neoclassical synthesis, as well as monetarism, meant that beginning in the early 1960s few academic economists doubted the *long run* desirability of liberalizing capital controls.

At this time, the U.S., reflecting the rise to advocates of the neoclassical synthesis to prominent policymaking positions, and West Germany became important advocates of greater freedom for capital movements. They in turn lent crucial support to an initiative from IMF managing director Per Jacobsson that would authorize the Fund to finance disruptive capital outflows (Chwieroth, 2010, ch. 5). Although France and Canada opposed the proposal, they could not prevent the initiative from being approved. Advocates of authorizing the IMF to finance capital account crises saw it as a means to encourage greater freedom for capital movements because it would enable governments to avoid the use of capital controls. The U.S. thus began to back away from its early post-war accommodation of controls and now came to support official financing not as a means to buttress ineffective controls but rather as a means to encourage liberalization.

The Fund staff's views also evidence some change during this period. With the change in preferences of some leading member states, there was now greater space for the staff to consider alternatives to Keynesianism. During this period the staff became less wedded to Keynesian prescriptions for implementing or tightening controls to deal with

capital flows surges; instead they placed greater emphasis on the need for adjusting policies and for drawing on official financing so as to refrain from using controls.

Although the staff were surely aware of the academic developments surveyed earlier, their new comparatively greater emphasis on adjustment and financing was not due to the emergence of the neoclassical synthesis and monetarism. On the contrary, while the staff did modify their proclivity for advocating controls to respond to disruptive capital flows, they retained a Keynesian understanding of market behaviour. Staff reports at the time continue to offer concerns about investor decisions governed by conventions; "especially as speculation tends to feed upon itself" and can "force a country into devaluation when it is not in a state of fundamental disequilibrium" (as cited in Chwieroth, 2010, p. 129). Moreover, the staff told the IMF Board that their informal approach would be to favour the use of controls over adjustment.

Instead of having new beliefs transmitted to them from the academic community, the staff adapted their beliefs in light of the experiences of the 1960s. The staff viewed the gradual liberalization of controls in the 1950s and 1960s as beneficial in promoting trade and development as well as easing the adjustment process in some countries. Country experiences with utilizing unilateral controls also suggested to the staff that they were increasingly ineffective.

In this period and later on existing organizational principles and practices shaped the staff's receptivity to adapting their beliefs. An important factor behind the staff's receptivity to greater emphasis on adjustment as opposed to controls was they way this adaptation fit with the Fund's approach to balance of payments adjustment. This approach, known as the Polak model, directed the staff's attention on deficit country policies as the source of instability and obscured the influence of external factors such as convention-driven investor behaviour. The lesson that controls were increasingly ineffective also resonated with the

Polak approach, which implied that measures that failed to address underlying payments imbalances, such as controls, would at best produce only a short-term improvement in the balance of payments.

Adaptation, and the way that these adaptations fit with existing organizational principles and processes, thus overturned previous beliefs that prioritized the use of controls to manage balance of payments pressures. But the experiences of the 1960s did not lead the staff to adopt the belief that unfettered capital mobility was desirable in itself. The Fund's personnel configuration of Keynesian-minded economists made the organization largely unreceptive to the possibility that liberalizing all capital flows was desirable, even though some leading member states—particularly the United States and West Germany—were advocating such a view. As a result, the staff members adapted their existing beliefs to the perceived limits of Keynesianism but failed to learn new ones that identified complete capital freedom as a desirable goal.

To be sure, capital controls were not yet stigmatized as a policy instrument, but the beliefs underpinning their legitimacy were notably different from those of the early post-war era. Rather than being seen as an essential and permanent solution to the problem of pervasive uncertainty, they were now cast as at best a temporary response to the limited difficulties posed by disruptive capital flows. The erosion of support for controls was clearly under way.

4. Academic stigmatization and international monetary reform.

The emergence of new classical economics based on rational expectations, efficient markets theory, and real business cycle (RBC) theory resulted in the academic stigmatization of capital controls. These new beliefs, which cast market actors as rational and efficient in the use of "all available information," resemble many of the same principles of neoclassical orthodoxy that Keynes had challenged. Market actors not only perfectly understand the

complex workings of the economy, they also are aware of the statistical distributions of all the shocks that can potentially hit the economy. In this world, there is no uncertainty, only risk. Systematic mistakes by market actors such as asset bubbles or excesses, self-fulfilling crises, short-run market errors, and lags are impossible since all actors know the workings of the economy.

These and other insights were later formalized in Dynamic Stochastic General Equilibrium (DSGE) models, which became the new bedrock of macroeconomics. Macroeconomists also resurrected the law of Ricardian equivalence, which suggested, contrary to Keynes, that fiscal policy could not affect output. RBC theorists further added to the stigmatization of government intervention through arguments that explained long-term growth and cyclical movements as a function of productivity shocks rather than fluctuations in aggregate demand. In the new field of financial economics, the efficient markets hypothesis suggested that since financial markets are "efficient" in employing all available information in determining asset prices, prices reflected the true state of the economy based on fundamentals, and actors could be left to make Pareto-efficient decisions based on unfettered trade in financial assets and to supervise themselves with self-regulation.

A new broad continuum of *Neoliberal* beliefs emerged that ranged from the neoclassical synthesis to monetarism to new classical economics. Although proponents of each of these schools of thought offer different views on the desirability and efficacy of government intervention and the behaviour of market actors, Neoliberals, as I define them, all draw to some extent on neoclassical-informed assumptions and models and share the view that unfettered capital mobility is desirable in the *long run*.

To be sure, there remained considerable debate among economists. Some economists, drawing on second-best arguments, highlighted that capital controls could be welfare-improving in the presence of other distortions. But these same economists also

generally only sought to demonstrate that controls could theoretically improve welfare. In practice, these economists argued it was better to remove the existing distortion by adjusting policies rather than introducing a new distortion.

Yet some economists, the New Keynesians, who see themselves as the intellectual successors of the neoclassical synthesis, remained sceptical of arguments that removed any scope for the use of controls. Like the neoclassical synthesis, New Keynesian understandings of market behaviour are premised on the assumption that market actors employ information efficiently in the long run, but not in the short run, where market errors could justify government intervention. But the New Keynesians, like their intellectual predecessors, focused largely on introducing Keynesian flavours to an otherwise neoclassical recipe. Introducing wage and price rigidities into a neoclassical model populated by rational and efficient market actors had little to do with the Keynesian emphasis on uncertainty and convention-driven behaviour (Skidelsky, 2009). Indeed, until the late 1990s, the differences that remained among most economists tended to be one of degree rather than kind. Debates persisted within the profession over sequencing and temporary controls, but few questioned the long run desirability of freeing capital movements. As Jean Tirole (2002, p. ix) observes: "[A] wide consensus had emerged among economists, capital account liberalization – allowing capital to move freely in and out of countries without restrictions – was unambiguously good." In short, academic economists had come to stigmatize capital controls.

With some key advocates of these new beliefs ascending to key policymaking position in the Nixon administration, their emergence had an immediate impact on the Fund's formal rules. Yet at least initially they did not affect the staff's informal approach nor did it produce a corresponding stigmatization in financial governance. Indeed, on the eve of the U.S. closure of the gold window in 1971, one observer (Krause, 1971, p. 536) noted, "Capital

movements have been progressively liberalized by most countries, but actions which tend to restrict capital movements do not elicit cries of outrage." In fact, European and Japanese officials, and the IMF management and staff, would not abandon their support for controls for some time, which pitted them against the U.S. who now for the first time pressed their removal.

Acting as a "norm leader," the U.S. insisted on changes to formal IMF rules so that they seemingly directed the staff to encourage liberalization, at least in circumstances where controls impeded balance-of-payments adjustment (Chwieroth, 2010, ch. 6). One modest change, made at U.S. insistence, was that the Fund's Articles now stated that one of the essential purposes of the international monetary system was to promote freedom for capital movements. But disagreements among the Fund's membership ensured that this revision did not undermine a government's right to use controls and that it feel short of developing a code of conduct on their use, which the U.S. had favoured.

Although the IMF's leading member state had become increasingly hostile to capital controls, the staff did not demonstrate much change. This was largely due to the fact that collectively shared beliefs within the Fund continued to view controls as a legitimate policy instrument. In the context of the reform negotiations most staff members initially favoured controls to support the fixed exchange rate system. But even after the move to generalized floating in 1974 – which is commonly depicted as a crucial turning point in lessening concerns about capital mobility – most staff continued to envision controls as one of several means that governments should use to maintain "normal zones" for their exchange rate. Moreover, staff support for controls also led them to rarely implement special consultations, which the U.S. had insisted upon, with a government if controls were introduced for balance of payments reasons. Thus, although the U.S. had become increasingly hostile to controls,

and had succeeded in changing of the IMF's formal rules, the organization had yet to stigmatize them.

5. Toward a general but uneven stigmatization.

The 1980s and 1990s was a period of significant change to the IMF staff's informal approach (Chwieroth, 2010, ch. 7). It was a period when most of the IMF's leading member states, including Japan and members of the European Union, came to accept the desirability of freeing capital flows and completed the process of dismantling their own controls. Although the staff recognized the emergence of this new ideational climate among the member states, encouragement for advocating liberalization or stigmatizing controls was not pushed on them. Without a legal mandate or active influence from member states or IMF management, the staff discarded their attachment to earlier beliefs that legitimized controls as essential policy instruments, and replaced it with beliefs that spanned the full continuum of Neoliberal beliefs described earlier. A new informal approach emerged that identified freeing capital flows as desirable, at least in the long run, but interestingly, until the mid-1990s, there was no change in the Fund's formal rules.

Rather than emphasizing uncertainty and convention-driven behaviour, as the staff did in the early post-war years, increasingly in the 1980s the staff saw market actors as rationally responding to an efficient reading of fundamentals. Beginning in the mid-1980s and continuing until the Asian financial crisis, the general informal orientation of the staff was to emphasize the cost of capital controls and the benefits of liberalization, while underemphasizing the risks and vulnerabilities associated with openness. Initially, the staff concentrated on the efficiency gains from capital account openness and the need to attract foreign investment as the principal rationales for liberalization. Over time the staff increasingly stigmatized controls as essential instruments of macroeconomic planning. Whereas for much of the post-war era the staff had lent legitimacy to traditional arguments

for controls (i.e. that controls could increase domestic investment and tax revenue, support financial interventionism and macroeconomic planning, permit greater monetary policy independence, and manage balance of payments pressures), the general orientation of the staff for much of the 1980s and 1990s was to stigmatize controls as harmful for economic performance, generating severe distortions, delaying policy adjustment, and sending negative signals to market actors.

With respect to capital flight, which was a major disruptive influence on Latin American economies during the debt crisis, rather than seeing it as early post-war IMF staff had, as a principal "cause" of the problem facing economies, the staff in from the mid-1980s onward understood capital flight to be a "symptom" of poor fundamentals. With this shift in the meaning fixed to capital flight, the IMF began emphasizing policy adjustment rather than the imposition or intensification of controls on outflows. In fact, in cases where controls were seen as ineffective because of extensive capital flight or use of parallel foreign exchange markets, some staff pressed for liberalization. By the mid-1990s, some staff had been encouraging liberalization informally, though not uniformly or indiscriminately, for nearly a decade.

These new beliefs led the staff to downplay the potential risks of capital flow volatility and to overlook the potential usefulness of "supply-side" regulatory measures aimed at market actors based in the financial centres of developed countries; a prescription consistent with an alternative interpretation, more closely aligned with Keynesian beliefs and often advocated by emerging markets and developing countries, that stresses factors intrinsic to the operation of international capital markets as contributing to financial instability. Tighter regulation of market actors, for instance; through internationally coordinated tightening of capital requirements to limit herding behaviour (Dobson and Hufbauer, 2001), could have proven useful in reducing the negative externalities that emanated from the

financial centres of developed countries. But the staff eschewed such regulatory measures; instead, often welcoming supply-side liberalization as beneficial for providing emerging markets and developing countries greater access to international capital markets.

It has often been said that the IMF's stigmatization of controls resulted from management acquiescence to pressure from the U.S., who in turn were shaped by demands from the private financial sector. But the evidence does not support this portrayal (Chwieroth, 2010, ch. 7). IMF management did little encourage the staff to shift their views. Michel Camdessus, managing director from 1987 to 2001, emerged in the mid-1990s as a strong support of giving the IMF the authority to promote liberalization and jurisdiction over the capital accounts of its members (Abdelal, 2007). But no specific intellectual or operational guidance was forthcoming from Camdessus or First Deputy Managing Director Stanley Fischer until after the staff had already shifted their views.

Without any strong indication that management favoured a particular orientation, it is difficult to conclude that it drove staff behaviour. To be sure, once management signalled its preferences, various organizational incentives played a role. But these incentives were largely limited to reinforcing the shift that had come "from within" rather than initiating any significant shift "from above."

The U.S. was also not the primary determinant of the change in the staff's orientation. To be sure, beginning the 1980s the U.S. saw greater freedom for capital movements as in its long-term interest and sought to promote it in specific bilateral settings such as Japan, South Korea, and Taiwan. But the issue was not viewed as a top priority or one on which to expend resources within the Fund. It is only in the mid-1990s that the U.S. Treasury began to make a big push for the staff to encourage liberalization. In short, though the Fund's new orientation benefitted long-term U.S. interests, it was not a direct result of them.

In the early 1990s, after most controls had been dismantled within Europe, some governments became strong advocates for greater freedom for capital movements, which in turn lessened the degree of preference heterogeneity among the G-7. Yet, importantly, this new preference configuration did not emerge until after the staff's general orientation had shifted. This new preference configuration may have helped reinforced the staff orientation, but it was not the source of it. It should also be noted that despite U.S. and European support for greater freedom for capital movements, the IMF Board could never reach a consensus on the legitimacy of controls and thus failed to issue any directives on the issue until 1995.

With respect to the private financial sector, it is clear that they exerted little influence on the staff's orientation. First, the staff failed to consult the private financial sector on this issue and thus it had little opportunity to make its views known. Second, if the staff had engaged in such outreach, it would have hard that the private financial sector was generally cautious in its support for greater capital freedom, viewing it as desirable in principle but with its enthusiasm tempered by an awareness of the risks and vulnerabilities that can accompany premature liberalization.

Without firm directives or formal rules from management or member states, and in the context of preference heterogeneity among IMF members, the staff were provided with significant autonomy to develop their orientation independently. This autonomy permitted the staff to rely on their own judgment and initiative to determine whether liberalization should be encouraged informally in a given case.

Professionalization and administrative recruitment were two critical factors shaping the staff's new orientation. Beginning in the mid-1980s, the substantial group of individuals who had served as members of staff since the 1940s and 1950s began to retire in large numbers. These retiring staff, which because of their Keynesian training and the experiences of the 1930s were more inclined to view controls as legitimate, were subsequently replaced

primarily by “Neoliberal-trained” economists who had joined the staff in the 1960s and early 1970s. This personnel realignment helped overturn long-standing beliefs and associated practices that had legitimated capital controls. Without this personnel realignment in the 1980s, the Fund’s stigmatization of controls therefore would have been, in all likelihood, delayed, more incremental, and less coherent than it was.

In the 1980s and 1990s, in addition to the role of new recruits replacing retiring staff members, learning via country experiences helped alter the orientation of the Fund. The transition to capital account openness – particularly among EU countries – was seen by many staff members as critical in demonstrating the desirability of liberalization. Other staff pointed to the case of Indonesia as an example of the benefits of liberalization for emerging markets and developing countries. Staff research studies also provided evidence that disconfirmed for many staff the validity of traditional arguments for controls.

These experiences and evidence helped foster among the staff a comprehensive reappraisal of organizational goals. Old organizational ideologies, norms, language, and routines were largely discarded, and new ones took their place. Rather than adapting through simply adding new agendas or policy instruments to existing organizational practice, the staff experienced a deeper shift in their beliefs about desirable goals. By helping to create an internal ideational configuration that made it more acceptable within the Fund to analyze controls from a more critical perspective, the personnel alignment of the 1980s played an important part in creating an environment conducive for learning. In the absence of this realignment, the cognitive difficulties associated with learning likely would have limited the extent to which it occurred.

Although it is difficult to assess the precise impact of the IMF’s general, but uneven, stigmatization, there is much evidence to suggest that it was significant. Notably the IMF was legally prohibited from requiring capital account liberalization as a formal condition for

loans and thus it could not insist that governments liberalize in the same manner it could for other policies. Processes of social approval and disapproval thus became an important influence.

Some governments initiated liberalization in the context of loan programs in order to ingratiate the IMF officials and gain their material and symbolic support and/or to provide political cover against their domestic opponents (Woods, 2006; Mukherjee and Singer, 2010).[4] Others drew on the expertise of the IMF through its technical assistance missions, which in many cases offered advice encouraging greater liberalization (Chwieroth 2010:171-173). IMF surveillance missions routinely encouraged governments to liberalize, serving as a "cheerleader" that provided technical and normative support to reformers (Independent Evaluation Office, 2005). Along with credit rating agencies, the IMF's stigmatization served to heighten the reputational costs imposed by financial market actors on countries that used or introduced controls (Abdelal, 2007). As a result, in contrast to the early post-war era, rather than intensifying or introducing restrictions during a crisis, governments in the mid-1980s began to liberalize them (Haggard and Maxfield, 1996:37). In short, controls became perceived as a negative signal by financial market actors.

Critics of the Fund have wrongly accused it of having uniformly promoted liberalization in a "one size fits all" fashion (Stiglitz, 2002). Yet careful examination of the evidence reveals that beneath the surface of the Fund's general orientation to support greater freedom for capital flows, lurked considerable internal debate over how governments should proceed toward this goal. The staff did not agree on whether to proceed rapidly or slowly, and whether to proceed with various preconditions or allowances for the introduction of temporary controls. Within the halls of the IMF these debates over interpreting and

[4] One staff report (Ishii and Habermeier, 2002:9) finds that since 1978 approximately "43% of IMF financial stabilization programs have influenced recipient countries to liberalize their capital account."

applying the emerging norm of freedom for capital movements took the form of a struggle between "gradualists" and supporters of a "big bang."

Gradualists emphasized sequencing (i.e., ensuring that certain supporting policies and institutions are in place before additional liberalizing measures are undertaken), while big-bang proponents argued for a rapid move to liberalization without regard to sequencing. Although both groups generally stigmatized the use of administrative controls (i.e. outright prohibitions or quantitative limits) and restrictions on capital outflows, particularly when they were introduced during a crisis, this consensus did not extend to the issue of sequencing or to the use of temporary market-based controls on capital inflows. The Fund thus promoted a general, but uneven stigmatization of capital controls. As a result, though the staff collectively shared a belief in the long-run desirability of greater freedom for capital flows, their views were not monolithic and they often offered conflicting analyses and recommendations on how to proceed toward it.

This internal debate was very much a reflection of a similar intellectual battle occurring within the economics profession. While professionalization and administrative recruitment fostered a shift in the general orientation of the Fund, it also created subcultures within the organization, as new recruits brought contrasting beliefs associated with unsettled debates within the economics profession. Intra-disciplinary debates about sequencing and allowances for selective capital controls provided an ideational basis for internal bureaucratic struggles within the IMF.

The gradualist position developed first. Informed by the neoclassical synthesis / New Keynesian understanding of market behaviour, it viewed liberalization as desirable in the long run, but viewed selective controls as often necessary to remove distortions or correct short-run market errors. Gradualists, for instance, saw the differential speed of adjustment for goods and asset markets as reason for sequencing reforms. The gradualist position was also

partly a reaction to a financial crisis in Chile in the early 1980s, which some staff attributed to the government's decision to liberalize in the absence of critical supporting policies and institutions, such as robust prudential financial regulations.

Drawing on standard second-best arguments for intervention, much of the initial gradualist sympathy for temporary controls was that they could insulate weak and poorly regulated financial systems from capital flow volatility. Controls would provide policymakers the breathing space necessary to implement, but not avoid, policy adjustments needed to strengthen their financial systems and prudential regulations. In a few countries the staff pointed to problems posed by weak banking systems (Poland in 1992 and the Czech Republic in 1993) or inadequate prudential regulations (Thailand in 1992 and Mexico in 1993) as suggesting a need to slow down the pace of liberalization or to tighten regulations.

But most of the staff failed to appreciate fully the need for sequencing. Instead, from the late 1980s until the mid-1990s, advocates of the big bang eclipsed the gradualists. Internal advocates or "norm entrepreneurs," such as Manuel Guitian, a high-ranking staff member, were quite successful in promoting this view within the IMF. Guitian and other big bang supports sought to discredit gradualist arguments, claiming that the ineffectiveness of controls made sequencing irrelevant and that gradualism was a recipe for vested interests to maintain the permanence of controls. Big bang supporters also downplayed the importance of constructing robust prudential regulations prior to liberalizing. Instead, they argued the best route to robust prudential regulations was to liberalize, as it would permit market discipline to operate and ensure that government stepped up their efforts to enhance the regulatory framework.

The overlap between big-bang arguments and organizational principles aided the advocacy of big bang proponents. During and after the 1980s debt crisis, the organization as a whole was receptive to market-based measures that permitted developing countries

greater access to capital flows. As a result, the Fund was often biased toward any liberalization, regardless of its sequence, as better than no liberalization at all. Big bang advocacy was also resonated with the general enthusiasm at the end of the Cold War for "shock therapy" approaches to market reform. The big bang approach was thus in many ways an extension of the shock therapy approach to non-transition economies, though it was also employed by some staff in Eastern Europe and the former Soviet Union as well. Arguments for sequencing based on second-best reasoning also did not fit well in organization with a culture that prioritized "first-best" policy prescriptions.

The ascendance of the big bang approach was also facilitated by the way the IMF was organized. Until 1992, organizational expertise and responsibility for monetary systems and exchange restrictions were kept in separate departments. Although staff in both departments were aware of the links between domestic financial and international financial liberalization, because organizational expertise and responsibility for monetary systems and exchange restrictions was kept separate until 1992, there did not exist a strong organizational capacity to explore systematically how domestic financial and international financial liberalization might be coordinated. When organizational expertise and responsibility for monetary systems and exchange restrictions was finally merged, it took some time for the staff in the new department to develop any specific conclusions about sequencing.

Despite their differences of view, gradualists and big bang advocates were united in their opposition to controls on outflows, a view that had started to emerge in the 1960s, when the staff found controls to be an inappropriate substitute for adjusting policies in response to balance of payments pressures, and that solidified in the early 1990s, when the staff observed the intensification of controls on outflows by some governments fail to prevent the collapse of their exchange rate commitments during the European Exchange Rate Mechanism crisis.

Support for any kind of administrative control that prohibited or limited particular transactions also all but evaporated. But temporary market-based controls on inflows proved much more controversial. At the centre of the debate was the use of such measures in Chile in the early to late 1990s. Big bang supporters attacked the measures as prolonging unsound policies, creating severe distortions, and failing to substitute for adjusting policies that were driving capital surges. Their initial evaluations suggested the effectiveness of the Chile's controls would prove short-lived, forcing the introduction of additional restrictions to maintain the same level of control and thus introducing further distortions. Initial empirical studies of the controls by big-bang supporters pointed to evidence that the Chilean controls did not appear to slow down the volume of capital flows, permit greater monetary independence, or prevent real exchange rate appreciation.

However, gradualists within the Fund saw the measures as providing a legitimate way of insulating Chile's underdeveloped and poorly regulated domestic financial system from capital flow volatility. Some prominent academic economists (Eichengreen and Wyplosz, 1996) also began to make similar arguments. But this prescription did not fit well with the framing offered by the big-bang supporters or with the organization's cultural emphasis on first-best policy prescriptions. As a result, influential gradualists developed a strategy to frame such measures not as a substitute for adjustment, but as "prudential measures" to safeguard the domestic financial system.

Big bang supporters initially proved resistant to this framing, but the crisis in Mexico in 1994-95 offered a gradualists an opportunity. The "twin" currency and banking crisis in Mexico provided a vivid demonstration for many within the Fund of the need to coordinate financial sector development, prudential supervision, and capital account liberalization. Although most within the IMF, including management, attributed the crisis to an unsustainable macroeconomic policies in the context of a fixed exchange rate, gradualists

were able to convince some staff members that Mexico's rapid privatization of the banking system and liberalization of the capital account had contributed to the crisis, and that Chile's relative stability during this period was due in part to its controls.

In the aftermath of the Mexican crisis, there was greater awareness of the risks of inadequate sequencing, enhanced receptivity to arguments stressing a need for prudential regulation, and heightened sympathy for temporary market-based controls. The Mexican crisis also helped the gradualists to undermine the big bang framing of the Chilean controls. As a result, the staff for the first time turned their attention toward evidence suggesting the controls had lengthened the maturity structure of inflows, thus minimizing vulnerabilities to the domestic financial sector. Although the general orientation of the Fund was to stigmatize controls on outflows and any type of administrative restriction, and to view temporary market-based controls on inflows as distortionary, waning in effectiveness over time, and as a poor substitute for policy adjustment, there was now increased sympathy for justifying such measures on prudential grounds and on a temporary basis.

In the immediate aftermath of the Mexican crisis, staff responsible for the organization's relations with Brazil, the Czech Republic, Hungary, Slovenia, and Thailand accommodated temporary market-based controls on prudential grounds. But a big division had opened up within the organization at all levels, even management, where Fischer appeared more open to Camdessus to the use of temporary market-based controls. In various countries, such as Chile, Romania, Russia, and South Korea, big bang supporters continued to advocate liberalization enthusiastically. Interestingly, in some countries, the staff from various departments within the Fund clashed in the advice they offered directly to country officials. Far from offering a "one-size-fits-all" policy template, in the words of one high-ranking IMF staff member, "one side of the house was stepping on the accelerator, while the other side was applying the brake" (as quoted in Chwieroth, 2010, p. 197).

Nonetheless, because big bang advocates tended to be the most vocal and do most of the writing about the topic, the Fund became widely perceived as in favour of rapid liberalization. To be sure, the orientation of the Fund created a general stigma on the use of controls. But this stigma was uneven and became increasingly so after the Mexican peso crisis. In spite of this unevenness, the perception on the part of key actors that it was uniform likely created many of the effects associated with stigmas that were outlined earlier.

6. Failed formal stigmatization and reconsideration of informal stigmas

The latter half of the 1990s witnessed within the Fund both the high-water mark and demise of enthusiasm for greater freedom for capital movements. It was period in which an attempt was made to align formal IMF rules with the general, though uneven, informal stigmatization of the Fund staff. An initiative emerged that sought to amend the IMF Articles to give the Fund the formal mandate to promote liberalization as well as fuller jurisdiction over the capital account policies of its members. In granting the Fund fuller jurisdiction over the capital account, the initiative would have prohibited governments from imposing virtually all types of controls without Fund approval and would have committed governments to liberalizing existing controls. In short, the amendment would have formally stigmatized capital controls. The amendment also would have enabled the IMF, for the first time in its history, to include capital account liberalization as a condition for accessing its financial resources.

IMF management and European governments embraced the proposal enthusiastically, but U.S. officials, while supporting the principle of greater freedom for capital movements, offered weaker support (Abdelal, 2007; Chwieroth, 2010, ch. 8). The amendment also faced opposition from developing countries who wanted to retain the autonomy to impose controls in crisis situations without IMF approval. They were also concerned that the IMF staff would become overly enthusiastic in advocating liberalization. Breaking from norm of G-7

consensus, Canada also opposed the initiative, stressing a need for greater understanding about preconditions and sequencing as well as legal aspects of amending the Articles before moving ahead.

Still, despite these divisions, the IMF Board did manage, in 1995, to offer its first operational guidance to the staff, directing them to cover capital account issues more fully and to strengthen their work in encouraging and supporting liberalization. This directive buttressed the general orientation of the staff, but failed to settle the debate between gradualists and big bang supporters. Between April and October 1997, efforts to amend the Articles reached their peak. Consensus on the amendment, however, proved elusive.

The initial financial turmoil in Thailand in July did little to dampen enthusiasm for the proposed amendment. Indeed, at the Fund's September meetings, the commitment to the initiative was reaffirmed. However, the subsequent spread and intensification of the crisis and growing criticism of the Fund's response undermined support.

While proponents of the amendment sought to represent the crisis as market actors rationally imposing discipline, though perhaps excessively, on economies characterized by policy and institutional deficiencies, a growing number of opponents were emboldened to advocate a rival view that pointed to "herding behaviour" and "contagion" among incompletely informed market actors whose excessive pessimism had triggered instability even in the presence of sound fundamentals. From this rival perspective the crisis undermined the case for liberalization and thus the proposal to give the Fund the authority to promote it. Equally significant for the downfall of the initiative was the threat from some influential members of the U.S. Congress to withhold their support for U.S. contributions for the pending IMF quota increase if the Treasury continued to support the amendment. The U.S. Treasury subsequently withdrew its modest support rather than jeopardize a key priority. The initiative was then suspended indefinitely.

Inside the Fund, the staff initially attributed the crisis to policy and institutional failures, legitimating policy adjustment and structural reform, rather than controls on outflows, as the legitimate response. Not surprisingly, the U.S. Treasury and IMF management offered a similar perspective. Thus, when Malaysia imposed controls on outflows in 1998 to deal with contagion from the crisis, it was subjected to severe criticism.

What is particularly noteworthy about this interpretation of the crisis is not the "causes" it identifies, but rather the ones it fails to identify. In focusing exclusively on causes this particular narrative obscured the impact of incompletely informed market actors driven by conventions toward "herding behaviour." In other words, it failed to highlight the more pervasive market failures associated with Keynesian views.

An alternative crisis narrative, reflecting a mixture of Keynesian and New Keynesian understandings, emerged that pointed to factors intrinsic to the operation of international capital markets that make them inherently volatile and prone to herding behaviour. In this alternative Keynesian-inspired view, the crisis was more an international financial panic than the result of policy and institutional errors (Sachs 1997; Stiglitz 1998). By the autumn of 1998, the climate of opinion among academic economists had clearly shifted toward a genuine reappraisal of pre-crisis beliefs.

Academic economists began to devote greater attention to factors intrinsic to operation of capital markets that could trigger herding behaviour and market panic (Bhagwati, 1998). In applying this perspective, many academic economists, like some members of the IMF Board, pointed to China and India as examples of countries that had maintained controls and therefore managed to escape the worst effects of the crisis. A number of academic economists also offered their support for restraints on capital mobility, with some – most notably Paul Krugman (1998) – even offering support for controls on outflows.

Inside the Fund a similar reappraisal of prevailing beliefs took place due to adaptation as well as advocacy of this alternative Keynesian-inspired view by some influential staff members. Internal advocates of the Keynesian-inspired view renewed the organization's attention to problems of asymmetric information and domestic distortions that create the possibility for "sharp investor reactions [that] can give rise to unpredictable market movements and, in the extreme, financial crises" (Eichengreen and Mussa, 1998, p. 2) The conclusion of an influential report (Eichengreen and Mussa, 1998, p. 30, emphasis added) testifies to the significant lessening of the stigma attached to controls:

> "To the extent that the problem is information asymmetries that are intrinsic to the operation of financial markets, that cannot realistically be removed, and that give rise to significant systemic risks, *this creates an argument for the permanent application of policies designed to influence the volume of certain types of financial transactions*. If these policies are operationalized through the use of taxes and taxlike instruments that make their effect felt by altering relative prices, rather than through the use of administrative controls, there is no reason why they should be viewed as incompatible with the still-desirable goal of capital account liberalization"

A few points should be noted about this conclusion. First, it suggests a remarkable revival of Keynesian-inspired understanding of market behaviour and standards of policy behaviour; factors intrinsic to markets, not fundamentals, are identified as possibly responsible for capital flow volatility, and permanent, as opposed to temporary, controls are seen as possibly essential. But the similarities to Keynesian views should not be overstated. The report's proposal is limited to market-based controls on inflows, and strictly rules out the use of administrative measures. More significant is the fact that the staff team that authored the influential report still clearly retained a belief in the long run desirability of liberalization.

Significantly, this belief in the long-run desirability of greater capital freedom channelled how the reassessment of beliefs within the Fund played out. Rather than implicating capital account openness per se as responsible for the crisis, prevailing beliefs led the staff to identify poorly sequenced liberalization, such as South Korea's decision to liberalize short-term but restrict long-term inflows, as a principal culprit. This interpretation undermined virtually all support for the big-bang approach but not induce reconsideration of

the long-run desirability of greater capital freedom. The demise of support for the big-bang approach also translated into stronger and broader support within the IMF for temporary market-based controls on inflows.

The stigma the IMF attached to controls on outflows also lessened somewhat, partly as a result of advocacy within the Fund for the alternative Keynesian-inspired view and partly as result of the Malaysian experience. In line with its initial interpretation of the crisis, the Fund staff had expected Malaysia's controls to prove ineffective, harmful to growth, and damaging to Malaysia's reputation by sending a negative signal to global financial markets. But when these expectations were not fully met, a number of staff members reconsidered their earlier beliefs. By 1999, the staff had become much more accommodating of Malaysia's decision and had concluded that they had been effective in creating temporary "breathing room" that government officials used to adjust policies. Some IMF officials now concede that the decision may have been the appropriate one. But the jury remains out as to whether the controls functioned as intended.

Nevertheless, the ultimate significance of the Malaysian experience was to challenge prevailing beliefs within the Fund, which had unequivocally stigmatized the use of controls on outflows during a crisis. The experience demonstrated for many inside the Fund and the economics profession that controls on outflows could prove effective in crisis situations, if only under a limited set of conditions. Although the general orientation of the staff was in principle opposed to controls on outflows and much more sympathetic, even supportive, of controls on inflows, they became much more accommodating of their selective use in the wake of the Malaysian experience.

In the decade between the Asian financial crisis and the financial crisis of 2007-2009, the staff elaborated and refined the gradualist consensus that had emerged (Chwieroth, 2010, ch. 9). Although they did not dispute the long-run desirability of capital account

liberalization, in the aftermath of the Asian financial crisis they became much more cautious in encouraging it and attached much greater legitimacy to selective limitations on capital mobility. Controls were tentatively and conditionally accepted as legitimate policy instruments in select circumstances, and even then most staff tended to offer strong reservations. Still, this did not prevent the staff from accommodating or even encouraging their use in certain circumstances, especially in contexts where liberalization threatened to expose countries with weak and poorly regulated financial systems to greater risk. The academic literature on capital controls in the decade that followed the Asian financial crisis as well as the importance that many academic economists and the Fund began to place on institutions as a critical determinant of economic performance reinforced the emphasis on gradualism.

Norm continuity was also apparent in the Fund's continued emphasis on poor fundamentals and institutions as the primary cause of financial instability, and in its insistence on policy adjustment and structural reform. The tacit presumption of the IMF and the G-7 was that the primary source of financial instability lay in emerging markets. Market actors, most of who were based in financial centres in developed economies, were relieved of most of the blame for financial instability and were not subject to tighter regulation. On the contrary, faith in markets led the G-7, and the US and Britain in particular, over the next decade to assign to market actors an increasingly significant role in the regulation and supervision of financial markets.

The IMF and the G-7 sought to correct errors and deficiencies in crisis-afflicted economies by encouraging them to adopt various international financial standards and codes, most of which were informed by the interests and experiences of G-7 countries, and in particular the Anglo-American regulatory approach, and virtually excluded emerging markets and developing economies from much input into their design. To be sure, the Fund

developed an increasingly sophisticated understanding and appreciation of factors intrinsic to the operation of international capital markets that can trigger financial instability, but the IMF showed little willingness to entertain regulatory measures aimed at reducing negative externalities emanating from the financial sectors of developed countries.

One reason for this was the preferences of leading member states, most prominently the U.S. and Britain, which opposed more intrusive regulation of their financial sectors. Although emerging market officials, particularly in East Asia, objected to the predominant interpretation of the IMF and G-7, they lacked adequate representation or influence within the IMF and standard-setting bodies to affect significant change in the policy discourse. In addition to the preferences of leading member states, the beliefs of the IMF staff also still prioritized their attention toward fundamentals and institutions in emerging markets; the tacit presumption being that the main risks to systemic stability lay there. Finally, the IMF lacked the institutional tools to provide equivalent leverage over developed economies.

It is important to highlight the consequences and risks; that is, the shortcomings associated with this continuity in norms. First, some emerging market officials perceived these norms as introducing asymmetric costs and benefits skewed in favour of developed countries and the interests of their financial sectors. Many emerging market officials also resented being encouraged to adopt standards and codes developed in bodies in which they had little or no input and which they perceived as inappropriate for their economies. Many of these officials also drew the lesson that measures needed to be taken to minimize their vulnerability to global financial markets and to the IMF.

In theory, capital controls could have provided one option. By limiting short-term flows and excessive risk-taking, restraints on capital flows could have been used to reduce the likelihood of financial crisis and thus the probability of borrowing from the IMF. Yet the stigma attached to controls raised the actual and perceived costs of their use and heightened

the appeal of reserve accumulation as an alternative insurance mechanism. Self-insurance via reserve accumulation, while seemingly optimal given the stigma attached to controls, has subsequently helped to generate some unintentional and unanticipated suboptimal outcomes that could have potentially been avoided had the stigma been lifted.

Precautionary reserve accumulation is, of course, beneficial. Reserves can be used unconditionally to meet any external financing need, thus freeing up "policy space," and they can help prevent crises through the signalling associated with the ability to meet short-term obligations and stem sharp depreciation of the currency. Reserves can also be used to minimize the need for costly adjustments during a crisis.

Yet reserve accumulation is not without costs and risks. Large reserve accumulation has significant opportunity costs in terms of foregone consumption and investment for the accumulating countries, particularly for emerging markets and developing countries with high returns to capital and many unsatisfied social needs (Rodrik, 2006). Moreover, if the counterpart of reserve accumulation is that many governments pursue export-oriented growth and current account surpluses, an aggregate systemic deflationary impact may emerge should the rest of the world be no longer willing to incur balance of payments deficits (IMF, 2010e).

Since governments have largely concentrated their reserve holdings in the government debt of few countries, this raises additional possible costs and risks. If large and sustained, accumulation may over time undermine confidence in the reserve currency through debt sustainability concerns. These concerns could escalate to the point of creating conditions for a rapid switch out of a specific reserve asset with large and disruptive exchange rate and wealth effects and possibly implications for financial stability. Such concerns have generated a long-running debate speculating on whether the U.S. dollar could collapse. Large and sustained accumulation, by depressing interest rates in the reserve issuing economy, may also foster excessive risk-taking and volatile capital flows. Indeed, some

observers draw such a link between the global macroeconomic imbalances that emerged after the Asian financial crisis and the recent financial crisis that originated in the U.S (Brender and Pisani, 2010). Finally, reserve accumulation concentrated in a select few currencies exposes the entire international monetary system to shocks arising in the reserve issuing economies.

Although the stigma attached to controls was not the sole motivation for reserve accumulation following the Asian financial crisis, it certainly played a role in heightening its appeal as way to minimize vulnerability to global financial markets and the IMF. The actual and perceived costs of imposing controls induced governments to search for alternative insurance mechanisms with reserve accumulation seemingly being the optimal strategy. Yet reserve accumulation, while offering some benefits, also creates costs and risks that underscore the potential shortcomings associated with stigmas; that is, that they rarely produce optimal outcomes despite often being cloaked in such language.

In fact, within the Fund there is growing recognition of such potential shortcomings. As part of the ongoing clarification of its views (see below), some within the IMF have suggested that greater use and acceptance of capital controls within an agreed multilateral framework could play an important part in managing capital flow volatility and thus potentially lessen a key motivation for reserve accumulation and the build-up of global macroeconomic imbalances (IMF, 2010e). Removing the stigma attached to controls, in other words, could lessen one key motivation for reserve accumulation by freeing up policy space for alternative insurance mechanisms.

7. Clarifying stigmas in the post-crisis era

The financial crisis of 2007-2009 has generated signs that the norms of financial governance are changing. The norm of self-regulation, upon which much of the Anglo-American model and international standards and codes has been based, has been seriously

undermined. There has been important ideational shift in the way that financial crises are understood. In contrast to the period following the Asian financial crisis, in the current reform debate there is a strong consensus that the same market actors who over the past decade had been permitted to self-regulate were responsible for triggering the crisis.

The need to minimize negative externalities emanating from the financial sectors of developed economies is now widely accepted. The severity of the crisis, along with the massive taxpayer rescue of the financial system, has generated significant popular backlash against financial institutions and the policy norms they championed. This popular backlash has generated unprecedented political pressure within the U.S. and Britain to tighten financial regulation. The policy response from developed countries also effectively re-wrote orthodoxy on crisis management. Over the past decade the G-7 had lectured crisis-afflicted countries on the need to restore confidence by closing insolvent financial institutions, strengthening fiscal discipline, and raising interest rates. Then, when faced with a crisis in their financial systems, G-7 countries pursued precisely the opposite policies.

Interestingly, the IMF, traditionally a preacher of fiscal discipline, was one of the first prominent advocates for governments to embark on Keynesian-style fiscal expansion. It has also called for and supported efforts to expand the perimeter of regulation so as to minimize negative externalities emanating from the financial sectors of developed economies. It has also developed new unconditional and precautionary lending facilities that are meant to provide insurance against crisis. Within the IMF, crises are clearly no longer understood as largely being a “home grown” phenomenon, there is now significantly greater recognition of the potential for externally induced crises to spread to otherwise sound economies.

In addition to damage done to Anglo-American intellectual hegemony and leadership, the crisis has also accelerated the gradual shift in financial wealth and geopolitical clout away from the West to new emerging powers. Indeed, there was great symbolism in the decision

to convene the G-20, rather than the G-7, to set the reform agenda and act as the steering committee for the world economy. Despite these important trends, it is still far from clear what, if anything, will replace pre-crisis norms as the new basis for financial governance. The E.U. has pretentions to exercise greater leadership, but problems in its banking system and sovereign debt markets have undermined the attractiveness of its norms. China's performance during the crisis, particularly the ability of its state-managed financial sector to maintain growth, has attracted many admirers. Yet for the time being China appears more interested in drawing on existing international standards and codes to upgrade its financial sector than in elaborating a new consensus (Walter, 2009). Without a clear focal point for coordination and in the face of significant domestic political pressure, there are increasing signs that governments, both from developed and emerging economies, are willing to stake out unilateral and regionally-defined norms of financial governance.

These important ideational and power shifts provided the backdrop for the IMF to clarify its orientation toward capital controls, which had modestly and cautiously lent greater legitimacy to their use since the Asian financial crisis. In the early stages of the recent crisis, some countries, such as Argentina, Iceland, Indonesia, Russia, and Ukraine, imposed controls on outflows as a way of managing contagion from the crisis. The IMF, in line with the more approach pursued since the Malaysian experience, accommodated and lent its tacit approval to these actions, even endorsing those in Iceland and the Ukraine as part of its lending programs with these countries. However, the IMF has not encouraged others to follow suit.

Some prominent academic economists began calling on the G-20 to offer greater support for controls on inflows to be used to protect weak or poorly regulated financial systems (Rodrik and Subramanian, 2008; Buiter, 2008) as well as for controls on outflows to offset sudden stops (Calvo, 2008). But the U.S. and Britain did not initially waver in their commitment to the free flow of capital. To be sure, the crisis did heighten the traditional

Franco-German scepticism of free market finance, but this scepticism did not yet spill over to Anglo-American officials.

The political atmosphere in developed countries began to shift in autumn 2009. Monetary easing and liquidity support, while helping to save the financial system from collapse, also permitted the financial sector to earn record or near-record profits and bonuses. This outraged the public at a time of rising budget deficits, public debt, and unemployment. Prominent politicians and regulators, such as the head of Britain's financial regulator (Turner, 2009) and the then German finance minister (Steinbruck, 2009), made statements in support of a global tax on financial transactions as one of several possible ways of recouping the cost of the financial rescues and as way to reduce the size of the financial sector and curb bonuses. But these statements did not command the support of the U.S. or UK Treasuries, though both did express interest in more work being done on how to discourage speculative behaviour and on how banks could make a bigger contribution given their greater reliance on taxpayer support. It was then at its September 2009 summit that the G-20 instructed the IMF to provide a report that would examine how banks could contribute to the cost of the crisis, with the Tobin tax being identified as one of several options under consideration.

In addition to the popular backlash that characterized the domestic political climate in developed economies, the frame attached to capital controls began to shift. Despite the allowances the IMF had made for controls following the Asian financial crisis, its general orientation was widely perceived to be one that identified controls as market-unfriendly and as imprudent policy. Critics of the Fund argued that though it had become more accommodative of controls, its orientation was that capital account openness remained fundamentally beneficial and that reaping the benefits placed the burden on governments to adjust their policies and institutions (Subramanian, 2009). This orientation, according to critics, precluded the staff from providing guidance to emerging markets on what to do

should governments be unable to undertake these reforms. While this criticism does not fully capture the diversity of views espoused by the IMF, it does point to a more critical gap in the Fund's orientation at the time. In particular, it points to IMF's failure to engage with important practical questions about how governments should design capital controls should they prove necessary. Critics suggest, not entirely without basis, that had the Fund done so, it would have associated itself with the view that capital account openness could be potentially harmful.

This orientation has started to change, partly because the crisis exposed intellectual deficiencies in the pre-crisis orthodoxy that held markets to be rational and efficient (Financial Services Authority, 2009). This may in turn have opened up space within the Fund for those staff members who have long been skeptical of this orthodoxy to press their arguments more forcefully. Growing interest within the economics profession in the insights of behavioural economists may also have been influential in shaping the Fund's views. Harkening back to Keynes, these economists stress the limitations of market rationality and efficiency and use social, cognitive, and emotional factors to understand how market actors make economic decisions (Akerloff and Shiller, 2009). These insights fit well with the emerging post-crisis consensus within the G-20 and the IMF on the need for to move toward greater macro-prudential regulation, which seeks in part to deal with how markets, if left unfettered, can create greater systemic risk.

Although not initially framed in this manner, capital controls began to feature in discussions about macro-prudential regulation (Subramanian, 2009a; Subramanian and Williamson, 2009). It has become increasingly accepted that controls could form part of the policy arsenal against future crises, especially the build-up of asset bubbles, by helping to counter-cyclically restrict credit growth and leverage caused by capital inflows. From late 2009 to mid-2010, a number of emerging markets, including Brazil, South Korea, and

Indonesia, introduced controls to protect their economies from financial instability and to reduce currency volatility.

With their enhanced clout, some emerging market officials have become increasingly emboldened to call on the IMF and the G-20 to provide greater support for the use of capital controls (Subbarao, 2010). Reserve accumulation and stronger policy frameworks and fundamentals have provided many emerging markets with the capacity to increasingly chart a course independent of IMF influence. As a result, the IMF management and staff may have been partly motivated to respond to these calls from emerging market officials as a way of currying their political support, particularly at a time when the Fund is seeking to boost its financial resources in part by drawing on additional contributions from some large reserve-holding countries.

An important political obstacle to lending greater support to controls was removed when the stance of the British government eventually shifted. Faced with significant domestic political pressures and polls predicting defeat in an approaching election, the Labour government subsequently did a U-turn and provided some backing for such calls made by emerging market officials. In November 2009, then Prime Minister Gordon Brown surprised his G-20 colleagues by raising the possibility of a Tobin tax as a as way that might help banks to pay for the insurance they received from taxpayers (HM Treasury, 2009). Having spent more than a decade defending the City of London's "light-touch regulation" from intrusive Franco-German initiatives, the approaching British election and the public outrage on banker bonuses and the costs of the financial rescue likely led Brown to seek to cultivate a tougher image.[5] Yet the U.S. Treasury remained steadfastly opposed.

In early 2010, the IMF elaborated its orientation. Although an IMF (2010c) report to the G-20 did not support the Tobin tax as a means to induce the financial sector could pay for

[5] The Labour government subsequently lost the election in May 2010. At the time of writing, it is unclear the extent to which the current Conservative-Liberal Democrat coalition supports such measures.

the taxpayer support it receives, the staff did release another well-publicized report (Ostry *et al.*, 2010) that clarified the circumstances under which controls on inflows would form a legitimate part of the policy toolkit.[6] The report identified controls as one of several legitimate tools that policymakers could deploy to moderate over-heating of their economies. Free-flowing capital can threaten emerging economies because surges of inflows can create shocks, causing currencies to rapidly appreciate and asset prices to soar, the report argued. There were thus important macro-prudential considerations that supported the use of controls on inflows in some specific instances; that is, when the economy is operating near potential, the level of reserves is adequate, the exchange rate is not undervalued, and if the flows are likely to transitory. But the report argued the circumstances under which controls were likely to prove effective were limited, and their effectiveness would likely prove mainly to be on the composition of flows rather than the aggregate volume.

In line with the macro-prudential framing fixed to controls, the report uncovered evidence that controls that reduced risky liability structures had been useful in reducing fragility during the recent crisis. It added that countries where extensive controls had been in place such as China and India experienced better growth trajectories during the recent crisis. Reflecting greater skepticism that capital flows are the result of rational and efficient market actors, the report also highlighted concerns about herding behaviour, bouts of excessive optimism and pessimism, and the possibility of collateral damage from asset bubbles and busts, even when the flows are fundamentally sound.

Finally, the report offered an interesting analysis of the multilateral dimensions of capital controls. On the one hand, it warns that widespread use could undermine the benefits of financial integration and divert capital to countries less able to absorb it. Widespread use could also frustrate needed rebalancing of global demand, especially if they were

[6] See also IMF (2010d).

implemented in economies with undervalued currencies as a means to resist appreciation. On the other hand, as indicated earlier, by curtailing short-term flows and risky liability structures, controls could limit the demand for reserves and thus contribute to reducing global imbalances. Such considerations led the staff to suggest developing a code of conduct governing the use of controls, something that the Fund has been considering as part of its ongoing mandate review.

In fact, as part of this review, some have raised the idea again of once again revising the IMF's Articles to provide it with a new mandate to oversee the capital account policies of its members (IMF, 2010a; 2010b). As part of its mandate review, the IMF is also considering strengthening surveillance so as to help members design and implement controls, ensuring that negative spillovers are avoided and that broader goals are taken into account. Despite this recent shift, the perception of a stigma still remains. Emerging markets still generally fear that the use of controls will send a negative signal and harm their reputations with official and market actors. The IMF managing director also recently made clear that controls should only be used to combat temporary surges and must not become permanent (Oliver, 2010). Surges of a long-term nature would indicate, according to the IMF managing director, the need for adjusting policies and institutions.

In spite of opposition from the U.S. and doubts from the IMF, European leaders continue to press for consideration of a global tax on financial transactions as a way of dampening speculation and providing resources for future financial rescues. The recent crisis in Greece and across the eurozone has only served to heighten traditional European skepticism about speculation and free market finance. The new intellectual climate, continued popular outrage at excesses in the financial sector, and the Obama administration's newfound willingness to contemplate radical financial reforms promise to make the issue one of significant debate in the months to come.

In terms of significance, it is clear that the evolution of the Fund's position following the Asian financial crisis and its recent clarification has opened up greater policy space for emerging markets that have the capacity to chart a policy course independent of IMF influence. Most of these recent actions to curtail capital flows have received a muted reaction from global financial markets and credit rating agencies. Yet it would be somewhat of a stretch to claim as some have that "the stigma on capital controls [is] gone" (Rodrik, 2010). It is perhaps more accurate to state that the stigma has been lifted on the use of capital controls for those economies facing a very precise set of conditions. In that sense, the recent crisis has simply formalized the unevenness of the stigma that has persisted since the mid-1980s, and at best added greater reinforcement to its uneven nature. One key task now facing policymakers is to confront the shortcomings that remain from it.

8. Conclusion

Policy stigmas are an important aspect of financial governance. The behavioural prescriptions contained in stigmas constitute and regulate issues, interests, communities, and modes of action in international finance. The behavioural prescriptions embodied in stigmas are regulative, but also constitutive because understandings of what counts as "good" or "legitimate" financial governance are brought to life through those behavioural prescriptions. Stigmas play an essential role in signalling and establishing and maintaining reputations for "good" behaviour. Understanding the source, significance, and shortcomings of these stigmas is vital to strengthening our knowledge of governing the financial sector.

This paper has sought to look at the source, significant, and shortcomings of one particular policy stigma, that which has been attached to capital controls. Focusing on the IMF, it has empirically traced how the degree of approval attached their use has varied considerably across time and space and within the organization itself. In the early post-war era, capital controls were endorsed and failed to elicit any cries of outrage, but then gradually

over time it became increasingly frowned upon for developed countries to employ them. From the mid-1980s onward, the IMF began to introduce this stigma as a universal requirement, though it did so in an uneven and selective fashion. Since the Asian financial crisis, the stigma attached to controls has become more uneven and to some extent this unevenness has been formalized. Changes in the IMF's orientation have been driven not just by shifts in the power and preferences of member states, but also by the evolving makeup, beliefs, debates, and strategic efforts of its staff.

The stigma attached to controls has not been without its shortcomings. There is much evidence to suggest it skewed the way the IMF reacted to problems, processed information, and formulated responses. To its credit, the IMF has shown it can adapt and learn, but this has depended more on the presence of a severe crisis rather than through routine institutionalized channels. Much of the more comprehensive reassessment of organizational goals has depended on generational change within the Fund driven by personnel realignment.

This suggests a somewhat pessimistic reading of the potential for organizational change. Organizations like the Fund appear locked into particular worldviews or cultures to which they remain wedded for prolonged periods. The important policy question that comes from this observation is how can we force organizations like the Fund to consider all policy options when needed? Put differently, how can we avoid group-think in policy? Such considerations suggest a need for the IMF to do more to strengthen the culture and practice of learning within the organization.

Critics of the Fund maintain that the stigma that remains attached to controls continues to restrict "policy space" for emerging markets. If correct, then the risk is that despite its recent clarification, the Fund's orientation on capital controls could feed into its long-standing legitimacy problems with emerging markets. This line of reasoning suggests

another important argument as to why the IMF should work to design a set of best practices for implementing controls, perhaps as part of its ongoing mandate review. If the IMF was to pursue such a course of action, it could go a long way in convincing many emerging markets and developing countries, who perceive the Fund's support for capital account liberalization to reflect the beliefs of developed countries and the interests of their financial sector, that it is representing and taking into account their interests and experiences. It thus could contribute to the on-going efforts to address its legitimacy problems. Finally, to the extent that the stigma has contributed to the build-up of global macroeconomic imbalances, if the IMF began work on designing a multilateral framework for the use of controls, it could help to minimize the appeal as well as the costs and risks of reserve accumulation.

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