

MASTER FILES
ROOM C-525

0409

BUFF/98/74

August 6, 1998

Summing Up by the Acting Chairman
Capital Account Liberalization—Theoretical and Practical Aspects
Executive Board Meeting 98/85—August 3, 1998

Directors welcomed the opportunity to discuss the theoretical and practical aspects of capital account liberalization. They considered the discussion to be an important step toward clarifying the costs and benefits of capital account convertibility and the Fund's role in that area.

Directors noted that the explosive growth in international financial transactions and capital flows in recent decades was attributable to a number of factors. They observed that advances in technology had played a powerful role in facilitating financial transactions by reducing costs and enhancing information transmission and diffusion. As countries had moved toward more market-oriented systems and had strengthened their macroeconomic frameworks, liberalization had also taken place with respect to financial transactions: the volume of international financial transactions had grown, and new financial instruments had been developed.

Directors welcomed these broad developments as being consistent with the classic theoretical argument that international capital mobility can be welfare enhancing. Nevertheless, most Directors agreed that the theoretical presumption in favor of both domestic and international financial liberalization, based on the efficient markets hypothesis, was weakened in the presence of information asymmetries and domestic distortions. In addition, many Directors noted that financial liberalization, both domestic and international, had sometimes been associated with costly financial crises, by making it possible for individuals, enterprises, and financial institutions to engage in risk-taking— sometimes to an imprudent extent. Those crises raised important questions as to how far and at what pace financial liberalization, particularly on the capital account, should be pursued.

At the same time, however, Directors noted that the complete elimination of information asymmetries could not be realistically expected, even with the provision of more information to markets, and that financial markets would, therefore, continue to be affected to a greater or lesser extent by adverse selection, moral hazard, principal agent problems, and herding behavior.

Some Directors stressed the importance of transparency in government policies and in the operations of domestic and financial institutions. In addition, Directors emphasized that

international financial liberalization, like domestic financial liberalization, should be properly managed in order to effectively contain dangers and diminish the risk of systemic problems. There was broad agreement on the need for sound macroeconomic policies consistent with the attainment and maintenance of financial stability; however, Directors agreed that this was a necessary, but not sufficient, condition for successful liberalization. Indeed, macroeconomic stability must be firmly supported by strong financial and banking systems endowed with adequate prudential and supervisory regulations as countries move to liberalize capital accounts. Many Directors agreed that, with safeguards in place, capital account liberalization and broader financial liberalization would be beneficial.

Directors were in broad agreement that the pace of capital account liberalization needed to take into account the ability of financial intermediaries and other market participants to manage risk. Directors agreed that optimal risk management—and the attendant prudential supervision—was becoming more complex even in the most advanced financial markets, and that until such techniques became better understood and more widespread in emerging markets, relatively simple regulation and supervision might need to be maintained. Directors focused in particular on the risks associated with short-term flows, especially when domestic corporate entities engaged in short-term borrowing in foreign currency, but failed to hedge the exchange rate risk either through financial instruments or through their international trade transactions. They noted that the Asian crisis highlighted the problems associated with short-term debt inflows and their volatility, especially in the presence of weak domestic financial sectors. Other risks related to currency and/or maturity mismatches by financial intermediaries and corporations borrowing abroad.

Directors generally agreed that prudential measures had an important role to play in managing or containing such risks. Of particular importance were the imposition of capital, liquidity, reserve, and open-position requirements governing the composition of the balance sheets of banks. While such measures were directed toward banks, short-term foreign currency borrowing by nonbank firms could also give rise to systemic risk, and Directors noted that improved monitoring of short-term capital flows to nonbanks would be beneficial. However, Directors recognized that it would be difficult to extend prudential regulation and supervision to control the foreign currency exposure of domestic corporate entities. A number of Directors considered that tax or tax-like measures to discourage potentially destabilizing foreign currency inflows and outflows merited further study. Other Directors raised doubts as to the effectiveness of such measures, at least beyond the short term, noting that they should not be considered a substitute for strong fundamentals, including the requisite banking sector reforms. More generally, the risks associated with short-term inflows could best be controlled by prudent borrowing by the sovereign, sound management and regulation of the financial system, and incentives for corporate borrowers to manage risks appropriately.

Several Directors considered that exchange rate flexibility could help in adjusting to capital inflows in certain cases, since a fixed exchange rate could be perceived by borrowers and lenders as a link in a chain of implicit guarantees on short-term foreign borrowing. At the same time, a few Directors pointed to those cases in which fixed exchange rate systems,

combined with appropriate prudential supervision and regulation, had provided an important source of stability. Directors agreed, however, that if a country decided to exit from a peg, the timing of the exit was critical, especially given the risks of switching to a flexible system when the banking and corporate sectors were weak.

Directors supported the arguments that, given the need in many cases to put safeguards effectively in place and to make the economy more resilient to possible shocks, a cautious and gradual approach to capital account liberalization should be favored for most developing countries. Many Directors voiced the opinion that, reflecting different circumstances and starting points, there should be considerable variation in the speed of capital account liberalization by member countries. In certain circumstances, a case could be made for the temporary use of controls on certain capital account transactions, possibly even if it implied the reimposition of controls. Some Directors, however, suggested that, as with restrictions and controls affecting current account transactions, controls should not be used by member countries to delay reforms that are necessary in moving toward liberalization. There was general agreement that price-based measures were more efficient than administrative measures, although a few Directors felt that the option of using administrative measures should not be ruled out in emergency situations.

Directors agreed that it was important to consider the optimal sequencing of capital account liberalization, taking into account the very different situations in member countries. Directors agreed that particular attention needed to be paid to the state of domestic banking systems. Some Directors thought it would be risky to remove most restrictions on capital account transactions before the major problems in the domestic financial sector had been addressed. At the same time, they noted that foreign direct investment was the most stable form of investment—with attendant benefits in augmenting domestic savings and transfers of technology and management skills—followed by equities and long-term debt instruments. Particular caution was needed with respect to opening up the economy to short-term inflows.

Noting the important role played by suppliers of capital flows, Directors looked forward to the forthcoming discussion on techniques to reduce risks from both the supply and demand side to be pursued in discussions of the architecture of the international monetary system. Given that disruptions and occasional crises were inevitable, Directors considered that the international system should be strengthened to contain the costs of crises. However, expectations of risky and inappropriate bailouts that might engender moral hazard should be minimized.

With respect to the role of the Fund in prudential regulation of capital and financial markets, Directors generally reiterated the view expressed at the recent discussion on international standards and Fund surveillance, that the Fund should concentrate in its areas of expertise and coordinate its work with other institutions and fora to avoid duplication of effort. While responsibility for implementing standards of banking soundness rested appropriately with national supervisory authorities, the Fund's universal membership and unique surveillance activity gave it a role to play in assessing the quality of domestic financial

supervision and regulation. The Fund could also support the efforts of national authorities through its technical assistance operations.

There was general agreement that the staff paper, with appropriate revisions in light of Directors' comments, should be published as soon as feasible.