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PPAA/98/11

INTERNATIONAL MONETARY FUND

IMF Institute

Capital Account Liberalization in the Southern Mediterranean Region¹

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September 1998

Abstract

The countries in the Southern Mediterranean region can benefit from the globalization of financial markets by moving to establish capital account convertibility. Some countries in the region (Egypt, Israel, Jordan, Lebanon, and Turkey) already have substantial capital account convertibility, while others (Algeria, Morocco, Syria, and Tunisia) still retain significant restrictions. This paper examines the extent to which the countries with substantial capital account convertibility need to reinforce their policies to sustain it, and identifies the actions the other countries need to take for an orderly transition to full convertibility. The paper also reviews some of the considerations regarding the speed and sequencing of the requisite policy actions.

JEL Classification Numbers: E63, F02, F21, F31, F33, F36

Keywords: capital account; convertibility; speed and sequencing of policy reforms

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¹This is an abridged version of a paper presented at the European Union's Seminar on the Southern Mediterranean Region, in Brussels, Belgium on April 2-3, 1998, and the Mediterranean Development Forum in Marrakech, Morocco, on September 3-5, 1998. The authors are grateful to numerous colleagues in the IMF, particularly Paul Chabrier, Joaquin Ferran, Henri Ghesquiere, Manuel Guitián, Martin Hardy, Barry Johnston, Mohsin Khan, V. Sundararajan, and Chong-Huey Wong for comments and suggestions, and to Ilse-Marie Fayad for research assistance and Farah Ibrahimi for editorial assistance.

I. INTRODUCTION

The countries in the Southern Mediterranean Region (SMR)² are facing an increasingly globalized world in which, it is widely acknowledged, they could reap considerable benefits if they were to fully liberalize their external accounts and establish full currency convertibility. All these countries, except two, have already established current account convertibility, and several have virtually established capital account convertibility. In varying degrees, however, these countries still need to take further actions to fully liberalize in an orderly manner their exchange systems.

In doing so, the SMR countries will be adapting to the profound changes in international capital markets that have taken place over the last two decades. Indeed, international economic integration has quickly taken hold in both the industrial countries and parts of the developing world, fostered by the relaxation of controls on current and capital transactions and broad economic liberalization. In several SMR countries, however, capital account convertibility remains tempered by deep-rooted concerns particularly about the potential volatility of capital flows, dating back to the early experience of the industrial countries and the more recent difficulties in Latin America and Asia. Those experiences, however, argue for the orderly and cautious progression to capital convertibility rather than against it.

²Defined in this paper to comprise Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, and Turkey. The European Union's New Mediterranean Strategy also includes Cyprus, Malta, and the former Yugoslavia in the group.

In the case of the industrial countries, the upheaval in the financial markets in the late 1960s and early 1970s, which culminated in the collapse of the Bretton Woods par value system, had a profound impact on capital liberalization. The initial reaction of these countries was to intensify exchange controls and to use them as instruments in crisis management. But they soon realized the ineffectiveness of controls, and by 1973, the tide of liberalization of exchange systems gained momentum. Today, none of the industrial countries maintains significant controls on capital movements (Shafer, 1995).

In the case of developing countries, as well, the past two decades have witnessed significant relaxation of restrictions on capital movements, particularly in Asia and Latin America. In pursuing capital convertibility, some removed most of their capital controls over a short period of time, while others proceeded more gradually (Quirk and Evans, 1995). However, the events in Mexico in 1994-95, with their spillover effects, and the more recent crisis in Asia in 1997 have rekindled the concerns of a number of SMR countries about the potential downside risks of capital account liberalization. However, these concerns need to be balanced by the realization that the recent volatility that faced Asian countries did not result from opening their capital accounts, but rather stemmed from the macroeconomic stances adopted, the institutional setting created, and the sequencing pursued in opening the capital accounts in these countries (Camdessus, 1998). The inadequate financial supervision and regulations, in particular, did not safeguard against the mismatch between short-term foreign liabilities and the term structure of assets.

This paper addresses five questions: (1) What are the benefits and costs of capital account convertibility? (2) What are the capital restrictions in effect in the SMR countries? (3) How close are the SMR countries to meeting the conditions for an orderly move to sustained full convertibility? (4) What actions do the SMR countries still need to take to meet those conditions? (5) How should they sequence those actions and how fast should they move?

II. THE BENEFITS AND COSTS OF CAPITAL ACCOUNT LIBERALIZATION

The benefits of globalization have not been shared equally by all the SMR countries. Although net private capital inflows have picked up in recent years, reflecting the progress achieved toward capital account liberalization in the region, they have varied considerably among these countries (Chart 1, Table 1). Lebanon, with virtually no exchange restrictions, had massive net inflows, while the country with the most exchange restrictions, Syria, had the least. Further, even though there are many factors affecting growth, the growth rates in the countries with most exchange restrictions, such as Algeria and Syria, have remained distinctly below those in countries with more liberal exchange systems (Chart 2).

The case for capital account convertibility can be made mainly on the basis of efficiency gains in global allocation of savings, and increased potential for foreign direct investment—both of which would help SMR countries achieve higher sustainable growth rates and reduce unemployment. Foreign direct investment depends also on the pursuit of appropriate economic policies and other factors, such as good governance, a sound banking

Chart 1. Private Net Capital Flows, 1996-97 Average
(in percent of GDP)

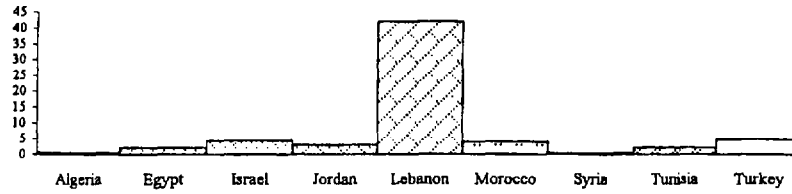


Chart 2. Growth Rates in SMR Countries, 1996-97 Average
(percentage change in real GDP)

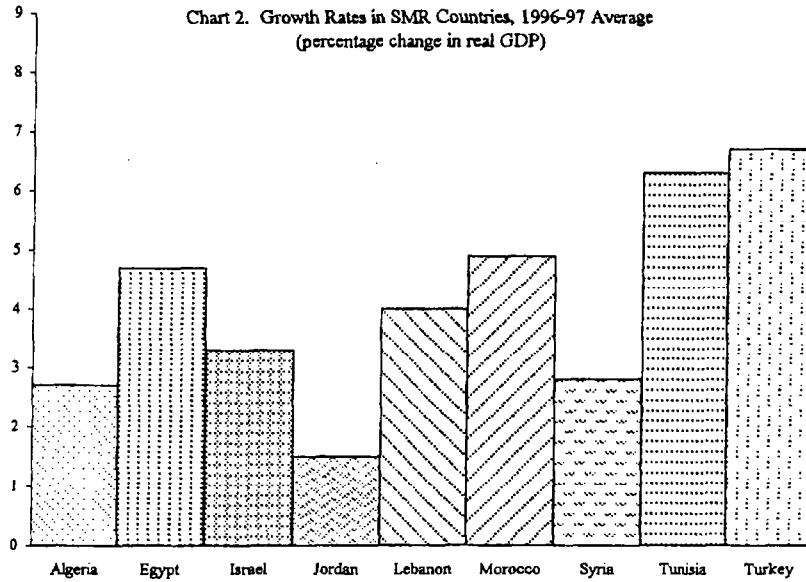


Chart 3. Central Government Balance, 1996-97 Average
(in percent of GDP)

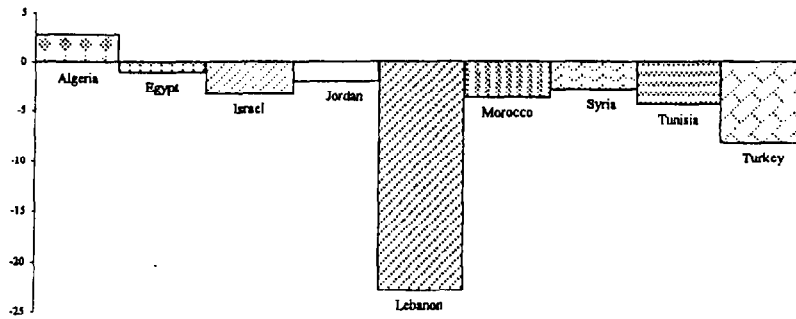


Chart 4. Current Account Balance, 1996-97 Average
(in percent of GDP)

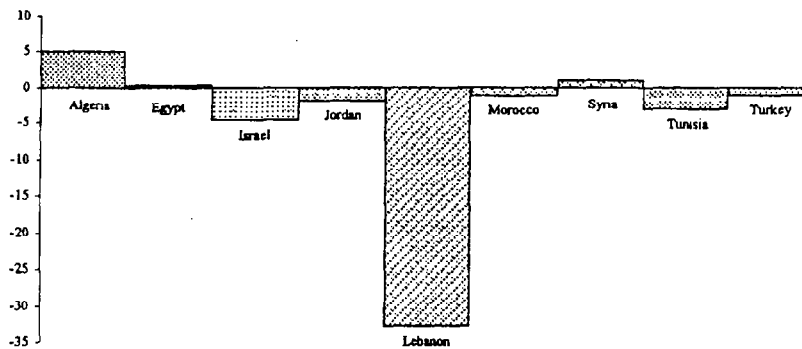


Table 1. Countries of the Southern Mediterranean Region: Selected Indicators, 1996-97 Average

	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia	Turkey
Growth rate (percent change in real GDP)	2.6	4.7	3.2	1.5	4.0	4.9	2.8	6.2	6.3
Rate of change in prices (percentage change in CPI)	12.2	6.7	10.2	4.8	8.3	2.0	5.4	3.7	82.8
Current account balance (in percent of GDP)	5.0	0.2	-4.6	-1.9	-32.8	-1.2	1.0	-3.1	-1.1
Net private capital flows (in percent of GDP)	0.6	2.1	4.5 1/	3.0	42.0	4.0	0.5	2.0	4.8
Foreign exchange reserves (in months of imports)	7.0	14.4	4.1	3.8	9.9	4.6	4.6	3.3	4.5
Real effective exchange rate (1990=100)	57.1	135.0	109.2	107.6	198.0	109.6	77.6	104.6	90.0
Gross external debt (in percent of GDP)	67.7	44.8 2/	50.3	93.5	17.5 2/	57.5	30.0 3/	48.7 4/	44.6
Central government balance (in percent of GDP)	2.7	-1.1	-3.3 5/	-2.0	-22.9	-3.5	-2.9	-4.4	-8.2
Weighted average tariff rates (in percent)	19.4 6/	28.0	7.2	16.5	24.2	19.3	35.0	32.0	...
Growth in broad money (in percent)	16.5	10.8	21.6	4.6	23.6	7.9	10.2	15.0	107.4
Nominal deposit rate	21.5	10.2	13.8	8.8	14.5	8.2 7/	7.0	7.8 7/	78.4
Interest rate differential 8/	15.8	4.6	8.2	3.2	8.9	2.6	1.4	3.0	72.2
Lending/deposit rate spread	...	4.5	5.9	4.6	8.3	5.9	0.25 9/	...	...
Banking sector indicators (1997)									
Capital/asset ratio	...	10.6	9.8 1/	16.9 1/	6.7	10.7	0.7 10/	6.2	9.3 1/
Nonperforming loans/total loans	...	...	...	...	11.4	11.2	...	22.4	...
Provisions/nonperforming loans	...	...	...	...	20.3	64.3	...	51.0	6.5 1/
Return/equity	...	...	9.3 1/	...	21.0	12.7	17.0	18.0 1/	20.8 1/
Foreign exchange deposit/total deposit	15.5	21.6	29.8 1/	18.3	60.1	...	20.6	-	51.7 1/
Foreign exchange liability /foreign exchange assets	...	78.5	91.2 1/	108.9	...	...	...	...	70.0 1/

Sources: Data provided by national authorities and IMF staff estimates.

1/ For 1996.

2/ Local currency government treasury bills and bonds are also held by non-residents and are not included in above figures.

3/ Excluding debt to the Russian Federation denominated in rubles.

4/ Medium and long term.

5/ Operational budget deficit.

6/ For 1998.

7/ Money market rate.

8/ Between average Eurodollar rate in London and average domestic deposit rate (money market rate for Morocco and Tunisia).

9/ Lending rate was computed as the average of lending rate range 7.5-9.0 percent.

10/ For 1995.

system, and a well-defined and effective legal framework. Removing controls on capital movements enhances global intermediation of resources through closer integration of financial markets and increased access of residents to foreign financial markets to finance trade and investment. In addition, increased cross-border competition provides a wider variety of risk adjusted rates of return, expands the opportunity for portfolio diversification, and enhances the efficiency of the domestic financial market. A rise in foreign direct investment can also foster technological transfers that increase productivity, competitiveness, and growth. Thus, even if gross capital inflows and outflows are balanced, asset holders would benefit from trading in financial assets owing to differences in preferences, production, and evaluation of risk.

Regarding the costs and risks associated with liberalizing capital movements, policy makers are also concerned about the possibility of massive net capital outflows as markets react to shocks or domestic policies. However, while markets may overshoot, with unwarranted contagion effects at times, evidence also shows that they generally react rationally in response to policy problems rather than whimsically (Fischer, 1997). Prudent macroeconomic policies and a sound domestic financial system are necessary in maintaining the confidence of both domestic and foreign asset holders. Second, ironically the obverse problem, namely a surge in capital inflows, is more common for countries opening their capital account in an orderly manner. This has been the case in Egypt and Jordan. The response to such surges has varied, depending on the circumstances of the country, and generally involves a mix of sterilization, fiscal tightening, and/or exchange rate appreciation (Schadler et al., 1993).

Another concern relates to the constraint on the effectiveness of monetary policy under an open capital account and a fixed exchange rate. However, given imperfect substitutability between domestic and foreign assets, monetary policy can still influence the domestic interest rate even in a completely open capital market. Furthermore, any loss in the effectiveness of monetary policy could be circumvented by adopting a floating exchange rate.

III. EXCHANGE RESTRICTIONS IN THE SMR COUNTRIES

This section highlights the main features of the remaining capital account restrictions in the SMR region and the progress that has been made to establish full currency convertibility. Full convertibility refers to the right of residents and nonresidents of a country to convert a national currency into other currencies at the prevailing exchange rate and to use the acquired balances for making international payments and transfers for any purpose. Full convertibility implies that there are no restrictions on underlying current and capital account transactions (Nsouli, 1996). The degree of convertibility prevailing in a country would thus depend on the extent to which that country institutes controls, restrictions, or quantitative or financial barriers on external transactions.³

All the SMR countries, except Egypt and Syria, have established current account convertibility by accepting the obligations under Article VIII of the Fund's Articles of Agreement (IMF, 1977b). This paper does not discuss current account restrictions, but

³See Guitián and Nsouli (1996) for a more detailed discussion.

focuses on the extent of restrictions on capital transactions in the SMR countries. Table 2 shows that controls on capital transactions vary considerably among the SMR countries from very few in Lebanon and Jordan to extensive in Syria.⁴ Restrictions vary from registration only to prior approval and licensing, quantitative restrictions, limits on the maturity structure of transactions, or outright prohibition. In general, capital outflows tend to be more tightly regulated than inflows.

With respect to direct investment, Egypt, Jordan, and Lebanon have virtually no stipulated restrictions. Israel maintains some on outward investment, while the remaining countries in the SMR group regulate to varying degrees both inward and outward investment. With regard to capital market securities and money market instruments, fewer restrictions are imposed, in general, on inflows than on outflows. However, in most SMR countries the financial markets are not sufficiently developed to freely encourage portfolio investment.

Lebanon, Israel, and Jordan have the most liberal capital and money market transaction codes, with no restrictions on either inflows or outflows through purchase and issuance transactions. While exchange regulations do not prohibit investment in domestic securities in the other SMR countries, restrictions on outward flows range from prior approval to full prohibition. Issuance of securities by nonresidents in the domestic market is unregulated in five countries (Egypt, Israel, Jordan, Lebanon, and Turkey), requires prior approval in

⁴Table 2 gives only an indication of the broad categories in which there are restrictions. This classification is based on a qualitative evaluation of the more specific restrictions, particularly on capital outflows by residents.

Table 2. Controls on Current and Capital Transactions in SMR Countries 1/

Category	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia	Turkey
Current account convertibility 2/	Yes	No	Yes	Yes	Yes	Yes	No	Yes	Yes
Controls on Capital Transactions									
Foreign direct investment									
Outward	Yes	No	Yes	No	No	Yes	Yes	Yes	Yes
Inward	Yes	No	No	No	No	No	Yes	No	Yes
Liquidation & repatriation	No	Yes	No	No	No	No	Yes	No	No
Capital market securities									
Purchase locally by nonresidents	n.a.	No	No	No	No	No	n.a.	n.a.	--
Purchase abroad by residents	Yes	No	No	No	No	Yes	Yes	Yes	No
Security issuance locally by nonresidents	n.a.	No	No	No	No	Yes	n.a.	Yes	No
Security issuance abroad by residents	n.a.	--	No	No	No	Yes	n.a.	Yes	--
Money market instruments									
Purchases locally by nonresidents	n.a.	--	No	No	No	No	Yes	Yes	--
Purchase abroad by residents	Yes	--	No	No	No	Yes	Yes	Yes	--
Issuance locally by nonresidents	n.a.	No	--	No	No	Yes	n.a.	Yes	Yes
Issuance abroad by residents	n.a.	--	No	No	No	Yes	n.a.	Yes	--

Table 2. Controls on Current and Capital Transactions in SMR Countries 1/

Category	Algeria	Egypt	Israel	Jordan	Lebanon	Morocco	Syria	Tunisia	Turkey
Derivatives									
Purchases locally by nonresidents	n.a.	n.a.	No	--	No	Yes	Yes	Yes	No
Purchases abroad by residents	Yes	n.a.	No	Yes	No	Yes	Yes	Yes	No
Profit repatriation and liquidation of capital	No	Yes	No	--	No	No	Yes	No	No
Credit operations									
Commercial credit									
Inflow	n.a.	No	No	n.a.	n.a.	n.a.	n.a.	Yes	No
Outflow	Yes	n.a.	No	No	Yes	No	Yes	Yes	n.a.
Financial credit									
Inflow	n.a.	n.a.	No	No	No	No	n.a.	Yes	No
Outflow	Yes	n.a.	Yes	No	No	Yes	Yes	Yes	n.a.
Deposit accounts of									
Nonresidents in foreign exchange	No	No	No	No	No	No	No	No	No
Nonresidents in local currency	No	No	No	No	No	No	No	No	No
Residents abroad	Yes	Yes	Yes	No	No	Yes	n.a.	Yes	No
Residents in foreign currency	No	No	No	No	No	Yes	Yes	No	No
Residents account convertibility	Yes	No	No	No	No	Yes	Yes	Yes	Yes
Nonresidents account convertibility	Yes	No	No	No	No	No	Yes	No	Yes

Source: IMF, Annual Report on Exchange Arrangements and Exchange Restrictions, 1997.

1/ Based on reporting reflecting end of 1997. "n.a." indicates unavailability of information; "yes" indicates controls are practiced; "no" indicates transactions are not restricted; and "--" indicates no reference has been made to that transaction in the exchange arrangements of the country. Control could range from prior approval to full prohibition.

2/ Based on the acceptance of the obligations under Article VIII of the Fund's Articles of Agreement.

Tunisia, and is prohibited in Syria. Three countries (Israel, Jordan, and Lebanon) allow unrestricted outflows and inflows of transactions in monetary instruments.

Tunisia is the only country to regulate commercial borrowing from abroad, while Algeria, Lebanon, Syria, and Tunisia impose controls on lending abroad. All the countries in the group permit nonresident accounts in foreign currencies and domestic currencies, although resident account convertibility is more regulated. Only four countries (Egypt, Israel, Jordan, and Lebanon) allow such convertibility freely into foreign exchange.

IV. PRESENT CONDITIONS FOR CONVERTIBILITY

For an orderly move to establish full and sustainable convertibility, thereby maximizing the potential benefits and minimizing the risks, the country concerned must meet a number of requirements relating to the macroeconomic and structural policies, including the financial sector. These preconditions comprise prudent fiscal and monetary policies, a market-clearing exchange rate, an adequate level of international reserves, a sound financial system, and a market-oriented incentives system (Gutián and Nsouli, 1996, and Mathieson, 1993). This section reviews the extent to which the SMR countries meet those conditions. For purposes of analysis, the countries are divided into two groups: (1) those with substantial capital account convertibility (Egypt, Israel, Jordan, Lebanon, and Turkey), and (2) those that still maintain significant restrictions on capital transactions (Algeria, Morocco, Syria, and Tunisia).

Fiscal policy: A prudent fiscal policy is viewed as an important element in an orderly move to and in maintaining capital convertibility. Large fiscal deficits that require financing through money creation raise the risk of destabilizing the exchange rate and discourage both foreign and domestic investment in the economy. Large budget deficits financed from abroad through high interest rates exacerbate debt management, reduce creditworthiness, and weaken the economy's ability to manage external shocks (Quirk and Evans, 1995). Based on average annual performance in 1996–97, among the countries with substantial capital account convertibility, only Lebanon and Turkey have relatively high deficits in central government operations (Chart 3, Table 1). Barring fiscal adjustment efforts, this raises questions not only about the sustainability of fiscal deficits in these two countries but also about the implications for the capital account. For the countries with capital restrictions, the results suggest that the fiscal positions of Algeria and Syria would facilitate their move to capital account convertibility, while Morocco and Tunisia would need to further reduce their deficits.

Monetary policy: A sound monetary policy that complements and is facilitated by fiscal discipline is another critical element. Monetary policy seeks to achieve macroeconomic balance, as otherwise excess liquidity would spill over into the external sector. Assuming a fixed exchange rate, adjustment would take place through inflationary pressures and capital outflows until the excess liquidity is eliminated and the risk-adjusted domestic and foreign interest rates are equalized. Assuming a floating exchange rate, the pressure would be reflected largely in a depreciation of the currency and rising inflation.

Monetary performance was mixed in the countries with substantial capital convertibility. Turkey's monetary policy appeared quite accommodating of fiscal policy, with an average rate of broad money expansion of over 100 percent in 1996–97, with a large portion of credit expansion absorbed by the central government. In Lebanon, as well, most of the credit expansion was attributed to the fiscal deficit. In Israel and Egypt monetary policy has been conducted with more independence from the central government. Jordan stands alone, among the five countries, with a highly restrained monetary policy. As Table 1 shows, among the countries with substantial capital controls, none had an excessive growth in domestic liquidity.

Exchange rate and reserves: A market-clearing exchange rate is essential to ensure external balance. Further, to avoid wide exchange rate fluctuations, prudent macroeconomic policies need to be coupled with an adequate level of international reserves to shield an economy from transient external shocks and to enhance its creditworthiness (Crockett and Nsouli, 1977). Among the countries with substantial capital account convertibility, Egypt was the only country with a current account surplus in 1996–97, while Lebanon had the largest deficit in the same period.⁵ The other countries in this group have deficits, as a share of GDP, in the low single digit range. The rest of the SMR countries had, on the whole, a better performance in terms of their average current account deficit-GDP ratio (Chart 4, Table 1). Syria, however, stands out as the only country with substantial external payments arrears.

⁵The external current account deficit in Lebanon is likely to be overstated as the current account data suffer from severe shortcomings. Some credit items, particularly merchandise exports, may be subject to undervaluation while data on other credit items, such as exports of nonfactor services and private transfers, are not readily available.

Regarding exchange rate policy, Israel and Turkey have pursued a flexible policy, although the real effective exchange rates of both have risen somewhat in recent years.⁶ Lebanon and Egypt, both of which have practically anchored their currencies to the U.S. dollar, witnessed sharp increases in their real effective exchange rates. Among the other set of countries that still maintain significant capital controls, Algeria and Syria posted falls in their rates. In Syria, this was mainly because of a slower rise in prices than in its trading partners, while in Algeria, the fall reflected a nominal adjustment in its exchange rate. Morocco and Tunisia have followed a managed float that, in recent years, has essentially stabilized their real exchange rates. All the countries had reserves well above three months of imports level (Table 1).

Financial sector: An efficient and sound financial sector is an essential ingredient of capital account convertibility. Efficiency requires market-based indirect monetary instruments and a liberal regulatory framework. This may call for the restructuring and recapitalizing domestic financial institutions to meet the requirements of prudential regulations. Opening the capital account increases banks' risks in two ways: (i) through the impact of a possible increase in the volume of capital flows on the deposit base, and (ii) through a possible increase in exchange rate volatility on banks' open foreign currency positions. Hence, banking supervision needs to be strengthened, including with regard to foreign exchange risks and exposure (IMF, 1998).

⁶The exchange rate for Israel is flexible within a crawling peg.

All SMR countries have undertaken varying degrees of reform of their monetary instruments and banking systems. Countries that have already opened their capital accounts have achieved greater reliance on indirect instruments and on market-based interest rates. In Egypt, Israel, Lebanon, and Turkey, indirect instruments play an important role in determining market interest rates. The treasury bill rate, which is determined through auctions, and the discount rate have an overwhelming influence on deposit and lending rates. The monetary authorities in these countries also rely, in part, on the sale and redemption of treasury bills to regulate reserves of banks and credit expansion. Jordan's interest rates have shown relative inflexibility, although some progress has been made in using indirect instruments.

By contrast, in the countries that restrict significantly capital transactions deregulation of financial markets is a relatively recent phenomenon and has not become well entrenched. Algeria has been shifting to greater reliance on indirect instruments since 1994, including repurchase auctions and open market operations. In Morocco, reform of the financial sector has been in progress for nearly a decade. Most interest rates have been freed of controls, public enterprises' preferential access to financial resources has been sharply reduced, and the government has moved toward market-based financing of the budget. In Tunisia, lending rates for nonpriority sectors and most interest rates have been liberalized. In Syria, credit continues to be allocated according to an annual plan and interest rates are set administratively.

Many SMR countries have undertaken significant reforms of their banking systems; however, data deficiencies hamper analysis of their performance. With few exceptions, data on

prudential indicators are either unpublished or unavailable. In Egypt and Jordan, progress has been attained in enhancing the capital base of banks and meeting international regulatory standards. The capitalization of Israeli banks is considered adequate by international standards at a ratio of 9.8, while their rate of return is one of the lowest among those in the region for which data are available. In Lebanon, banks quickly regained profitability since the end of the civil war in 1989, and their capital adequacy ratio has risen steadily with a more stringent enforcement of prudential regulations (Table 1).

In Turkey, a performance dichotomy has permeated the banking system for some time. While the capital adequacy ratio, at 9.3 percent for the banking sector as a whole, surpassed the Basle minimum of 8 percent, state commercial banks (which constitute 42 percent of total commercial banks' assets) are seriously undercapitalized. In addition, the state banks have experienced persistent losses and liquidity problems associated with direct lending at subsidized rates. In recent years, private banks have strengthened their capitalization but remain exposed to maturity mismatches of their assets and liabilities and to a substantial open net foreign exchange position.

In Morocco and Tunisia, a well-established system of supervision based on international prudential standards has recently been developed and strengthened. Moroccan banks have adequate capitalization, though uneven, and provisioning rates to counter a high nonperformance loan ratio. In Tunisia, profitability of the banking sector, while high, has fluctuated considerably, reflecting recapitalization by public and private banks.

Market orientation: A well functioning market price mechanism is essential to avoid distortions that could influence capital flows. Subsidies, tax concessions, and price controls that distort prices and resource allocations need to be phased out in order to attract foreign investment and external financing. In varying degrees, all SMR countries (except Syria) have taken measures to decontrol prices of commodities, resulting in a fairly liberal price system. Regarding the labor market, Lebanon and Jordan have fairly unstringent regulations, while Israel continues to maintain controls and recently raised the minimum wage. Considerable labor rigidities remain in the other SMR countries. These rigidities may lead to higher labor costs and reduce the attractiveness of foreign direct investment. Although several countries have made progress in privatizing and reforming public enterprises, Algeria, Egypt, Morocco, Syria, Tunisia, and Turkey still have a long way to go. Among those countries, Syria has the most extensive public enterprise sector.

Tariffs that generate distortions between international and domestic prices can adversely affect resource allocation and capital flows. Among countries with substantial capital convertibility, based on statutory ratios to GDP, Israel has the lowest average tariff rate, at 7.2 percent, and Egypt the highest, at 28 percent. Among the other countries, Morocco has the lowest rate, at 19.3 percent, while Syria has the highest rate, at 35 percent. Several of the countries in the SMR region have implemented trade liberalization measures including the abolition of rates on some imports, the reduction of maximum customs duty rates, and the elimination or reduction of quantitative restrictions (Table 1).

V. MEETING THE CONDITIONS FOR CONVERTIBILITY

From the above review three conclusions can be drawn. First, the SMR countries vary significantly in the degree of restrictions on capital transactions. Second, the performance of countries with substantial capital convertibility suggests that, in varying degrees, some need to strengthen their performance to sustain capital convertibility. Third, the countries with significant restrictions on capital transactions fall into two groups—those that need to reinforce their policies to establish full convertibility (Algeria, Morocco, and Tunisia); and Syria, which will need to make a major effort to meet the conditions for establishing and sustaining convertibility of its currency.

Removal of restrictions: Even some of the countries with substantial capital account convertibility still have important restrictions that need to be removed on foreign direct investment (Israel and Turkey), on resident deposits abroad (Egypt and Israel), and on resident and nonresident account convertibility (Turkey). Not surprisingly, the countries with substantial restrictions on capital transactions have a wider agenda ahead of them. The focus of these countries has to be on liberalizing the outflow transactions by residents and by nonresidents. Among this group, Morocco and Tunisia have the least restrictions to remove, followed closely by Algeria, while Syria faces the greatest challenge.

Policy areas: To sustain convertibility in those countries that already have substantially liberalized their external account and to remove fully the remaining restrictions in

the other group of countries, actions need to be taken in the various areas outlined in the previous section. In discussing the agenda in those areas, the SMR countries will have to be looking both at the totality and internal coherence of their policies. This section highlights only the most important areas for action in the SMR countries.

With regard to *fiscal policy*, Lebanon and Turkey stand out among the more liberalized economies with significant fiscal deficits that need to be addressed. Morocco and Tunisia, which have the highest fiscal deficits among those countries with substantial capital account restrictions, will have to pursue fiscal reform.

Turkey and Lebanon need to review the coherence of their *monetary policy* with other policy instruments. The fiscal problems are reflected, in part, in the average interest differential between the Eurodollar rate in London and the domestic deposit rates during 1995-96 (Table 1). For the countries with substantial controls, the differential is more limited, given the constraints on capital flows, but it is notable that a high differential exists in Algeria (about 16 percent for repurchase rates by the central bank). This differential probably reflects a determined effort to keep a tight monetary policy to contain inflation and support the exchange rate.

Turning to *exchange rate policy*, Egypt and Lebanon, among the countries with substantial convertibility, witnessed significant increases in their real effective exchange rate, reflecting the peg of their currencies to the U.S. dollar in recent years. While this indicator

does not necessarily suggest an overvaluation of those currencies, the steady upward trend underscores the importance of carefully monitoring exchange rate policy, in conjunction with other policies, in light of developments in their external accounts. For countries with significant restrictions, the real effective exchange rates do not indicate major movements. However, if the capital account were to be opened, the nominal and real exchange rates would change and these countries would have to review carefully the management of their exchange rate systems.

With regard to the *financial sector*, Syria stands out as the only country needing to move to indirect monetary instruments. As regards the soundness of the banking system, the lack of data for several SMR countries points to a major vacuum that needs to be filled. It is essential to achieve the necessary transparency to maintain orderly capital accounts in countries with substantial capital convertibility and to progress to capital convertibility in an orderly manner in the countries with significant restrictions. For the countries that have some data available, Lebanon, Tunisia, and, to a major extent, Syria need to raise the capital/asset ratios of their banking systems to above the 8 percent minimum recommended by the Basle Committee.

Turning to *market orientation*, Syria has the widest array of controls to dismantle, followed at considerable distance by Algeria. In varying degrees, most of the SMR countries still have a major agenda ahead in privatizing and reforming their public enterprises, with Syria and Algeria leading the way, followed by Egypt, Morocco, and Tunisia. In all the SMR

countries, except Lebanon and Jordan, considerable efforts are required to liberalize the labor markets. Finally, with regard to import tariffs, all the SMR countries, with the exception of Israel, need to reduce significantly their tariff rates, and Syria, in particular, needs to eliminate import controls.

VI. SPEED AND SEQUENCING

The appropriate pace and sequencing of actions to liberalize the capital account are generally viewed as essential to an orderly process. Two basic questions arise for SMR countries still maintaining significant restrictions: (i) how fast should the capital account be liberalized; and (ii) in what order should policies be taken to liberalize the capital account? To achieve an orderly move toward and to sustain capital account liberalization, each country has to find the optimal adjustment trajectory that will maximize its intertemporal welfare, subject to various financial and structural constraints (Nsouli, 1996). Three generalizations follow: (i) the higher the social discount rate, other things being equal, the lower the optimal speed of adjustment, if there are net up-front costs, as there will be a tendency to defer net costs; (ii) the greater the financial constraints, the faster the speed of adjustment required, since the imbalances will have to be reduced in line with resource availability; and (iii) the greater the structural constraints—in terms of infrastructure, institutional capacity, administrative capacity, and so forth—the slower the speed of adjustment, as the time required to effect the structural changes will be longer.

With regards to sequencing, the specific situation of a country is critical. If the country is faced with large internal and external financial imbalances, priority would need to be given to the adoption of sound macroeconomic (fiscal, credit, and exchange rate) policies. In dealing with structural problems, the phasing of structural reforms will have to take into account the complementarity of the structural reforms, including in the financial system, with the macroeconomic policies, and the lead time needed for the requisite preparatory work and the implementation. Johnston et al. (1997), in reviewing the experiences of Chile, Indonesia, Korea, and Thailand, emphasized the need for an integrated economic reform program for liberalizing the capital account. They also underscored the importance of the macropolicy stance (exchange rate/interest rate mix) for avoiding disruptive and unsustainable capital flows. They stressed, as well, the importance of financial sector reform, as the stage of development of the financial system influences the growth and composition of capital flows, and the efficiency of their use.

It is against this background that the paper considers the two questions posed in this section. First, with regard to speed, assuming equal social discount rates, the two factors affecting the speed of the countries that still need to liberalize their capital account are the magnitudes of the financial and the structural constraints. From a financial point of view, Algeria, Morocco, and Tunisia are servicing their external debt in an orderly manner and have adequate reserves. Syria, however, has considerable external arrears, reflecting its financial imbalances, even though it has adequate reserves. This suggests that Syria would need to move the fastest to reduce its external imbalances to establish capital account convertibility, followed by Algeria, Tunisia, and Morocco (Nsouli et al., 1992 and 1993). With regard to the

structural constraints, the above analysis suggests that Morocco and Tunisia have the least, while Algeria has considerable constraints, and Syria the most. Thus, taking into account structural constraints alone, the move to full convertibility could be fastest in Morocco and Tunisia, followed by Algeria, and, at a considerable distance, by Syria. Combined, however, with Syria's financial constraints, this would suggest the need for Syria to put in place a major front-loaded structural reform package alongside the supportive macroeconomic adjustment policies.

Second, with regard to sequencing, the following generalizations could be made, subject to the caveat that an integrated and coherent package of policies should be in place. Syria would have to give initial priority to addressing the structural constraints on the incentives system, strengthening the banking sector to improve the capital asset ratio, and moving to indirect instruments of monetary control, coupled with unifying the exchange rate system and introducing exchange rate flexibility. Algeria would need to give priority to reforming the financial sector and privatizing the public enterprise sector. In Morocco and Tunisia, the priority in sequencing will have to be given to strengthening and reforming their banking systems and pushing ahead with privatization of public enterprises. To identify more specific measures to strengthen banking soundness and to increase transparency, all the countries would have to include the improvement of data on their banking systems as part of their initial action packages.

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