ECO
1997

CAPITAL ACCOUNTS
CONVERTIBILITY

Western Hemisphere Department
Immediate Office
Economic Subject Files
1997

Mr. Loser 10-100

(1) ADM- Work Program

(2) ECO- Capital Accts..

CL
TTM
ASL
SI
IO
F

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
97 OCT 16 06

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

October 15, 1997

From: S. J. Anjaria SJA

Subject: **Work Program on Capital Account Liberalization**

As you know, SEC is putting together, on the basis of departmental submissions, the Work Program scheduled for discussion in November 1997. May I take this opportunity to submit for your consideration a somewhat novel way of dealing with the upcoming discussions in the Fund on capital account liberalization?

As you mentioned at last Thursday's Department Heads' meeting, a considerable educational effort will be required over the coming months to persuade not only our membership, but also financial market participants, parliamentarians, and the general public of the need for, and desirability of, giving the Fund the central role in promoting orderly capital account liberalization. In particular, a conscious effort will be required from the outset to avoid this initiative being seen as a mere legalism. Also, we will need to guard against this move being perceived only as more "corporate welfare." At the same time, I am struck by the positive evolution in the thinking of members on the desirability of greater transparency more generally; the relatively ready acceptance by the Interim Committee of language on the development by the Fund of a code of good practices in the areas of openness and accountability of economic policymaking is the most recent illustration.

In light of these considerations, it will be worth considering if Executive Directors, during their discussion of the substance of the Work Program, should also be asked to consider conducting the internal debate on issues relating to capital account liberalization somewhat differently from what is customary. More specifically, Executive Directors might be asked to consider accepting from the outset the principle that all staff papers prepared for Executive Board consideration in the area of capital account liberalization will normally be released to the public shortly after each Board discussion, following procedures similar to those used for the World Economic Outlook. This would require, of course, that the policy papers in question—especially those giving the economic rationale for open capital markets in a globalized world economy—be drafted with an audience in mind that is broader than the Executive Board. Consideration might also be given to seeking Board endorsement for releasing to the public the summings-up of such Board discussions. In parallel, simplified articles and pamphlets, such as those in the Economic Issues series, could be prepared, as appropriate, for broader public dissemination. In addition, press briefings or seminars in the Economic Forum series could be scheduled not only at headquarters, but also in selected member countries in Latin America, Africa, and Asia, perhaps on a regional basis.

The above suggestions would be one way of giving concrete form to the notion that a systematic educational effort should be attempted in the area of the Fund's role in capital account liberalization. Of course, we could launch other, less ambitious forms of openness. However, at the Board discussion I would expect any staff proposals to be watered down. For tactical reasons, therefore, I would suggest that our proposals in this area for the Executive Board err on the side of more, rather than less, ambition.

If it is decided to move along the lines suggested above, consideration should also be given to releasing at the outset a paper that brings the public up to date on the discussions in the Fund thus far—perhaps an edited version of the Managing Director's report to the Interim Committee.

cc: Department Heads
Mr. Russo
Mr. Cross

ECO - Capital Accounts

CAPITAL ACCOUNT LIBERALIZATION AND THE ROLE OF THE IMF

Stanley Fischer[1]

1. This Annual Meeting is taking place at a time of profound change in East Asia, propelled by an astonishing record of sustained economic growth, that within less than two decades has improved the living standards of more people, more rapidly, than at any other time or place in history. For the IMF, Hong Kong has for months appeared likely to be the meeting of the Capital Account and of Fund resources -- the annual meeting at which our Executive Board would be given the mandate to complete its work on an amendment of the Articles of Agreement to promote capital account liberalization, and at which agreement could be reached on a quota increase and a special issue of SDRs. Coming a little over fifty years after the original Articles of Agreement put current account convertibility and trade liberalization at the center of the Fund's mandate, and at a time when the globalization of capital markets proceeds apace, the capital account amendment and the increase in resources would enable the Fund to play its full part in promoting the orderly liberalization of international capital markets.

2. But the recent market turmoil in the region has raised two fundamental sets of questions: the first, about the sustainability of the Asian miracle; and the second, about the risks of capital account liberalization. I will not discuss the Asian miracle, except to record my firm belief that, after a relatively brief pause, rapid growth will resume in those economies now adjusting to recent shocks, home- and foreign-made. And there is no reason that growth in other parts of Asia, most notably in India, should not increase to and be sustained in the range of 6-8 percent per annum. It is just a matter of policy -- of the right macroeconomic policies, of accelerating market-oriented structural reforms, of improving education, and of opening up to trade and foreign investment.

3. My main focus today will be on the capital account. The question is whether the recent market turbulence in the region -- the attacks on the Thai baht and its devaluation, the subsequent devaluations of other currencies in the region, and the contagion effects that have been present in East Asia in 1997, just as they were in Latin America in 1995, and perhaps also in Europe in 1993 -- does not suggest that the capital account is more often the source of economic difficulties and risk rather than benefit, and therefore that capital account liberalization should be put off as long as possible. If that were so, perhaps the proposed

[1] First Deputy Managing Director, IMF. This paper was prepared for presentation at the seminar "Asia and the IMF", held in Hong Kong, China on September 19, 1997. I am grateful to Barry Johnston for his assistance.

capital account amendment of the Fund's Articles of Agreement would be unnecessary, and everybody -- not least the Fund's overworked Legal Department -- could be saved a great deal of effort.

4. You will not be surprised to hear that I emphatically reject this view. But the concerns of those policymakers who fear some of the consequences of capital account liberalization cannot and should not be lightly dismissed. What I would like to do is to persuade those of you who remain sceptical about capital account liberalization of three things:

- that the benefits of liberalizing the capital account outweigh the potential costs;
- that countries need to prepare well for capital account liberalization: economic policies and institutions, particularly the financial system, need to be adapted to operate in a world of liberalized capital markets; and
- that an amendment of the Fund's Articles of Agreement is the best way of ensuring that capital account liberalization is carried out in an orderly, non-disruptive way, that minimizes the risks that premature liberalization could pose for an economy and its policymakers.

In making this argument, I will also touch on several critical issues about international capital movements that recent crises have put on the policy agenda. I must though apologize in advance for raising more questions than I can answer.

I. The Growth of Capital Movements

5. First, some background facts and forecasts: Both gross and net international capital flows have increased markedly in recent years, and for many countries capital movements have been a critical factor in the balance of payments. Average annual net capital inflows to developing countries exceeded US$150 billion in 1990–96. After a pause in the first half of 1995 following the Mexican crisis, the pace of inflows to developing countries recovered, and has continued to increase since then. A net total of US$235 billion in foreign capital flowed to developing countries in 1996, and this rate of flow appears to have been sustained in the first half of 1997. This is not a small amount: it is nearly 0.8 percent of world GDP, and well above 2 percent of developing country GDP.

6. Asia, in particular, has benefited from recent capital inflows, receiving more than US$60 billion per annum in 1990–96, and a total of US$107 billion in 1996. Asia has received a higher proportion of foreign direct investment, 55 percent of total capital inflows, than other regions. Net inflows to some countries in this region have averaged 5-8 percent of GDP over long periods, often with much of that taking the form of foreign direct investment.

7. Why have global capital flows increased so much? Let me mention four factors:

- first, rates of return in recipient countries. Capital inflows have responded favorably to successful stabilization and reform efforts. In some cases, especially where the flexibility of the exchange rate has been limited by policy, short-term capital has been attracted by high interest rates needed to fight inflation;

- second, the liberalization of international capital transactions by both industrial and developing countries. Indeed, in some cases the liberalization of capital outflows has strengthened the capital account by encouraging both foreign investment and a return of flight capital;

- third, the development of stronger financial systems in recipient countries; and

- fourth, external factors -- including the declining trend in longer-term interest rates in the advanced economies over the last decade, and the emergence of large institutional investors in industrial countries.

8. International capital flows have by no means reached their peak. Portfolios in the advanced countries are still insufficiently diversified internationally; and the residents of developing countries likewise have much to gain from investing in capital markets in other countries. We can be sure that the volume of gross international capital flows will continue to increase, as information about the potential of developing country markets spreads, as transaction costs continue to decline, and as the liberalization and sophistication of capital markets in developing and advanced countries continues to grow.

II. Benefits and Risks of Capital Account Liberalization

9. There are two arguments in favor of capital account liberalization. The first is that it is an inevitable step on the path of development, which cannot be avoided and therefore should be adapted to. In support of this view, we may note that all the most advanced economies have open capital accounts. This is a powerful argument, and a correct one, even if it begs the question of how rapidly the inevitable has to be accepted. But while sufficient, it is not as satisfactory as the second argument, that on balance the benefits of capital account liberalization outweigh its costs.

10. Put abstractly, free capital movements facilitate a more efficient global allocation of savings, and help channel resources into their most productive uses, thus increasing economic growth and welfare. From the individual country's perspective, the benefits take the form of increases in both the potential pool of investable funds, and the access of domestic residents to foreign capital markets. From the viewpoint of the international economy, open capital accounts support the multilateral trading system by broadening the channels through which

developed and developing countries alike can finance trade and investment and attain higher levels of income. International capital flows have expanded the opportunities for portfolio diversification, and thereby provided investors with a potential to achieve higher risk-adjusted rates of returns. And just as current account liberalization promotes growth by increasing access to sophisticated technology, and export competition has improved domestic technology, so capital account liberalization can increase the efficiency of the domestic financial system.

11. Abstract as these arguments may sound, they have concrete counterparts in the real world. Access to global savings means in part foreign direct investment, about the benefits of which there is no longer any serious controversy. Governments all over the world borrow in the Euro-markets, gaining access to cheaper financing than they might be able to obtain domestically. Domestic corporations likewise can obtain cheaper and more sophisticated financing by borrowing abroad. The new financial technologies that accompany the entry of foreign participants in domestic markets can upgrade the entire financial system. Residents of countries that permit portfolio investment abroad can hold more diversified, less risky portfolios. These are not abstract concepts, but benefits that every country represented in this room has enjoyed as a result of its access to the international capital markets.

12. Still, what about the risks? International capital flows tend to be highly sensitive to the conduct of macroeconomic policies, the perceived soundness of the domestic banking system, and unforeseen economic and political developments. Accordingly, market forces should be expected to exert a disciplining influence on countries' macroeconomic policies. Normally, when the market's judgment is right, this discipline is a valuable one, which improves overall economic performance by rewarding good policies and penalizing bad. Of course, policymakers do not always welcome discipline of which they are the object, even if it is appropriate; nor are they likely to admit when trouble comes that the capital markets were only the messenger, delivering a verdict on their performance. Rather they may be tempted to shoot the messenger.

13. However markets are not always right. Sometimes inflows are excessive, and sometimes they may be sustained too long. Markets tend to react late; but then they tend to react fast, and sometimes excessively. Of most concern, market overreactions sometimes take the form of contagion effects, spillovers from a crisis in one market to other, related, markets. Some spillovers are entirely rational and efficient -- for instance, when a country devalues, the equilibrium exchange rate for its competitors may also depreciate. But sometimes, including to some extent in the recent East Asian crisis, and certainly in the attack on Argentina in 1995, contagion effects seem to be overreactions, perhaps based on incomplete information, perhaps a result of herd behavior, perhaps based on an inaccurate appraisal of the underlying economic situation. Contagion effects are all the more worrying in light of the possibility that attacks

become self-fulfilling prophecies, for instance because the banking system weakens in the face of an attack that forces a devaluation and higher interest rates.[2]

14. While I believe we sometimes see examples of market overreactions and unjustified contagion effects, I also believe that capital movements are mostly appropriate: currency crises do not blow up out of a clear blue sky, but rather start as rational reactions to policy mistakes or external shocks. The problem is that once started, they may sometimes go too far.

15. To sum up: Liberalization of the capital account can bring major benefits to countries whose residents and governments are able to borrow and lend on more favorable terms, in more sophisticated markets, whose own financial markets will become more efficient as a result of the introduction of advanced financial technologies -- and who for all those reasons will attain a better allocation of both saving and investment, and will therefore grow more rapidly in a more sustainable manner. These gains have been seen all over the world where countries have accessed the international capital markets and allowed foreign competition in their own capital markets -- and they have certainly been seen in Asia in the last two decades. At the same time, capital account liberalization increases the vulnerability of the economy to swings in market sentiment. Almost always these swings are rationally based, but they may on occasion be excessive, and they may sometimes reflect contagion effects, which may themselves be excessive on occasion. This is a valid concern to those contemplating capital account liberalization, and for the international community.

III. Managing a Liberalized System.

16. What is the right response to operating in a system that offers major benefits, but that may penalize mistakes severely, and occasionally burden the economy with inappropriate shocks? The prime need obviously is to avoid policies that can cause rapid capital flow reversals, and to strengthen the structure of the economy and its policy framework so as minimize its vulnerability to sudden changes in market sentiment. Some of what needs to be done is well known and uncontroversial, in particular:

- to pursue sound macroeconomic policies;
- to strengthen the domestic financial system; and
- to phase capital account liberalization appropriately -- which means retaining some capital controls in the transition.

---

2 These are cases of so-called multiple equilibria.

There are also more controversial questions about:

- the provision of information to the markets;
- the role of surveillance; and
- the potential need for financing.

Let me take these topics up in turn, touching lightly on those elements on which there is a well-understood consensus, emphasizing rather the more novel or controversial points.

A. The macroeconomic policy framework

17. A sound macroeconomic policy framework is one that promotes growth by keeping inflation low, the budget deficit small, and the current account sustainable. As a formal matter of debt dynamics, the sustainability of the current account depends on the economy's growth rate and the real interest rate at which the country can borrow. But sustainability has another sense, of the ability to withstand shocks, and that is less susceptible to formal analysis. In any case, large current account deficits -- depending on the growth rate of the economy, in the range of 5-8 percent of GDP, and certainly any higher -- should be cause for concern. Current account deficits financed by longer-term borrowing and in particular by foreign direct investment are more sustainable; sizable deficits financed in large part by short-term capital flows are a cause for alarm.

18. It is sometimes difficult to deal with short-term capital inflows that are a response to high domestic interest rates, particularly in a context in which policy limits exchange rate flexibility. This is the famous <u>capital inflows problem</u> that so many countries seeking to stabilize from moderate rates of inflation have faced. There is no easy answer to this problem, but a tightening of fiscal policy is the first line of defense. A second response is to increase the flexibility of the exchange rate.

19. How flexible should exchange rates be? The recent experience of East Asia has reopened the question of whether any form of fixed exchange rate system is consistent with free capital mobility. The G-7 countries, except for those intending to join EMU, long ago decided on flexible rates. But freely floating rates, even among the major currencies, have moved excessively, and no developing country seeking growth through integration into the world economy would want to live with such fluctuations. East Asian countries were well served over a long period by exchange rate systems that either fixed the exchange rate or limited its flexibility, thus providing exporters and importers with a measure of exchange rate certainty that facilitated their participation in the international economy. Nonetheless, those countries that allowed the rate to float when threatened by an imminent speculative attack, made the right choice.

20. As more normal conditions return, the question of the optimal exchange rate system will be back on the agenda. There is no generally agreed answer to that question. Some conclusions are easy: if the exchange rate is pegged, it is almost certainly better to peg to a basket of currencies rather than a single currency. Beyond that, it may be that countries will return to some form of exchange rate band, with very wide margins, perhaps -- depending on domestic inflation -- a crawling band. If they do, they should stand ready if circumstances warrant, to move the band. In any case, the level of the exchange rate is bound to be a concern for policymakers, particularly in developing countries relying on export-led growth, and macroeconomic policy needs to be adjusted when the exchange rate (equivalently the balance of payments) shows signs of moving out of desired ranges.

B. Strengthening the financial sector

21. The critical role of the strength of the financial system was becoming clear before the Mexican crisis; it was crystal clear in that crisis and its aftermath; and it has been equally clear in the Thai crisis and its aftermath. Much of the extensive work done on this issue in the last few years will be discussed here in Hong Kong at conferences early next week. The Fund staff's important paper, "Toward a Framework for Financial Stability" will be made available at that time, and I refer you to it for a detailed analysis of what is required for a healthy banking and financial system. By now, policymakers have a good idea of what needs to be done to strengthen financial systems, by improving supervision and prudential standards, by ensuring that banks meet capital requirements, provision for bad loans, limit connected lending, publish informative financial information, and by ensuring that insolvent institutions are dealt with rapidly. Implementing those changes, particularly in a banking system already in trouble, is frequently difficult, especially where political pressures hamper the supervisory authorities. The task is nonetheless urgent, both in countries now seeking to recover from recent crises, and those that seek to avoid future crises: it cannot be emphasized strongly enough that a healthy banking and financial system is essential for the growth of the economy, and that a weak banking system is both a standing invitation to a macroeconomic crisis and a guarantee of the severity of any such crisis.

C. Phasing and the use of controls

22. There are obvious dangers in liberalizing capital movements in an economy in which the macroeconomic framework and the financial sector are weak. There is thus a case for phasing capital account liberalization, paying due regard to the country's macroeconomic situation (including the balance of payments), the stage of development of its financial markets and institutions, and the impact of existing controls. But in this area, as in the case of more familiar structural reforms, there are few hard and fast rules, and some countries -- notably Indonesia -- successfully liberalized the capital account very early in the reform process.

23. Absent the coordination of capital account liberalization and financial sector reform, there may be regulatory distortions and regulatory incentives for capital movements that are unrelated to underlying economic conditions. Both factors could risk instability in capital movements. Weak domestic financial institutions may be incapable of efficiently intermediating large flows of funds to which they obtain access as a result of capital account liberalization; they may in addition be adversely affected by movements in asset prices that result from international capital flows. Most importantly, weak financial institutions are especially vulnerable to potential reversals of capital flows.

24. The obverse side of the phasing of liberalization is the continued use of capital controls. Let me first offer a general perspective on the use of controls. Controls, except for prudential controls, are generally inefficient and costly for the economy. They are viewed by markets as an additional country risk factor, and their prolonged use has often been associated with capital flight. Countries that have already removed controls are unlikely to reimpose them except perhaps on a limited basis, temporarily, for emergency purposes. Countries that now have non-prudential controls in place will remove them, generally gradually, perhaps in a big bang. Countries that retain some controls may seek to refine them, removing those that cause the greatest distortions, perhaps replacing them with less distortionary controls -- just as tariffs often replace quotas at the start of trade liberalization. Against the background of a general trend of progressive capital account liberalization, we need to consider the controls that are likely to be in place during transitional periods.

25. A theoretical case can be made for countries whose financial systems are not sufficiently robust to restrict selected forms of capital inflow, for instance the short-term inflows that produce the capital inflows problem. A judgment on whether any particular restriction in a particular country is desirable would have to take into account the costs of such restrictions, their effectiveness or lack thereof, the speed with which they will lose effectiveness, as well as their potential benefits if any. Whatever controls might be imposed, they are likely to do less damage if they are market-based, for instance taking the form of reserve requirements on foreign deposits, rather than quantitative. Controls on outflows may have been imposed for balance of payments reasons and retained both for that reason and because they provide a captive source of funds for domestic financial institutions. Their gradual removal is generally desirable.

26. Prudential controls on foreign capital are already in place in many countries, for instance restrictions on the open positions domestic banks can take in foreign currency. Similar restrictions could be contemplated on open positions taken by corporations. Such controls, intended to reduce the vulnerability of domestic institutions to shifts in foreign capital flows, could well form part of internationally accepted prudential standards.

27. Every currency crisis produces demands to do something about hedge funds and speculators. Usually the anger at the speculators would better be aimed closer to home, and in practice nothing much has yet been done to tame them. Still, occasional cases of market overreaction raise the question of whether better provision of information to and by market

participants, as well as improved prudential regulations, could increase the efficiency of the markets. Since speculative positions have counterpart transactions in the domestic economy, we need to ask whether prudential regulation of the domestic economy could reduce the occasional excesses of speculative attacks, perhaps thereby also increasing the efficiency of the international capital markets. These are issues that deserve serious analysis.

D. Information provision

28. One of the many lessons drawn from Mexico was that the extent of the crisis was worsened by the poor quality of information supplied to both the official sector (including the IMF) and the markets. Specifically, information on reserves was provided with a long lag, and information on the structure of the external debt was not readily available. As a result, the IMF's data standards initiative was initiated and the Special Data Dissemination Standard was established in early 1996. Considerable progress has been made with the development of the associated Dissemination Standards Bulletin Board.[3] The Thai crisis reinforces the argument for better and more timely provision of information, including information on central bank forward operations. There are two arguments for the provision of such information. First, better informed markets are likely to make better decisions. In each of the Mexican and Thai crises, this would have meant that the markets would have withdrawn funds sooner than they did, thereby hastening adjustments that needed to be made in each of those cases. Second, the obligation to publish information on certain interventions would affect the extent and nature of those interventions, and help prevent some unwise decisions.

29. There is much work to be done in thinking through the question of the optimal extent and timing of information provision. If the policy game is thought of as a battle between the authorities and hostile markets, then the official penchant for secrecy is easy to understand. If instead, the problem is thought of as one of designing a framework to influence both the choice of policies, and the effectiveness of markets in responding to and disciplining policies, then the case for more information provision is strengthened. As that framework is developed, we will also have to consider the information that market participants need to make public in order to discipline their own actions and increase the efficiency of markets. These issues will surely be on the agenda in the next few years.

E. The role of surveillance

30. Since the Mexican crisis, the IMF has placed increased emphasis on timely surveillance of market developments. It is fair to say that the Fund's new surveillance procedures worked well in the case of Thailand, and reasonable to expect they will work well in future. But it would be a mistake to imagine that the Fund or any other surveillance could ever be made

---

[3] This electronic bulletin board on the Internet provides information concerning countries' economic and financial data systems. By September 1997, there were 43 subscribers, including Hong Kong, China.

perfect. The Fund will surely miss the warning signs of some future crisis, and just as surely will predict some crises that do not happen. The international system cannot be built on the assumption that improved surveillance, or the increased provision of information to markets, will prevent all future crises, even though they should reduce the frequency of crises. The effectiveness of Fund surveillance is also limited by the fact that a country may be warned but not take action. Because the Fund's ability to conduct its surveillance depends on its privileged access to information, it is not in a position to enlist the markets in the cause of surveillance by making its concerns fully public. That is a limitation that we will have to accept.

31. Fund surveillance operates at the global level. There is in addition room for mutual surveillance within smaller groups of countries, such as those in the OECD, or in the European Union. Such mutual surveillance enables countries with similar experiences, or likely to be affected by what their neighbors do -- for instance different groups of Asian countries -- to become more familiar with the policies of fellow group members, and to exert mutual pressures for good policies. To be effective such surveillance should be based on a sound analysis of the economic situation, and here the Fund is willing to play its part in supporting regional and other groups.

32. After a crisis, we in the Fund sometimes hear the refrain, generally from policymakers but sometimes from the markets, "But no-one -- including the Fund -- warned us of the dangers we faced". When such a complaint is accurate, and after every crisis, we need to draw the lessons and seek to improve our performance. At the same time, it is important not to lose sight of where the primary responsibilities lie. The prime responsibility for pursuing the right policies rests with the national authorities; the Fund and neighbors can provide information, analyze, suggest, seek to persuade, and cajole, but it is ultimately the government that has the duty to evaluate the situation and make the right decisions. There is also a responsibility on market participants to appraise the underlying economic situation accurately; if they do so, market incentives will ensure that markets operate efficiently. The prime responsibility for correctly evaluating the economic situation rests with market players, provided they are given the information they need.

F. The need for financing

33. No matter how much information is provided to markets, surveillance is strengthened, prudential regulations are refined, and government policies improve, crises will happen. In a crisis, private sector financing evaporates, and countries are forced to take painful adjustment measures. One of the purposes of the IMF set out in the first Article of Agreement is "To give confidence to members by making the general resources of the Fund temporarily available to them under appropriate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity". The Fund -- that is the international community -- has shown its willingness to act in this way in many crises. The Fund will continue to act in

accordance with its purposes, and to provide financing, with the conditionality that provides the safeguards referred to in Article I (v), to countries faced with the need to take actions to stem the destructive effects of an external crisis.

34. The Mexican and Thai crises, and the proposed capital account amendment of the Articles of Agreement have raised two important interrelated questions about Fund lending: first, whether the increased scale of international capital flows requires a reexamination of the criteria that determine the size of Fund loans; second, whether the Fund's willingness to lend in such circumstances creates a moral hazard. The answer to both questions is yes. As the efficiency of the international capital markets improves, it is reasonable to expect that there will be fewer crises requiring official funding in future, but it is also likely that they will be on a larger scale than typical in the past. In both the Mexican and Thai crises, the Fund was able to provide very large loans relative to the country's quota by invoking the "exceptional circumstances" clause, and such a route will be available in the future. But if capital account liberalization increases the likelihood of larger, even if fewer, crises, it would also be appropriate to review Fund lending criteria, to ensure that Fund loans -- in some cases together with supporting funding -- will remain adequate to their task.

35. There is no question that the Fund's willingness to lend to countries in trouble creates a moral hazard. The hazard is not that the availability of Fund financing in emergencies encourages countries to behave recklessly, for Fund conditionality is such that governments in trouble are usually too slow rather than too fast to come to the Fund. Instead the hazard is that the private sector may be too willing to lend, because it knows that a country in trouble will go to the Fund rather than default. Spreads in some markets are so low as to support this view. The international community has struggled with the question of how to reduce this moral hazard, but has not yet found a good solution. We need to find one, a way of ensuring that the private sector shares in the financial costs of dealing with crises.

36. The regional roles in financing in both the Mexican and Thai crises raise the question of whether more permanent regional financing arrangements need to be put in place, to provide reassurance to countries that they will receive adequate help in crises. We see an important role for regional groups in the prevention of crises, by improving surveillance. We are more sceptical about the establishment of large regional funds for crisis financing, especially when their creation runs the risk of reducing the conditionality attached to crisis financing. The existence of such funds would also increase moral hazard, by making it clear to speculators that more official financing is available if a crisis hits.

37. One classic rule of lender of last resort financing, intended to reduce moral hazard, is not to be too clear about the circumstances and amounts in which such lending will be available. There is thus a tradeoff between the volume of funds known to be available to deal with crises, and the likely size of crises. This is a consideration that has to be weighed in considering both the size of Fund lending limits, and the desirability of prepositioning regional support funds rather than leaving them to be arranged on an ad hoc basis.

IV. The Role of the Fund and the Capital Account Amendment

38. Finally, let me turn briefly to the proposed amendment to the Articles of Agreement to extend the Fund's jurisdiction to capital movements. Against the background of the increased importance of capital movements for the operation of the international financial system, many countries have been liberalizing the capital account. Such decisions have potentially important effects on the balance of payments and on the demand for Fund resources. De facto, the Fund has become increasingly involved in helping member countries liberalize in a manner that does not undermine economic and financial stability. Yet the only formal jurisdiction the Fund has in this area is the right to require countries to impose capital controls in certain contexts.

39. In April of this year the Interim Committee of the IMF agreed that there would be a number of benefits from amending the Fund's Articles of Agreement to make the liberalization of international capital movements a central purpose of the Fund and to extend the Fund's jurisdiction to capital movements. In a nutshell, **the prime goal of the amendment would be to enable the Fund to promote the orderly liberalization of capital movements.**

40. In doing so, it is likely that the Fund will develop the analogies for the capital account of the present Articles VIII and XIV that apply to the current account. When they are ready, members accept the obligation under Article VIII, to refrain from imposing restrictions on the making of payments and transfers for current international transactions. In accepting the obligations of Article VIII, a country provides confidence to the international community that it will not impose restrictions on the making of payments and transfers for current international transactions without Fund approval and will, therefore, pursue policies that will obviate the need for such restrictions. Until a country is ready to accept Article VIII, it may, under Article XIV, maintain and "adapt to changing circumstances" existing restrictions that were in place when it joined the Fund, until its balance of payments position is sufficiently strong that reliance on exchange restrictions is no longer warranted. This framework has allowed the Fund to take account of the different starting positions of its members and has, at the same time, provided a basis for dialogue between the Fund and the member on the appropriateness of its restrictions and the policies and reforms that would be necessary to allow for their elimination.

41. Similarly, in the case of the capital account, we can envisage members eventually accepting the obligation to liberalize the capital account fully -- though what precisely that means will have to be worked out. Until they are ready to do so, they would avail themselves of transitional arrangements that would be approved by the Fund. Members would be able to adapt to changing circumstances the controls in place when the amendment comes into force.

New restrictions could be approved to reflect considerations of market and institutional evolution and for prudential reasons. The Fund might also have provision to approve temporarily restrictions needed to address macroeconomic and balance of payments problems. Similarly to the acceptance of Article VIII, a members's acceptance of the new obligations with respect to capital movements would send a clear signal of its intentions to the international financial community, and could serve to strengthen its access to international capital markets.

42. If this framework is adopted, the Fund will have to develop its analysis and evaluation of different types of capital controls, to advise countries on which types of controls are most likely to help them attain their goals, and on optimal methods of liberalization. In doing so, we will need to distinguish: between controls on capital inflows and capital outflows; between general and selective controls; between market-based and quantitative controls; between prudential controls and those imposed for balance of payments or macroeconomic reasons; and among controls on different types of capital flow -- and no doubt among other categories of controls too.

43. A capital account amendment that provides for a transitional period during which capital controls could remain in place, would make it possible for the Fund to encourage the liberalization of capital flows while paying due regard to the varying circumstances of members. It would facilitate the establishment and application of a universally-applied code of good behavior in the application of capital controls, enabling the Fund to determine when macroeconomic, structural, and balance of payments considerations require adherence to -- or permit exemptions from -- obligations relating to capital account liberalization. This is of particular importance in light of the fact that the Fund may also be called upon to finance the balance of payments problems that are caused by capital movements.. And by giving the Fund jurisdiction in the area of capital movements, it would strengthen the Fund's surveillance role over international capital flows. The extension of Fund jurisdiction would thus complement rather than duplicate existing bilateral, regional, and multilateral agreements and initiatives in this area.

V. Concluding Remarks

44. I hope I have explained why we believe a capital account amendment along these lines, including transitional arrangements, will be in the interests of all Fund members. We all recognize that an international environment of free international capital movements provides enormous opportunities, but also entails significant challenges and risks for countries and the international monetary system. Recent developments in this region remind us of these risks. But the many benefits countries in this region have derived from capital inflows also remind us that no country can afford to cut itself off from the international capital markets. The increasing importance of international capital flows is a fact, which needs to be better reflected in the laws and agreements that help bring order to the international economy, and to the

process by which individual countries liberalize their capital accounts. The proposed amendment to the Articles of Agreement will serve this purpose and our member countries well.

Eco— Capital Acct Convertibility cover + (keep w/ main Board paper when) Mr. Loser (F)

Office Memorandum

To: The Managing Director
The Deputy Managing Directors

February 4, 1997

From: Jack Boorman, François Gianviti, and Manuel Guitián F.G. MG

Subject: **Capital Account Convertibility—Revised Main Paper**

Attached please find the revised CAPCON main paper reflecting our discussion last week and the background paper on the Review of Experience with Capital Account Liberalization. The main changes in the paper are as follows:

- The most substantial revisions are in Section V, dealing with the scope of an amendment. In particular, the "broad approach" now proposes a coverage of underlying transactions similar to that under the OECD Capital Code. The proposed coverage would include all credit transactions between residents and nonresidents; transactions in securities and other negotiable financial claims; foreign direct investment; and personal capital movements. Given the breadth of this coverage, the discussion of approval policies and transitional arrangements has been adjusted to indicate liberal treatment of restrictions on inward FDI that are maintained for social, sectorial, and strategic reasons.

- The paper (Section IV) has also been revised to indicate the desirability of amending Article I, making the liberalization of international capital movements a specific purpose of the Fund.

- The section on approval policies (paragraph 74) now indicates that controls designed to change the composition of capital inflows (à la Chile) could be approved by the Fund for a more extended period in circumstances where the state of development of the financial system constrains the achievement of monetary/exchange rate policy objectives consistent with an open capital account.

We are of the view that the signaling effect of the amendment is probably severely muted by the liberal treatment of restrictions on inward FDI. On the one hand, realism would seem to demand such leniency; on the other hand, it will likely lead to a system under which a vast majority of the countries have some restrictions on FDI which would appear to limit the signaling effect.

R:\DOC\ER\CAPCON\PAPER\COVEMGT2.MEM February 4, 1997 (2:33pm)

So that we can issue the main paper sufficiently in advance of the Board seminar on February 19, 1997, and so that it can reach the Deputies before their meeting next weekend, may we have your approval by noon, Wednesday, February 5, 1997. In this connection, we need to consider the representation of the Fund at the Deputies' meeting.

Attachments

cc: Heads of Departments:
AFR, APD, EU1, EU2, FAD, MED, RES,
SEC, STA, TRE, WHD, PAR, GEN
Mr. Russo
Mr. Quick

Office Memorandum

Eco - Capital acct. Convertibility
Mr. Loser

To: The Managing Director
The Deputy Managing Directors

January 17, 1997

From: Jack Boorman, François Gianviti, Manuel Guitián

Subject: **Capital Account Convertibility--Main Paper**

Please find attached for your guidance and approval the above-referenced paper.

Most commenting departments expressed general support for the paper. RES and TRE took the view that there is sufficient flexibility under the existing Articles for the Fund to promote capital account liberalization. RES, STA and WHD questioned the appropriateness of excluding foreign direct investment under a possible amendment that follows the "broad approach".

In the context of a possible amendment, there are differences in views among the drafting departments regarding the provision of Article VI, Section 1(a), which limits the Fund's ability to finance large or sustained capital outflows. The attached draft presents three possible alternatives (maintaining, modifying, or deleting the provision), without expressing a preference. MAE believes that the paper should simply propose deletion of the provision, on the grounds that, with an extension of jurisdiction to capital, there need no longer be any distinction in the Articles themselves between the financing of current and capital transactions. MAE feels that the Fund has sufficient authority under other provisions of the Articles (Article V, Section 4, for overall access, and Article V, Section 3, for conditionality) to ensure that an extension of jurisdiction does not impose undue risks for its resources. While LEG and PDR agree that reliance on such provisions is an option to be presented to the Board, they prefer the neutral approach taken in the paper with its three alternatives. Their concern is that an explicit recommendation to delete the limitation in Article VI would risk sending a misleading signal at this early stage regarding the implications of an amendment for the use of the Fund's resources.

As you may be aware, the G-10 Deputies are scheduled to meet to discuss these issues on February 9, and it might be useful for them to have this report available ahead of that meeting.

In the circumstances, we would like to request your approval by Friday, January 24, 1997.

Attachment

cc: Heads of Departments: AFR, APD, EU1, EU2, FAD, MED, RES, SEC, STA, TRE, WHD, PAR, GEN
Mr. Sugisaki
Mr. Quick

Ex - Capital Acct Conv. CL
EHC
LDD
IO
F

Office Memorandum

To: Mr. Guitián

January 14, 1997

From: David Williams

Subject: **Capital Account Convertibility and the Role of the Fund–Review of Experience and Considerations of a Possible Amendment of the Articles**

Some general comments are given below, given the very tight deadline:

1. The potential impact on the demand for and the safeguarding of the Fund's resources of the proposed change in the Articles deserves much more attention than is given in the topic of this paper. While the paper raises these issues (for example, in paragraphs 70-72), it does not explore them. Clearly, the resource and potential risk implications of a more active stance by the Fund to possibly commit resources in the context of a liberalized system of capital transactions are not inconsequential. The paper notes that the Fund would not seek such liberalizations without prior assurance that the domestic banking systems are sound, etc., but this would require much more expertise and work on the part of both country authorities and Fund staff. More worryingly, the paper seems also to advocate the use of Fund resources to finance large and sustained outflows of capital which may, in any case, be contrary to the wider goal of achieving stability in the system. For a stable system the Fund could and should finance reversible payments deficits, even if they are large (e.g., Mexico), and this is already Fund policy. If the present limitations on the use of Fund resources for financing large and sustained outflows of capital were relaxed, and members were to face a potentially wider array of payments problems, they would need a larger safety net from the Fund through higher quotas, more liberal access policies, and perhaps more frequent SDR allocations.

2. I am in sympathy with the cautionary views of RES as regards the need to amend the Articles of Agreement. Specifically, we view capital transactions as fundamentally different from current transactions in that the former can take on many forms and whose gross volumes are typically a multiple of that of associated current transactions. Unfettered transactions in financial assets raises substantially the likelihood of financial crises, and this, prima facie, calls for some form of regulation or controls.[1] Trade in goods and services, on the other hand, is generally more visible and easier to monitor than trade in financial assets, and in any event, the transfer of resources (savings) from capital-rich to capital-poor countries necessarily takes place through imbalances in the current account and not solely through capital or financial transactions. In short, we would feel more comfortable with a scenario in which the Fund continues to promote the liberalization of current account transactions, and

---

[1]The domestic market analog is the need for a regulatory authority, for example, over stock and bond markets to avoid fraud and market excesses.

the transactors themselves bring pressures on their governments to liberalize the associated capital transactions. This hierarchy of roles seems more natural, retains the Fund's traditional catalytic role, and leaves the Fund out of potentially difficult jurisdictional issues that are likely to arise in its relations with its members. In any case, we believe that the present Articles provide an adequate mandate for surveillance of capital markets (Article IV, Section 1, explicitly includes capital flows as well as the exchange of goods and services).

3. We also wonder whether the paper should not strengthen the case by providing some quantification of the net benefits of capital account liberalization. So much of the paper seems to assume that this net benefit is always positive. Even if so, the relevant question is whether it is worth the effort of amending the Articles.

cc: Mr. Mussa
Mr. Boorman
Mr. Calamitsis
Ms. Carson
Mr. Chabrier
Mr. Gianviti
Mr. Loser
Mr. Münzberg
Mr. Neiss
Mr. Odling-Smee
Mr. Russo
Mr. Saito
Mr. Tanzi
Mr. Brachet
Mr. Tait

Mr. Loser
CL
EHC
CDD
IO
F

Ew -

Office Memorandum

To: Messrs. Boorman, Gianviti and Knight

January 13, 1997

From: Hubert Neiss HN

Subject: **Capital Account Convertibility Paper**

Thank you for sending us this interesting and important paper for comment. The paper provides a careful and balanced assessment of issues in extending the Fund's jurisdiction to capital account transactions and our comments deal mainly with points of emphasis and clarification. The paper correctly, in our view, emphasizes that an extension of the Fund's jurisdiction to the capital account would raise a host of very difficult legal and economic issues, consideration of which will require much additional work. We would have liked also to have seem some discussion of what extending the Fund's jurisdiction would imply for the work of Area Department missions, particularly if the jurisdiction were to be applied to the underlying capital transactions.

1. We were surprised there was not more discussion of the consistency between capital account liberalization and the Fund's mandate to promote a stable system of exchange rates. We would suggest to include some discussion of how an extension of jurisdiction would influence our mandate to foster exchange market stability and how we would deal with controls imposed to reduce exchange rate volatility. In addition, there could be some discussion of the implications of capital account liberalization for members' choice of exchange rate regime.

2. The paper makes the point that the Fund has tended to rely more on "persuasion" than jurisdiction in promoting current account convertibility. If this is the case, however, the argument for extending jurisdiction to the capital account—rather than continuing to encourage liberalization during the Article IV process—needs to be strengthened. Are we dissatisfied with the progress toward capital account liberalization or concerned about backsliding? Is it the intention for the Fund move away from the persuasive approach and begin to be firmer in the application of its jurisdiction?

3. If jurisdiction were extended to the capital account, we agree it would probably need to be applied to the underlying transactions in order to be effective and that it would also have to be applied to inflows and as well as outflows (cf. the current account). The extension raises a number of questions: a. Would Fund jurisdiction over the current account continue to apply only to outflows? In the event that such jurisdiction were applied to inflows, would existing restrictions on inflows be grand fathered or immediately become subject to Article VIII? b. How would the Fund deal with the approval of restrictions on inflows? Obviously, balance of payments need cannot be the basis for such approval but we are

skeptical about using criteria such as whether the member is following the "right" macroeconomic policies. Perhaps, the consistency of the restriction with the Fund's mandate to promote exchange market stability could be the basis for the temporary approval of restrictions? c. There is the possibility that certain transactions currently classified as current transactions for jurisdictional purposes (for example, regular amortization) might be reclassified in the event that our jurisdiction was broadened. Alternatively are some capital restrictions to be judged in terms of whether there is a limitation on the underlying transaction and others by whether the restriction is applied through the exchange system? Finally, a general question that needs to be addressed is whether the Fund would regard current and capital transactions as equally harmful to the functioning of the international monetary system. Alternatively, would we tend to put more emphasis on the early removal or restrictions on current transactions?

4. Any extension of the Fund's jurisdiction to underlying capital transaction would, especially in the event of financial services, raise issues of jurisdiction with the WTO. We assume that these issues have been covered in the background papers.

cc: Heads of Area Departments
FAD, RES, SEC, PAR and GEN
Mr. Saito

Contributor:
Charles Adams

Mr. Loser
ECO - Capital acct. Convertibility
CL
EHC
LDD
IO
F

Office Memorandum

To: Mr. Boorman
Mr. Gianviti
Mr. Knight

January 13, 1997

From: Donald J. Mathieson DJM

Subject: **Capital Account Convertibility and the Role of the Fund**

This paper carefully and clearly lays out the argument in favor of an amendment to the Articles of Agreement to give the Fund a clearer mandate to pursue capital account liberalization. This department's position remains, as expressed in Mr. Mussa's June 7, 1996 memo to Mr. Fischer, that the Fund has sufficient flexibility within the existing Articles to meet this objective, and that there are significant risks associated with attempting to reach agreement on an Amendment.

Pertaining to the current draft of the paper, we see two important difficulties. The first is that while the paper notes on a few occasions (e.g., pp. 25, 43) that there may be valid grounds for maintaining some kinds of controls on capital flows for prudential reasons and to limit the exposure of the financial safety net, the paper seems to recommend that such considerations be left to future discussion. There is no mention of this rationale for controls in the proposed Amendment. We feel strongly that any Amendment must include an allowance for capital controls for prudential purposes at the outset. Clearly, it will be the responsibility of the Executive Board, on a case by case basis, to judge whether particular measures introduced by member countries meet this criterion.

A second difficulty with the proposed Amendment is the separation that the paper attempts to draw between controls on foreign direct investment (FDI) and controls on the resulting "payments and transfers." We are doubtful that it is possible to draw a sufficiently clear distinction between the underlying FDI transactions and other types of capital flows to make this separation workable. Moreover, controls on foreign direct investment that take the form of domestic ownership regulations, for example, would also restrict portfolio investment flows into equity markets. More generally, we are not convinced of the need for, or feasibility of, restricting the Fund's capital account liberalization policies to only those types of capital flows that "have the most significant impact on the Fund's role." Why should all capital flows not be covered by a liberalization program, particularly given the ease with which capital transactions can be re-engineered to get around restrictions?

cc: Mr. Mussa, Mr. Calamitsis, Mr. Chabrier, Mr. Guitián, Mr. Loser, Mr. Neiss, Mr. Odling-Smee, Mr. Russo, Saito, FAD, SEC, PAR, GEN

Contributor:
Michael Spencer

- CL
EU
FUB
64
SD
IO
F

INTERNATIONAL MONETARY FUND

58, Rue de Moillebeau
1209 Geneva, Switzerland
Principal Office, Washington, D.C. 20431

OFFICE IN GENEVA

Cable Address
Interfund
Geneva
Telephone: (22) 918 0300
Facsimile: (22) 918 0303

10-100
ECO. Capital Acct Conv.

Facsimile Service Cover Sheet

Number of Pages:	3	**Date:** January 10, 1997	
To:	Mr. Boorman Mr. Gianviti Mr. Knight	**CC:** Heads of Area Departments FAD RES SEC PAR (direct)	AFR APD EUR I EUR II MED WHD
Facsimile Numbers:			
From:	Guler Fitzgerald		

Messages:

Please see attached on comments on Draft Board Paper on Capital Account Convertibility.

021467

97 JAN 10 PM 2:23

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

97 JAN 10 AM 11:

RECEIVED

Authorized by: **Signature:** Guler Fitzgerald

Office Memorandum

To: Mr. Boorman
Mr. Gianviti
Mr. Knight

January 10, 1997

From: Mr. Alan A. Tait

Subject: **Comments on Draft Board Paper on Capital Account Convertibility**

Thank you very much for sending us for comments the draft of your most interesting and well written paper. Clearly, this is potentially one of the most important papers to come before the Board in recent years.

Our main substantive comment relates to the relationship of any potential Fund jurisdiction on the capital account with existing rules of the GATS that in liberalized service sectors in some cases require countries to liberalize capital transactions and related payments. It would be useful to clarify for the reader whether this might imply an overlap of jurisdictions. For example, GATS rules seem to cover, for the opened sectors, payments and transfers for capital transactions (Article XI), free cross-border movement of underlying capital related to supply of a service from abroad (e.g. a resident purchasing securities in another country - mode 1) or inflow of funds related to services supplied via establishment (Article XVI, footnote 8), and that restrictions cannot be introduced either to the underlying transactions or related payments unless consultations are held with the WTO (Article XII).

More minor comments are:

Page 8. Para 13 contains some duplication with the previous para.

Page 12. The word "conclusion" in para 19 seems too ambitious in view of what follows in the bullets, which could be merged into a paragraph. There also seems to be some overlap between the first and second bullets.

Page 20. On para 31 third line, the text presumably refers to liberalizing trade in goods and services and not to liberalization of services as such, which is a much broader issue. Therefore the text should read "...a member liberalize trade in goods and services, and the associated payments..."

Page 21. On para 33 it might be useful to mention that capital controls under Article VI have never been introduced.

Page 27. Last sentence. Can we really talk about "experience" with the GATS as it only has been in existence for two years and no BOP restrictions have been notified? Moreover, as a warning, we should be aware that the WTO may consider that jurisdiction in this area is governed by the Vienna Convention that the most recent convention has precedence (i.e. GATS) and that the more specific treaties have precedence over the more general.

Box 1, second line of second para. Replace "recent" with "continuing", and in the third para eighth line, an example to clarify what is meant by the sentence that GATS signatories are not prevented from restricting the overseas activities of their local service suppliers would be useful (e.g. transactions related to credits from resident banks to nonresidents).

Page 39, paras 63 and 65. Would excluding FDI from coverage not lead to substitution with other types of financial flows in a same way as with short and long-term flows making the distinction difficult with modern techniques of "financial engineering"?

Page 48. It would be useful to mention how "admission of securities" is covered by the GATS in addition to the OECD Codes.

Page 50. Same as above vis-a-vis nongovernmental or proprietary actions.

Page 51, Para 78 mentions the treatment of branches and subsidiaries by FDI treaties. It would be useful to mention that GATS also covers transactions of foreign subsidiaries unless the access commitment is subject to reservations. Furthermore, your example of cross-border transactions in terms of credit from non-resident banks to a resident are also potentially covered for the resident country by the GATS with free cross--border transfers of related capital transactions.

Para 84. Add to the start of the third sentence "Recognizing that amending the Fund Articles might take some time would Executive Directors agree that an ..."

cc: Heads of Area Departments
FAD
RES
SEC
PAR

Mr. Loser

ECD —

CL

EHC

LDD

ID

F

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
97 JAN 13 AM 10:32

Office Memorandum

To: Mr. Boorman
Mr. Gianviti
Mr. Knight

January 10, 1997

From: Vito Tanzi Vito Tanzi

Subject: **Draft Board Paper on Capital Account Convertibility and the Role of the Fund**

We are in agreement with the general thrust of this paper, viz.,that the operations of the Fund should recognize more fully the dramatic changes in global capital movements. We agree with the approach that includes both an intensification of surveillance and technical assistance as well as an extension of jurisdiction through an amendment to the Articles of Agreement, to treat capital account payments and transfers more symmetrically with current account transactions. An amendment to the Articles of Agreement comports with the principle underlying the Executive Board's earlier expressed support of a strengthening of the Fund's surveillance and technical assistance activities in encouraging members to liberalize capital movements, as well as with the current Article XXX, which explicitly includes some capital flows in the definition of current payments. I wish to emphasize several points:

- Controls adopted temporarily and in response to crises should be distinguished from controls introduced for other reasons. For example, the market for capital is inherently imperfect, in any country or globally, as a result of information asymmetries (apart from those leading to sudden swings in market sentiment). It is important that any amendment to the Articles that places restrictions on a member's policy making in this area does not preclude legitimate national regulation to control monopolistic and other noncompetitive behavior in national capital markets.

- Similarly, many capital account transactions and associated payments and receipts give rise to a tax liability in national tax systems. Any amendment to the Articles extending jurisdiction to promote orderly liberalization of capital payments should not preclude the use by members' tax administrations of the most efficient administrative tools to assess, collect, and enforce national taxes.

- Similarly to the taxation of international capital transactions, quantity controls on international capital movements can have an impact on national budgets, indirectly through their effect on prices (e.g., on government borrowing costs) and through other means.

- While it may be true that a world with international capital movements is better off than one without such flows, there is no evidence that the benefits attributed in this paper to capital movements hold at the margin. The Fund's activities with regard to international capital movements may eventually need to be seen in the context of international collective action to address market failure.

- There are potential problems in limiting jurisdiction, under the broad approach, to a subset of underlying capital transactions (¶ 64), as it provides incentives to design economically equivalent transactions that fall formally outside the jurisdiction. In addition, the liberalization of only some transactions would compound the existing incentive for financial engineering of international transactions for tax avoidance and evasion purposes.

cc: Heads of Area Departments, RES, SEC, PAR and GEN

Mr. Loser

ECO

CL
EHC
LOD
IO
F

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
97 JAN 13 PM

Office Memorandum

To: Messrs. Boorman, Gianviti and Knight — January 10, 1997

From: Leslie Lipschitz LL

Subject: **Capital Account Convertibility and the Role of the Fund: Review of Experience and Consideration of a Possible Amendment of the Articles**

This is a very lucid and cogently-argued draft. It is weakened to some extent, however, by an appearance of one-sidedness, and the five points below all are in the direction of making the paper seem slightly less committed.

- Underlying much of the argument is an assumption that capital flows are equilibrating--that is, they discipline errant policymakers rather than themselves creating instability. (There is some cursory acknowledgment of the possibility of capital flows being disruptive (in paragraph 9) but it is only cursory and does not really impinge on the flow of the paper.) Thus it would seem that, as long as policies are sensible, we have little to fear from free capital flows. We would propose that the paper acknowledge much more directly that large shifts in capital (like exchange rates, stock market movements, and shifts in any asset markets) can reflect bubbles, bandwagon effects, and bouts of both *irrational exuberance* and depression. This would suggest that there are likely to be many instances of justifiable deviation from the new liberal norm that the paper proposes establishing.

- It is not at all obvious that *as a general matter, [Fund] financing is designed ...to reduce member's reliance on both capital and current transactions* (p 19). There are many cases of successful programs that have started and ended with capital controls in place, and these have remained in place for years afterwards.

- The problem with the case for universality (paragraph 43) is, of course, that it limits case-by-case pragmatism.

- The *narrow approach* seems something of a red herring. As is clear in paragraph 56, *as a matter of practice, controls on capital movements are... [almost always] imposed on the underlying transaction rather than on the associated payment and transfer.* The (negative) assessment of this approach is too long.

- The circumstances envisaged in paragraph 72 were not entirely clear to us. If massive capricious capital flows were to undermine economic developments in a country, would we expect the country to enter into negotiations with the Fund on a program before imposing the capital controls necessary to win some breathing space? Surely it would be important for the Fund to propose capital controls immediately to staunch the flow, and then to embark quickly on program negotiations.

cc: Heads of Area Departments, FAD, RES, SEC, PAR, and GEN

ECO.

CL
EHC
LDD
IO
F

Office Memorandum

To: Messrs. Boorman, Gianviti and Knight

January 10, 1997

From: C. Loser

Subject: **Comments on Capital Account Convertibility and the Role of the Fund**

This paper lays out some of the key considerations on this important topic, but I have a serious reservation about the underlying premise of the broader approach, as described in Section V, B.

This approach proposes to limit the coverage of transactions to those most closely related to the Fund's and identifies these transactions to be portfolio securities transactions and intermediated financial claims. It also explicitly excludes foreign direct investment (FDI), noting that "these transactions are generally regulated for social, sectorial and strategic reasons rather than concerns regarding the member's macroeconomic policies or its balance of payments position."

I strongly doubt that, in practice, we are able to distinguish among different types of capital movements. For example, transactions often recorded as FDI are actually short term flows related to the working capital of multinational corporations, and in countries with one or two large state enterprises in sectors such as petroleum, such flows could be large and could be used by the government to meet program targets. Also, the market is already very adept at bypassing a set of rules that applies to a subset of capital transactions--i.e., they would categorize nondirect capital transactions as direct..

The exclusion of FDI would mean that the Fund would implicitly approve of regimes that allocate FDI among sectors or otherwise restrict these inflows. As indicated by the experience of Chile, open regimes for FDI are crucial to helping a country improve its growth performance.

cc: Heads of Area Departments
FAD
RES
SEC
PAR
GEN

Mr. Loser

CL
EHC

Office Memorandum

ACTION

LDI
IO
(w/ ATTACH

To: Heads of Area Departments, FAD,
RES, SEC, PAR and GEN

January 7, 1997

F.G.

From: Jack Boorman, François Gianviti, and Malcolm Knight

Subject: **Capital Account Convertibility and the Role of the Fund: Review of Experience and Consideration of a Possible Amendment of the Articles**

Please find attached a draft of the above titled Board paper. We would appreciate if we could receive your comments on the draft by c.o.b Friday, January 10, 1997.

Attachment

cc: Mr. Guitian (o/r)

R:\DOC\ER\PAPERS\CAPCON\AREADPT.MEM January 7, 1997 (4:42pm)

Ew -

CL
EHC
LDD
IO
F

Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
97 JAN 16 AM 10: 26

To: Messrs. Boorman, Gianviti and Knight

January 10, 1997

From: Hari Vittas

Subject: **Capital Account Convertibility and the Role of The Fund**

1. We appreciated the opportunity to review this paper, which deals with a topic of potentially great significance in determining the Fund's role and responsibilities in the future. The draft is well organized and does a very good job in setting out the main issues that will need to be addressed by the Board before a decision can be made on how best the Fund should respond to the growing importance of capital flows in the international monetary system. However, given the complexity of these issues, it would be desirable to allow for more time for discussion at the staff level prior to submitting the paper to management and the Board.

2. The paper introduces an interesting distinction between a "narrow" and a "broad" approach to amending the articles and suggests that there is scope for discrimination in deciding which underlying capital account transactions should be subject to Fund jurisdiction under the second of these approaches. These ideas may turn out to be useful in helping to overcome the strong opposition of many developing countries to extending Fund jurisdiction to the capital account. However, some of the arguments that are made to support these ideas are not convincing. In particular, it is not entirely clear to us (a) why capital inflows would not be covered under the narrow approach; (b) whether it would be possible in practice to allow the continuation of restrictions on capital transactions on a selective basis without encouraging distortions and the associated wasteful use of scarce resources; and (c) why WTO or some other multilateral agreement on capital transactions could not (or should not) be relied upon to safeguard the freedom of underlying transactions if and when progress is made in liberalizing the payments system.

3. Discussions in other fora (e.g. the G-10) have suggested that the position of individual countries on capital account convertibility, and the Fund's role therein, may be influenced significantly by whether the explicit promotion of capital account liberalization would have implications for access policy and the adequacy of Fund quotas and/or borrowed resources. In view of this, you may want to include a preliminary (pre-emptive?) discussion of these issues in the paper.

4. A few more specific comments are attached. I would also note that we have not yet had time to look carefully at the text box on publicly traded securities, which relates closely to some OECD work that we have followed closely, but plan to do so over the weekend.

Attachment

cc: Heads of Area Departments, FAD, RES, SEC, and GEN

AFR, APD, EURI, EURII, MED, WHD

Contributors:
H. Vittas, E. Gardner, C. Clarke

COMMUNICATIONS DIV.
97 JAN 15 PM 3: 56
RECEIVED IMF

023504

ATTACHMENT

January 10, 1997

Specific Comments On Sections 4, 5 and 6 and text Box 1.

These sections do a good job in identifying and organizing the issues, but the rather uneven drafting makes for a difficult and confusing read. Perhaps this is inevitable in a paper that is neither an advocacy piece nor a neutral presentation of alternatives. There seems to be strong presumption in favor of an amendment, which if made explicit would allow for a much clearer presentation and perhaps would have a better chance of eliciting a focused Board discussion.

Text Box 1

First paragraph: NAFTA (although more than an investment treaty) is an important exception to the rule that bilateral and regional investment treaties do not have BOP safeguard clauses; also worth noting that bilateral and regional investment treaties focus equally on treatment of foreign investment (enterprises), which differs from the concept of "protection."

Second paragraph: mentions NAFTA but the text deals only with GATS; perhaps here is the place to mentions that NAFTA (like GATS) has a BOP clause.

Third paragraph: "above" not "previous" agreements; remove parentheses around description of EU arrangements and delete "although."

Para. 52 "As a general rule, however, they may restrict the underlying transaction itself" should be accompanied by a caveat such as "subject to the jurisdiction of the WTO." Similar statements appear in later sections and should be qualified by at least clarifying that such freedom relates to the current and prospective Articles of the Fund.

Para. 60 It is not clear what is meant by the OECD Code being "generally appropriate for the Fund's intensified focus on capital account regulatory issues."

Para. 62 Unless we missed it, there is no discussion in "previous sections" of the relevant underlying transactions.

Para. 67 The assessment of the broader approach mentions that this approach would offer greater liberalization, but this is a function not only of the number of categories of transactions included under Fund jurisdiction (as noted) but also the effective coverage of inflows as well.

Para. 71 The final sentence suggests that the existence of Article V, Section 4 would undermine the Fund's ability to provide members with "confidence to undertake capital account liberalization." This begs the question whether this confidence has been undermined for 50 odd years in the context of current account liberalization.

Para. 78 In the final sentence, the reference should be to investment treaties that focus on the "treatment and protection of foreign-owned enterprises...."

Para. 79 The presentation separates "direct investment" from other terms that will need to be defined in an amendment or in subsequent decisions. Unless there is a substantive reason for doing so, "direct investment" should be added to the illustrative list of other terms (or better yet deleted!).

Para. 81 We would be wary of describing possible changes to Article I as "consequential."

ECO —

CL
EHC
LDD
IO
F

Office Memorandum

To: Messrs. Boorman, Gianviti, and Knight — January 10, 1997

From: Wanda Tseng

Subject: **~~Capital~~ Account Convertibility and the Role of the Fund: Review of Experience and Consideration of a Possible Amendment of the Articles**

I have the following comments on the draft paper:

A main question for the Executive Board is whether there is a need for an amendment of the Articles to extend the Fund's jurisdiction to capital account issues. At the July 1995 Board discussion, most Directors took the view that sufficient scope was available to the Fund under the present Articles and under the surveillance decision to accommodate increased emphasis on capital account issues. This conclusion appears to be omitted in the paper's description of the July 1995 discussion. The paper presents a persuasive case for an amendment of the Articles, and the case would be strengthened if the earlier conclusion were confronted head on, with a clear explanation of why the thinking has evolved since the 1995 discussion and reasons for reassessing the case for an amendment. In this context, the issue for discussion raised in paragraph 83 and paragraph 85 seems to be the same. Also, giving the Fund sufficient powers to discharge effectively its mandate in overseeing the international monetary system is a much stronger argument for an amendment than addressing an asymmetry between the treatment of current and capital account transactions.

In the discussion about whether to retain the provision on the Fund financing large or sustained capital outflows, rather than focusing only on legal aspects, the paper should address why such a provision should or should not be retained--in terms of its economic effects and relationship to policies on use of Fund resources.

In the discussion of approval policies, there is a question as to how capital account liberalization would relate to conditionality policies, particularly those related to external borrowing. If such performance criteria on external borrowing were to be retained, would future Fund arrangements require approval for the imposition of a capital restriction? and would it not be somewhat inconsistent for Fund arrangements to be at odds with a policy on capital account liberalization?

On page 12, it is not accurate to limit the call for adjustments of fiscal and structural policies to cases "where lack of confidence in domestic policies underpinned adverse capital flows." In fact, fiscal policy adjustments were called for in many cases because of the excessive burden and or limitations of monetary policy in dealing with capital inflows.

cc: Mr. Munzberg
Heads of Area Departments, FAD, RES, PAR and GEN