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Concluding Remarks by the Acting Chairman
Capital Account Convertibility—Transitional Arrangements,
Approval Policies and Implications for Financing; and Capital Movements Under an Amendment of the Articles—The Treatment of Inward Direct Investment
Executive Board Meeting 97/74
July 18, 1997

This discussion has moved us forward on the various aspects of an amendment to extend Fund jurisdiction to capital movements. Executive Directors focussed on the key policy aspects, including transitional arrangements, approval policies, and implications for financing on the basis of the staff paper (SM/97/173). They also considered issues relating to the treatment of inward direct investment under an amendment covered in another staff paper (SM/97/168). The discussion clarified a number of issues in those areas, although Directors emphasized that, in light of the complexity of the issues involved and the need to consult more widely with their authorities, their views were only preliminary and were stated without prejudice to their final positions.

Transitional Arrangements, Approval Policies and Financing

On the design of transitional provisions and approval policies, Directors generally agreed that it would be useful to build upon the principles underlying the Fund's existing jurisdiction. Specifically, they considered that the principles of avoiding backsliding, clear signaling regarding a member's commitment to liberalization, and flexibility in approval policies were generally appropriate. Policies based on those principles should strike an appropriate balance between promoting the liberalization of capital movements and paying due regard to the varying circumstances of members.

With those principles in mind, most Directors supported an extension of the present interpretation of transitional provisions to capital movements. That would permit members that avail themselves of the transitional arrangements to maintain restrictions in place when the amendment comes into effect and, subsequently, to adapt them to changing circumstances. All new restrictions would be subject to approval by the Fund. A few Directors suggested that, consistent with the principle of no backsliding, the provision for adaptation should be structured to allow a reduction in the restrictiveness of the protected measures, but avoid accommodating their intensification. The latter would then be subject to approval by the Fund.

Some Directors favored enhancing the scope of Fund involvement as compared to what has been the policy under current jurisdiction to help ensure that members relying on the transitional arrangements neither unduly delayed accepting the obligations of freedom of capital movements nor moved prematurely to accept those obligations. Some Directors were of the view that greater reliance should be placed on members' own convictions that conditions for accepting such obligations were met, thereby allowing members to proceed with liberalization at their own pace. A few Directors suggested that consideration be given to a post-ratification transition period for the amendment to come into effect, which would allow members to take stock of their systems in relation to the amended Articles. Other Directors considered that that would be adequately addressed by the transitional provisions as well as the flexible treatment of measures introduced for prudential and market and institutional evolution reasons. The staff will need to consider those issues further.

Directors emphasized the importance of liberalizing capital flows in the broader context of appropriate macroeconomic policies and reforms. They generally agreed that, in order to provide a clear signal to the international community, members should be encouraged to accept the obligations of the new Article only when the configuration of macroeconomic policies, the situation of the financial system, and the institutional infrastructure provided sufficient confidence that they would not need to rely on restrictions. In that regard, emphasis would need to be given to the development of financial institutions and markets as part of the process of appropriately sequencing capital account liberalization. Accordingly, most Directors were of the view that the conditions under which a member would cease to avail itself of the transitional arrangements should be broader than under current jurisdiction in order to encompass the development of the member's financial system.

Directors stressed that approval policies would need to be developed that would provide sufficient flexibility to allow members to introduce or retain controls on capital movements as required by their circumstances. In that connection, they discussed the staff's suggestion that approval policies be developed to cover restrictions imposed for: (i) balance of payments and macroeconomic management purposes; (ii) market and institutional evolution reasons; (iii) prudential considerations; and (iv) reasons of national and international security. Some Directors, however, considered the concept of market and institutional evolution ambiguous. Those Directors were concerned that a separate approval policy in that area could create a significant loophole in Fund jurisdiction, and suggested that restrictions imposed for such reasons be brought under the policies addressing prudential considerations. Some other Directors, however, underscored the importance of the development and soundness of financial institutions in the liberalization process and considered it appropriate that approval policies be tailored to address such concerns.

Concerning temporary approval of restrictions imposed for balance of payments and macroeconomic reasons, Directors supported the view that the criteria applied to the approval of restrictions under the Fund's existing jurisdiction were broadly appropriate with suitable modifications. Specifically, with respect to capital outflows, Directors agreed that approval should be based on whether the restriction was imposed for balance of payments reasons, was nondiscriminatory among Fund members, and was temporary. They considered that it would be appropriate for the Fund to develop a policy for the emergency approval of restrictions on capital outflows to provide members with the flexibility to respond to crisis situations. Specific modalities, in that regard, would need to be developed to allow members sufficient time to elaborate policies in response to the crisis. Directors also agreed that, when imposing restrictions, members should, to the extent possible, employ controls that were least disruptive to their international financial relations and to their ability to maintain access to international capital markets. Several Directors considered that any Fund role in the prioritization of payments should be of an advisory nature and not part of approval criteria, while others were more willing to examine the feasibility of incorporating prioritization in approval criteria.

With respect to restrictions on capital inflows, Directors were generally in favor of approval criteria analogous to those suggested for capital outflows. They agreed that such criteria should require that the restriction was needed for reasons of macroeconomic management, was nondiscriminatory among Fund members, and was temporary. With respect to an emergency approval procedure for the imposition of restrictions on capital inflows, most Directors felt that such a procedure would give members flexibility in responding to destabilizing inflows when their room for maneuver with traditional policy instruments was constrained. A few Directors, however, noted that, since inflows usually build gradually, and considering the nature of the threat to macroeconomic stability they pose, an emergency approval procedure for restrictions on capital inflows may not be necessary.

Directors considered that members may need to impose restrictions on capital movements in the process of financial market development and in order to limit the vulnerability of the financial system in situations where there were weaknesses in financial institutions or markets, or where financial instruments were inadequate. Directors generally agreed that approval criteria for such measures should be based on an assessment of whether the measures were part of a process that would in time reduce the general restrictiveness of the system and place the member in a better position to observe the obligations for liberalization of capital movements. The period of approval would have to be considered: the time frame could be similar to that for macroeconomic and balance of payments purposes, but longer periods could be considered in appropriate circumstances. Most Directors noted that, consistent with the objective of clear signaling, members' recourse to controls for such reasons would be expected to be limited once the member accepted the obligations for the freedom of capital movements.

Views differed on how to treat prudential measures that give rise to restrictions under the amendment. Most Directors were of the view that, given the mandate of the Fund, it would be appropriate for the Fund's jurisdiction to cover prudential measures that give rise to restrictions, recognizing that in most instances prudential measures would not give rise to restrictions. The period of approval of the restrictions would take into account the extent to which the restrictions conformed to existence of best practices and norms and the country's capacity to implement those norms. One Director also called for a detailed examination of the institutional architecture for prudential measures in considering their treatment under an amendment. A few Directors suggested that the treatment of prudential measures should carry a presumption in favor of the member about the need for such restrictions. However, it was broadly agreed that any treatment of prudential regulations should seek to minimize abuse, recognizing that that would involve the Fund in an examination of such measures and a right to challenge them in appropriate circumstances. Some Directors also supported extending the procedures for prudential measures to restrictions maintained because of institutional constraints on the effectiveness of monetary control instruments.

Most Directors agreed that the existing procedures for restrictions imposed for national and international security could be applied under the Fund's extended jurisdiction. A few Directors, however, cautioned against members abusing those provisions in order to impose or maintain restrictions for macroeconomic and balance of payments reasons.

Turning to financing implications of the amendment, most Directors emphasized that capital account liberalization would substantially increase access of members to private capital and, to that extent, would reduce reliance on official financing. Nevertheless, many Directors recognized that the increased magnitudes and volatility of capital flows could episodically result in cases of large need for Fund and other official financing, including where a systemic risk was involved. All Directors cautioned that the provision of such financing in individual cases would need to be carefully considered. Particular attention would need to be given to the adequacy of safeguards for Fund resources; the effect on the Fund's liquidity position and capacity to provide financing to other members; and the concentration of the Fund's exposure.

Several Directors considered that it was important for the Fund to provide the assurance that its resources would be available, if necessary, to support members' liberalization policies. All Directors agreed that in providing Fund financing it was important to avoid engendering moral hazard and sending markets a wrong signal about the Fund's willingness to finance capital outflows, and also to ensure adequate safeguards for Fund resources. Accordingly, some Directors preferred to retain the existing prohibition in the Articles on the financing of "large or sustained" capital outflows on the grounds that the provision provided additional safeguards for the use of Fund resources. Several other Directors noted that, under an amendment establishing obligations of freedom of capital movements, it would not be appropriate to retain that provision in its present form, which reflected the priority accorded under the existing Articles to the financing of current account deficits. Recognizing that there may be occasions where financing balance of payments deficits stemming from large capital outflows would be appropriate, they considered that more evenhanded language referring to limitations on financing of payments imbalances rather than capital outflows might be preferable. At the same time, in light of the Fund's purposes, particularly to shorten the duration and lessen the degree of disequilibrium in the balance of payments, as well as the requirement to safeguard the temporary use of its resources, those Directors did not consider it appropriate for the Fund to finance sustained capital outflows. They observed, however, that it was large and sustained use of Fund resources in the context of capital outflows that would raise serious concerns about the impact on the Fund's liquidity, safeguards, and concentration of exposure. Accordingly, those Directors favored reformulating the relevant provision of Article VI with a view to protecting against "large **and** sustained" use of Fund resources.

Some other Directors noted that Article V, Section 3(a) already provided for adequate safeguards for the temporary use of the Fund's general resources, which was reflected in the Fund's policies on conditionality and access. Accordingly, they felt that the constraint in Article VI on Fund financing of "large or sustained" capital outflows would not be necessary under an amendment extending Fund jurisdiction to capital movements. Deletion of that provision would give members confidence to accept the obligation to liberalize capital movements. A few Directors suggested that it would be appropriate to give consideration to a possible role for higher charges in that context.

Some Directors also noted that, in the formulation and implementation of its policies on conditionality and access, the Fund may find it necessary to include the recommendation of controls on capital outflows, as a temporary measure, to limit the use of its resources. Accordingly, an explicit provision in the Articles allowing the Fund to request members, in the context of conditionality, to impose controls on capital outflows should be considered. A few other Directors considered that the Fund should not be able to require members to impose restrictions.

Treatment of Inward Direct Investment

Executive Directors engaged in a wide-ranging discussion on the treatment of inward direct investment under the amended Articles.

A number of Directors supported the staff's proposal to use a tripartite classification of inward direct investment consisting of: (i) the acquisition of real estate and nonfinancial intangible assets; (ii) the acquisition of an interest of 10 percent or more of the total ordinary shares or voting power in an incorporated enterprise, or the equivalent in an unincorporated enterprise; and (iii) the acquisition of an interest of less than 10 percent in an enterprise whose activities were regarded by the relevant member as necessary for its essential interests.

It was generally agreed that restrictions on the first category of direct investment—that is, acquisition of real estate and nonfinancial intangible assets—should remain outside Fund jurisdiction, and a number of Directors also agreed that the second and third categories should be excluded as proposed by the staff.

With respect to the second and third categories, however, a number of Directors took the view that an equity threshold such as 10 percent was an artificial yardstick. Moreover, a few Directors considered that all restrictions on inward equity investment should be regarded as restrictions on inward direct investment and should remain outside Fund jurisdiction. One Director suggested that the Fund should also exclude from its jurisdiction loans made for the purpose of exercising an effective influence over the management of an enterprise, for example, a loan by a parent company to a subsidiary.

Some Directors advocated a different approach under which it would be left to each member to define inward direct investment and, thus, decide which restrictions would fall within or outside the Fund's jurisdiction, although different views were expressed as to whether the Fund should have the power to challenge members' views in that area.

One Director suggested that the goal of capital account liberalization could be more effectively achieved through the use of the Fund's conditionality without extending Fund jurisdiction to restrictions on capital movements. According to that Director, such an approach could apply not only to restrictions imposed on inward direct investment but also to restrictions imposed on other capital movements.

A suggested possible alternative approach—for which some Directors expressed support—was to recognize, in principle, the jurisdiction of the Fund over all inward capital movements subject to the following qualification: it would be agreed at the time of the amendment that the Fund would grant a general waiver with respect to all restrictions on the making of inward direct investment. It would also be agreed that this policy of waiver could be reviewed by the Fund from time to time taking into account the evolution of members' practices.

There was broad support for the position that restrictions imposed on the right of establishment should remain outside the jurisdiction of the Fund.

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In light of the Board discussion and the request by Directors for additional work in certain areas, the staff will prepare two papers for Board discussion prior to its consideration of a report to the Interim Committee. The first paper will elaborate further on the scope of the amendment, its relationship with other treaties, and related legal issues. The second paper will address further the other issues raised during this discussion. These will include, inter alia, restrictions imposed for prudential and market evolution reasons, the modalities of emergency approval, and the treatment of an intensification of restrictions under the transitional provisions. Board discussion of these papers will form the basis of the report to the Interim Committee. Further issues will be addressed in papers for consideration after the Annual Meetings.

On the whole, we have made considerable progress, although it must be made explicit again that many Directors have indicated that their views are preliminary and that they will need to consult further with their authorities. Nevertheless, these concluding remarks should provide an indication of where there is a meeting of minds and where there are matters requiring further consideration, on which basis the two papers will be prepared. These remarks will remain without prejudice to Directors' final positions.