INTRODUCTION

1. Capital flows can bring substantial benefits for countries but also carry risks. They help smooth consumption and finance investment, diversify risks, and contribute to a more efficient allocation of resources. They can also foster economic growth by facilitating the transfer of technology and managerial skills, stimulating financial sector development, and generating incentives for better governance and stronger macroeconomic policy discipline. At the same time, large and volatile flows can pose macroeconomic and financial stability risks, which can be magnified by gaps in a country’s financial and institutional infrastructure. 1

2. The adoption of the IV was an important milestone in developing a consistent framework to guide advice on the liberalization and management of capital flows. The IV established a consistent framework for policy advice and, where relevant, assessments of members’ capital account policies, without altering members’ rights and obligations under the Articles of Agreement or other international agreements. 2 It provided guidelines for managing capital flows, by identifying circumstances when capital flow management measures (CFMs) may be useful. It also developed a roadmap for safe capital account liberalization without presuming full liberalization to be an appropriate goal for all countries at all times; and highlighted the importance of international cooperation on capital flow policies. Subsequent work elaborated the policy guidance under the IV and an interdepartmental team has been overseeing its consistent application in surveillance. 3

3. This paper reviews the IV, informed by advances in research (notably the work on the Integrated Policy Framework, IPF), the recommendations from the IEO evaluation, and lessons from experience. At the time of its adoption, it was envisaged that the IV would evolve and be reviewed in the light of research and lessons from its implementation. A review of experience with the IV in 2016 found that it remained broadly appropriate, while pointing to emerging issues warranting further research, clarification, or elaboration (IMF, 2016). This review is informed by the insights from the staff’s work on an Integrated Policy Framework (IPF) undertaken in recent years (IMF, 2020), the findings of the IEO evaluation on IMF Advice on Capital Flows (IEO, 2020), other relevant research, and staff’s experience in the implementation of the IV.

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1 For a discussion on the benefits and risks of capital flows and using CFMs, see Background Note 1.

2 In accordance with Article VI, Section 3 of the Fund’s Articles of Agreement, members are free to exercise such controls as are necessary to regulate international capital movements; the IV does not in any way alter these rights. However, in line with members’ obligations under Article VIII Section 2(a) and 3, and Article VI, these controls cannot be used to restrict payments for current international transactions or unduly delay transfers of funds in settlement of commitments. The right of members to regulate capital movements is also qualified by their obligations under Article IV relating to the stability of the system of exchange rates, including their obligation to avoid manipulation of exchange rates or the international monetary system in order to prevent effective balance of payment adjustment or to gain unfair competitive advantage over other members. Furthermore, in the Use of Fund Resources (UFR) context, pursuant to Article VI, Section 1(a), the Fund can request a member to introduce capital controls to prevent the use of the Fund’s general resources to meet a large or sustained outflow of capital. See IMF (2012b), Section IV.

3 See IMF (2013a); IMF (2015); and IMF (2017). IMF (2018) explains how the IV has been implemented in surveillance.
4. **The core principles of the IV remain valid.** There is broad consensus among the membership that the core principles underpinning the IV should be retained, namely that capital flows are desirable as they can bring substantial benefits for countries, and that CFMs can be useful in certain circumstances but should not substitute for warranted macroeconomic adjustment. Experience suggests that in most cases there will be a need (as well as room) to adjust macroeconomic and structural policies. Only rarely would CFMs or CFM/MPMs be the sole warranted policy response to the risks posed by capital inflows. The proposals in this review are consistent with those principles and the IV’s aim of helping countries reap the benefits of capital flows while managing the associated risks in a way that protects macroeconomic and financial stability and does not produce significant negative outward spillovers.

5. **This paper proposes two changes to the existing policies under the IV:**

- **Allow for the use of preemptive CFM/MPMs on inflows in some circumstances.** Based on the insights of the IPF, the review proposes that the use of inflow CFM/MPMs in a preemptive manner, i.e., in the absence of a capital inflow surge, could be appropriate under certain circumstances. Such CFM/MPMs may be imposed on FX debt inflows to address systemic financial risks stemming from FX mismatches; in narrower cases, they may be imposed on local-currency debt inflows. Figure 1 summarizes the IV’s advice to manage capital inflows, incorporating the proposed revision.

- **Establish a special treatment for certain categories of measures.** Currently, once a measure is determined to be a macro-critical CFM, staff is required to assess its appropriateness in accordance with criteria established in the IV. However, there are some measures that, because of their nature, require a differential and special treatment. These include measures introduced solely for reasons of national or international security, certain measures adopted pursuant to internationally agreed prudential frameworks (including reciprocity agreements), AML/CFT measures implemented consistently with international standards, and measures arising from certain international cooperation standards against the avoidance or evasion of taxes.

6. **The review does not propose changing the other key elements of the IV but elaborates on several concepts that play an important role in its implementation.** The review maintains the IV’s existing policy advice to manage the macroeconomic risks associated with overvaluation and overheating and financial stability risks during an inflow surge (Figures 1 and 2), the policy advice on managing disruptive outflows (Figure 2) and capital flow liberalization (paragraphs 52 and 53). To support policy advice under the IV, the review offers additional guidance on some concepts and operational issues, such as macro-criticality, capital inflow surges, imminent crises, and premature liberalization. Box 1 summarizes the IV’s advice on the role of source countries and international cooperation.

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4 CFM/MPMs refer to measures that are both capital flow management measures (CFMs) and macro-prudential measures (MPMs).
7. **Some other topics, while important, are not tackled in this review, because the analytical foundation to propose policy changes is insufficient at this time.** Establishing this foundation will require additional time and research. These topics include the use of CFMs for social or political objectives, the distributional effects of capital flow liberalization, the use of outflow CFMs outside of (imminent) crisis circumstances, and the effects of digitalization and climate change on capital flows.

8. **The paper is organized as follows.** Section II presents the case for preemptive CFM/MPMs on certain inflows and describes an assessment process for their appropriate use, building on the insights of the IPF. Section III proposes to modify the IV’s treatment for certain categories of
measures. Section IV elaborates some concepts and policies that play an important role in the IV's implementation. Section V addresses other operational issues that have arisen in the application of the IV.

Figure 2. Institutional View—Unchanged Elements Regarding Capital Flow Management

Managing Capital Inflow Surges:

- Exchange rate overvalued
- Lower rates/Intervene
- Lower rates
- Intervene + Sterilize
- Appreciate/Lower rates
- Appreciate
- Appreciate/Intervene + Sterilize
- Reserves adequate
- Economy overheating

Managing Disruptive Outflows:

- Exchange rate undervalued/Balance sheet FX exposure high
- Raise rates/Intervene
- Raise rates
- Intervene + Sterilize
- Depreciate/Raise rates
- Depreciate
- Depreciate/Intervene + Sterilize
- Reserves inadequate
- Economy stagnating

Source: IMF (2012b) and IMF (2015).
Box 1. Institutional View – The Role of Source Countries and International Cooperation

Role of source countries. The IV maintains the principle that source country policies have a role in mitigating the multilateral risks associated with capital flows. It recognizes that surges in cross-border flows may indicate a need for adjustment in both recipient and source countries; that countries should consider measures to address the macroeconomic and financial stability risks associated with cross-border activities of markets and institutions in their jurisdictions; and that cross-border policy coordination between source and recipient countries would help to mitigate undesired spillover effects of policies. Spillovers from source country policies and coordination of policies are addressed in the context of the Fund’s multilateral and bilateral surveillance with member countries, consistent with the Integrated Surveillance Decision (ISD).¹

International cooperation. The IV does not (and legally could not) alter members’ rights and obligations under other international agreements. Conformity with obligations under international agreements are determined solely by the existing provisions of those agreements. Yet, by establishing a framework that is broadly agreed by the membership, the IV helps foster a global dialogue on the management of capital flows and promotes a more consistent approach on how to handle capital flows in international agreements and frameworks. For example, it encourages members to take into account macroeconomic and financial stability and the effective operation of the international monetary system (IMS) as key considerations in the use of CFMs within the scope of bilateral, regional, and multilateral agreements. The IV also calls for the Fund to strengthen collaboration with other organizations involved in the design of policies affecting capital flows, such as the Organization for Economic Cooperation and Development (OECD), the Bank for International Settlements (BIS), and the Financial Stability Board (FSB). Significant progress has been made in this area since the adoption of the IV, as reflected by the close engagement with these organizations and the Fund’s support for financial sector regulatory and supervisory reforms. Steps to collaborate further with the OECD, the FSB, and Standard Setting Bodies (SSBs) are contemplated as part of the Management Implementation Plan in response to the recommendations from the IEO evaluation on IMF advice on capital flows.² In addition, the Fund contributes to international efforts to reduce the volatility of cross-border flows, inter alia through its participation in FSB work on nonbank financial intermediation and crypto assets.

¹ For example, in the 2021 US Article IV Consultation, substantial consideration was given to the importance of careful communication of policy changes, so that adverse spillovers could be minimized. The October 2021 IMF WEO also emphasized the importance of clear and state-contingent forward guidance and communication from advanced economy central banks during the period of normalization to avoid taper-tantrum-like scenarios.
² See IMF (2021a).

PROPOSED POLICY CHANGE: THE CASE FOR PREEMPTIVE CFM/MPMS ON INFLOWS

A. Conceptual Case for Preemptive Inflow CFM/MPMs

9. The IV recognizes that inflow surges can generate systemic financial risks; however, even in the absence of a surge, stock vulnerabilities can be a source of such risks. FX mismatches can arise from an overall FX balance sheet mismatch across all remaining maturities, or
an FX maturity mismatch at shorter horizons, or both. Mismatches may gradually build in the financial, household, or corporate sectors and pose risks even if there is no ongoing inflow surge. If they are large enough, they increase the probability that capital flow reversals and currency depreciations generate costly balance sheet effects and severe output collapses (Background Note 1). The impact of FX mismatches may be amplified by other frictions and vulnerabilities (e.g., leverage, and asset price bubbles). In some circumstances, systemic financial risks may also arise from the accumulation of external debt denominated in local currency.

10. During a capital flow reversal, conventional policy instruments may not be effective in addressing the balance sheet effects related to FX mismatches. First, while a currency depreciation due to a capital flow reversal may boost net exports, it may also tighten external borrowing constraints by reducing the FX value of local-currency assets, collateral, and income relative to FX debt and liabilities. In such circumstances, monetary policy faces a difficult trade-off: raising the interest rate could result in excessively tight domestic monetary conditions, with procyclical effects on credit and economic activity; while lowering it could lead to further depreciation, tightening external borrowing constraints further. Second, the capacity of the government or the central bank to provide FX liquidity to the private sector to satisfy rollover needs on FX debt may be limited, owing to insufficient FX reserves or other sources of FX funding.

11. These arguments indicate that CFM/MPMs on FX debt inflows may be useful in a preemptive manner, i.e., in the absence of an inflow surge, to prevent a further accumulation of already-elevated FX mismatches and the associated systemic financial risks. If the adverse balance sheet effects of a currency depreciation can be mitigated preemptively through CFM/MPMs that reduce FX mismatches, the exchange rate can be allowed to adjust more flexibly after external shocks, hence reducing the cost of capital flow reversals and facilitating the needed external adjustment. Such arguments have been developed in the IPF workstream and the IEO report as rationales the preemptive use of inflow CFM/MPMs.

12. The accumulation of external debt in local currency can also pose financial vulnerabilities in the private sector, but a wider set of policy tools is typically available to address them. Maturity mismatches and excessive leverage in local-currency debt positions increase rollover risks and the probability of fire-sales of domestic assets during capital flow reversals. In those cases, adequate MPMs would typically address these risks effectively. Even when MPMs cannot successfully mitigate the systemic risks, capital flow reversals in the absence of FX mismatches may not trigger the same amplification effects as those in the case of FX mismatches. First, the currency depreciation does not worsen the balance sheets of entities indebted in local currency. Second, the depreciation increases the expected FX return on local currency-denominated assets, leading to a revaluation of foreign assets. If the revaluation is large enough, it can offset the negative impact of the currency depreciation on the entire balance sheet and/or liquidity risks from short-term liabilities.

5 FX mismatch at any relevant remaining maturity is defined as the stock of FX liabilities which is not covered by liquid FX assets or FX hedges of the same maturity (either natural hedges, such as export revenue or remittances, or financial contracts in deep hedging markets). FX mismatches give rise to solvency risks that may arise from impact of currency depreciation on the entire balance sheet and/or liquidity risks from short-term liabilities.

6 In countries whose exports are denominated in the dominant currency, most notably the US dollar, the increase in net exports tends to be muted in the short term.
assets, which may induce some foreign or local investors to expand or maintain their positions, thus preventing a downward spiral. Therefore, policymakers do not face the same trade-offs in the use of monetary policy as they may face in the presence of FX mismatches. Policymakers can also more easily provide liquidity support in local currency, while as described in the previous paragraph, their ability to provide such support in foreign currency may be more constrained. There may be some exceptional circumstances, however, where both MPMs are insufficient and ex-post policy instruments may be impeded in preventing a sharp tightening of financial conditions during a capital flow reversal; if so, preemptive CFM/MPMs may be warranted in the presence of financial vulnerabilities in the private sector from accumulated external debt stocks in local currency.

13. **The use of preemptive inflow CFM/MPMs can carry risks that should be mitigated.**

First, CFM/MPMs may be inferior to other measures available which are not CFMs. For example, CFM/MPMs could substitute for warranted macroeconomic policy adjustments or MPMs that would alleviate the systemic financial risks in question. They could also substitute for structural policies to develop financial markets which would reduce the frictions that may create a need for CFM/MPMs. Such structural policies are especially important to reduce the reliance on CFM/MPMs because these measures may have adverse side-effects, e.g., misallocation of resources and rent seeking (see Background Note 1). Second, CFM/MPMs may help maintain or exacerbate a stronger-than-warranted external position or gain an unfair competitive advantage. Since preemptive CFM/MPMs can be imposed outside of an inflow surge, the appreciation pressures that typically occur during a surge might be absent, and the currency may as a result become or stay undervalued. Furthermore, it may take time for preemptive CFM/MPMs to reduce existing stock vulnerabilities. Given this context, it is essential that they are used in a way that minimizes adverse side-effects.

**B. Proposed Policy Change**

14. **Preemptive inflow CFM/MPMs may be appropriate in some circumstances.** Drawing on the above discussion regarding the conceptual case for preemptive CFM/MPMs and the risk of their side effects, the determination of their appropriateness involves the following three key considerations:

- Are systemic financial risks elevated?
- Is the preemptive CFM/MPM needed to address these risks?
- Would the preemptive CFM/MPM help maintain or exacerbate a stronger-than-warranted external position that is mostly caused by domestic policy gaps?

Paragraphs 15-22 discuss the above considerations and outline the criteria that can be used for making these judgments.
Are Systemic Financial Risks Elevated?

15. **Preemptive CFM/MPMs on FX debt inflows are appropriate only if systemic financial risks are elevated due to FX mismatches.** Elevated FX mismatches at relevant remaining maturities expose the economy to systemic risks and are the key vulnerability that justifies the use of preemptive CFM/MPMs. To assess FX mismatches, overall and at the relevant remaining maturities, multiple indicators can be used, subject to data availability. Data should be analyzed to determine: (a) sectoral and economy-wide private sector FX debt and asset positions (external and domestic); and (b) whether the FX debt is hedged at the relevant maturities, either naturally (such as in the case of exporting firms) or via holdings of FX assets, or through financial contracts in deep hedging markets. If FX mismatches are identified, systemic risks stemming from such FX mismatches should be evaluated, taking account of any amplifying and mitigating factors, such as FX leverage, asset price bubbles fueled by external FX borrowing, and FX buffers held by the central bank or government, including access to other FX liquidity sources (e.g., central bank swap lines). The risk assessment can draw on the IMF’s macroprudential framework (IMF, 2013b and 2014a) to assess FX-related systemic risks as appropriate and use stress tests, where feasible. Such an assessment would be compatible with the calls in the 2021 Comprehensive Surveillance Review for strengthening systemic risk analysis in Article IV consultations to better anchor macroprudential policy advice (IMF 2021c, d).

16. **In narrow and exceptional circumstances, systemic financial risks may justify preemptive CFM/MPMs on local currency debt inflows.** Such risks could arise, for example, from high foreign investor participation in local-currency debt markets, which may amplify maturity mismatches, fuel asset price increases, or generate excessive leverage. Unlike in the case of FX mismatches, there would be a presumption that a wider set of macroeconomic policy tools would be available to manage an abrupt reversal in local currency debt inflows. Therefore, for local-currency debt vulnerabilities to generate costly capital flow reversals, such policies (and risk mitigants) would need to be substantially impeded or unavailable. In particular, the following conditions should be expected to be jointly satisfied in the event of a disruptive capital flow reversal: (i) local currency debt and FX markets are sufficiently shallow so that an outflow by some foreign investors would be unlikely to be offset by other investors; (ii) a large depreciation is costly due to FX mismatches or other reasons (e.g., if it de-anchors inflation expectations), and these costs outweigh the benefits of depreciation, such as from the improvement of net exports; (iii) domestic monetary policy is constrained and FX reserves are low; and (iv) other relevant ex-post policy instruments to address capital flow reversals, particularly local-currency lender-of-last-resort and liquidity facilities, are substantially impeded or unavailable.

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7 Background Note 2 illustrates how systemic financial risks may be assessed.

8 In a deep hedging market, investors can execute their (large) transactions efficiently even after severe shocks, i.e., without causing significant price movements that could affect the cost of executing the transaction or significantly increasing their exposure to counterparty risk.
Is the Preemptive CFM/MPM Needed to Address Systemic Risks?

17. The policy measure should be a CFM/MPM that can reduce the relevant systemic financial risks effectively. It should be an MPM in addition to being a CFM (IMF, 2017 and Box 2). To meet this standard, in the case of systemic risks arising from FX mismatches, the measure should address systemic risks from unhedged FX debt, i.e., it should reduce existing FX mismatches, prevent capital inflows from causing a further increase in FX mismatches from already-elevated levels, or increase resilience to FX mismatches by requiring capital or liquidity for external borrowing in FX (Background Note 3). In the case of systemic risks from local-currency external debt stocks, the measure should lower local-currency stock vulnerabilities by reducing such inflows. In line with the current IV, the measure should target debt inflows in the specific sector that give rise to the risk as closely as possible. Moreover, it should be calibrated in a manner that addresses risks effectively while minimizing costs and side effects. For example, if the coverage or calibration of the measure goes beyond what is necessary to address the financial stability risk at hand, and this could be avoided by using a better-calibrated tool, the measure would not be appropriate.

Box 2. Definition of CFMs, MPMs, and CFM/MPMs

The Fund’s policy framework distinguishes between CFMs, MPMs, and CFM/MPMs. CFMs are measures that are designed to limit capital flows, while MPMs are primarily prudential tools that are designed to limit systemic financial risks. Measures that are designed to limit such risks stemming from capital flows are classified as CFM/MPMs (IMF 2012b, 2013b, 2017). An interdepartmental group works with country teams to ensure consistent and evenhanded classification of measures, while also ensuring that the policy recommendations provided are adequately guided by the different frameworks.

The classification of measures requires a careful assessment of their design, objectives, and the circumstances under which they are introduced. It has been recognized that the delineation of CFMs from other policies and measures affecting capital flows can be challenging and would need to take into account the overall context and circumstances in which the measure was adopted. In practice, measures that affect international financial transactions and discriminate based on residency have been assessed as CFMs. In addition, non-discriminatory measures may also constitute CFMs if they are designed to limit capital flows based on the circumstances under which they were introduced.

To determine whether a CFM is also an MPM, three conditions need to be fulfilled: (i) its primary objective is to safeguard financial stability; (ii) a source of systemic financial risks can be identified; and (iii), the CFM can reasonably be expected to mitigate such risks. Currency-based measures may in many instances be only MPMs, but in some cases also CFMs if they are designed to limit capital flows based on the circumstances under which they were introduced.

CFMs are not labeled as CFM/MPMs if their design or context suggest that their primary objective is not financial stability or that they are unlikely to limit systemic risks. For instance, if the authorities’ stated objective is explicitly not financial stability, the CFM would not be classified as an MPM even though it could mitigate systemic risks. Conversely, measures that are stated to be taken for financial stability purposes may not be classified as MPMs if their transmission does not suggest that they can be expected to mitigate systemic risks. For instance, if a measure has been imposed and its usage or design magnify rather than mitigate risk, this information would be an input into the assessment of the primary objective of the measure. CFMs that mainly operate through the exchange rate are given extra scrutiny and may not qualify as MPMs.
18. **Preemptive CFM/MPMs should not be used if MPMs alone would be sufficient to address the risks.** While MPMs are typically able to contribute substantially to managing risks from FX borrowing (e.g., IMF, 2014b, and IMF, 2017), they may be unavailable or insufficient to address the risks in question. Under these circumstances, using a pre-emptive CFM/MPM—either alone, or to reinforce MPMs—may be the least distortive way to address the risks effectively.

19. **The preemptive inflow CFM/MPM should not be used to substitute for warranted adjustments in macroeconomic policies.** If monetary policy, exchange rates, or fiscal policy are at inappropriate settings, and if correcting them would eliminate the systemic risks, these policies should be adjusted instead of using CFM/MPMs. In the case that immediate adjustment is unduly costly, or may take time to have effect, CFM/MPMs may be temporarily appropriate alongside a commitment to a plan to undertake the warranted policy adjustments that are recommended in the context of Article IV consultations. If macroeconomic policies are at inappropriate settings but correcting them would have only a small or partial effect on systemic risks, a temporary CFM/MPM may be an appropriate instrument to address the risks, alongside the correction of macroeconomic policies.

20. **The preemptive CFM/MPM should not substitute for market development or structural policies that could reduce the underlying frictions, nor undermine such policies.** The preemptive CFM/MPM should not undermine market development in a manner that exacerbates the underlying friction, e.g., if the preemptive CFM/MPM is being used to reduce FX mismatches, it should not prevent the development of markets which could provide funding in local currency. Structural policies can go a long way in addressing the frictions that call for the need to introduce preemptive CFM/MPMs and, unlike some CFM/MPMs, may not produce adverse side-effects. Since such policies can take time to be implemented and become effective, preemptive CFM/MPMs may be appropriate in the interim unless they undermine such efforts. If preemptive CFM/MPMs are used, it would be desirable to combine them with reforms to address the underlying frictions, which may include, for example, developing local currency bond markets, boosting the credibility of the macroeconomic policy framework, and developing sound financial supervision and regulation. 9

**Would the Preemptive CFM/MPM Help Maintain or Exacerbate a Stronger-than-Warranted External Position that is Mostly Caused by Domestic Policy Gaps?** 10 If so, is the Country Taking Sufficient Actions to Address its External Position?

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9 The appropriate reforms for the specific country may draw on the menu of options in Annex I.

10 The external sector assessments (ESAs) categorize countries’ external positions as either “broadly in line,” “moderately weaker (stronger),” “weaker (stronger),” or “substantially weaker (stronger)” than the level implied by medium-term fundamentals and desirable policies. In this section, the term “stronger-than-warranted external position” corresponds to the external positions being categorized in the ESA as either “moderately stronger,” “stronger,” or “substantially stronger.” The ESA builds on staff judgment, country-specific circumstances, and the estimates provided by the External Balance Assessment (EBA) and EBA-lite models. These models help identify and provide estimates of the contributions of some domestic and foreign policies to the external sector assessment. Country-specific knowledge and other analytical work may help identify other distortions that are not included in the models, but which may contribute to an external imbalance.
21. The preemptive CFM/MPM should not help maintain or exacerbate a stronger-than-warranted external position. Whether the preemptive CFM/MPM does so depends on the following factors:

- The strength of the external position and the contribution of domestic policies. If the country’s external position is stronger than warranted relative to the level implied by medium-term fundamentals and desirable policies according to the External Sector Assessment (ESA), and the policy gaps underpinning external imbalances are mostly domestic rather than foreign, it raises the concern that the use of preemptive CFM/MPMs could add to the set of domestic policies generating the external imbalance.

- The expected effect of the preemptive CFM/MPM on the external position. Relative to the counterfactual of no CFM/MPM use, the inflow CFM/MPMs would be expected to depreciate the currency and strengthen the external position, unless a case can be made that its impact on the currency would not be economically significant.\(^\text{11}\)

- Policy actions to address a stronger-than-warranted external position. If the country has a stronger-than-warranted external position caused by domestic policy gaps, an important element to consider is whether it is undertaking corrective policy actions to address them or is committed to undertake them. The absence of such actions or commitment would raise concerns that the use of the preemptive CFM/MPM could exacerbate the external imbalance.

Putting it all Together and Arriving at an Overall Assessment

22. The appropriateness of the preemptive CFM/MPM depends on the assessment of systemic financial risks, whether it is needed to address these risks, and the external position. Identifying elevated systemic financial risks and determining that the preemptive CFM/MPM is a needed policy instrument to address these risks are necessary conditions for appropriateness. A third consideration stems from the assessment of the external position and how it may be impacted by the preemptive CFM/MPM. The assessment of the external position would render the preemptive CFM/MPM inappropriate in the following circumstances:

- If the preemptive CFM/MPM would help maintain or exacerbate a stronger-than-warranted external position mostly caused by domestic policy gaps, and the country is not taking policy actions to address these gaps, the measure would be inappropriate, as it would distort the country’s external position further.

- If the preemptive CFM/MPM would help maintain or exacerbate a stronger-than-warranted external position mostly caused by domestic policy gaps, but the country is undertaking policy

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\(^{11}\) Only macro-critical CFMs/MPMs are assessed in bilateral surveillance (See section IV.A). However, macro-criticality does not necessarily imply a significant effect on the exchange rate, as the measure could have a significant effect on other macroeconomic variables even if it does not have a significant effect on the exchange rate. The impact on the currency may depend on the ease of substitution of the assets targeted by the measure. The availability of alternative assets could depend on the existing capital flow management regime (e.g., existing CFMs and the effectiveness of their enforcement) and on the level of the country’s financial development. If a measure has a significant effect on the exchange rate, it is likely to be macro-critical.
actions to address these gaps or is committed to undertake them, assessing the appropriateness involves a trade-off between its benefits in reducing systemic financial stability risks and its costs in maintaining or exacerbating a stronger than warranted external position. In that case, the preemptive CFM/MPM would be inappropriate if the extent and duration of the strength of the external position are large relative to the systemic financial risks and relative to the expected effectiveness of the policy actions.

The criteria outlined in paragraphs 15-22 are summarized in Figure 3.

**Figure 3. When Would a Preemptive CFM/MPM Be Appropriate?**

1. Systemic financial risks are elevated

2. The preemptive CFM/MPM is needed to address systemic financial risks

**unless**

3. The preemptive CFM/MPM would help maintain or exacerbate a stronger-than-warranted external position mostly caused by domestic policy gaps and...

   a. ... the country is not taking policy actions to address the gaps

   or

   b. ... the country is taking some policy actions to reduce the gaps, but the extent and duration of the strength of the external position are large relative to the systemic financial risks and the effectiveness of policy actions

Source: IMF staff.

23. **Countries with fixed exchange rate regimes may face tighter policy constraints that may strengthen the case for preemptive CFM/MPMs.** During capital flow reversals, such countries would face tighter constraints in the use of monetary policy and/or in allowing for nominal exchange rate flexibility to achieve external adjustment than those with more flexible exchange rate regimes. In addition, their ability to provide local currency liquidity support may also be limited. These constraints may strengthen the case for preemptive CFM/MPMs, while bearing in mind that these measures should not substitute for warranted macroeconomic and structural adjustments or help maintain unsustainable currency pegs.

24. **Policy advice on preemptive CFM/MPMs should take spillovers into account.** The spillovers could arise from the effects of the preemptive CFM/MPM on the exchange rate and the
external position or international financial flows, e.g., contagion effects in international financial markets by affecting expectations of market participants and capital flows to other countries. The effects of the CFM/MPM on the external position are analyzed via the approach outlined in paragraph 21, and hence, to the extent that it contributes to maintain or exacerbate a stronger-than-warranted external position, they enter the determination of whether the preemptive CFM/MPM is regarded as appropriate under the IV. If the use of the CFM/MPM is assessed as appropriate, the treatment of spillovers should follow the guidance set by the ISD, which mandates staff to discuss outward spillovers from members’ policies if they significantly influence the effective operation of the IMS. In such case, staff should examine whether alternative policy actions could achieve domestic objectives while minimizing negative spillovers. However, consistent with the ISD, if the policies promote the member’s own domestic and balance of payments stability, the authorities would not be obliged to act on staff recommendations. Staff may also discuss with the authorities any outward spillovers that have important implications for other members but not for global stability.

25. **The preemptive CFM/MPM should be reviewed periodically to assess whether its use continues to be appropriate.** Periodic evaluations in Article IV consultations, as appropriate, should ensure that the conditions that were satisfied at the time of the introduction of the CFM/MPM continue to hold. The evaluations should follow up on new information regarding economic and policy developments since the introduction of the measure: e.g., whether MPMs have become available to address the risk; whether the measure has become a substitute for warranted macroeconomic adjustment; whether there has been progress on reforms to diminish the need for the CFM/MPM; whether the measure has caused the exchange rate to depreciate significantly; whether the external position has become stronger than warranted following the introduction of the measure; and whether the authorities have taken measures to address the domestic policy gaps underpinning the strength of the external position. These evaluations should ensure that the CFM/MPM continues to be the appropriate policy tool, is designed appropriately, and is as targeted and temporary as possible. If any of the conditions required for the measure to be appropriate are no longer met, the CFM/MPM should be removed—immediately if it is feasible without jeopardizing macroeconomic or financial stability; or in a phased manner, with the appropriate speed of phasing depending on the feasible time path for the needed macroeconomic, financial, and structural policy adjustments.

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12 There should be no presumption that a preemptive CFM/MPM would have negative spillovers: similarly to other MPMs, a preemptive CFM/MPM may have positive spillovers by supporting domestic and global financial stability.

13 Outward spillovers are deemed to “significantly influence” the effective operation of the IMS, if by themselves, or in combination with spillovers from other members’ policies, or through their regional impact, they enter the macro-financial policy considerations of members representing a significant portion of the global economy.

14 Using CFM/MPMs to influence exchange rates in order to gain unfair competitive advantage would also be inconsistent with countries’ exchange policies obligations under Article IV.

15 See IMF (2013a), paragraph 7.