FOR AGENDA

SM/97/173

July 1, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **Capital Account Convertibility—Transitional Arrangements, Approval Policies and Financing Under an Amendment**

Attached for consideration by the Executive Directors is a paper on capital account convertibility—transitional arrangements, approval policies and financing under an amendment, which is tentatively scheduled for discussion on Friday, July 11, 1997. Issues for discussion appear on pages 25 and 26.

Mr. Fisher (ext. 38755), Mr. Hagan (ext. 37715), Mr. Johnston (ext. 38980), or Mr. Wajid (ext. 37114) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Capital Account Convertibility—Transitional Arrangements, Approval Policies and Financing Under an Amendment

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(In consultation with the Research Department)

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July 1, 1997

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I. INTRODUCTION

1. In its April Communiqué, the Interim Committee agreed that the Fund's Articles should be amended to make the promotion of capital account liberalization a specific purpose of the Fund and to give the Fund appropriate jurisdiction over capital movements.[1] The Committee also indicated that the scope of the amendment should be carefully defined and that sufficient flexibility should be allowed through transitional provisions and approval policies. In response, a set of papers is being prepared to address various aspects of the amendment. The scope of the Fund's jurisdiction under the amendment is covered in SM/97/146; issues related to the exclusion of inward foreign direct investment from the scope of jurisdiction are discussed in SM/97/168; and the consequential effects of the amendment for the other Articles of the Fund will be taken up in a forthcoming paper. This paper addresses policy issues relating to transitional arrangements, approval policies and financing under the amendment.

2. The rest of this paper is organized as follows. Section II provides an overview of the design of transitional arrangements and approval policies and their implications for members' obligations under the Articles; Section III discusses transitional arrangements for maintaining restrictions on capital movements under the Fund's expanded jurisdiction; approval policies are covered in Section IV, including those concerning restrictions imposed on a temporary basis for macroeconomic and balance of payments reasons and those imposed on a relatively longer-term basis for reasons of market and institutional evolution, prudential concerns, and national or international security. Financing implications of the amendment are addressed in Section V. Finally, Section VI sets out the issues for discussion.

II. OVERVIEW OF THE DESIGN AND IMPLICATIONS OF TRANSITIONAL PROVISIONS AND APPROVAL POLICIES

A. Design of Transitional Arrangements and Approval Policies

3. In considering the design of transitional arrangements and approval policies, it is useful to build upon the principles underlying the Fund's existing jurisdiction. Under Article VIII, members are obliged not to impose restrictions on the making of payments and transfers for current international transactions without the approval of the Fund. The transitional provisions of Article XIV, which permit a country to grandfather the restrictions it has in place at the

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[1]Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund, Press Release No. 97/22, April 28, 1997.

time it becomes a Fund member, have allowed countries to maintain restrictions on current account transactions pending the implementation of reforms which would eliminate the need for restrictions, while still meeting their obligations under the Articles. At the same time, the Fund's policy on approval of newly adopted exchange restrictions has allowed members breathing space while adjustment measures designed to address balance of payments difficulties take hold. Through these provisions, the Fund has recognized the varying circumstances of its members while fostering widespread liberalization of payments and transfers for current international transactions. The extension of jurisdiction to capital movements will need to take particular account of the complexities of capital movements (which, it has been proposed, will include inflows and outflows, payments and transfers, and underlying transactions under the Fund's jurisdiction). Transitional arrangements and approval policies, accordingly, will need to be responsive to the differing initial conditions of members, the further evolution of their financial markets and instruments, their need for prudential controls, and their changing circumstances. At the same time, they should serve to facilitate an orderly liberalization of capital movements.

4. In light of the foregoing, the design of the transitional provisions and approval policies under the amendment could be based on the following principles:

- ***No backsliding***—Consistent with existing jurisdiction, while members would be able to maintain and adapt existing restrictions under the protection of the transitional provisions, they would not be able to introduce new restrictions absent Fund approval.

- ***Signaling***—Members would have the right to accept the obligations of the new Article at any time and the Fund would encourage members towards that goal. At the same time, however, members would be advised to give up the protection of the transitional arrangements, by "accepting the obligations" of capital liberalization, only when they were in a sufficiently strong position to confidently avoid reliance on restrictions imposed for macroeconomic and balance of payments reasons. Since restrictions imposed for other reasons (e.g., prudential and national security) would be approved on a longer-term basis, a member that maintains only these restrictions would not have to rely on the transitional arrangements.

- ***Flexibility in approval policies***—Approval policies would be designed to take into consideration the need for flexibility in view of the complexities of capital movements, while promoting the benefits of liberalization and appropriate signaling. Accordingly:

    - ***Temporary approval policies*** would be extended to capital movements and would be designed, inter alia, to: (a) provide for approval of restrictions on capital outflows for balance of payments reasons, including approval on an "emergency" basis in certain circumstances and (b) encompass restrictions on capital inflows for macroeconomic policy purposes.

- ***Market and institutional evolution restrictions*** could be approved so as to allow for situations where, in the overall context of market development and liberalization, members may need to impose new restrictions.

- ***Prudential restrictions*** would also be approved. As will be discussed below, however, most prudential measures would not be expected to give rise to restrictions.

- ***National and international security restrictions*** would, as under the Fund's existing jurisdiction, be approved on an open-ended basis. [2]

B. The Implications of Transitional Arrangements and Approval Policies

5. Before discussing in detail the possible design of transitional arrangements and approval policies under an amendment of the Fund's Articles, it is useful to provide an overview of the implications of these arrangements and policies for members of the Fund. As will be discussed below, it is for consideration whether these implications should be identical to those under existing jurisdiction for restrictions imposed on international capital movements.

Members' relations with the Fund

6. At present, an exchange restriction subject to the Fund's jurisdiction [3] is consistent with a member's obligations under the Articles if: (i) it is maintained under the transitional provisions of Article XIV, Section 2, or (ii) has been approved by the Fund in accordance with Article VIII, Section 2(a).

7. The fact that a restriction is maintained or introduced in conformity with a member's obligations under the Articles does not, however, mean that such restrictions have no other consequences on the member's relations with the Fund. Specifically, if a member introduces an exchange restriction during the period of a stand-by or extended arrangement (other than first credit tranche arrangements), such an introduction will constitute the nonobservance of

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[2] As per Executive Board decision No. 144 (52/51), adopted August 14, 1952, *Selected Decisions, Twenty-First Issue*, p. 379.

[3] The Fund's present jurisdiction over exchange restrictions is limited to restrictions on the making of payments and transfers for current international transactions. These payments are defined in Article XXX(d).

the standard performance criterion (which, in the absence of a waiver, would interrupt purchases under the arrangement), irrespective of whether the new restriction has already been approved.[4]

8. Conversely, the failure of a member to meet its obligations under Article VIII does not, in itself, preclude a member from using the Fund's general resources. As was noted in *"Legal Effects of Approval and Nonapproval of Exchange Restrictions by the Fund,"*[5] the Fund has not implemented a policy of withholding approval of an arrangement solely on the grounds that a member maintains exchange restrictions that have not been approved by the Fund. Similarly, if a member introduces a restriction during the period of an arrangement, the Fund has not adopted a general policy of making the approval of that restriction a condition for a waiver of the relevant performance criterion.

9. It will need to be considered whether the above-described relationship between the Fund's jurisdiction and its policies on the use of its resources should remain unchanged under the proposed amendment.

Members' obligations under other international agreements

10. As is discussed in SM/97/32, Supplement 2, there are a variety of bilateral, regional and multilateral agreements that cover transactions and related payments and transfers which fall within the Fund's existing jurisdiction. Under the terms of some—but not all—of these agreements, restrictions maintained by the signatory that have been approved under Article VIII or are protected under the transitional provisions under Article XIV will not constitute a violation of the signatory's obligations under the agreement in question. Such terms are contained in the GATT and the GATS. The extent to which they will be included in the proposed Multilateral Agreement on Investment (MAI) is still under consideration.

11. The extent to which these agreements will also defer to the Fund's jurisdiction over capital movements will depend on the agreement in question. In the case of the GATS, deference to the Fund's jurisdiction is limited to the Fund's *existing* jurisdiction; accordingly,

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[4]However, the approval of the restriction may provide a basis for a waiver of the relevant performance criterion.

[5] EBS/88/13 (1/28/88).

deference to approval and transitional arrangements relating to restrictions on capital movements would require an amendment of the GATS.[6] The extent to which the MAI will defer to both existing and future jurisdiction is currently under consideration. These issues will be discussed in a subsequent paper.

Unenforceability of contracts

12. Article VIII, Section 2(b), of the Fund's Articles reads, in part, as follows:

> "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member."

13. The meaning of the above provision has not been interpreted uniformly by the courts of the Fund's various members. Under the interpretation that prevails in certain jurisdictions, contracts that are contrary to restrictions on current payments and transfers that have been approved by the Fund or are maintained under the transitional provisions of Article XIV will not be enforceable. Under this interpretation, therefore, the Fund's approval of exchange restrictions imposed, for example, on loan repayments that fall within its jurisdiction (interest payments and moderate amortization of principal) would result in an automatic stay in creditor litigation relating to the arrears arising from such restrictions. Under the much narrower interpretation that currently prevails in the United States and the United Kingdom, however, Fund approval of such restrictions would not give rise to such a stay.[7]

14. If the Fund's Articles are amended to bring international capital movements within the jurisdiction of the Fund, it is likely that the meaning of Article VIII, Section 2(b) will change for certain countries, even if the text is not revised. Specifically, for members that have adopted the broad interpretation described above, restrictions on capital movements would be consistent with the Articles only if they are maintained under the transitional provisions or

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[6] Under the relevant provision of the GATS, restrictions on capital movements that are otherwise inconsistent with the terms of the GATS will be permitted only if they are requested by the Fund under Article VI, Section 1, which empowers the Fund to request members to impose controls to prevent use of its resources for large or sustained capital outflows. As will be discussed in this paper, it is for consideration as to whether this or a similar provision should be retained in the Articles in the context of the proposed amendment.

[7] A detailed review of Article VIII, Section 2(b), and the various interpretations that have been given to this provision is set forth in "Legal Effects of Approval and Nonapproval of Exchange Restrictions by the Fund" (EBS/88/13, 01/28/97).

have been approved by the Fund.[8] In that case, therefore, restrictions imposed on the capital portion of loan repayments (i.e., bullet repayments of bonds and loans) would result in a temporary stay if they have received Fund approval. However, given the proposed scope of the Fund's coverage of capital movements, an additional question of interpretation would arise for these countries. Specifically, since this provision, unless modified, would be applicable only to restrictions on capital movements that are considered "exchange controls", the question would arise as to whether "exchange controls" would be limited to capital payments and transfers or would also embrace underlying capital transactions and, if so, which transactions.

15. Given the lack of uniformity of interpretation of this provision among the Fund's members and the additional uncertainty that an extension of Fund jurisdiction will create if this provision is not clarified, the amendment will have different and, in some cases, unpredictable consequences in various jurisdictions. Accordingly, it is for consideration whether this section should be modified to clarify its meaning or, alternatively, deleted altogether.

16. The application of Article VIII, Section 2(b) is of particular relevance in light of the increasing importance of international bonds in private sector borrowing from international capital markets, and the possibility that bondholders will initiate litigation following a default. Such litigation may make it difficult for the Fund to obtain adequate financing assurances to provide support for a member's adjustment efforts.[9] Issues relating to Article VIII, Section 2(b) will be discussed at a later stage of the amendment and will also be addressed in the forthcoming review of the Fund's policy on external payments arrears to private creditors.

The signaling effect

17. Under the Fund's existing policy, members are encouraged to accept the obligations of Article VIII when they are satisfied that they are not likely to need recourse to such measures in the foreseeable future. Accordingly, when a member notifies the Fund that it accepts the obligations of Article VIII, this notification (which is publicized) represents a clear commitment by the authorities to avoid, to the extent possible, reliance on restrictions on current payments and transfers. As a result of the design of the Fund's policies, the imposition of any new restriction will be approved only if it is judged to be temporary, nondiscriminatory, and imposed for balance of payments reasons.

18. As will be discussed in greater detail below, the transitional arrangements and approval policies applicable to restrictions on international capital movements would, to the extent

[8] In Germany, courts have refused to apply Article VIII, Section 2(b) to capital transactions on the grounds that they are outside the Fund's jurisdiction.

[9] A related question concerns whether members should be protected from litigation following a default on sovereign obligations.

possible, also be designed to send a clear signal to the international community. Given the complexities of capital movements and the scope of the Fund's jurisdiction under the amendment, it is recognized that flexible approval policies will have to be developed. Nevertheless, the principle should be maintained that, before discontinuing the protection of the transitional arrangements, members will be encouraged, to the extent possible, to eliminate reliance on restrictions imposed for reasons of macroeconomic and balance of payments management.

III. Transitional Arrangements

19. Article XIV on transitional arrangements under the existing Articles of Agreement sets forth certain principles and procedures. Specifically, members are to notify the Fund whether they intend to avail themselves of these arrangements; a member availing itself of the transitional arrangements may maintain and "adapt to changing circumstances" the restrictions that were in effect when it became a member; "members shall withdraw restrictions as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner that will not unduly encumber their access to the general resources of the Fund;" and, in exceptional circumstances, the Fund may make representations to a member that conditions are favorable for the withdrawal of any particular restriction, or for the general abandonment of restrictions that are inconsistent with the provisions of the Articles.

20. Under Article XIV, Section 2, a member is permitted to maintain and "adapt to changing circumstances" the exchange restrictions that were in existence when it became a member of the Fund. The above-quoted language has been interpreted as permitting a member to either relax, intensify, or vary a restriction that it already applies to payments and transfers of a particular current transaction. The imposition of a restriction on previously unrestricted payments and transfers would not, however, be an "adaptation" but would constitute the introduction of a new restriction, therefore requiring approval by the Executive Board. The transitional provisions for restrictions on international capital movements could follow this interpretation.

21. As at present, annual consultations, surveillance, and the provision of technical assistance would continue to serve as the primary means by which the Fund would assist members to ensure that capital account liberalization was neither premature nor overdue and to encourage them to accept the new obligations for capital movements. The assistance provided by the Fund would emphasize the importance of developing financial institutions, markets, and instruments that would allow the member to achieve sustainable liberalization of capital movements and to avoid the need to resort to controls. In this context, attention would be paid to the sequencing of capital account liberalization appropriately with supporting

structural reforms, particularly in the monetary and financial sectors, and to the pacing of liberalizations, in order to take proper account of the specific circumstances and policies of individual countries.

22. Policies could provide the Fund with a somewhat greater role in assisting members to establish conditions that would enable them to discontinue reliance on transitional arrangements relating to capital movements than it has had so far regarding the transitional arrangements for restrictions on current international transactions. At present, the practice of the Fund staff is to examine the exchange systems of members and to encourage them to eliminate all restrictions subject to the jurisdiction of the Fund under Article VIII, before accepting the obligations of that Article.[10] This practice could be specifically reflected in the Board decision which sets forth the policy of the Fund, consistent with meeting the objectives for acceptance of the obligations, thus, helping to avoid premature acceptance of the obligations.

23. The present Articles refer to the members' withdrawing restrictions "as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner that will not unduly encumber their access to the general resources of the Fund." In considering an extension of the obligations to capital movements, in particular to capital inflows as well as outflows, it may be appropriate to broaden the conditions under which a member shall withdraw restrictions maintained under the transitional arrangements to encompass the development of the member's financial system. This would be consistent with the emphasis that would need to be given to an appropriate sequencing of capital account liberalization with institutional and structural reforms in the financial sector to achieve a durable liberalization.

24. Under present transitional arrangements, the Fund has the authority, in exceptional circumstances, to make representations to a member that conditions are favorable for the general or partial abandonment of restrictions on current international payments and transfers. If a member persists in maintaining these restrictions following such a representation, the Fund may declare the member ineligible to use Fund resources. In practice, though, the Fund has never declared a member ineligible on the basis of this provision. Nevertheless, under an amendment to extend the obligations to freedom of capital movements, the Fund's right to make representations to eliminate restrictions could be preserved.

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[10]Decision No. 1034, June 1, 1960, states that "it would be desirable that, as far as possible, [the member] eliminate measures which would require the approval of the Fund, and that to satisfy themselves that they are not likely to need recourse to such measures in the foreseeable future." However, a formal examination is not specifically mandated.

IV. Approval Policies

25. Members ready to accept the obligations for the liberalization of capital movements would be expected to have eliminated the need to rely on restrictions for balance of payments or macroeconomic management purposes. There are, however, situations in which a member (regardless of whether or not it avails itself of transitional arrangements) may need to maintain or introduce restrictions on capital flows. Besides temporary approval in the case of controls imposed in the face of pressing balance of payments or macroeconomic management problems, there are essentially three situations in which this need could arise: (i) in response to serious weaknesses in financial institutions, markets, or instruments, or in the process of promoting their development; (ii) in connection with prudential measures that give rise to a restriction because of the way in which they are designed or implemented; and (iii) for reasons of national and international security. Consistent with existing procedures under Article VIII, the introduction of all new restrictions on capital movements by all members would be subject to approval by the Fund.

A. Temporary Approval

26. The Fund's primary role in helping to prevent balance of payments difficulties is through encouraging members, in the context of surveillance, to adopt sound macroeconomic, structural, and debt–management policies. In recent years, the Fund has intensified surveillance over international capital markets with the aim of improving its ability to identify emerging financial tensions at an early stage. The Fund is also strengthening its surveillance over the financial and banking sectors, focusing on countries facing financial sector difficulties that could have macroeconomic significance.

27. With the globalization of international capital markets and improvements in market access, private capital has become an increasingly important source of external financing for many developing countries. At the same time, however, this has increased countries' vulnerability to shifts in market sentiment, and associated risks of balance of payments crises. This underscores the importance of adopting forceful and prompt corrective policies in the face of emerging tensions in the external accounts. Experience suggests that markets would be willing to support credible and forceful policies, in some cases supported by the Fund, with new financing, albeit with higher interest rates, and thereby allow countries to weather a storm without resorting to the imposition of restrictions on either current international payments and transfers, or capital movements.

28. It is expected that members would generally be able to address balance of payments and macroeconomic difficulties without recourse to capital controls. In some cases, however, if adverse contingencies are too large, and/or the policy response has been delayed, members may face an intensification of such difficulties, which may be amplified by substantial flows of

private capital. In such circumstances, countries may need recourse to temporary controls on external transactions, including capital movements, while corrective policies are elaborated. Such controls can provide temporary breathing room while policies take hold and can, thereby, facilitate orderly balance of payments adjustment and stable macroeconomic conditions.

29. Under its extended jurisdiction following an amendment, the Fund would have the authority to approve such restrictions and would need to develop policies for determining when the imposition of temporary restrictions would be justified. In particular, separate criteria would need to be established for approving restrictions on capital outflows and inflows.

Restrictions on capital outflows

30. In assessing whether it would be appropriate to impose or intensify restrictions on capital outflows, a balance would need to be struck between the costs of taking additional macroeconomic adjustment measures, the availability of additional financing on appropriate terms, and the costs associated with the use of restrictions.

31. Under the Fund's existing jurisdiction, the criteria for approving exchange restrictions are that the restrictions be: (i) needed for balance of payments purposes; (ii) temporary, and (iii) nondiscriminatory.

- ***Needed for balance of payments purposes.*** Under the Fund's current jurisdiction, assessment of whether a restriction is warranted by actual or prospective external imbalances has been based on the representation of the member concerned and a broad assessment by the staff of the purpose of the restriction.

- ***Temporary.*** Under the Fund's existing jurisdiction, assessment of whether controls are temporary is based upon: (i) a member's commitment to remove the restriction, generally within a specified period not exceeding two years; and (ii) an assessment by the Fund of whether there is a reasonable prospect of the member being able to remove the restriction within the proposed timetable. In forming this assessment, the Fund has needed to look at the *effect* of the restriction, as well as at the prospects for the external accounts.

- ***Nondiscrimination.*** Under the Fund's current jurisdiction, this is based upon an assessment of whether or not the restriction discriminates among Fund members.

It would seem appropriate also to apply these criteria to restrictions on capital movements.

32. There is a question as to whether, in the context of capital movements, these criteria should be supplemented by additional criteria which would take account of the types of transactions that are restricted. The following points can be made:

- First, it would be in the member's own interest to adopt measures that would be the least disruptive to its international financial relations. Thus, temporary *ex ante* controls[11] which would likely have a more limited impact on prosperity and trade over the medium term, would generally be preferred to restrictions on "vested rights"[12] which could have severe medium–term implications for the member's ability to maintain access to international capital markets, as well as, potentially, for the value of creditors' claims.

- Second, members facing extreme balance of payments disequilibria may in some circumstances have only limited prospects of regaining access to international capital markets within a reasonable period, notwithstanding the firm implementation of appropriate policies. In such cases, the cost of achieving the necessary improvement in the balance of payments through the compression of imports may outweigh the costs to the member, and the international monetary system more generally, of a temporary interruption of vested rights, including debt service.

- Third, it may be difficult to prioritize a priori between restrictions on current and capital account transactions. For example, the emergence of arrears on either current or capital account transactions could have adverse effects on prosperity and the balanced growth of world trade.

33. ***Emergency temporary approval***—It is not envisaged that restrictions introduced in the context of an emergency would need to be approved by the Fund prior to their imposition. Instead, as discussed in SM/97/86, approval policies could allow for a lapse–of–time approval for a limited period (say, 30 days) upon notification by the member soon after (say, within 10 days) of the imposition of restrictions on an emergency basis. Approval would be designed to provide members with the flexibility to introduce controls during a crisis without prior Fund approval and for a specified time period. In such cases, it would seem desirable to maintain the criteria that restrictions should be *nondiscriminatory* among Fund members *and needed for balance of payments* purposes. In addition, approval could require a representation by the member concerned that the controls are temporary. It should be noted, however, that the Fund would not be able to assess at the outset whether the necessary policies are in place or are being elaborated that would enable the restrictions to be removed within a reasonable period. Therefore, in these circumstances, a finding of temporariness could not be made.

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[11] For example, the freedom of residents to make capital investments abroad.

[12] For example, controls on the ability of private debtors to meet external debt–service obligations, and the rights of nonresidents to liquidate investments and repatriate capital.

34. In some cases, with the adoption of forceful adjustment measures, the crisis may have passed by the end of the (say) 30–day approval period and the restrictions on outflows may have been removed. In other cases, a Fund arrangement might be in place which would allow the Executive Board to decide whether any remaining restrictions satisfied the criterion of being *temporary*.[13] The possibility cannot be precluded, however, that at the conclusion of the period, there would not have been sufficient time for the preparation and Board discussion of a paper that would describe recent developments and make recommendations as to whether or not the restrictions should be approved. In such cases, it would seem appropriate for the Board to have the option to extend emergency approval for a further period provided that, in the opinion of the Managing Director, the authorities were cooperating with the Fund to find a solution to their balance of payments difficulties, which could eventually provide a basis for forming an assessment that, with appropriate policies, the controls would be *temporary*.

35. Where members invoke the emergency provisions, it would be important to ensure that, to the extent possible, restrictions were designed to allow debtors to continue to meet their external debt–service obligations without interruption.

Temporary restrictions on capital inflows

36. Notwithstanding their generally beneficial effects, sizeable net capital inflows can, in some cases, create difficulties for macroeconomic management. Large inflows can arise from an inconsistency between interest rates needed for domestic equilibrium and those needed for external equilibrium, resulting from an inconsistent policy mix, or from exogenous developments (such as a decline in world interest rates). By constraining the effectiveness of monetary/exchange rate policy, surges in capital inflows, particularly those of a short-term nature, can have potentially adverse implications for inflation, the real exchange rate, and the external current account.

37. The possible *policy responses* to surges in capital inflows have been addressed by the Executive Board on a number of occasions.[14] They include limited sterilized intervention and/or exchange rate appreciation in certain situations, fundamental adjustments in the mix of fiscal and monetary/exchange rate policies, and structural reform (including trade and exchange control liberalization). The appropriateness of the response depends on the nature of the inflows and the circumstances of the country concerned.

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[13] Possibly in the context of an arrangement approved under the accelerated procedures of the emergency financing mechanism.

[14] In the context of discussion of "Recent Experience with Surges in Capital Inflows" (SM/93/113, 5/2/93) and various discussions of international capital market developments. See also of "Review of Experience with Capital Account Liberalization and Strengthened Procedures Adopted by the Fund" (SM/97/32, Sup. 1, 2/6/97), and *Capital Flows in the APEC Region*, IMF Occasional Paper No. 122 (March 1995).

38. As discussed in SM/97/32, temporary *controls to deter capital inflows* may be appropriate in some circumstances.[15] In situations where capital inflows create difficulties for macroeconomic management, temporary controls can provide some breathing room while other policy adjustments take hold, although it is recognized that such controls are generally inefficient and should not be used to sustain inconsistent macroeconomic policies. The imposition or intensification of controls may be justified on the grounds of preserving macroeconomic stability and avoiding the need for sharp and costly policy adjustments in response to transitory surges in inflows; the latter underscores the importance of examining the nature of inflows in assessing their benefits and potential pitfalls. The justification for temporary controls would need to be reassessed periodically.

39. Where capital inflows pose persistent problems of macroeconomic management, they suggest a limited capacity to absorb such inflows without a realignment of policies, including fiscal adjustment, exchange rate flexibility, and trade/capital outflow liberalization. Accordingly, sustained inflows giving rise to problems of macroeconomic management would call for fundamental policy adjustments, and the temporary maintenance of controls would be appropriate only to the extent that such adjustments are being effected.

40. It was suggested above that restrictions on capital outflows introduced in the context of an emergency need not be approved by the Fund prior to their imposition (paragraph 33). There is a question whether restrictions in capital inflows should be treated similarly. Capital inflows generally build more gradually and can be dealt with through some combination of monetary and exchange rate policies (including sterilized intervention) without the need for an immediate recourse to capital controls. In such cases there would be adequate time for the member to consult with the Fund and for the Fund to assess whether the use of controls was warranted. On the other hand, there may be occasions when inflows build rapidly and in a destabilizing manner at a time when the needs of the domestic economy limit the flexibility of traditional policy instruments. In such cases, an emergency approval procedure for capital inflows would allow members greater flexibility in responding to such inflows, while requiring them to consult with the Fund shortly after the imposition of restrictions.

41. ***Approval criteria***—The approval criteria could be similar to those in approving controls on capital outflows. The problems posed by the inflows typically involve the excessive expansion of domestic liquidity stemming from the external sector and/or disorderly upward pressure on the exchange rate. Therefore, analogous to the balance of payments criterion, a criterion for approving a restriction on capital inflows under the amendment could be that the measure was needed for reasons of domestic liquidity and/or exchange rate (i.e., macroeconomic) management. The assessment could take into account the extent of the pressures generated by the inflows and the stance of policies, including an assessment that

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[15] See "Capital Account Convertibility and the Role of the Fund—Review of Experience and Consideration of a Possible Amendment of the Articles" (SM/97/32, 2/5/97), pp. 3-4.

fiscal and monetary/exchange rate policies were consistent with the authorities' macroeconomic objectives—such as economic growth, inflation, or sustainability of the external balance—or were being appropriately adjusted. In other words, the restriction was needed as a complement to otherwise appropriate domestic policies.

42. With respect to the other approval criteria under existing jurisdiction—i.e., that restrictions be temporary and nondiscriminatory among Fund members—they would also appear to be applicable to the inflows covered under the amendment. The assessment of temporariness would inevitably require considerable judgment and take into consideration the strength of the accompanying policies, the progress made in reducing reliance on the measure, and the length of time the measure has been in effect (if the measure has been introduced or approved earlier). The criterion of nondiscrimination would be consistent with the orderly, multilateral approach to the liberalization of capital movements (as discussed in SM/97/32).

43. A related issue arises as regards the extent to which the nature of capital inflows and the specific measures that are adopted should be considered in the approval process. To the extent that controls are imposed in order to limit short-term speculative inflows, they may be viewed more favorably than controls on movement of long-term capital. A prioritization based on the nature of the inflows may not be effective except in the very short run, however, in light of the possibility of circumvention through financial engineering. Consideration might be given to reflect, in the approval criteria, a preference for price-based and transparent controls over direct quantitative limitations and measures involving a high degree of administrative discretion.

44. As a general matter, notwithstanding the exclusion of inward direct investment from the Fund's jurisdiction, members should be dissuaded from restricting nondebt creating inward direct investment inflows for reasons of macroeconomic management. Such inflows typically provide lasting benefits to the economy and are usually driven by perceptions of the recipient's medium-term prospects.

B. Approval of Restrictions for Market and Institutional Evolution Reasons

45. As stated above, members may need to impose restrictions on capital movements (a) in the process of financial market development and (b) to limit the vulnerability of the financial system, until the necessary institutions are developed and strengthened. To maintain the signaling objective, however, it would be understood that recourse to this policy by such countries that had accepted the obligations for capital movement would be relatively limited. For members with developed markets and institutions, there would be a presumption that the regulation of new instruments would be achieved through measures that are not restrictive (i.e., which do not discriminate between domestic and international transactions). As is discussed below, however, to the extent that restrictions are of a purely prudential nature, they would be addressed through more-open ended approvals.

46. Examples of restrictions on capital movements that could be approved for reasons of weaknesses in markets, instruments and institutions under this policy are the following:

- When a new financial market or instrument emerges in a member country, the member would have an obligation under the Fund's extended jurisdiction to allow: (i) nonresidents to transact in that new market or instrument locally on the same footing as residents, and (ii) residents to transact in similar markets or instruments abroad. However, while such market development may reflect a deepening of a country's financial system, the country's situation may not allow for it, at the same time, to liberalize external transactions because of a structural need to husband domestic savings or because of inadequate institutional development. Thus, the liberalization obligations under the amendment, in such cases, could complicate the development of financial instruments and markets, and the member may need to restrict its residents' access to similar markets and instruments abroad and nonresidents from transacting in such markets or instruments locally.

- When a member needs to develop prudential standards to ensure that a capital inflow does not threaten the stability of the financial system (as, for example, when there is a need to establish loan loss and provision requirements that adequately reflect the risks of on-lending funds sourced from abroad), the member may have to contemplate temporary controls on capital inflows to the banking system before it is in a position to apply commensurate prudential standards.

47. Policies on the approval of restrictions of this nature could be based on an assessment of whether the measure is introduced as 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. Such an assessment could include whether the member were putting in place the necessary supporting reforms and procedures that would render the capital control redundant. For example, if the rationale advanced for imposing reserve requirements on certain types of capital inflows is that the banking sector is not sufficiently sound or well-equipped to deal with the large capital inflows, temporary approval could be based on whether the authorities are addressing the banking sector's actual or potential vulnerabilities, through restructuring and improved supervision practices.

48. The period for approval of such measures would have to be considered. In many instances, the time frame for approval under current procedures could be applicable, but longer periods could be considered in appropriate circumstances.

C. Approval of Prudential and Other Restrictions

49. As noted in *Capital Movements Under an Amendment of the Articles - Concepts of International Capital Movements and "Restrictions"* (SM/97/146), most prudential measures will not discriminate between domestic and international transactions and, therefore, will not constitute restrictions. For example, open foreign exchange limits that are exclusively designed to limit the foreign exchange exposure of financial institutions (as established by the Basle Committee on Banking Supervision) would not be discriminatory since they do not impose a special burden on transactions between residents and nonresidents that does not apply to purely domestic transactions. Even in cases where the prudential measures provide for special treatment for transactions with nonresidents, this treatment will not be discriminatory if the special treatment is justified by relevant differences in circumstances between residents and nonresidents. Accordingly, the authorities would be permitted to introduce special admission procedures for nonresident securities if they are designed to ensure that the authorities have adequate information to enable them to assess whether the nonresident is subject to regulatory standards comparable to residents.

50. In some cases, however, prudential measures will use nonresidence as the exclusive basis for less favorable treatment. For example, the authorities may feel that their regulatory capability is so limited that they are not in a position to assess the quality of nonresident securities and, therefore, may prohibit the local issuance of all nonresident securities. Similarly, the authorities may prohibit institutional investors from purchasing any nonresident securities, irrespective of the quality of the securities in question. In both these cases, the measures would give rise to restrictions since, as noted in SM/ 97/146, nonresidence may not, on its own, be a sufficient justification for less favorable treatment.

51. In the above cases, it would be appropriate to approve these measures under policies designed by the Executive Board. The principal question would be the criteria that would be used for determining the length of the approval period. Under one approach, determination of the length could be made dependent on whether: (i) there are alternative, generally accepted best practices or norms to achieve the same prudential result without the need to impose a restriction; and (ii) the extent to which the country has the capacity to implement these norms. In some cases, measures of a prudential nature might need to be approved for an extended period where alternative best practices to avoid restrictions have not been developed. Best practices, however, evolve over time, for example, with improvements in cross-border cooperation between regulators. Hence, the appropriateness of the approval could be reviewed periodically to reflect developments in regulatory practices and procedures. In the context of surveillance and technical assistance, the Fund could advise members on the experience of other members with best regulatory and operational procedures that could allow for the elimination of the restrictive features of the prudential measures.

52. It should be emphasized, however, that the above approval policy would not be available for measures that, although prudential in form, are clearly imposed for balance of payments reasons and do not serve a prudential purpose. The specific concern would be the presentation of measures as prudential when the purpose is of a macroeconomic or balance of payments nature.

53. It is for consideration whether the proposed policy for prudential measures should also extend to measures imposed for monetary control purposes. Discrimination between residents and nonresidents is not a usual feature of monetary regulations or policies that rely on indirect monetary instruments. Still, a review of the restrictions and reservations maintained by OECD member countries under the OECD Capital Codes (see SM/97/32, Supplement 2, Appendix)[16] indicates that certain countries have claimed that discrimination between foreign and local banks with respect to the issuance of certificates of deposit was justified because foreign banks are not subject to the country's reserve requirements.[17] Similar approval policies could be applied as described above in the case of prudential measures. In such an event, approval would require an assessment to the effect that the monetary control measures respond to institutional constraints, rather than balance of payments or macroeconomic management purposes.

D. Approval of Measures Introduced for National and International Security Purposes

54. As recognized under existing policies, members may need to introduce exchange restrictions for national and international security purposes. Under the amendment, the Fund could extend its present policy of granting nontemporary approval for restrictions imposed for national or international security reasons. Procedures that already exist to handle these types of measures under existing jurisdiction could be applied under the Fund's extended jurisdiction. Members are to notify the Fund of these restrictions, and unless the Fund informs the member within 30 days after receiving this notification that it is not satisfied that the restrictions are imposed solely for such security, the member may assume the restrictions are approved.

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[16]The review focused on these countries because of the higher quality of information since these countries' capital controls frameworks have already gone through significant review by the committee of Capital Movements and Invisible Transactions (CMIT) of the OECD, and because it would be expected that a number of OECD member countries would accept the obligations for capital under the amendment. This review also indicated that restrictions or reservations are maintained in two cases for tax administration.

[17] Although France is one of the two countries that maintains such restrictions, it justifies the maintenance of this restriction on the grounds that it ensures equal competitive opportunities for domestic banks.

V. Implications for Fund Financing

A. The Fund's Current Role in Providing Financial Support in Addressing Balance of Payments Problems

55. The Fund's financing mandate is defined in broad terms. Article V, Section 3(a), requires that: "[t]he Fund shall adopt policies on the use of its general resources... that will assist members to solve their balance of payments problems in a manner consistent with the provisions of this agreement and that will establish adequate safeguards for the temporary use of the general resources of the Fund." Article V, Section 3(b), specifies the conditions entitling a member to make a purchase from the Fund, including that "the member represents that it has a need to make a purchase because of its balance of payments or its reserve position or developments in its reserves."

56. The use of Fund resources to finance a capital account deficit is not precluded and, subject to the limitations of Article VI, a capital account deficit can be financed even if it is not accompanied by a current account deficit. The limitation imposed by Article VI is that "a member may not use the Fund's general resources to meet a large or sustained outflow of capital." With respect to the meaning that has been given to this limitation, the following may be noted.

57. First, the drafters of the Articles and the Executive Board have consistently refrained from identifying any quantitative measures for the concept of "large or sustained." Rather, it has been emphasized that the application of this limitation would require the exercise of considerable judgment, taking into consideration the circumstance of each particular case and a number of relevant factors.

58. Second, for purposes of identifying "relevant factors," it is important to recognize that the drafters were concerned that priority be given to the financing of current account deficits. Such financing would assist in elimination of restrictions which fell within the Fund's mandate. Accordingly, in order to determine whether a particular outflow was "large," it was recognized that an assessment would have to be made as to whether the financing of such outflows would affect the Fund's ability to finance current account transactions. Therefore, the Fund's overall liquidity is seen as a relevant factor that should be taken into account.

59. Finally, the exercise of the Fund's judgment in the context of "large or sustained" has also focused on the consistency of the use of the Fund's resources with the Fund's purposes.[18]

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[18] Article I ((v) and (vi)) specifies that among the Fund's purposes are: "[t]o give confidence (continued...)

In view of the fact that Fund resources are to be used to help members correct their balance of payments difficulties, a determination as to whether the capital outflows are "large or sustained" would involve an analysis of the causes of the outflows. In particular, an assessment would have to be made as to whether the member's policies are such that the use of the Fund's resources would contribute to—rather than delay—the resolution of these difficulties "by shortening the duration and lessening the degree of disequilibrium" in the balance of payments. For example, if appropriate corrective polices were not being taken, the outflows would more likely be "sustained." Similarly, the analysis would also take into consideration whether there are adequate safeguards for the Fund's resources.

60. Finally, the limitation imposed by Article VI has not prevented the Fund from providing financial support in the context of a large capital outflow, in support of an adjustment program that seeks to address the underlying difficulties giving rise to these outflows and that seeks to achieve a reversal and a reconstitution of reserves.

B. Capital Account Liberalization and Demand for Fund Financing

61. The liberalization and rapid growth of international capital flows in recent years raises important issues about the Fund's financing role in the international monetary system. It is recognized that, notwithstanding their generally beneficial effects, the magnitude and volatility of capital flows may result in disorderly developments in members' exchange rates and/or balance of payments. As mentioned above, the Fund's response to the increased globalization of financial markets has emphasized the importance of effective surveillance in promoting orderly underlying conditions and thereby reducing the need for the use of Fund resources. Under the amendment, surveillance would remain a central element of the Fund's approach to dealing with capital flows. Nevertheless, it can be expected that circumstances will arise when members would require financial support from the Fund.

62. Increased access to international capital markets has substantially reduced countries' reliance on official financing in recent years. A key consideration in preserving market access is the conduct of domestic policies, since imprudent domestic policies often spill over to the external sector and provoke an adverse market reaction. Thus, the desire to maintain access to international capital markets may exert a disciplinary influence on domestic policies and thereby serve to reduce the need for exceptional financing. By the same token, if such access

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[18](...continued)
to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" and "... to shorten the duration and lessen the degree of disequilibrium in the international balance of payments of members."

allows unsound policies to be pursued longer than would be the case otherwise, balance of payments pressures could result as markets come to recognize the unsustainability of policies. The reduction or loss of market access could, in such cases, give rise to large financing requirements and increase the need for the use of Fund resources in support of orderly adjustment. [19]

63. A likely consequence of the liberalization of capital flows under the amendment would be an increased tendency toward larger current account deficits in many countries, as external savings flow to those with better investment opportunities. For countries liberalizing capital flows, returns to capital would tend to govern the underlying demand for borrowing and, given appropriate risk–adjusted returns, markets are likely to provide such financing. To the extent that larger current account deficits are financed through the markets, they are, in themselves, not likely to increase the demand for Fund resources; such demand may even be reduced to the extent that private and other official arrangements are put in place to deal with adverse developments.[20]

64. While increased access to capital markets may tend to reduce the need for the use of Fund resources in "normal" circumstances, for a number of reasons freedom of capital movements could mean potentially larger requirements in individual cases and at particular times. First, the supply of market financing is subject, inter alia, to sudden shifts in risk perceptions and changes in creditors' relative rates of return. Such shifts in the availability of market financing could put severe strains on a member's balance of payments and require substantial financing, including from the Fund.[21] Second, debt–creating private market financing, if not carefully managed, could over time contribute to a structural widening of individual members' current account deficits and result in larger financing requirements in the event of policy or exogenous shocks. Third, a build–up in the stock of debt through market

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[19] In 1995, in the context of the Mexican crisis and its spillover effects, the share of official financing in total financial flows to developing countries increased sharply from 13.3 percent in 1994 to 23.2 percent.

[20] A growing number of Fund members have also arranged alternative mechanisms for financing (such as lines of credit with commercial banks and swap arrangements with other central banks) to deal with short–term balance of payments pressures.

[21] Net capital inflows concentrated in inward foreign direct investment, which generally contribute to economic growth and expansions of exports are likely to be less problematic. Fluctuations in these flows would tend to be associated with offsetting balance of payments developments to the extent that a reduction in inward direct investment is accompanied by a reduction in associated imports.

borrowing results in contractual obligations which could be difficult to roll over in the event that market perceptions change. This could give rise to the need for large amounts of exceptional financing.

65. It is difficult to predict with any degree of confidence the net effect of the amendment on the need for the use of Fund resources. Nevertheless, the evolution of the current account deficits and the greater reliance for their financing on potentially volatile private capital flows would suggest that the Fund would need to be prepared to provide a larger quantum of temporary financing in support of a member's adjustment policies in cases where the supply of private financing is significantly and abruptly curtailed and the country is willing to implement the needed adjustment policies.

C. Constraints on Fund Financing of Capital Outflows

66. Following the amendment, members would not be able to impose controls without Fund approval and may require the Fund's financial support in the face of balance of payments pressures arising from capital outflows. The Fund's readiness to assist in such circumstances would give members confidence to liberalize capital movements. As mentioned above, the financing requirements associated with balance of problems due to capital outflows in individual cases could be "large." The merits of substantial financial support for a member facing large outflows would need to be assessed on a case–by–case basis. Generally, a strong up-front adjustment effort by the member would be the first line of defense. With good prospects for correcting the problem and maintaining market access, the member's program could be supported by the Fund's financing and catalytic role in mobilizing financing from other creditors.

67. There may, however, be circumstances where a member faces large capital outflows with only limited prospects for regaining access to capital markets within a relatively short time period. There is a question whether in such circumstances it would be appropriate to provide Fund financing. In particular, consideration 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, keeping in mind the principle of uniformity of treatment; and concentration of the Fund's exposure. In addition, Fund financing in such circumstances could engender moral hazard for both creditors and debtors, to the extent that it resulted in an unduly favorable assessment of market risk on the part of creditors and/or weakened the incentives for members to take early corrective measures in the face of emerging pressures. In some cases, the extent of adjustment required and the magnitude of financial support needed could outstrip both the member's capacity to undertake such adjustment and the ability of the Fund and others to provide the level of financing that would be required for the member to continue to adhere to its obligations concerning avoidance of current and capital account restrictions. In such circumstances, controls on capital outflows on a temporary basis might have to be considered.

68. In the formulation and implementation of its policies on conditionality and access, the Fund may find it necessary to include the imposition of restrictions or other controls on capital outflows, as a temporary measure, to limit the use of its resources. Since restrictions on capital outflows would be contrary to the purposes of the Fund (as redefined by the amendment), an explicit provision allowing the Fund to impose this type of conditionality would be needed. To that extent, there would continue to be an asymmetry with current payments.

69. An additional question arises in the context of the amendment whether it would be appropriate and desirable to maintain the injunction against financing "large or sustained" capital outflows, or some similar safeguarding language, in the Articles. There are several aspects to this question. First, as noted above, the existing language reflects the priority the drafters of the Articles accorded the financing of current account deficits. Whether that priority would remain appropriate under the amendment is questionable. If some such injunction is retained in the Articles, consideration could be given to more evenhanded language, referring perhaps to payments imbalances rather than capital outflows. Second, it is difficult to see how financing by the Fund of a "sustained" capital outflow could be regarded as consistent with the purposes of the Fund to shorten the duration and lessen the degree of disequilibrium in the balance of payments and the requirement to safeguard the temporary use of the Fund's resources. As discussed above, there may, however, be cases in which the financing of "large" outflows is compatible with these provisions and appropriate. Third, the drafters were presumably not concerned mainly with possibly small Fund financing for capital outflows that were themselves large or sustained in an individual case, but rather with large and sustained use of Fund resources by a member in the financing of capital outflows. If a provision along the present lines is retained in the amended Articles, consideration could also be given to a reformulation of this part of the provision with a view to capturing more closely the point of protecting against undue use of the Fund's resources.

70. More basically, however, it is not clear that retention of such a provision is essential. As noted above, Article V, Section 3(a) already requires the Fund to establish adequate safeguards for the temporary use of the Fund's general resources. This would apply in all cases, regardless of whether the problem is related to the current account or the capital account. The safeguards are embedded in the Fund's policies on conditionality and access, and can be supplemented by use of the provisions of Article V, Section 4, also related to safeguards. Reliance on the requirements of Article V for safeguards, and associated Fund policies, could be considered to provide sufficient protection for the Fund's resources.

VI. Issues for Discussion

71. The paper proposes that the design of transitional arrangements and approval policies under the amendment could reflect the following principles: (i) no backsliding, (ii) clear signaling, and (iii) flexibility in approval policies. Directors may wish to comment on these principles for the architecture of transitional arrangements and approval policies.

72. Under the Fund's existing jurisdiction, the transitional provisions have been interpreted as permitting a member to relax or intensify an existing restriction, while the introduction of a new restriction would require approval by the Fund. Directors' views on whether this interpretation should also apply to the Fund's extended jurisdiction under the amendment would be welcome.

73. Approval policy would need to be developed to take account of the complexities of capital movements, the specifics of the case and the purpose of the restriction. Directors may wish to comment on the suggestion that the main areas that approval policy would need to cover are: (i) macroeconomic and balance of payments; (ii) market and institutional evolution; (iii) prudential; and (iv) national and international security.

74. Concerning temporary approvals for macroeconomic and balance of payments reasons, the paper suggests that it would be appropriate to apply the existing criteria for the temporary approval of restrictions on current international payments and transfers to the approval of restrictions on capital outflows i.e., that they are necessary for balance of payments reasons, temporary and nondiscriminatory. It also suggests that there would be a need, in some cases, for approval of restrictions on capital outflows on an emergency basis. In regard to restrictions on capital inflows, the paper suggests that approval be based on a judgment that the controls are necessary for reasons of macroeconomic (i.e., domestic liquidity and/or exchange rate) management, and that they are temporary and nondiscriminatory. In addition, it raises a question whether there would be a need for an emergency approval procedure for controls on capital inflows. Directors may wish to comment on these issues.

75. Directors may wish to discuss the approaches to the approval of restrictions for market and institutional evolution, prudential, and national or international security reasons. In particular, Directors may wish to comment on: (i) the extent to which members should have recourse to restrictions for market and institution evolution reasons once they have accepted the obligations for capital movements; (ii) the length of period for the approval of measures that are taken for prudential reasons and whether this should take into account the existence of best practices and norms, and the country's capacity to implement these norms; (iii) the approval of measures maintained because of institutional constraints on the effectiveness of monetary instruments; and (iv) the appropriateness of extending the existing procedures for restrictions maintained for national and international security under the amendment.

76. The paper suggest that in some cases, in the context of conditionality, the Fund may need to request members to impose controls on capital outflows. This authority would need to be made explicit in the Articles. Directors may wish to comment.

77. It is difficult to judge the net effect of the amendment on the use of Fund resources. Increased access to markets may tend to reduce the need in the normal course of events. Nonetheless, the evolution of current account deficits and greater reliance on potentially volatile capital flows for their financing would suggest that the Fund will need to be prepared to provide larger amounts of temporary financing in support of a member's adjustment policies in cases where the supply of private financing is significantly and sharply curtailed. Directors may wish to address the issues in this area.

78. Finally, the paper has addressed the question of retention in the Articles of the present injunction against Fund financing of large or sustained capital outflows, perhaps in a modified form that treats capital and current account imbalances more evenhandedly, and an alternative of relying on other provisions of the Articles and related Fund policies for assurances regarding adequate safeguards for the temporary use of Fund's resources. Directors' comments on these issues would be welcome.