February 12, 1997
Approval: 2/20/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/73

10:00 a.m., July 28, 1995

Contents

Executive Board Attendance

S. Fischer, Acting Chairman
A. D. Ouattara, Acting Chairman

Executive Directors	Alternate Executive Directors
A. A. Al-Tuwaijri	
M.-A. Autheman	
J. Bergo	E. Srejber
	B. Grikinyté, Temporary
L. E. Berrizbeitia	V. J. Fernández
	M. Alemán, Temporary
	J. Guzmán-Calafell
I. Clark	
B. S. Dlamini	
	J. Shields
K. P. Geethakrishnan	W. Hettiarachchi
	L. M. Cheong
D. Kaeser	R. Cippa, Temporary
	A. Calderón
	J. C. Estrella, Temporary
	G. P. Ramdas, Temporary
W. Kiekens	J. Prader
	S. N'Guiamba, Temporary
G. Lanciotti	G. Schlitzer, Temporary
K. Lissakers	B. S. Newman
	M. Brettschneider, Temporary
H. Mesaki	T. Fukuyama
	Y. Tahara, Temporary
A. Mirakhor	M. Daïri
	M. A. Hammoudi, Temporary
	A. G. Zoccali
S. Schoenberg	B. Esdar
	Y. Y. Mohammed
	T. K. Gaspard, Temporary
D. V. Tulin	B. M. Lvin, Temporary
	J.-H. Kang
	C. M. Gonzalez, Temporary
J. de Beaufort Wijnholds	G. A. Kyriacou, Temporary
Zhang M.	Wei B.

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant
D. Rajnes, Assistant

Also Present

IBRD: U. Hewer, Central Asia Regional Office. African Department: C. Brachet, Deputy Director; P. A. Acquah, M. T. Hadjimichael, R. Randriamaholy. European I Department: M. Russo, Director; B. B. Bakker, B. Banerjee, G. Bélanger, I. Halikias, W. Jack, T. D. Lane, S. M. Meehan, E. J. Zervoudakis. External Relations Department: H. P. Puentes. Fiscal Affairs Department: M. Sakaguchi. IMF Institute: P. B. de Fontenay, Director; A. Ouanes. Legal Department: R. H. Munzberg, Deputy General Counsel; P. De Boeck, J. L. Hagan, Jr., H. V. Morais, D. E. Siegel. Middle Eastern Department: A. Jbili. Monetary and Exchange Affairs Department: M. Guitian, Director; V. Sundararajan, Deputy Director; P. T. Downes, J. P. Green, K. M. Huh, R. B. Johnston, A. Kovanen, J.-Y. Lee, C.-J. Lindgren, D. Menchikov, M. B. O'Brien, P. J. Quirk, P. J. Sandoval, T. Yoshimura. Policy Development and Review Department: M. Allen, Deputy Director: D. N. Lachman, Deputy Director; T. Leddy, Deputy Director; S. V. Dunaway, H. M. Flickenschild, V. Galbis, R. T. Harmsen, R. H. Nord, J. P. Pujol, S. B. Schwartz, S. K. Wajid. Research Department: M. S. Khan, Deputy Director; F. Larsen. Statistics Department: S. P. Quin. Treasurer's Department: L. Aylward, W. J. Byrne. Western Hemisphere Department: B. C. Stuart, Deputy Director. Office of the Managing Director: K. Sugisaki, Special Advisor, D. Burton. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, B. Andersen, P. Cailleteau, A. Cserés, S. K. Fayyad, J. Guzmán-Calafell, He J., J. Jonáš, J. Justiniano, R. Kannan, S. O'Connor. Assistants to Executive Directors: S. E. Al-Huseini, T. Berrihun, P. I. Botoucharov, J. A. Costa, J. Dagustun, D. Desruelle, S. Fukushima, D. Giga, M. Giulimondi, A. Guennewich, R. J. Heinbuecher, O. A. Himani, C. Imashev, P. Jilek, A. M. Koulizade, K. Kpetigo, T.-M. Kudiwu, N. L. Laframboise, Ng C. S., H. Petana, V. Rigász, S. Rouai, M. W. Ryan, D. Saha, K. I. Sakr, T. Sitorus, Song J., V. Trivedi, V. Y. Verjbitski, Wang Y., J. B. Wire.

1. CAPITAL ACCOUNT CONVERTIBILITY - REVIEW OF EXPERIENCE, AND IMPLICATIONS FOR FUND POLICY

The Executive Directors considered a staff paper on a review of experience and implications for Fund policies relating to capital account convertibility (SM/95/164, 7/10/95; Sup. 1, 7/10/95; Sup. 2, 7/11/95; and Sup. 3, 7/11/95).

Mr. Clark made the following statement:

The experience of countries in my constituency with capital controls is interesting with respect to its diversity. According to the 1994 annual report on Exchange Arrangements and Exchange Restrictions, two countries--Ireland and Antigua and Barbuda--have no restrictions on capital account transactions whatsoever. Canada and Jamaica have absolutely no restrictions on capital movements but do impose some "prudent portfolio" restrictions, usually designed to establish a hedge against exchange rate risk, on the foreign exchange activities of some financial institutions. Canada, like many other countries, also reviews some direct investments respecting foreign ownership in strategic industries. The remaining countries in my constituency, which are all small Caribbean nations, impose restrictions on capital outflows--typically approval requirements--and, in most cases, on inflows, including both foreign direct investments and portfolio investments. Although it is difficult to assess how strongly, or evenly, these controls are enforced, many of the countries in my constituency clearly believe that there is some rationale for preserving certain types of capital account restrictions.

The argument for restrictions on capital movements is typically one of preserving financial market and exchange rate market stability. All of my Caribbean constituents have fixed their exchange rates against the U.S. dollar and are concerned that their banking systems and financial markets are insufficiently competitive and robust to withstand volatility in capital flows. Some of the central banks do not have the capacity to effectively sterilize capital flows or to conduct indirect monetary control operations because of underdeveloped money markets. Capital controls, therefore, are seen to offset the distortions from financial market imperfections. Many are unconvinced by arguments that a phased elimination of these restrictions, as an element in an appropriately sequenced financial sector reform program, will improve the competitiveness and strength of their domestic financial systems and help preserve their exchange rate parities through greater discipline on macroeconomic stabilization policies. Ironically, some point to robust activity of their off-shore banking industries, which attract foreign investment flows in response to relatively onerous taxes and financial restrictions in other countries, as a contrast to their domestic banking sector.

The non-Caribbean members of my constituency find convincing the empirical evidence cited in the supplements to the staff paper on the ineffectiveness of restrictions on capital flows and the excessive distortionary nature of these controls. Notable here are the empirical results indicating that restrictions are largely ineffective in preventing capital outflows and generally drive a wedge between domestic and world interest rates that raises the cost of capital in the regulated country. Also persuasive is the evidence that capital restrictions do not generally eliminate the prospect of economic instability nor protect the integrity of financial markets and institutions. Moreover, the re-imposition of controls during a crisis period is not considered to be effective, except possibly as a temporary support for the introduction of more fundamental policy measures. Canada and Ireland firmly believe that the elimination of controls on capital transactions as part of financial market reform is generally a first-best solution to financial market inefficiencies and is, therefore, welfare-improving.

On balance, I support this general conclusion while noting that the direction and pace of financial reform and the elimination of restrictions on capital movements can vary from case to case. For some countries, more flexibility in exchange rates than at present may be required for a smooth transition to a post-controls environment. Also, it is worth emphasizing that the sooner the process begins, the sooner the economic gains can be realized. In a world where capital markets are integrating rapidly with the elimination of informational and regulatory barriers to capital movements, the economic costs of delay can accrue quickly.

In terms of staff procedures with regard to advice to members on capital account restrictions, a further intensification of the current approach within the existing Articles is warranted. The staff has, over the past few years, increased its efforts to convince members imposing capital account controls of the benefits of liberalizing these restrictions in the context of monetary and financial sector reforms. The staff's work for this discussion adds impressive ammunition for that effort, which justifies a degree of escalation in both surveillance and technical assistance activities. In fact, the staff should consider publishing these studies as Occasional Papers, along with the additional work that it should undertake on the efficacy of specific types of capital controls and their role in the financial sector reform process.

I support, of course, the notion of coordinating this advice with other interested institutions, such as the Organization for

Economic Cooperation and Development (OECD) and the World Trade Organization (WTO), and would certainly have no objection to investigating the adoption of the OECD code, or some variant, as a guideline for the staff's position. A more compulsory approach, which would involve substantial changes to the Articles, would be time-consuming and does not appear to be necessary at this point as the staff seems well able to proceed under the existing Articles.

Mr. Mirakhor said that he supported Mr. Clark's suggestion that the staff papers be published.

Mrs. Cheong made the following statement:

In today's environment of an increasingly integrated global financial system, it would be in every country's best interests to expedite the process of capital account liberalization. Most countries are already liberalizing their capital accounts because this is generally viewed as an effective way to promote foreign investor interest. However, the pace of such liberalization should not be forced upon member countries. Due cognizance must be given to the differences in terms of implementation capacity in individual countries. It would, therefore, be more practical to pursue capital account convertibility on a case-by-case basis, bearing in mind the varied circumstances of the Fund's membership. The need for a gradual or even cautious approach is particularly relevant as liberalization is usually considered irreversible. In addition, as this chair has emphasized many times, capital account liberalization has a significant impact on the sequencing of financial sector and other reforms. Hence, one should make haste slowly.

On the question of the efficacy of quantitative controls to curb capital inflows, experience has been limited to a few countries. It is difficult to make a prima facie case that such controls were effective or ineffective because in most cases, they were implemented together with other instruments to tighten monetary and fiscal policies. The staff papers cited several countries in my constituency in regard to their recent experiences with capital controls. I would like to emphasize my authorities' view that the use of temporary, administrative measures during 1990-94 played an important role in stemming the influx of short-term capital inflows, particularly those in search of arbitrage opportunities. At the same time, my authorities agreed with the staff that such controls could have distortionary implications and should, as intended, be lifted once their objectives had been achieved. More important, there should not be an over-reliance on exchange controls as the foremost measure to address capital inflows. The main policy measures should still be an appropriate mix of monetary, fiscal, and exchange rate policies. Exchange control measures should only be necessary to address the speculative element in capital inflows. Our experience was that these measures provided a breathing space to enable more fundamental macro-policies to be implemented subsequently. I do not believe that capital control measures delay policy adaptations. Market forces would dictate that such capital controls cannot be maintained over a prolonged period owing to the efficiency losses arising from market distortions. The market itself will force authorities to ensure that more fundamental fiscal, monetary, and exchange rate adjustments are implemented, after which the temporary exchange control measures should be removed.

During the years when we faced capital inflow problems--and even in the earlier days of exchange control liberalization--countries in my constituency have found the present Fund treatment of capital account policies under its surveillance and technical assistance functions to be adequate in encouraging members to liberalize capital controls as part of the overall deregulation of the financial system. Evidence in the emerging markets has shown that lack of Fund legal jurisdiction has not impeded voluntary relaxation and elimination of exchange controls. Although by virtue of Article VI of the Fund's Articles of Agreement, the Fund cannot rule against a country imposing capital controls, advice on appropriate deregulation of exchange controls has been useful and effective. The Fund can and should continue to provide such advice in the context of measures to improve members' balance of payments positions and promote growth and efficiency in their financial sectors. We already have an effective vehicle for conveying such advice, namely, in the context of the Article IV consultations.

In this regard, I believe that the current provisions of the Fund's surveillance decision relating to capital transactions are broadly appropriate. I can also support the use of Fund technical assistance to help member countries establish the necessary preconditions for capital account convertibility. At the same time, I can be persuaded on the merits of adapting the Fund's surveillance and technical assistance functions to enable it to play a more active role in promoting capital account convertibility. However, I believe more work is needed to assess the usefulness of extending the Fund's jurisdiction over capital account transactions. As I mentioned earlier, the pace of capital account liberalization should be determined on a case-by-case basis, not forced upon the membership.

Because extending the Fund's legal jurisdiction is a very important step, it would be useful if the staff could undertake a detailed assessment of the possible consequences of such a course of action, particularly in terms of the additional obligations that the membership must meet. A balanced analysis of the advantages and disadvantages would go a long way toward facilitating an informed decision. This analysis should also evaluate the advantages and disadvantages of the present system which accords flexibility to members, vis-à-vis a possibly more constrained environment when Fund jurisdiction is extended to capital transactions. In addition, an informed decision could be facilitated by a clearer staff exposition on the objective of extending Fund jurisdiction, especially with respect to: the "unfinished business" reported in the staff paper in footnote 1, page 16; the need to avoid overlap with work in other institutions indicated on page 17, as sound policies require the Fund's functions to complement, rather than duplicate, that of other institutions; the need for provision for controls on short-term inflows indicated on page 16, when current rules already allow such measures; and the claim that legal jurisdiction would allow the Fund to provide financial assistance to members facing balance of payments problems associated with fluctuations in capital flows indicated on page 17, whereas current Fund assistance under a stand-by arrangement can, and does, in effect help to prop up reserves to improve a member's balance of payments position.

In particular, I would appreciate the staff's comments on how extending jurisdiction would promote capital account convertibility, in view of the fact that many developing countries are already deregulating controls based on the dictates of economic necessity and, as the staff paper had clearly indicated, certain preconditions must be in place before capital account convertibility will yield economic benefits.

Mr. Mirakhor made the following statement:

In assessing appropriateness of capital account liberalization and implications for Fund policies, including extension of Fund jurisdiction to the capital account, lessons from the experience of developing countries in the area of current account convertibility and industrial countries' move to full capital account liberalization are helpful. Regarding the former, the experience is characterized by four major features. First, rapid acceleration of Article VIII acceptance occurred only in recent years after a long period of implementation by countries of macroeconomic stabilization programs and structural reforms. Second, the formal acceptance was preceded by a long process of gradual liberalization of the current account. Third, the liberalization process did not discriminate between current account and capital account. In fact, several countries had already achieved a degree of capital account liberalization even before formal acceptance of Article VIII obligations. Fourth, and as in the case of the countries of our constituency, the acceptance of current account convertibility was generally of a voluntary nature with the Fund's technical assistance.

With respect to industrial countries' experience with capital account liberalization--apart from the fact that this process was gradual and completed only recently--the staff notes two important features. One is the close relationship between the removal of capital controls on inflows and outflows and the strength of the balance of payments. In this context, the staff indicates "that countries which had a strong balance of payments position tended to rely on controls on inflows, whereas those which had a generally weaker position maintained controls on capital outflows." The other notable feature highlighted by the staff is the distinction between short-term and other flows. The staff indicates that "inward or outward short-term flows were viewed as potentially destabilizing and, therefore, were usually subject to more stringent controls than long-term flows, such as foreign direct and portfolio investment."

With the benefit of these experiences, the merits of capital account liberalization should be discussed on a case-by-case basis, and both the positive and negative elements should be taken into account when recommending capital account liberalization. Although it is recognized that efficiency and risk-diversification gains would accrue to any country that moves toward full capital account liberalization, as the staff paper notes, there are also costs that can be substantial.

One argument against premature and full capital account liberalization would be that in the sequencing of structural reforms, capital controls may be necessary to prevent volatile capital flows that would disrupt the reform program itself. For example, there could be excessive capital inflows during a structural reform program that would lead to a real exchange rate appreciation. That, in turn, could offset the beneficial effects of trade and price reforms on the external competitiveness of domestic firms. Another argument would be that capital controls help to ensure that scarce domestic savings are used to finance domestic investment rather than the acquisition of foreign assets. Yet another argument for capital controls would be that they help to maintain the authorities' ability to tax domestic financial activities, income and wealth. For these and other reasons, it has often been recommended that the opening of the capital account should occur late in the sequencing of stabilization and structural reform programs in developing countries.

The foregoing considerations point to significant differences between capital and current account liberalization and, indeed, the Articles of Agreement have taken these concerns into account. Any consideration of extending existing obligations under

Article VIII to capital account will have to, at a minimum, address these concerns. It should also take into account the specific circumstances of individual countries and recognize that considerable time and effort is required before some developing countries will be in a position to liberalize fully their capital accounts without jeopardizing their adjustment and other policy objectives. Thus, the issue of capital account convertibility should be approached with pragmatism and flexibility. Rigid rules, which could be viewed by countries as conditionality rather than a necessary and helpful step in their development strategy, should be avoided.

In our view, such a flexible approach could include the following four elements. First, on a case-by-case basis, the Fund could encourage countries to accelerate capital account liberalization when there is agreement between the Fund and the authorities that the country satisfies the necessary preconditions. There is a general agreement that, among the preconditions, it is important to achieve a stable macroeconomic environment characterized, among other things, by a viable balance of payments position. Other important preconditions include domestic financial reforms to achieve competitive and market determined interest rates, efficient money and foreign exchange markets, robust financial system with adequate prudential regulations, as well as increased flexibility in the conduct of fiscal policy to support capital account liberalization.

Second, the Fund should also highlight the potential risks associated with this move, particularly during the transition period. In this connection, countries could be more inclined to accelerate liberalization of capital transactions if they are reassured of multilateral support to overcome short-term pressures.

Third, during the process of capital account liberalization, a gradual approach should be followed with priority given to stable and long-term capital inflows like foreign direct investment.

Finally, it should also be recognized that temporary reintroduction of capital controls may be decided by the authorities at their own discretion and without review by the Fund when the countries are confronted with exchange rate pressures or large and unsustainable capital flows. Temporary controls may provide the authorities the opportunity to design an appropriate policy response.

Extending his remarks, Mr. Mirakhor said that he would support any plans for publication of the set of staff papers, after due consideration had been given to the Board discussion.

Mr. Bergo made the following statement:

At the outset, I would like to welcome this review of the Fund's potential role in monitoring capital account restrictions and encouraging capital account restrictions. As this is the first more general discussion of a very important issue that could have widespread consequences for the Fund's future role, I would also like to emphasize that my views are of a preliminary nature at this stage.

I will try to concentrate my remarks on two major themes, namely, the experiences with capital account convertibility and the potential future role of the Fund.

In regard to experiences with capital account convertibility, I am in broad agreement with the staff's analysis and conclusions. Restrictions on foreign exchange convertibility, whether in the current or the capital account--the distinction between the two becoming increasingly irrelevant--seldom have the intended effects and, to the degree they have any effect, it is most often a serious distortion of the functioning of the economy. Moreover, as the staff paper underscores, open financial markets and exposure to private capital flows put a premium on disciplined implementation of sound policies, and on the consistency and continuity of such policies. Thus, the market discipline generally speeds up the recognition of unsustainable policies and thereby brings about needed policy adjustments.

Nevertheless, the appropriate speed and necessary conditions for full capital market liberalization remain important policy issues. I would like to emphasize that freeing capital account transactions should preferably be undertaken subsequent to--and certainly not prior to--a number of other reforms, including domestic financial market reforms, strengthened prudential regulations and requirements, and strengthened capacity to adopt appropriate fiscal policies. It is certainly true that the most beneficial results come when convertibility goes hand in hand with the pursuit of prudent macroeconomic policies and comprehensive structural reforms. The larger the initial distortions and the smaller the initial market credibility, the more care should be taken in structuring and implementing the liberalization. The appropriateness of liberalization needs to be judged on a case-by-case basis, with a bias toward removing the rigidities as soon as circumstances permit.

On the efficacy of specific efforts to deter or slow capital inflows, I have little to add to what was said by this chair in connection with the surveillance discussion on capital markets (EBM/95/51, 5/24/95). A number of factors are of relevance when examining the causes and responses to unsustainable capital inflows, and, in view of the significance of country-specific factors, it is not easy to undertake a general discussion and draw firm conclusions about the appropriate mix and sequencing of policy responses. Once capital account liberalization has been introduced, I would agree that the process should be reversible. However, in exceptional cases, it is reasonable to have recourse to capital controls, but only as a strictly temporary measure, such as the safeguard clause contained in the EU Treaty. Moreover, such exceptional measures should only be considered within the context of other policies and mainly for the purpose of buying time to deal with the underlying causes of the unsustainable developments. Consequently, I would not totally exclude the possibility that capital controls, broadly defined, may be of some use for countries experiencing an unsustainable surge in capital inflows; however, I would also like to stress that recourse to capital controls must be an exception and, in most cases, probably will be more appropriate to deal with the underlying causes through other measures, such as fiscal policy measures, sterilization, and the allowing of some appreciation of the exchange rate. In this context, I found it useful that the staff, based on some country cases, concludes that, on balance, capital controls seem to have been far less important in successfully dealing with capital inflows than the adjustment of underlying fundamental macroeconomic policies.

Turning to the future role of the Fund, let me begin by stressing that, in general, I would find it appropriate that the Fund pay more attention to capital account issues. Moreover, the Fund should be more active in encouraging liberalization of capital movements in the time ahead.

The main question is whether the Fund has the means, based on the Articles, to aid the momentum of progress and to what extent the Fund utilizes its means, or whether an amendment of the Articles would be necessary for the Fund to achieve its main objective of a multilateral system of exchange free of restrictions.

As to whether the Fund has the means to aid the momentum, I would argue that even if the current Articles might look somewhat old-fashioned in today's changing world of increasingly integrated capital markets and greater recognition of the benefits of capital account liberalizations, Article I, when read in conjunction with Article IV, Section 1, appears to give the Fund a mandate to promote capital account convertibility--albeit perhaps not a very clear one and without specific means of enforcement. Article VI also appears to leave considerable room for supporting such policies with Fund resources, if and when needed and appropriate.

As to whether the Fund utilizes its means, we should not lose sight of the role that the Fund has played in maintaining and speeding up the momentum toward convertibility. The advice given by the Fund in the context of regular surveillance exercises, Fund programs, and technical assistance has played an extremely important role. Simply by assisting members with their programs of macro-economic stabilization and structural reforms, particularly in the area of adopting market-based monetary policy instruments, the Fund makes a most valuable contribution. Moreover, it seems reasonable to expect that countries that pursue sound economic policies will abolish foreign exchange restrictions sooner or later, as this is in their own interest. We should also recognize that the most important forces, economic and political, that are building the momentum for change toward full convertibility are at work largely outside the Fund's sphere of direct influence. Of particular importance is the general liberalization that has taken place in the regional context, the efforts within the EU and the European Economic Area being illuminating examples. Once economies have been liberalized on a regional basis, the perceived advantages of maintaining restrictions toward the rest of the world will diminish.

However, I would agree with Mr. Clark that a further intensification of the current approach within the existing Articles is warranted and that the work done by the staff for this discussion adds impressive arguments for such efforts. I can therefore support the Fund's more actively promoting capital account liberalization through its existing surveillance and technical assistance functions. I would also agree that the Fund, responding to the changing world of increasingly integrated capital markets, could pay greater attention to restrictions on capital flows in member countries and encourage their removal in conjunction with appropriate macroeconomic adjustments.

Accordingly, a strengthening of the Fund's information base seems fully justified. I would also be open to investigating the adoption of some code, possibly based on the OECD code, as a guideline for the staff's position. Furthermore, I would not rule out, in some cases, including recommendations and performance criteria for capital account convertibility in Fund-supported programs, although great care should be devoted to ensure that the proper conditions are fulfilled with respect to the underlying policies. As Mr. Wijnholds pointed out in our seminar on international exchange and payments systems (Seminar 94/10, 11/16/94), the Article of Agreements do not include either the enforcement of fiscal consolidation or modest growth of net domestic assets, although these are often performance criteria in Fund-supported programs.

In conclusion, I see a strong case for enhancing the Fund's surveillance of capital movements and for increasing the Fund's activity in encouraging capital account liberalization. In the short term, this must take place within existing surveillance and technical assistance. However, an extension of the Fund's jurisdiction could be examined in the light of developments that have taken place in capital markets and the further experience gained. The extent to which developments toward capital liberalization should indicate a need for changes in the design of Fund-supported programs would also be relevant in these considerations. Such an extension of jurisdiction would combine well with the Fund's surveillance of exchange rates and the international monetary system.

Mr. Kaeser made the following statement:

We would like to thank the staff for the excellent set of papers that provide a solid basis for today's discussion.

In previous discussions on capital inflows to developing countries, we had agreed that greater capital market integration could improve economic growth and macro-economic performance through a more efficient allocation of resources; however, we had also pointed out the challenges that such an integration implied. For instance, capital market integration could imply sudden reversals in capital flows, increasing the volatility of local markets. In addition, massive capital inflows raised the question of the efficiency with which a country could absorb them. Last year's World Economic Outlook suggested that, at least for Latin American countries, investment had not substantially increased while consumption had surged, indicating that foreign capital was a substitute for domestic savings.

As capital outflows are generally triggered by a crisis, imposing capital controls in such circumstances would only amplify the outflows. Again, in previous discussions on capital inflows to developing countries, by contrast, we had encouraged the staff to take a more positive look at the measures that could be taken to discourage short-term capital movements. For countries implementing sound macro-economic policies, we argued, such temporary measures could contribute to reducing the destabilizing effects of massive capital inflows. This position seems to be confirmed by the evidence provided in recent staff studies, according to which sterilization operations have increased short-term interest rates, increasing in turn the inflow of capital and triggering a change in its composition toward short-term instruments; moreover, liberalizing capital outflows has induced even heavier inflows by increasing the confidence of foreign investors.

As the experiences of Chile and Colombia tend to show, the only type of measures that have reduced the volume of capital inflows and altered their composition toward longer-term investments seem to have been those aimed at discouraging short-term capital movements. In this respect, it would be interesting to learn whether the staff would advise the authorities to resort to fiscal disincentives--for instance, a flat tax--or to administrative measures.

The Fund should, nevertheless, continue to cautiously encourage capital account liberalization. Full capital account convertibility should be the long-term goal of every country participating in international capital markets. A code of liberalization might be useful in this regard, but this objective should not be pursued precipitately. Even if capital controls are considered as ineffective, they can temporarily drive a wedge between domestic and international interest rates.

We believe that capital account liberalization should be an irreversible process, not one characterized by trial and error. This does not exclude the existence of safeguard clauses; a liberalized capital account must only be implemented when a set of conditions is met. One important element is the commitment of the government to stability-oriented policies. Other elements include the strength of the balance of payments; the structure and extent of the external debt; the structure of the financial sector; the effectiveness of the prudential and regulatory mechanism; the adequacy of the exchange rate; and strength of international reserves. If liberalization is introduced and then reversed, any further attempt to liberalize would lack credibility. We suspect that reintroducing capital controls is more costly than having controls in place. Economic agents prefer to act in an environment in which the rules of the game are predictable. Predictability stabilizes expectations and contributes to higher investment and economic activity.

Notwithstanding the clear language of Article VI, the Fund's policy has been one of implicitly and explicitly encouraging the membership to liberalize capital account transactions when it was deemed that the preconditions for such a liberalization were met. The Fund's approach was generally supportive toward industrial countries; it adopted a more cautious, case-by-case approach toward developing countries. In view of the increasing volume of worldwide capital transactions and in the light of recent developments in world capital markets, we believe that there is a case for a more active Fund role in the area of promoting capital account convertibility.

Is it desirable to extend the Fund's jurisdiction to cover capital account restrictions by an amendment of the Fund's

Articles of Agreement? In this respect, we must be very cautious, as such an extension could be dangerous and costly. As indicated by the staff, "the Fund could become increasingly involved in financing fluctuations of capital flows, since by accepting the obligations of an expanded Article VIII members may expect that they would be supported by access to Fund financing in the event that they experience pressure due to capital account imbalances." For the time being, the liberalization of the capital account could be promoted more actively by the Fund within the existing legal framework, without ruling out an extension of the Fund's Articles of Agreement at some future point.

The main vehicles of the Fund to promote capital account liberalization among its members would certainly be its surveillance and technical assistance activities. In addition to the recent decisions on strengthening Fund surveillance, additional consideration should be given to advising a member on questions relating to the liberalization of capital transactions. In the medium run, this would involve a broadening of the Fund's information base. In addition to extending the information base, the staff might be forced to deepen its analysis and its capacity for policy advice to members on questions of pace and sequencing of capital account liberalization.

By strengthening its capacities and deepening its know-how in the field of capital account convertibility, the Fund should actively cooperate with institutions that have long expertise in the area, that is, the OECD and the European Union (EU). We believe that in the longer run the Fund should aim at developing a code on a liberalized capital account in close cooperation with those and perhaps other institutions. It should be clear, however, that a future Fund code would inevitably have to deal with a much wider range of countries. As a first step, the strengthening of the database on capital controls in the Fund's annual report on <u>Exchange Arrangements and Exchange Restrictions</u> could be undertaken.

Mr. Wijnholds made the following statement:

I welcome the opportunity to have a thorough discussion on the issue of capital account convertibility, especially on the role that the Fund should play in this area. It is inevitable and also desirable for the Fund to become more involved in capital convertibility as the world moves toward liberalization, as emerging markets converge into global financial markets, and as capital flows tend to dominate the movements in balance of payments. The purpose would be to consolidate and expand the present degree of liberalization of Fund members. The convincing relationship between the (de)stabilizing nature of capital flows and the (un)soundness of macro-policy also points to an important role for the Fund, using its vast expertise in macroeconomic policy advice.

I largely support the staff's view on the limited effectiveness of exchange restrictions, especially those aimed at stemming outflows; the supporting evidence from the background reports is overwhelming. Restrictions on inflows may play a useful role in some countries--with immature capital markets and monetary policy instruments--in the sense of temporarily supporting sound macro-policies, rather than helping to perpetuate wrong policies. It should be recognized, however, that restrictions are always second-best; in general, the sequence and pace of liberalization are important. In terms of sequencing, restrictions are usually best phased out in line with the development of a viable banking system and well-functioning financial markets. As regards the pace of capital liberalization, a gradual approach could be preferable for some developing countries in view of certain accompanying policy adjustments that may be necessary, as well as reluctance to remove restrictions in some quarters.

The logical way to address the increased role of the Fund in this area would be to amend the Articles of Agreement, possibly resulting in an expanded version of the present Article VIII as member states accept the obligation to establish capital account--in addition to current account--convertibility. An amendment of this kind could be contemplated at a future stage. There should, however, first be more clarity concerning the extent of the Fund's involvement. Would it require only freedom of payments and transfers, or the liberalization of the underlying transactions also?

In the meantime, the Fund could extend its surveillance to systematically take into account in its Article IV consultations the relationship between capital flows and the macroeconomic adjustment process. The surveillance could also--if warranted by the circumstances--indicate the scope for further liberalization of capital transactions, in conjunction with the modernization and strengthening of the domestic financial system. The Executive Board could furthermore review on a regular basis the overall progress toward liberalization. In order to avoid undue overlaps, it would be desirable for the Fund to seek cooperation with the OECD and the WTO. The widened mandate of the WTO and the additional commitments that its members have undertaken require increased awareness on the part of the Fund as regards the WTO policy advice and actions.

Some important questions remain with respect to the possible consequences of a greater degree of capital account convertibility. As demonstrated in some recent cases, policy mistakes in an environment of free capital movements may substantially raise the amount of needed liquidity support. I would appreciate the staff's comments on the implication of an expanded Fund mandate on the need for Fund credit to member states and on the advisability of a link with an increase in Fund quota.

Mr. Kiekens made the following statement:

Since the signing of the Articles of Agreement, great progress has been made in liberalizing international capital movements and capital account transactions. Currently, all industrial countries have full capital account convertibility, and each year the number of developing countries liberalizing their remaining current and capital account restrictions far outweigh the small number who reimpose some controls. Obviously the movement has been toward a more liberal system of international capital movements.

Today's discussion revolves around two questions. First, what are the implications of capital account liberalization for the Fund's responsibilities? Second, what lessons can be drawn from experience thus far with capital account liberalization, and how should the Fund's advice to member countries via technical assistance or regular consultations reflect this experience?

The staff offers three possible responses to increased capital account liberalization and spreading acceptance of capital account convertibility among member countries. These range from preserving the status quo, at the one extreme, to changing the Fund's jurisdiction as defined in the Articles to encompass capital account convertibility, at the other.

It is obvious that the text of the Articles that deals with the capital account does not reflect the reality of the 1990s. The Fund has a clearly defined responsibility for the exchange rate policies of member countries, and in pursuing this responsibility, it has to take account of all relevant factors. Here, capital account transactions are of paramount importance, and the Fund has to pay them sufficient attention. However, it is a fact that Fund members have accelerated their acceptance of capital account convertibility independently of the Fund's jurisdiction in this area. At the same time, the Fund's lack of explicit jurisdiction did not prevent it from recommending to selected member countries that they implement or accelerate steps leading toward capital account convertibility, even though the staff notes that "Fund programs have generally not included explicit recommendations and performance criteria for capital account convertibility." It is our view that officially extending the Fund's jurisdiction to this area would have no important effect on further progress toward universal capital account convertibility.

Even without changing the way its jurisdiction is defined in the Articles, the Fund has begun in recent years to pay more attention to various issues, for example, structural reforms, that it deems relevant for the sustainability of a member's external position and exchange rate policies. This is also true for capital account liberalization. As indicated in the supplementary paper, the Fund has frequently expressed its views on capital account liberalization while discussing members' policies, and we think that current mechanisms of surveillance and technical assistance provide sufficient room for the Fund to make appropriate policy recommendations, and even for stronger ways of expressing its views on certain measures and policies if needed.

We recognize, however, that explicitly extending the Fund's jurisdiction to capital account transactions would have certain benefits in terms of harmonizing the treatment of restrictions on current and capital account transactions. However, it is still not clear at this stage what consequences such an extension of the Fund's jurisdiction would have for balance of payments assistance to members. The staff indicates that extending Article VIII might lead members to expect access to Fund financing in the event of capital account imbalances. But would this not mean that countries who dragged their feet in the matter of capital account liberalization would now be rewarded by the possibility of increased financial assistance from the Fund while the countries that liberalized their capital accounts at earlier stages would be forced to do without such assistance? And would not the expectations of increased access to Fund financing undermine the disciplinary effect that a more liberalized capital account is expected to have on members' domestic financial policies?

To sum up, we believe that formally incorporating capital account liberalization into the Fund's jurisdiction would contribute little to the acceleration of this generally desirable process. We also believe that the current procedures allow the Fund to deliver, with sufficient strength, any necessary message to member countries concerning the policy of capital account liberalization. At the same time, it does not appear that the provision of Article VI, Section 3 has been misused by member countries in the past as an excuse for postponing or reversing measures toward greater capital account liberalization.

Such observations do not provide a strong argument for expanding Article VIII to require members to commit themselves to liberalizing capital account transactions nor for providing an obligation for the Fund to approve the reintroduction of capital account restrictions. We therefore find ourselves supporting the second approach, namely, using the existing procedures to provide more explicit recommendations from the staff regarding capital account liberalization.

However, we believe that careful consideration should be given to introducing, in the Articles of Agreement, a provision that the Fund's approval of temporary restrictions on making payments and transfers in the framework of orderly workout procedures for sovereign debts in foreign currencies would be binding on creditors in the sense that observing such restrictions would not constitute default, triggering possible consequences such as attachment of assets. This provision may be seen as a necessary safeguard to limit the Fund's involvement in the financing of capital outflows. It will also reduce the risk of moral hazard of investors by making clear that the rules are available to impose market discipline on creditors by forcing them to maintain, temporarily, in parallel with the Fund's financing, the credit they freely decided to provide with an adequate risk premium. We also believe that the present principled prohibition under Article VI (1) against using Fund resources for financing capital outflows should be carefully reconsidered. We understand, however, that this item will be more thoroughly examined during our forthcoming discussion of the role of the Fund, and perhaps also as part of the issue of "emergency financing procedures."

Before adopting a policy of more explicit recommendations from the staff concerning the speed and scope of capital account liberalization, we need to have a better understanding of the risks and benefits of that process. This relates to the second issue, namely, the lessons to be drawn from experience with capital account liberalization thus far.

Concerning the desirable speed of capital account liberalization, history provides no clear-cut lessons. There are countries that moved to a full capital account convertibility gradually and countries that successfully liberalized their capital account transactions in a short period of time. In light of the increased flexibility and efficiency of the financial markets, however, we would argue that the experience of the industrial countries following the Second World War, when they were able to move to full capital account convertibility slowly over a period of several decades, would be hard to duplicate today. As more and more countries enjoy the economic benefits that more liberalized financial systems provide, it becomes harder and more costly for other countries to maintain extensive controls on their external capital transactions. Where circumstances permit, the Fund should encourage quick capital account liberalization. The conditions needed for successfully liberalizing the capital account are mostly under the control of a country's authorities.

The legitimate reasons for reintroducing capital account controls are limited. In the 1990s, the inflow of capital posing a risk to domestic monetary stability has accelerated, and several countries have reimposed controls on capital inflows in the hope of preventing a destabilization of domestic monetary conditions and a deterioration of competitiveness. Such controls may have shifted the maturity structure of the capital inflow in some countries, but I recognize that they have had little discernible effect on the total size of inflows. The issue is complicated by the increasing practical difficulty of distinguishing between short- and long-term inflows owing to increased fungibility.

In view of this general observation, we believe that the staff paper could have been more discriminatory in discussing the merits of capital controls. It lays little stress on the importance of correctly identifying the causes of capital flows. In circumstances where capital inflows are caused by improved economic policies and increased confidence on the part of investors, as has been the case in many developing countries during the 1990s, the temporary introduction of controls on inflows makes little sense. It is now generally accepted by the staff that controls on capital movements can be justified only as temporary measures intended to give the authorities time to deal with the domestic distortions that have caused the inflow. However, in cases where the inflow is not due to domestic distortions but the result of increased confidence on the part of foreign investors, there is hardly any need to buy time.

In other circumstances, the inflows may be partly motivated by interest rate differentials that are caused, for example, by imperfect market integration and high costs of intermediation by domestic banks, as in the case of the Czech Republic. In response to intense capital inflows, largely short term, the Czech authorities have introduced some limits on short-term capital inflows. However, this step was taken only after the limits of sterilization had been reached and because additional fiscal tightening was difficult to achieve with the budget already in surplus. These controls are considered strictly temporary measures to give the authorities time to deal with distortions contributing to a large spread between deposit and lending rates. Moreover, the Czech authorities do not expect that these measures will substantially slow the total inflow of capital and view them more as measures to prevent both an excessive increase in liquidity and vulnerability in the banking sector.

Unlike episodes of capital inflows, capital outflows are in most cases a sign of unsustainable economic policies. They are often triggered by an overvalued exchange rate that eventually has to be corrected if the economy is to continue functioning on a market basis. Unlike inefficiencies in the domestic financial sector, which can trigger short-term capital inflows attracted by interest rate differentials, unsustainable macroeconomic policies and overvalued exchange rates can be corrected relatively quickly if the political will to do so exists. Therefore, temporary and limited capital controls can only be justified as a means of buying the time to implement adequate policies.

Mr. Mesaki made the following statement:

I would like to thank the staff for preparing comprehensive papers on the issue of capital account convertibility. Useful as they may be to enhance our understanding of this issue, however, they do not significantly reduce the difficulty in deciding what course to take.

Capital account liberalization is desirable; this should be the starting point for all consideration. The Articles of Agreement certainly allow capital account restrictions but should not be interpreted to mean that these restrictions are appropriate. The economic circumstances surrounding the drafters of the Articles may have made them hesitate to delve deeply into the capital account convertibility issue, despite their recognition of the general desirability of liberalization. That is why the staff has, in effect, encouraged capital account liberalization and why the Board has generally supported it. Nevertheless, this does not necessarily lead to the conclusion that the Fund should change its Articles of Agreement to more vigorously promote capital account liberalization even when economies are globalized and the importance of capital flows is well recognized. The issue is not as simple as that.

I have a vague conceptual difficulty with changing the Articles of Agreement. As the staff points out, there is a set of preconditions that should be established before the capital account is liberalized, and appropriate sequencing is important. This means that hastening full capital account liberalization may not be appropriate at any given stage; as Mrs. Cheong says in her statement, one may have to make haste slowly. Moreover, at the recent Board discussion on international capital markets (EBM/95/51, 5/24/95), some believed that the temporary use of restrictions aimed at containing short-term capital inflows provided breathing time for the authorities until more fundamental measures were taken, implying that there are cases where capital account restrictions are justified. This contrasts with current account restrictions, which are rarely justified but may be reluctantly admitted if circumstances require them. Thus, I am not sure whether we can treat both kinds of restrictions in the same manner in the Article of Agreement.

Furthermore, it is rather difficult to recognize clear differences among the three approaches mentioned by the staff concerning the Fund's future role in promoting capital account convertibility. One might say that the second and third approaches are more effective because the Fund is expected to play a more aggressive role, but the distinction between the second and third approaches is more difficult. It may be that the third approach is expected to be more effective as, under that approach, capital account liberalization is an obligation, the breaching of which is subject to some sort of punishment. If that is the case, the question arises whether punishment--regardless of its actual possibility--is suitable to capital account restrictions which may be justified in certain cases. In this connection, I recall that, at a previous discussion on this issue, a question was raised by Mr. Al-Jasser whether a change in the Articles of Agreement--which merely encourage capital account liberalization--would, in fact, be possible. The staff paper does not seem to provide an answer to this.

Ms. Lissakers made the following statement:

The supplementary papers provide an excellent orientation for today's discussion of capital account convertibility.

The review by Michael Dooley of the academic literature reminds us that there is a compelling theoretical argument that free capital movements are likely to be welfare enhancing, identical to the argument for the gains from trade in goods and services. At the level of first principles, there ought to be a presumption that capital account convertibility recommends itself to us just as strongly as current account convertibility.

But, in typical theoretical fashion, market imperfections and distortions open the possibility that first-best, free capital movement solutions are unattainable, and second-best controls might improve the situation. They might, but review of the academic literature, the supplementary papers, and actual experience suggests that this may not be the case. Strong doubts have been raised as to whether capital restrictions are effective, and if effective, whether they are welfare enhancing.

Apart from welfare considerations, capital controls are frequently presented as necessary backstops to domestic monetary and fiscal policies, because capital flows might undermine monetary control or tax collections. Careful research suggests capital controls are more frequently a device for preserving suboptimal macro policies. The preferred solution should be either to recast domestic policy or to correct the underlying internal distortions that frustrate the smooth functioning of monetary and fiscal polices.

On one point the academic literature is quite clear. When there is a basic inconsistency in the policy regime, capital controls can, at best, only extend the life of the regime. Controls may allow the authorities to buy time, but the time must be used wisely.

The lesson we draw from the academic literature is that there ought to be a strong presumption, both theoretically and empirically, in favor of free capital movements and capital account convertibility. We should not lose sight of this basic orientation as we grapple with the concrete details of what the Fund or our member countries should or should not do in the area of capital account convertibility.

There are also a number of lessons to be drawn from the postwar history of progressive liberalization of capital movements, including:

(1) Among the industrialized countries, capital movements are now almost completely liberalized;

(2) Liberalization proceeded more rapidly after the advent of floating;

(3) Floating, however, is not required to maintain an open capital account. As long as policy inconsistencies are avoided, many countries have demonstrated that pegged rates can be well maintained with an open capital account;

(4) Reimposition of controls has most frequently occurred during a foreign exchange crisis, usually, but not exclusively, in the context of defending a fixed peg. Reimposed controls have, however, played little role in the solution of such exchange rate crises;

(5) Among the industrialized countries, capital account liberalization has been associated with less, not more, use of Fund credit;

(6) Liberalization has generally been phased, frequently in tandem with domestic financial market liberalization, and it has frequently been an inducement to improved financial market supervision;

(7) There is very little evidence that capital account liberalization has been disruptive, and if there are concerns, liberalization can be phased;

(8) Capital account liberalization has been opportunistic. Countries with weak balance of payments positions tended first to

liberalize capital inflows. Those with strong balance of payments positions tended first to liberalize outflows;

(9) The OECD Codes and the EU Directives have provided a structured and progressive basis for capital liberalization for member countries;

(10) Capital account liberalization is not merely an industrialized country phenomenon. In recent years, a number of developing countries, in a wide range of economic circumstances, have successfully opened their capital accounts.

Turning to the questions posed by the staff for today's discussion, regarding the Fund's activities in this area and whether the Fund should play a more active role in the area of promoting capital account liberalization, the simple answer is, yes. The Fund needs to do more than it has been doing, and needs to have a more systematic policy about its objectives and what is expected of members in this area. We would see merit in an amendment to the Articles of Agreement to bring capital convertibility explicitly within the jurisdiction of the Fund and to introduce obligations regarding the staged liberalization of capital account transactions. For now, however, work will have to begin within the existing Articles of Agreement.

The suggestions under Item 2 on adaptation of existing practices to encourage capital liberalization are all useful. Capital account liberalization issues are already taken up during Article IV discussions of exchange rate policies, but apparently the discussions are guided by general economic principles rather than specific Fund policies or country obligations. Of equal importance is clear policy guidance for encouraging capital account liberalization in the context of Fund programs. Some sharpening of the policy guidance--both for Article IV consultations generally and for program design--would be both desirable and able to be done within the parameters of the existing Articles of Agreement.

Standards of best practice need to be developed. The OECD experience in implementing its Code of Liberalization of Capital Movements is the most useful reference point for such an effort. Step by step, progressive and cumulative liberalization has carried OECD countries a long way. Use of Fund resources by the industrial countries that have totally liberalized their capital accounts, or almost completely, has actually declined rather than increased--although one can argue about the link between the two phenomena. However, increased capital liberalization under Fund auspices would not necessarily lead to higher demand for Fund resources; experience demonstrates the contrary. Without a change in the Articles of Agreement, Fund standards would not carry the legal obligations of the OECD Codes. They would, however, provide a basis for equal treatment of all countries in the Fund's surveillance work, and they would provide a framework for advising and encouraging countries on the pace and sequencing of steps toward capital convertibility.

Work on the EU capital directives has developed some sharp insights into the relationship between internal financial market liberalization and external capital account convertibility. An agenda of capital account liberalization requires and reinforces an agenda of desirable domestic financial reforms. This is useful experience on which to draw. But the EU model, to the extent it emphasizes harmonization, compulsion, and date-certain actions, is less relevant to Fund work than is the OECD Code and experience.

Regarding reintroduction of controls on inflows or outflows, again, the OECD experience is instructive. The presumption should be that once a control has been lifted, at least for most items, it will not be reintroduced. Some safety valve is probably needed. Therefore, some form of time-limited derogation in response to clearly identified adverse economic and financial developments could be recognized as acceptable practice.

The staff paper points out that there are large gaps in our knowledge of country practices with respect to capital restrictions. Establishing such a data base should be an early item on our capital account convertibility work program.

We are skeptical of efforts to deter or slow capital inflows by quantitative controls or incentives, particularly if such controls are introduced as a supplement to the traditional tools of macroeconomic policy. Experience suggests that capital controls for this purpose are often symptoms of some other more basic distortion or misorientation of policy. The correct response is to deal with the underlying problem, not to ratify the underlying problem with an additional external distortion.

We would be somewhat less categorical about the use of temporary capital controls to deal with surges in inflows. There may be circumstances when such surges undermine well-structured domestic policies or leave a country overexposed to the risk of a reverse outflow. The fact is that surges frequently have their origins in inconsistent macroeconomic policies, particularly policies that frustrate an inward transfer of resources by trying to maintain a stable real exchange rate and avoid a current account deficit in the face of attempted voluntary capital inflows. The Feldstein-Horioka puzzle indicates such policies are not uncommon.

In any case, experience suggests that controls on capital inflows rapidly lose their effectiveness if the underlying incentives for the inflows persist. If controls buy time for policy adaptation, they do not buy much time. We should keep first principles clearly in mind when evaluating the appropriateness of controls to deal with surges of capital inflows and also in setting a standard or policy guidance for the phasing of elimination of capital controls.

The Acting Chairman observed that Ms. Lissakers appeared to favor the staff's second proposal--to intensify efforts within the existing framework. At the end of the staff's third proposal, however, was the recommendation that a two- or three-year period of experimentation be allowed in order for consideration to be given to extending the Fund's jurisdiction.

Ms. Lissakers explained that it was not clear to her what experimentation would, in fact, entail. Many countries had already opened their markets or decontrolled capital flows, or were in the process of doing so. The benefits of that liberalization were clearly enunciated in the staff paper and in the survey of both the theoretical literature and the experience. There was sufficient evidence to accept the principle that freeing capital movements enhanced welfare. If experimentation meant looking into modalities to increase the Fund's activism in that area, she could agree with it. The Fund needed to think about how it could sharpen its policy advice to members if the membership supported that principle. That might be done in the context of Article IV consultations and Fund program design. She would also be willing to look seriously at the idea of amending the Articles of Agreement, but there appeared to be ample scope for a more active Fund approach even within the existing Articles of Agreement. There might be strong support among the members that the next task would be to sharpen the Fund's policy guidance with respect to capital account liberalization, in particular with respect to the question of sequencing of the steps in that regard, and the tricky question of the appropriate view to take of the sudden reimposition of capital controls.

Mr. Mesaki, responding to a request for clarification from the Acting Chairman, said that he was in favor of the staff's second proposal. He was skeptical about the third proposal. Perhaps the staff could comment on whether or not an amendment of the Articles of Agreement was in order, however.

Mr. Esdar made the following statement:

I would like to thank the staff for the papers, which are an excellent basis for our discussion on capital account convertibility. We very much appreciate this discussion in view of the effects of globalized markets, stemming from dramatic growth, worldwide opening and liberalization, as well as the huge enrichment of market instruments and rapid technical advances. It is time to examine the issue of how the Fund should react to these developments in its surveillance policy.

All industrial countries and many developing countries have already opened their financial markets to enable the flow of funds across borders and to participate in the gains of improved resource allocation. Theory and evidence clearly demonstrate that the free flow of capital not only improves its allocation but also helps to strengthen growth and facilitates trade liberalization.

Nevertheless, countries have to prepare themselves to attract the funds. Markets always check the investments made--the very nature of an efficient allocation--and move funds from one investment to another if the expected return proves to be more profitable or if the funds appear to be in danger. Efficient allocation also implies that these reactions are rapid and normally without advance notice. Because markets merely react to positive or negative developments in certain countries, countries must provide conditions that attract investors. In this respect, financial markets push countries toward discipline, which is certainly in the interest not only of the country. Against this background, reconsideration of the Fund's surveillance policy appears necessary provided there is some scope for adjusting to developments.

We strongly support the idea that the Fund in its policy advice should encourage countries to liberalize their financial markets. It should also be pointed out that capital controls impair the efficient allocation of resources, preserve vested interests--which usually implies some waste of resources--and can be expected to be of only limited impact because markets almost certainly will find ways to circumvent them. Directors will recall the situation at the beginning of the debt crises when capital controls proved to be incapable of preventing capital flight.

Regarding the sequencing of steps to liberalize capital flows, at best, monetary and fiscal policy should have adequate and efficient instruments at hand, and structures in the financial and banking sector should be appropriate and supported by an adequate supervisory and regulatory framework. Nevertheless, we share the view that liberalization at an early stage may be quite helpful, as it enhances the confidence of international investors and increases the discipline of authorities with respect to adjustment and stabilization policies. Without such a disciplinary background, there may be some doubt as to whether structural reforms in the financial and other sectors will be pursued with the same commitment, especially in the case of vested interests.

With regard to experiences of industrial countries many years ago, as Mr. Mirakhor has pointed out, liberalization was implemented in a gradual process over a longer period of time. Circumstances--especially concerning the volume and speed of capital flows--at that time were much different from today's conditions. Markets were much more segregated than they are today; capital controls and exchange restrictions were widely spread. If current conditions had existed at that time, almost certainly the liberalization process would have been much faster. Therefore, we are not inclined to draw any strong conclusions from these experiences for a strategy under today's circumstances.

We are quite skeptical about the possible approach pointed out by the staff of a different speed of liberalization with respect to capital inflows and outflows. On the one hand, capital will probably circumvent such barriers, so that the effectiveness of such a measure is questionable. On the other hand--and this seems to be the most important aspect--the attitude of the authorities toward liberalization may be perceived as questionable by market participants, and they may even fear a "mouse trap" situation. As experience shows, a poor reputation in this respect will be remembered by markets for quite a long time, even if capital controls are abolished leading to a higher risk premia.

It is often argued that rapid capital inflows and outflows may hamper exchange rate and monetary policy. There is no doubt about that--the situation in Czech Republic provides a good example--but one should not mix up causes and consequences. In the case of large inflows, a "suitable mix of fiscal, monetary, and exchange rate policy is the most appropriate response" as the staff has correctly stated. In some special cases, instruments such as taxes or levies may temporarily facilitate the policy reaction and allow more time for their implementation, but if these controls are effective, market perception will probably change and costly distortions will emerge. Experience also has shown that it is quite a widespread illusion that capital controls allow maintenance of an exchange rate at a misaligned level.

Regarding the role of the Fund, we favor the second approach. The need to adapt surveillance guidelines can take place within the existing Articles of Agreement, which provide sufficient room. The Fund should promote the liberalization of capital account transactions and, at the same time, encourage countries to adjust their macroeconomic and structural framework accordingly. There is no urgent need to adjust the legal framework and to extend the Fund's jurisdiction on the capital account as suggested under the third approach. We would like to invite the staff to review the progress made in regard to the prospective surveillance guidelines and to work in close cooperation with other relevant international institutions, such as the OECD, the EU, and the Bank for International Settlements.

We were puzzled by the view that it might be necessary to establish a new financing facility or to provide higher access limits in support of countries liberalizing their capital account. We do not see such a need, and we are opposed to such a proposal. Capital outflows and capital flight basically have their causes in policy slippage in the respective country, not in the process of liberalization. We should not establish moral entitlement for countries pursuing inadequate policies and make the reaction of markets a scapegoat. Rather, I agree with Ms. Lissakers that, as a consequence of liberalization, financing requirements would be expected to decrease.

Moreover, even under existing regulations, capital outflows are taken into account when calculating a balance of payments need of a certain country. It has become increasingly difficult to distinguish between current account and capital account transactions and between long-term and short-term capital flows. The staff clearly stated in its paper on stabilization funds (EBS/95/109, 6/30/95) that only large and sustained capital outflows could not be financed under existing regulations. Therefore, I see no legal impediment to considering the overall balance of payments situation--which has been done in the past; for example, the debt problems in the 1980s were addressed with Fund financial support, and their crucial effects were seen especially in the capital account, caused by capital flight and refinancing problems.

Mr. Kaeser said that, when he had visited the headquarters of the European Union (EU), he had been told that the liberalization of capital movements would have little effect if it were not accompanied by the liberalization of financial services. He wondered whether Mr. Esdar shared that view. The question was whether investors would feel comfortable sending investment money overseas to a foreign bank if there were no domestic branches of a foreign bank in the investor's country. Perhaps there was a link, therefore, between capital account liberalization and financial sector liberalization. In his view, liberalization of financial services was necessary to obtain the optimal allocation of capital.

Mr. Esdar replied that he agreed with Mr. Kaeser. The process of structural reform of the financial services sector should go hand in hand with liberalization of capital markets, and there was a close link between them. It was important to begin liberalization of the capital account at an early stage, in order to put pressure on those who might have a vested interest in hindering effective liberalization of the financial sector.

Mr. Berrizbeitia made the following statement:

Although the treatment of the capital account in the Articles of Agreement may be considered anachronistic for many reasons, it is still too early to extend the Fund's jurisdiction to the capital account by amending the Articles. Rather, in light of the evolution of the international financial system toward globalized markets and massive capital flows, and the increasing relevance of these developments for the discharge of the Fund's mandate in the areas of monetary and exchange rate policies, it is more appropriate to continue intensifying the Fund's role in capital account liberalization through its surveillance and technical assistance activities, in the context of the existing Articles of Agreement. In other words, this chair favors the second of the proposed approaches contained in the staff paper prepared for today's discussion.

It remains to be seen whether a progressively more active role by the Fund in capital account liberalization will eventually lead to a formal extension of the Fund's jurisdiction through an amendment of the Articles; this chair will keep an open mind on this issue. Nonetheless, the proposed intensification of the Fund's role, as suggested in the second approach, would imply a significant qualitative step forward, with important implications for the Fund and its member countries.

Turning to some of these implications, first, in the area of financing considerations, to the degree that the Fund's policy advice further emphasizes such liberalization, it would be reasonable for members to expect support from the Fund in the event of capital account pressures, especially when derived from exogenous shocks. Thus, a decision to proceed in this direction raises issues related to the interpretation, or eventual modification, of the first section of Article VI, at the same time that it lends greater urgency to the Board's important discussions on the Eleventh General Review of Quotas.

Second, in regard to sequencing issues, liberalization of the capital account unquestionably imposes a large and generally desirable quantity of macroeconomic discipline on the management of any member economy. However, in light of the magnitudes and volatility of capital flows in globalized financial markets, recent events have shown that even relatively minor departures from strict macroeconomic discipline can result in extremely destabilizing and even disproportionately onerous punishment for individual economies. Thus, in promoting capital account liberalization, the Fund must exercise a great deal of prudence to ensure that such liberalization occurs progressively, and parallel to the development of an appropriately strong macroeconomic and structural policy environment that ensures the sustainability of the liberalizing process over the long run.

In this context, it should be noted that even among the advanced and presumably well-disciplined economies of the European Union, full capital account liberalization is only a very recent phenomenon, and it occurred progressively--during a period of over 30 years--with appropriate recognition of relative differences across countries. Similar progressiveness and caution should be observed by the Fund as it proceeds with policy advice on further capital account liberalization among its members. Notwithstanding Mr. Esdar's comments to the effect that times have changed and capital markets do not function today as they did 20 or 30 years ago, we should be cautious because of the many differences across member countries and precisely because the magnitude and the speed with which capital markets react can be extremely punishing even for relatively small deviations from appropriate policy. In addition, appropriate differentiation of individual country situations will need to be taken into account, as is well evidenced by the country diversity described in Mr. Clark's statement.

In the process of liberalization, particular attention needs to be given to the sequencing of financial sector deregulation vis-à-vis capital account liberalization, and especially to the prior institutional and regulatory strengthening of governments' role in banking, insurance, and capital market supervision. In this sense, again I refer to Mr. Esdar's comments on the sequencing of the early liberalization of the capital account, which may, in fact, be something to be considered. However, the prior supervisory function must be strengthened before even the financial liberalization process proceeds, then the capital account liberalization process. Although the staff paper points to diverse examples of sequencing in such liberalization processes, with varying degrees of permanence or success, it is notable that more than a few program countries have recently experienced considerable financial sector difficulties. It is not entirely a coincidence that such difficulties have typically arisen in the context of financial sector deregulation and capital account liberalization, and in the absence of an adequately strong supervisory structure.

Also, the need for very careful staff advice--the sharpening of policy advice, as stated by Ms. Lissakers--on capital account liberalization is most important in situations in which exchange rate anchors are recommended in the context of Fund-supported programs. In view of the destabilizing potential of capital flows in such situations, extreme care must be taken to ensure that such a combination of advice is compatible in practice, and not just in theory.

On the question of reversibility of capital account liberalization, once capital account convertibility has been established, the reimposition of controls is not recommended, and the staff paper rightly indicates that these are generally ineffective. Nonetheless, there are situations in which the application of controls may be temporarily justified, even in times of crisis. For example, temporary capital controls on either inflows or outflows could provide breathing space for the authorities to adopt fundamental policy measures aimed at correcting the underlying disequilibria, with or without Fund support.

I am not suggesting that such controls can provide a long-term solution to a crisis situation. This is clearly evidenced by the experience of my own country, Venezuela, which established exchange controls in the midst of its banking crisis in 1994. These controls were initially successful in stemming capital flight and in helping rebuild international reserves. Unfortunately, their imposition was not immediately followed by the adoption of a strong macroeconomic adjustment program, and the initial breathing space they provided was not used in a sufficiently advantageous manner. Despite this, there is no doubt that they were temporarily and initially effective in a crisis situation, and that they would have been extremely useful overall had they been accompanied with appropriately strong and simultaneous corrective measures of a macroeconomic dimension.

Another type of situation in which capital controls have been found to be partially effective is that related to controls on short-term capital inflows. Although the staff paper does not find conclusive evidence that such types of control have been successful--for example, in Chile and Colombia--neither does it demonstrate that they have not been useful in aiding monetary and exchange rate policy. Furthermore, the fact that these two countries were among the least affected in the Western Hemisphere by the sequel to the Mexican crisis may be indicative that, in addition to the generally strong macroeconomic policy stance, such controls may have been helpful in partially insulating these economies from the generalized capital flight to quality that followed the Mexican crisis.

As Mr. Wijnholds notes, the potential usefulness of these temporary measures on inflows is directly related to the degree of development of a country's capital markets, which may allow for greater or lesser differentiation between short- and long-term capital flows. I also note that Mr. Esdar recognized the appropriateness of certain temporary measures--such as tax measures--under certain circumstances in support of fiscal, monetary, and exchange policies.

Thus, achieving capital account convertibility should not preclude the possibility of reintroducing temporary controls when countries are confronted by unexpected exogenous capital flows that can destabilize their economies. This is the case in the safeguard clauses contained in the European Union regulations on these issues, and similar flexibility provisions should be taken into account as the Fund progresses in this direction.

As a final comment, the promotion of capital account convertibility implies magnification and faster propagation of both positive and negative effects of individual country policies through the workings of the international financial markets. Although this is obviously more relevant for countries with global or regional systemic impacts, it should be clearly recognized by all members and accompanied by increased emphasis in the Fund's surveillance of such economies to contribute to greater stability and predictability of capital flows in the globalized financial markets.

I would like to associate myself fully with Mr. Mirakhor's concluding summary of the manner in which the Fund should proceed on the issue of further promoting capital account convertibility among its members.

Ms. Lissakers commented that, with respect to Mr. Berrizbeitia's observations on sequencing, many had emphasized the importance of financial market reforms as a first step. That notwithstanding, it was useful to bear in mind that the liberalization of capital flows could be an important catalyst--and perhaps an essential one--in promoting strengthened supervision of, and better management in, the financial services sector. In her view, the two went hand in hand. In discussing sequencing, it would not be useful to try to set up a somewhat artificial structure, under which banking supervision and the transformation of banking institutions and the domestic market were seen as prerequisites for the liberalization of the capital markets. Rather, experience suggested that one tended to reinforce the other, and each interacted with the other.

Pegging the exchange rate was a viable option under liberalized capital flows, as the experience of the industrial countries had shown, provided the underlying macroeconomic policies were sound, Ms. Lissakers noted.

The Chilean experience showed that there were some real benefits in moderating capital inflows on a continuous basis, Ms. Lissakers concluded. However, the Chilean experience also suggested that, to be effective over a long period of time, existing restrictions had to be continuously bolstered by new restrictions. In fact, a new wave of restrictions had just been imposed by Chile, and at some point, those would be counterproductive and distortionary. That being said, it might be too soon to draw firm conclusions from the Chilean experience.

Mr. Esdar said that he shared the view of Ms. Lissakers on the issue of sequencing, concerning which there were many nuances. At the same time, if capital account liberalization were to await the establishment of secure domestic financial markets and effective supervision, the risk would be run that the political constituencies that benefitted from the status quo would have time to muster opposition to reform, thereby jeopardizing the success of efforts at capital account liberalization. Placing capital account liberalization higher up on the political agenda would put pressure on politicians to make the necessary structural reforms.

Mrs. Cheong commented that there was a distinction between the liberalization of capital markets and ensuring that the domestic banking system had adequate prudential rules. Many countries in southeast Asia had had an unpleasant experience with regard to the latter. In that vein, she supported Mr. Berrizbeitia's point that the strength of the banking sector was of primary importance. Whether efforts in that direction should be made before or after capital account liberalization could be decided on a case-by-case basis. It was important to ensure that whatever liberalization steps were taken did not endanger the financial system.

Mr. Berrizbeitia observed that there appeared to be actually very little conflict between the points raised by Ms. Lissakers, Mr. Esdar, and Mrs. Cheong, with all of whom he could agree. Capital account liberalization and the development of a secure domestic banking and financial system could be, as Ms. Lissakers had said, interactive. The importance of a strong banking system should not be overlooked, one way or the other, as Mrs. Cheong had said. Although liberalization might foster that, it could also create many problems if the banking system was weak. There had been many examples of program or former program countries--such as Argentina, Chile, Mexico, Turkey, and Venezuela--that had run into serious trouble after having liberalized their capital accounts without having had a strong supervisory structure in place. An appropriate balance had to be struck between the two.

He agreed that exchange rate anchors were not inconsistent with capital account liberalization, Mr. Berrizbeitia continued. However, exchange rate anchors tended to magnify the potential destabilizing effect of massive capital flows. The case of Argentina and its currency board arrangement was an extreme example; it had shown how capital flows could be extremely destabilizing in the context of a very strong exchange rate anchor.

He also agreed that capital controls had to be temporary if they were going to be effective, Mr. Berrizbeitia concluded. There were always ways of getting around such controls in the long run. They were useful to the degree that they surprised the markets and were short-lived.

Mr. Shields made the following statement:

Along with others, I thank the staff and compliment it for the papers, which have depth and thoroughness. I enjoyed in particular Supplement 3, on the review of academic literature, including the references to the lack of observability of optimal tariffs or their equivalents on the capital account. That is a sobering judgment, because it is always tempting to look at supposed theoretical justifications that are rarely met in practice.

Capital account liberalization, when undertaken as part of a broad process of financial sector reforms--most importantly, strengthened supervision of the banking sector and of foreign exchange risks--can lead to great benefits. These gains accrue not just to the economy that is liberalizing, but also to others--there are positive externalities, as with free trade. I wholeheartedly welcome the focus on capital account liberalization of other multilateral organizations, such as the OECD and EU.

The Fund's role in this area has so far been less prominent, and that clearly reflects the lack of a clear mandate in the Articles of Agreement. The Fund has been doing much in terms of advice and programs, but has not actually taken the lead. Now we have the call by the Interim Committee in the Madrid Declaration for further progress toward capital account convertibility by all members. The surveillance decision has also been revised to take more account of private capital flows. This means that we need to move on further, although I do accept, as the main paper says, that the Fund's Articles themselves were framed in a different era.

One of my concerns about the Articles is not so much about what they restrict us from doing, but about the signals that they give. At present, the Articles give us the power to request a member to exercise controls and to put sanctions on them if they do not comply. This seems completely the wrong message. That is one of the reasons why I see a great deal of attraction in amending the Articles in such a way that they would give us a mandate toward capital account convertibility, and would also prevent our attitude from being totally misinterpreted.

Equally, I accept that we need to be realistic and pragmatic, and so I am quite happy to go along with the recommendations in the staff paper that we continue to work on a case-by-case basis for the next two or three years. I hope that underlying this, however, we will step up our efforts toward promoting further liberalization. If we do this, clearly we will build up our expertise further, and we can see what is needed to build up a more effective policy approach before perhaps taking a firm decision on whether to seek an extension of our jurisdiction. At the moment, it is tempting to think eventually of the abolition of Article VI and an expansion of Article VIII and Article XIV to cover the capital account and the consequences of transitional arrangements.

The papers before us, particularly Supplement 1, give several interesting examples of how the Fund has encouraged capital account liberalization on a case-by-case basis in the context of wider liberalization. These lead me to a few conclusions.

First, we should not underestimate the costs of restraining the flows of capital to and from developing countries. It is very easy to be seduced by the case for trying to protect economies from big swings, from boom to bust. However, we need to bear in mind the longer-run effects of controls designed simply to prevent some of these short-term fluctuations. Even if controls are very rarely fully effective, and whatever the leaks around them, they still raise the cost of capital and hinder efficient investment and proper resource allocation.

Second, the degree of success from opening the capital account clearly depends on the freedom and competitiveness of domestic financial markets and on effective supervision in the domestic markets. The discussions we have just been having on sequencing are very relevant, but whatever the theoretical case is, there is much to be gained, as Mr. Esdar said, from moving forward. The fact that one is opening up markets provides considerable incentive to make sure that domestic markets adjust, and also that the right incentives are given to setting in place an adequate supervisory approach as quickly as possible. Being too cautious in that regard may actually mean that progress is delayed for much too long, and we do not want big mistakes, the consequences of which we have seen already. At the same time, allowing for no risk at all would probably just delay us forever. In economies, particularly in transition economies, that have an intense need for foreign capital at the moment, it simply would not be wise to wait until everything is perfect before encouraging foreign capital inflows.

Controls in general are not as effective as some would wish in maintaining unsustainable exchange rates, for example, except beyond a very brief period. As others have suggested, they can provide some sort of breathing space, but there is always a temptation to use them unwisely and to keep them in place too long. If that happens, they contribute to distortion and inefficiency.

One possible set of controls clearly are transaction taxes, which often tend to be aimed specifically at reducing short-term volatility or, perhaps more crudely, speculation. That may be simply aiming at the wrong target. The more basic problem is long-term misalignments, but we are not very good at spotting those and trying to use taxes in this respect. It is likely to be inappropriate.

On the question of whether capital account convertibility should be reversible, it is difficult to rule it out. Thus, in talking about changes that might be made in the Articles, it probably would be sensible to treat capital account convertibility along the same lines as current account convertibility--treatment similar to Article VIII.

Although many industrial countries have either completely liberalized, or have moved a long way in that direction, there still remain impediments to the free flow of capital in many countries. I am thinking, for example, of restrictions on foreign ownership of companies and on the holdings of overseas assets by pension funds and insurance funds. In the same way as current account convertibility and trade liberalization need to go hand in hand, so capital account convertibility and the removal of institutional impediments will have to go hand in hand with the free flow of capital.

The Acting Chairman wondered about the distinction between impediments to the free flow of capital and precautionary controls.

Mr. Shields replied that making such a distinction was indeed difficult. However, cross-country comparisons might be useful in that regard. Also, the stability and performance of funds invested in countries with a liberal attitude toward foreign investment might be contrasted with the performance of funds invested in less liberal countries.

Mr. Kang made the following statement:

In our constituency, Australia and New Zealand have freed their capital accounts since the early 1980s. Korea and the Philippines have adopted a gradual approach.

Korea's past experience of twice reaching very low reserve levels--in the late 1970s and the early 1980s--served as warnings on the need for a cautious policy stance in the area of capital account liberalization. Its high dependence on imported raw materials and geopolitical environment also helped in the design of such approach. Large conglomerates, in particular, have now become strong advocates of capital liberalization and the benefits of low-cost international funds. Greater integration is clearly required, and it is an inevitable trend, but many problems have yet to be resolved--particularly problems in the financial market itself--such as the high burden of nonperforming debt and inadequate prudential regulations and implementation.

The papers touched on the issue of sequencing which I believe is important in helping ensure that liberalization achieves its desired effects. Countries that have yet to free their capital account can learn from the experiences of others. Liberalization should work best in a stable macroeconomic environment, and where financial market reforms and prudential regulations are adequate.

In my view, capital account liberalization should follow trade liberalization and economic liberalization, in particular interest rate liberalization. If a country's development strategy necessitates a certain industrial strategy such as support to small and medium enterprises, a longer time is needed to shift to a fully liberalized interest rate policy. A gradual process of liberalization, accompanied by a sustained pursuit of stabilization policies and financial reforms, as well as adoption of an appropriate framework of prudential supervision, should constitute a strategy.

The question of whether a country has benefitted from the liberalization should be answered from the perspective of whether industrial and financial competitiveness has improved as a result.

Ideally, restrictions that have already been lifted should not be reimposed because any reversals would tend to erode confidence in the consistency of a country's economic policies. However, there could be exceptional cases where some reintroduction of controls may help address severe short-term pressures on the balance of payments and on the exchange rate while other more fundamental policy reforms, as Mr. Clark and Mrs. Cheong mentioned, are being put in place.

Faced with the destabilizing effects of huge short-term capital inflows, some developing countries have accelerated the relaxation of capital outflows, supplemented by the reintroduction of various forms of capital controls, usually intended to be of a temporary nature. For example, in the Philippines, responses to large capital inflows included successive increases in the ceiling on allowable foreign investments of residents, and a prior approval requirement on forward purchases of foreign exchange by nonresidents. There is evidence that the reintroduction of controls has worked without undermining the credibility of the countries concerned, particularly if overall macroeconomic management remained sound and the controls were quickly removed once the desired degree of stability had been restored. But like others, I believe that in dealing with excessive capital flows, the reimposition of controls are second best to the implementation of appropriate macroeconomic and structural policy adjustments.

We do not see a pressing need for a formal extension of the Fund's jurisdiction to the capital account. The Articles of Agreement already provide the Fund with a broad surveillance mandate under which capital account liberalization may be actively promoted. In doing so, I agree that it would be useful to consult closely with other multilateral institutions such as the OECD, EU, the World Bank and the WTO that have equally strong interests in this area.

We thank the staff for their work. Perhaps they could provide more information on the underlying reasons for some countries' experiences on capital account liberalization being more successful than others.

Mr. Lanciotti made the following statement:

I welcome today's discussion, as it is part and parcel of a broader debate which involves the issues of the Fund's direct or indirect financing of balance of payments needs related to capital account imbalances--as it might be the case for an emergency financing facility or a currency stabilization fund--and of the Fund's participation in workout arrangements to deal with sovereign debt illiquidity problems. I also would like to compliment the staff for the insight provided in their clear and comprehensive set of papers.

The staff's review of the academic literature starts from the well-established opinion that free capital movements allocate capital in the most efficient way and maximize welfare in a perfectly competitive environment with full information. Of course, the scenario becomes more blurred when moving to second-best situations and introducing real-world distortions. In fact, the most fundamental question of whether or not the costs of the distortions created by controls exceed the advantages generated by the offsetting of different, pre-existing distortions is still to be given a general, convincing answer. A very recent piece of literature casts some light on the actual reasons that have inspired governments in imposing restrictions on capital convertibility, that is, essentially, to limit the cost of domestic debt service through lower interest rates and to maintain higher seignorage revenue through higher inflation. This strategy has been empirically found associated with low income, large share of government in economic activity, insufficient development of the financial and banking systems, and scarce independence of the central bank in the conduct of monetary policy.

Many clues seem to point to a general preferability of a more control-free environment. Likewise, some very recent developments in international capital markets seem to add to the attractiveness of the concept that free capital markets, in a context of stabilization and reforms, tend to pay off eventually. I refer to the resumption of capital inflows in Latin America, where renewed access to the bond market and the recovery of equity markets seems to be faster than expected, probably because of the increased confidence generated by continued adherence to adjustment and liberalization policies, in the wake of, and notwithstanding, the Mexican crisis.

These academic and empirical findings suggest that the Fund should continue to pursue a policy decidedly oriented toward encouraging capital market liberalization, whether in the surveillance, in the technical assistance, or, at times, in the financing domains of its activity. However, I am not sure that a formal extension of the Fund's jurisdiction would add much to what the Fund has achieved and is currently doing. I definitely believe that the international capital markets' increasing globalization and technical advances is continuously urging the Fund to adapt its existing practices in order to promote more actively capital account liberalization. However, in the meantime, there is a stringent need that certain macroeconomic and structural prerequisites be in place in order that capital account convertibility produces welfare-enhancing rather than disruptive effects.

The experience of capital account liberalization in industrial countries clearly demonstrates that liberalization measures have been gradual and sequenced in a way that has prioritized the achievement of a sustainable balance of payments position based on appropriate fiscal, monetary, and exchange rate policies. The Fund's strategy in promoting the removal of restrictions on capital flows must require that appropriate supportive macroeconomic policies be in place and a sequencing of structural reforms be observed, with special emphasis on the strengthening of the financial and banking sectors and the implementation of prudential regulation and supervision before proceeding with major liberalization measures.

I believe that the Fund's experience in this area has been fairly satisfactory so far, The Fund should continue to promote capital account convertibility by operating on a case-by-case basis, and this action should be more actively pursued along the lines suggested by option 2 outlined in the staff paper.

If, for the time being, there is no need for a formal extension of the Fund jurisdiction through a change in the Articles of Agreement, at the same time, it is not clear, what the consequences would be of such an extension. A prudent stance in matching the elimination of capital controls with the removal of the macroeconomic imbalances would be all the more necessary, the greater will be the extent to which the Fund's financial support is destined to ease balance of payments pressures emanating from the capital account. Too hasty liberalization could increase capital flows fluctuations and generate intolerable pressures on the Fund's liquidity stemming from demands for financial support.

In this light, the progressive adoption of a supervisory code on the subject, which would take the OECD codes as a model, would certainly give helpful guidance to the Fund staff and membership--thus contributing to the international harmonization of economic policies--without being necessarily linked to a formal extension of Fund jurisdiction.

Mr. Gaspard made the following statement:

Like other speakers, I support the publication of this very informative set of papers. These papers include, however, many unresolved issues, which is not to belittle the staff's contribution but rather to underline the complexity of the issue of capital account convertibility--no small part of which is the proper definition of what constitutes capital account convertibility. The same problem applies to the issue of current account convertibility, for which the Fund has adopted a specific definition which is centered around the aspects of payments and the exchange rate. I look forward to the forthcoming important paper that elaborates these issues further, including the provision of comparative definitions of various types of convertibility.

I would like to address the issues before us today by attempting to draw a list of lessons that can be inferred from the staff papers.

The first lesson is that there is a consensus that capital controls are usually ineffective and not welfare enhancing. This general view follows from the fundamental principle of the optimality of free markets and the distortions that result from any limitations that are put on the free operation of markets.

A theoretical case can be made, however, for the establishment of controls in the context of a second-best solution or in the more general context of the existence of multiple equilibria. Capital controls can serve, for instance, to deter short-term speculative capital inflows or to buy time to establish a record of sound macroeconomic policies. As it is often difficult to identify a speculative transaction, it is crucial to note that the conditions under which controls can buy time and can be economically justified are quite restrictive; hence, their application must be carefully assessed. In any event, controls should be temporary and, above all, they should not serve to support inefficient or inconsistent domestic policies. Mainly, the circumstances in which they are effective are in dealing with capital inflows rather than outflows. Their effectiveness in stemming speculative attacks on the exchange rate may well be counterproductive in that they could produce a perverse effect.

The second lesson is that capital controls may not be that important after all. There are two considerations that lead to this conclusion. The first consideration is of an empirical nature. Recent surges in capital flows, especially in developing countries where capital inflows have accelerated sharply in recent years, would appear to constitute prima facie evidence that capital controls are already being lifted quite rapidly and are generally ineffective in stemming the flow of capital across countries. The second consideration is even more interesting and is related to the Feldstein-Horioka puzzle, referred to in the supplement on review of literature. The puzzle, in increasingly integrated financial markets, is the lack of either relatively large current account imbalances or savings-investment imbalances that one would expect in such markets, implying that capital controls are not important as a barrier to real capital mobility. It could also imply that the focus of economic policy should be on domestic macroeconomic policies in order to promote real capital mobility and growth.

The third lesson is the need for achieving certain preconditions before the full liberalization of the capital account. Most important would be establishment of a record in macroeconomic stability and reform of the domestic financial sector, including the implementation of prudential regulations. I find it difficult to discount the potential destabilizing character of unhindered capital flows in the absence of these preconditions, especially in developing countries.

My last point is that it may be premature to contemplate amending the Articles of Agreement for the sake of the establishment of capital account convertibility, although the Fund should continue to promote it. I therefore support the second approach. The phenomenon of open capital accounts is still a very recent experience in industrial countries, many of which have had to reverse their earlier liberalization measures on a number of occasions. Moreover, the OECD approach to capital account liberalization emphasizes the continuity of progress in this regard and retains "safety valve" provisions that allow the temporary suspension of liberalization measures. This serves to indicate that, notwithstanding the desirability of establishing capital account convertibility, the urgency of the matter is still not compelling.

A possible sequencing of reforms would be to continue to encourage remaining countries to accept the obligations of Article VIII, particularly the removal of multiple exchange rates. At the same time, we may need to extend the concept of current account convertibility beyond the aspects of exchange rate and payments to include the liberalization of exports--including the lifting of surrender requirements for export proceeds--and to promote a less restrictive import policy. Once current account convertibility is widely and effectively established in a larger economic sense than the strict legalistic sense adopted by the Fund, capital account convertibility would soon follow with fewer impediments to its establishment than if capital controls were addressed as a separate issue.

Mr. Zoccali made the following statement:

We welcome the excellent papers provided by the staff, even though they seem to give greater emphasis to the argument that capital controls are difficult to implement or ineffective than to the welfare-enhancing attributes of capital account liberalization. Such attributes include more efficient allocation of global savings, faster dissemination of technological and managerial know-how through private foreign direct investment, improved domestic financial intermediation from greater competition and, last but not least, the confidence building that accompanies the willingness of a country to place itself under the scrutiny and disciplining behavior of international capital markets. As noted by Mr. Mesaki and Mr. Lanciotti, a certain ambiguity surrounds the issue in view of the existence of market imperfections.

Capital account liberalization needs to distinguish between controls on inflows and outflows, because the motives are radically different. The latter is more fiscal in nature, as governments often resort to exchange and payments barriers to amplify the benefits of the inflation tax or seigniorage under the assumption that capital flight can be contained by these means. At the same time, controls on inflows--particularly sterilization measures to gain control over the monetary aggregates--also produce fiscal costs. As we support the publication of these papers, we would welcome some reference to this budgetary impact, for example, in connection with the recommendation of sterilization as an alternative in footnote 1 on page 6.

A second and perhaps even less effective motivation has been containment of pressures for devaluation or prevention of an excessive appreciation in the face of a capital surge.

As noted by the staff and other speakers, the evidence against controls on outflows is overwhelming. At the same time, the effectiveness of restrictions on inflows is less clear-cut in view of the fungibility of different types of flows and their distortional effects on resource allocation. Thus, although some restrictions on inflows may have served, as in the case of Chile, to discourage short-term movements, their efficacy is clearly short-lived and correlated with the authorities' track record to ensure that the time gained will be used to enhance the consistency of policies. Chile's continued strong macroeconomic performance nonetheless required resorting to greater exchange rate flexibility and additional liberalization of outflows to minimize the destabilization risk of large inflows.

Ultimately, it is the mix of macroeconomic and--I would add--structural policies in a given economy that will determine both the incentives for inflows of foreign capital and its permanence in the country.

The speed and sequencing of capital account liberalization in developing countries is inextricably linked to the extent of market imperfections. The slow pace of capital account liberalization in many industrialized countries, however, should not be the guide in this regard in light of historical and structural differences. The main points to consider in the case of developing countries are the strength of the financial system and the adequacy of regulatory and prudential regulations, as stressed by Mr. Berrizbeitia. The reference to Argentina in Supplement 1, where banking sector problems intensified following rapid liberalization of the capital account, does not apply to the most recent liberalization drive in December 1989, in the context of the currency board arrangement. On the contrary, the currency board served to enhance the credibility of the Government's commitment to stabilization and was followed by a rapid reversal of the earlier process of financial disintermediation.

A critical mass of financial sector reforms, accompanied by a consistent macroeconomic policy mix, would make it preferable to proceed with actions, such as a swift removal of controls, to minimize political resistance from the "control bureaucracy and its constituency." discussed in Supplement 3. The notion of "iterative sequencing" is appealing, as it is important to keep in mind that the costs of backtracking are extremely high in terms of policy credibility and market confidence.

On balance, we would side with those that favor a more unambiguous role for the Fund in fostering capital account convertibility, through its surveillance under Article IV consultations. As noted in the discussion, the most logical way to address the issue of capital account liberalization would be through an amendment to the Articles of Agreement. We agree with the staff that they no longer are in harmony with the new international financial system of globalized markets and massive capital flows. In the meantime, the flexibility envisaged in the Articles for moving to current account convertibility should guide us with respect to capital account transactions. In this regard, although restrictions on real sector transactions underlying capital account transactions, such as inward foreign direct investment, are excluded from the definition of capital account convertibility, the process of deregulation of real transactions is yet unfinished, even in industrialized countries, despite their full capital account liberalization. The learning period proposed by the staff to gather information, prepare policy approaches, and assess resource implications is deemed both reasonable and necessary before proposing a formal extension of the Fund's jurisdiction.

Although recognizing that capital account liberalization would "increasingly involve the Fund in financing fluctuations in capital flows," the discipline of markets can also serve to strengthen the effectiveness of its surveillance and, over time, help members reduce their reliance on official balance of payments financing. In any event, sudden shifts in market sentiment and their concomitant contagion effects are today's problem, challenging the ability of the Fund to respond adequately to members' needs.

In closing, we found Section IV of Supplement 3 on multiple equilibria and first-best arguments particularly useful. Two aspects deserve to be highlighted in this regard: the dynamics of self-fulfilling speculative attacks and private sector expectations concerning the sustainability of monetary policy can generate a collapse of a system that would otherwise be fully viable under a different set of expectations; the importance of political-economic forces as guarantors of a monetary discipline was evidenced by events in my own country earlier this year.

Mr. Zhang made the following statement:

The staff has provided informative papers for today's discussions. I share the view of other speakers that capital account convertibility has become increasingly important with the integration of the global economy. However, the fact that many developing countries maintain certain controls, and many industrial countries had been unable to remove them until recently, reminds us of the reality we have to face. I will base my remarks mainly on the experience of my own country and countries still keeping some restrictions, although I believe that if the staff had elaborated further on why the industrial countries have taken so long to eliminate capital controls, more light could be shed on the subject.

Few would dispute members' awareness of the factors prompting capital account liberalization. Indeed, in the long run, restrictions distort allocation of resources and run contrary to the globalization of markets. However, many countries have yet to outgrow the usefulness of some restrictions. They are concerned that, in view of the underdeveloped capacity of prudential supervision, capital account liberalization may, as the staff has noted, "increase the risks for banks, through the impact of increased volumes of capital flows on the deposit base, and a possible increase in exchange rate volatility on banks' open foreign currency positions." In particular, for countries undergoing dramatic reforms of their economic systems, the development of integrated domestic exchange and money markets, a competitive financial system, and indirect monetary instruments--including credible market-driven interest rates--and the ease with which the authorities employ such instruments are essential preconditions.

Regarding the Fund's approach to this issue, the current stance appears appropriate. I do not find the Articles of Agreement in any way impeding the staff's efforts to assist members in their liberalization process. Furthermore, such a process is best promoted by economic necessity and on a voluntary basis. Most members are already well on their way, and the remarkable changes in the volume and direction of capital flows--especially long-term capital--toward the developing world has acknowledged such efforts and progress.

The illustrative examples of Southeast Asian countries remind me of my own country's experience. Promotion of free flow of capital, as well as goods and services, has always been an important component of China's economic reforms. In view of the complexity of the economy, this process has proved arduous; for example, it took 15 years for China to unify and stabilize the exchange rate. But it has also proved rewarding; foreign capital inflows increased from scratch to an annual amount of over $30 billion. China has been, and will continue to be, prompted by economic necessity in this process. It has benefitted from the Fund's advice and will continue to value such assistance. The ongoing reforms and the challenges resulting from the massive capital inflows have complicated the authorities' macroeconomic management. Although they are compelled to resort to some capital restrictions, especially on volatile flows, it is obvious that such restrictions are applied to smooth, not to delay, the progress toward liberalization.

The satisfactory handling of the post-Mexico-crisis situation by many members should also be seen as a sign of reassurance; thus, an undue increase in pressure and haste on the part of the Fund would be counterproductive. I am not convinced of the need for amending the Articles to extend its jurisdiction. Although the Articles provide that Fund resources cannot be used to "meet a large or sustained outflow of capital," they did not prohibit the institution from acting forcefully during the recent crisis.

Finally, current and capital account restrictions are of different natures and therefore should be addressed differently. The latter requires considerably more flexibility. A number of preconditions--in particular, successful financial sector reform to help lay the foundation for capital account convertibility--have to be achieved before taking decisive measures in liberalizing the capital account. Too much haste will involve risks, which should be avoided. Probably that was one of the considerations of the great pioneers of the Bretton Woods institutions when they put only current account convertibility, not capital account convertibility, under the jurisdiction of the Fund in drafting the Articles of Agreement for the Fund 50 years ago. I join the others in supporting a case-by-case approach and in believing well-designed technical advice appears the most effective means.

Mr. Calderón made the following statement:

Economists, from time to time, tend to form a consensus on fundamental topics. Approximately 15 years ago, there was the consensus that capital account liberalization should always follow current account liberalization, and the famous "Washington Consensus" on trade liberalization, macroeconomic stability, and the power of private markets. Infrequently, one of these consensus tends to be reformed or replaced. Krugman, in a recent article in Foreign Affairs, "Dutch Tulips and Emerging Markets," writes that some economists now maintain that the "Washington Consensus" is incomplete in the sense that economic liberalization and orthodox macroeconomic policies do not guarantee sustained high growth rates. It is clear that the most important factor in a capital account liberalization--more than sequencing, current account, od capital account--is the existence of appropriate regulatory and supervisory frameworks which deter financial intermediaries from taking excessive risk in an environment of unrestricted capital flows. Countries that obeyed the first sequencing rule but did not have suitable regulatory frameworks experienced serious financial problems.

A corollary of the last point is that a premature liberalization of the capital account could do more harm than good. Hence, it is appropriate that, in its consultations with developing countries, the Fund continue with its case-by case approach to this type of liberalization.

A more recent consensus on the capital account--reached in the aftermath of the Mexican crisis--is the following from the World Bank Document "Latin America After Mexico: Quickening the Pace":

The composition of capital inflows is very important. Short-term flows are very sensitive to changes in interest rates and to political events. Keeping speculative capital under control, while encouraging long-term investment--as Chile has done--makes eminent sense."

What is not so clear is how to induce these long-term capital inflows, or how to discourage disruptive short-term capital inflows.

It is true, as the staff paper points out, that the most appropriate way to deal with large capital inflows is through an appropriate mix of fiscal, monetary, and exchange rate policies. Nevertheless, what happens when a country already has a fiscal surplus of 2 percent, a very tight monetary policy, and a dangerously appreciated real exchange rate? One tries to use other instruments, which is what Chile, and Colombia, with a similar experience, tried to do by imposing capital restrictions.

Both Chile and Colombia, after liberalizing some years ago their capital accounts, have imposed reserve requirements on short-term capital inflows. As Chile's 1994 staff report recognizes, the substantial reduction in short-term private capital inflows was in part a response to these restrictions. In Colombia's case, 70 percent of the projected capital inflows for 1995 will be direct investment and the remainder long-term inflows.

The foregoing does not necessarily mean that capital controls work. We are all fairly certain that they do not work in the long run, and I am not certain of how well they work in the short run; however, I do not believe that the case has been made for totally abolishing this instrument, which seems to have had some effect on the composition of capital inflows in some countries.

Countries should strive toward capital account convertibility. However, many issues remain unexplored, such as Mr. Zhang's point that not until recently did several industrial countries move to benefit from total capital account liberalization. Those developing countries that manage to diversify their export base--to decrease excessive volatility owing to terms of trade shocks--pursue and maintain credible policies--as one of the most vital prerequisites--develop their financial sectors, and increase their savings rate, should liberalize their capital account. In this sense, I agree with

Mr. Clark and other speakers that a further intensification of the current approach by the staff, within the existing Articles, is warranted. But, at least until a new consensus is reached on how to deal with capital flows, a more compulsory approach does not seem appropriate.

Mr. Tulin made the following statement:

I would like to thank the staff for the thorough analysis and the wealth of background information presented to us in a set of interesting papers on capital controls. The papers make it clear that separate treatment of capital and current account transactions in the Articles is the reflection of the conditions in the world economy immediately after the Second World War, when capital flows were small and the majority of member countries employed extensive capital controls to retain domestic savings in the economy for financing reconstruction and development. Now that the task of liberalization of current account transactions among Fund members is well advanced, with more than one hundred member countries having adopted Article VIII obligations, and as full capital account convertibility has been embraced by all industrial countries--Iceland became the last industrial country to adopt it at the beginning of this year--it is timely to take a forward-looking approach and chart our course for the years ahead. As my colleagues have greatly facilitated my task, I can limit myself to stating our basic views on several key points.

There is enough evidence to demonstrate that, in the long run, capital controls and regulations have proved to be inefficient throughout the world, although, in those countries where controls on inflows of foreign capital were practiced, the verdict of inefficiency is not overwhelming and indisputable. Even in those successful instances, however, the argument can be made that the ultimate success was attributable mainly to wise macroeconomic policies, and that without controls the economic performance might have been even better.

There is overwhelming support for the view that prudent monetary and exchange rate policies underpinned by strong fiscal consolidation and structural reform efforts are sine qua non for achieving the degree of stability necessary for successful capital account liberalization. A set of more specific preconditions, outlined in the staff paper and in Mr. Kaeser's statement, may need to be met before full currency convertibility is adopted. However, I note that some countries, for example, the Baltic states, have adopted full capital account convertibility notwithstanding an annual inflation rate of about 1000 percent, rudimentary financial markets, and relatively weak international reserves positions. Thus far, they have fared relatively well, which clearly underscores the merits of a case-by-case approach by the Fund in advising its members as to the timing and sequencing of capital account liberalization.

By all means, countries adopting full currency convertibility need to avoid repeated reintroduction of capital controls to maintain their policy credibility. Accordingly, it is important that the Fund's efforts to promote capital account liberalization in adjusting economies always be accompanied by adequate technical assistance pertaining to interest rate policy, prudential regulations, bank supervision, development of secondary markets for government securities, financial sector reform, and other areas that are key to successful sterilization, as the latter may become necessary.

In general, it is fair to suggest that elimination of capital controls by as many member countries as possible would reduce distortions in the world economy and improve allocation of global savings in the long run. As such, it deserves to become an important permanent objective of the Fund, together with traditional pursuit of current account liberalization. Thus, I would view the expansion of the Fund's jurisdiction over the capital account transactions as being only a matter of time. Obviously, de facto, the Fund is already providing advice and advocating the benefits of full capital account convertibility, and a great deal can be done within the framework of the existing Articles; however, clearly stating that the Fund has jurisdiction over all balance of payments issues, including the capital account, may be in the best interests of the membership, helping to avoid costly duplication of this work and facilitating the Fund's cooperation with the WTO, the OECD, the EU, and other relevant organizations. Therefore, I do not regard as extreme the proposal to begin our work on amending Article VI and, perhaps, strengthening Article VIII.

Nevertheless, many economic and political factors connected with the slippages in implementing economic policies--the lack of necessary experience and even lack of confidence of the authorities in their capabilities--may lead to the utilization of capital controls. The fact that a vast majority of the industrial countries had exercised controls on capital flows for decades, until they felt themselves prepared to liberalize their regulations, attests to the nonincidental nature of this phenomenon. General and unqualified appeals to remove capital controls from industrial nations known for recent sophisticated protectionism in this area would not sound very convincing to the rest of the world. In any case, promoting the merits of liberalization should be more subtle and very closely related to the concrete needs of respective countries.

The world is changing rapidly, and it is to be hoped that a large group of countries that have not yet become an integral part of the globalized capital markets will be able to put into effect full capital account convertibility much more quickly than industrial countries following World War II. Nonetheless, there should be no mandatory procedures for any member country of the Fund to remove capital controls. The Fund should encourage the introduction of capital account convertibility by member countries, but not force them.

As some countries choose to temporarily employ prudential or indirect instruments of capital controls to sterilize unsustainable short-term capital inflows, they would be well advised to use them wisely and only to buy sufficient time for developing an appropriate policy response. It is true that considerable capital inflows may easily reignite inflationary pressures in relatively small economies or lead to rapid exchange rate appreciation and loss of competitiveness. The authorities' attempts to tighten and improve prudential and administrative controls over inward--as well as outward--capital flows may be doomed, as they have previously failed even in countries with a very strong administrative capacity. The staff has made a very clear point that, in the present circumstances of highly integrated and globalized capital markets, proliferation of derivatives trading, and increased fungibility, the distinction between short- and long-term capital inflows is so blurred that it may not be possible to distinguish between them. Hence, the countries experiencing large capital inflows with limited room for fiscal tightening may need to address the underlying causes of these inflows and allow some exchange rate appreciation rather than target short-term capital inflows through restrictive measures. Again, the Fund's technical assistance in policy formulation in this area may play a very important role.

On balance, I would support either the second or third approach regarding the Fund's policies, whichever wins a consensus in the Executive Board. In supporting the third approach, I believe that the degree of commitment, in substance and timewise, to achieve capital account convertibility would be comparable with the spirit of Article VIII, which deals with the issues of convertibility on current account transactions.

In the near term, the Fund needs to expand its database on capital controls and study closely the OECD and the EU experience in this area. I can go along with using the OECD Code of Liberalization of Capital Movements and the respective EU Directives as the basis for developing the Fund's policy guidelines on capital controls.

In conclusion, I agree with others that the staff's studies on capital controls deserve to be published as Occasional Papers and could stimulate debate outside the Fund on this subject of paramount importance to many developing countries and economies in transition.

Mr. Autheman made the following statement:

I welcome this new discussion on capital account convertibility. After having read the report and its background papers, I am more than ever convinced that the experiences are so eclectic and the academic literature so spread out, that the pragmatic tonality of the report is appropriate.

First of all, let me underscore that this paper, as others have already said, is central to our surveillance endeavors. There is a clear link with our recent discussion on data provision and standards of publication. We have to encourage countries to open their capital account because capital mobility enhances welfare and because the disciplinary role of the financial market is in the own interest of countries and in the interest of this institution.

However, I think that the link alluded to at the end of the report between a voluntary approach to a capital account convertibility and the creation of another new facility is a bit repellent. Indeed, we come to be concerned with the risk of confusion. This is the third new facility that has been discussed or mentioned in the Board over the last month, and we consider that this is not a very attractive way to convince countries to open their capital account to sell the enactment of a legal requirement with the anti-poison facility.

We consider that the freedom of capital account is an objective in its own right and that the risks associated with it are not attributable to specific pathology so that they should be treated by a special facility.

The report is appropriately pragmatic, and I was struck by Mr. Clark's statement presenting the various situations and approaches in his constituency. I believe that it is time to try and build a consensus, but it is probably too early to create new rules.

We should, at this stage, work on guidelines. Of course, we should keep in mind the option of extending the Fund's jurisdiction to capital account transactions as a way to consolidate, some time in the future, the consensus we would like to reach soon.

Let me add that we would also like to avoid stop-and-go legislation. It would seem a bit paradoxical to start discussions both on an amendment creating orderly workout procedures and on another amendment extending our jurisdiction to capital account freedom.

Our position is that we should aim at establishing an operational consensus on this issue which could govern our surveillance exercise. I would identify, among others, three issues on which such an operational consensus could be established.

First, there are, in our view, only two kinds of legitimate capital controls: first, those based on prudential justifications. I have in mind the traditional measures such as limits on foreign exchange exposure or reserve requirements. I have also in mind the maintenance of controls when the financial or banking sector is not robust and sound enough to accommodate huge and volatile capital flows. The other kinds of legitimate restriction could be those established to allow the authorities to preserve the soundness of a recently acquired macroeconomic credibility. I would consider this restriction as a temporary answer to huge flows which would be perceived as an unexpected price of success.

We believe that our tolerance for such capital controls should be accompanied by a greater demand as regards the need to open up direct investments. In this regard, I agree with the conclusion of Mr. Quirk in a working paper (WP/94/81, 7/1/94) which stated that early moves to open up direct investment constitute a priority because the need for foreign investors to establish an intensive relationship is likely to result in a natural phasing of inflows, and because direct investment is intrinsically stable, entailing positive implications for monetary stability and prudential monitoring.

Another area in which we should try and establish a consensus is the issue of reimposition of controls for economic policy reasons after the opening of a capital account. In my view, we should consider that safeguarding measures are legitimate only if they comply with the two following requirements: first, they must be of a transitory nature; second, their reversible nature must be as free of cost as possible. That means that we should remain extremely reluctant to endorse any controls on capital outflows.

A third area on which we have to work to design operational guidelines--and here I would refer to Mr. Mirakhor's statement--is a process to attain capital account liberalization.

At this stage, I would only suggest two conditions.

The first set of conditions is of a prudential nature. This involves naturally everything that has been written and said by the staff and other Directors about the effectiveness of prudential and regulatory mechanisms. But I would like to say that I was attracted by Ms. Lissakers' concept of "interactive sequencing."

The second set of conditions is related to the basic functioning of the economy, to its macroeconomic stability. I am in agreement with the conclusion of another working paper by Mr. Vicente Galbis, "Sequencing of Financial Sector Reforms," which concludes that macroeconomic stability cannot be set as a necessary precondition for all cases because then many countries would have to wait a long time to get the benefits of financial liberalization. What would seem necessary, however, is that macroeconomic policies be coordinated in such a manner that their combined operation does not distort relative macroeconomic prices in a way that is detrimental to the business sector.

The Acting Chairman commented that he wondered whether it was a contradiction to pursue both capital account liberalization and orderly debt workout procedures at the same time. In his view, they seemed to go hand in hand.

Mr. Autheman replied that, to the layman, it would be hard to understand why the Fund should push at the same time for an amendment that made freedom of capital a principle of the Fund, and another amendment showing the way, in a manner or speaking, to punish those who believed in the freedom of capital by organizing defaults. The Fund's credibility would then appear to be at stake. Of course, defaults happened, and a way should be found to deal with them, but the Fund should insist on the idea that defaults were absolutely undesirable.

Ms. Lissakers agreed with the Acting Chairman. Dealing with both issues simultaneously was neither more nor less inconsistent and incompatible than pressing for simultaneous liberalization of banking activities and strengthened supervision and regulation. Mr. Autheman had said himself that there were certain conditions under which it was legitimate for a government to impose capital restrictions--such as in the case of an exchange or banking crisis, for example. It seemed logical to set a standard and a goal, and at the same time to create specific guidelines for exceptional circumstances when a deviation from the standard or goal would be sanctioned.

Mr. Kiekens observed that each wave of liberalization had gone generally hand in hand with Fund jurisdiction in respect of the reintroduction of restrictions. In that respect, the Fund had been given jurisdiction in approving the reintroduction, under certain special circumstances, of current account restrictions precisely because the Articles of Agreement also introduced the principle of the liberalization of current account transactions. Similarly, the World Trade Organization (WTO) had been empowered to assess whether a temporary trade restriction could be accepted precisely because the WTO had been charged with protecting the principle of trade liberalization; the Commission of the EU and the European Council had been charged with ruling on the temporary reintroduction of restrictions on capital transactions precisely because capital account liberalization was accepted in the context of the European Union. Therefore, it was logical that, were the Fund to be given a mandate to encourage full liberalization of the capital account, the Fund should also be given jurisdiction over the temporary imposition of restrictions on capital account transactions.

Mr. Esdar said that he had some sympathy for the remarks of Mr. Autheman. If the question of capital account liberalization were presented at the same time as the question of a debt workout procedure, the wrong impression could be created that defaults were usually the consequence of liberalization. For that reason, the two should be kept separate. In that regard, it needed to be borne in mind that the debt crisis of the 1980s had been a consequence not of liberal markets, but of wrong policies.

Ms. Lissakers said that while she agreed with Mr. Esdar's last point, she generally concurred with Mr. Kiekens's observations. Jurisdiction over the reimposition of restrictions went hand in hand with jurisdiction in the matter of liberalization. The advantage of having clear Fund jurisdiction in that area would be that the Fund could say that the international community supported the reimposition of controls and deemed them legitimate under certain circumstances, only to the extent that they were temporary and that a timetable for their removal was agreed, and provided that they were accompanied by certain other supporting policy measures. Indeed, perhaps in making progress in the area of debt workouts, it would become clearer that the formalization of Fund jurisdiction over capital account liberalization was needed by an amendment of the Articles of Agreement.

Mrs. Cheong said that she would like to have the view of the Legal Department as to whether or not the Fund had any jurisdiction over the capital account under the present Articles. Were a country to go back on capital liberalization measures and end up in a dispute before the WTO, for example, she wondered whether a Fund assertion that the backtracking had been owing to balance of payments problems would be accepted. It was her understanding that, under the current Articles, the Fund could tell the WTO that the country had a balance of payments problem and that it therefore could impose restrictions, even though they were restrictions on the capital account.

Mr. Al-Tuwaijri made the following statement:

At the outset, I would like to compliment the staff for producing this excellent and concise set of papers for today's discussion.

The experience with capital account convertibility has been quite diverse across the Fund's membership. Evidently, this underscores the appropriateness of the Fund's case-by-case approach to advice on these matters. I will focus my remarks on the future role of the Fund in this area.

We can all agree that capital account convertibility is both desirable and welfare enhancing for an individual country as well as for the world economy as a whole. Individual countries' circumstances have necessitated different approaches. Thus, it is difficult to reach a judgment on a uniform approach for capital account liberalization that is applicable in all circumstances. For example, my own country, Saudi Arabia, liberalized its capital account at a very early stage of its economic development, even before most industrial countries.

The staff sets out a number of criteria that can be viewed as necessary for successful capital account liberalization, including stable macroeconomic conditions and adequate prudential regulations. These are, of course, goals that should be pursued for their own merit, irrespective of whether or not the authorities are contemplating particular measures for liberalizing capital movements.

The Fund has been active in encouraging capital account liberalization and has provided assistance and advice to members in this area. Nevertheless, the question that arises is whether and how the Fund should be more involved in promoting greater capital account convertibility.

The Fund should continue its efforts in promoting capital account convertibility, as well as in monitoring restrictions on capital movements, for several reasons. An active role of the Fund in this area is a natural and essential element of its role in surveillance over a member's exchange rate policies. We can agree that greater capital mobility is welfare enhancing for the world economy as a whole. It is therefore in the interest of the membership as a whole that greater capital movement be encouraged by this institution.

More complex questions arise regarding the form that Fund involvement should take. Although a case could be made in favor of extending the Fund's jurisdiction in this area, the staff paper points to a number of complex issues that will arise in such an event. On balance, and after listening to the views of other Directors, it would seem that pursuing an expansion of the Fund's jurisdiction may not be the optimal course of action. Furthermore, such an expansion might have significant implications for the use of Fund resources.

In sum, we can all agree that capital account convertibility is a desirable end. However, countries have been liberalizing capital movements on their own accord. The Fund can, and does, provide advice and technical assistance in this area to members. I therefore see merits in concentrating our efforts along the lines outlined by the staff in the second approach.

Mr. Geethakrishnan made the following statement:

The staff deserves to be complimented on their extensive analysis of this issue, and too from different angles. We have now before us not only interesting but also extremely useful data from which we can draw meaningful conclusions.

In the recent spring Interim Committee meeting, the Finance Minister of India had dwelt briefly on capital convertibility issues. I cannot do better than to quote him. I quote, "The recent developments in the foreign exchange market have also raised a few interesting questions about capital account convertibility. The important message is that, unless domestic macroeconomic parameters in the recipient countries are on a solid foundation, these inflows could reverse at any time. Emerging market economies are much less able to withstand sudden fluctuation in private capital flows than a country that has enjoyed long years of political and economic stability. This reinforces our conviction that the capital account liberalization should be at the end of the tunnel of the reform process. Before introducing such a measure, a country should ensure that inflation is brought well under firm control, supervision and control of banks is adequate, external account is in balance, and fiscal deficits within manageable limits."

The data placed before us by the staff clearly bear out the wisdom of my Finance Minister's observations. It is seen from Supplement 1 of the staff paper that in the case of industrial countries that enjoyed good, stable economic and political stability for long periods, the process of liberalization accelerated only in the 1980s and early 1990s. In the United Kingdom, there was a significant move toward complete liberalization only in 1979, and in Japan, the completion of the liberalization process took place in 1980. There was a quick removal of all capital controls in Australia in 1983. Then came New Zealand in 1984, and extensive liberalization by European countries followed.

The staff paper contains a whole box on page 7 regarding reimposition of controls by several emerging markets when they were faced with large capital outflows after having enjoyed a period of stability following elimination of control controls. Indonesia, Malaysia, Philippines, Brazil, Chile, and Colombia have figured in this list. More recently, Mexico might have also joined this list but for the enormous support of US$20 billion from the U.S. and US$17.5 billion from the Fund and that too pledged in record time.

I wonder whether other countries that already have capital convertibility or that may be encouraged to do so now could count on such massive support from the Fund and other major donors and that, too, in such record time if they should unfortunately face major capital outflow problems. Maybe some restrictions would, therefore, be in order, as has been demonstrated by Chile. The basic objective should be to ensure that the broad thrust of the opening-up process not get reversed and that capital convertibility not be spoken of as a matter of dogma.

Equally important, the staff paper also brings out clearly how there exists even now numerous restrictions in the OECD countries. Even in the U.S. where least restrictions exist, it is still difficult for foreigners to raise capital through American Depository Receipts (ADRs). I understand that there has since been some simplification by the introduction of Regulation 144a, but some complexities remain. On the other hand, there are some emerging markets that have complex capital account restrictions but that have in recent years still attracted sizable private capital flows. What has facilitated this development is a moderation of some crucial controls and, more important, the signals sent by a strong commitment to structural reforms and macroeconomic stabilization. Thus, it is not so much a matter of whether or not we should aim at total capital account convertibility. It is an issue of more convertibility versus less convertibility. In other words, it is a question of keeping the controls at a level consistent with the developments in all other sectors of the country and gradually reducing or minimizing these controls as other parameters improve.

The moral of the lesson is very simple. As the Indian Finance Minister observed in the spring Interim Committee meeting, capital account convertibility should be the end result of a successful process of macroeconomic stabilization and structural reform efforts aimed at integration of a country's economy with the global economy. It should be reached without being set as an objective. It should be the culmination of the reform process. It cannot be set as a target either at the starting point or at an intermediate stage. Any attempt at enhancing the status of capital account convertibility in the Fund's mandate through an amendment of the Articles of Agreement would only lead to increased pressure for premature introduction of capital account convertibility and this will be disastrous. The present procedures, the Article IV discussions, do help to focus on this issue without making it an end in itself. In my view, this is adequate.

Before I conclude, I would like to give the Board a real-life situation that I faced in this matter which I think is relevant to the issue. In 1987, I went to two countries to finalize the purchase of property for our embassy. One was in North Africa; the other in Western Europe. In North Africa, I chose a property close to the President's palace because I felt sorry for the Ambassador there; he did not have much work, because we had only six people, Indians, totally in that country, no trade, nothing. At the end of the discussion, I was asked whether I would mind putting the value at one third of the negotiated price and putting two thirds in the Swiss bank account! This I could understand because in my own country, with all restrictions on foreign exchange, in fact, if you had a dollar note in your pocket, you could be questioned; you should have surrendered it to the authorities. I could understand because in my own country, at that stage, the premium on foreign exchange was 25 percent and what is called the black money was as wide as 40 to 60 on the sale of property.

I then went to the Western European country. In this country they had full capital account convertibility. At the end of the negotiations I was taken to a side room and asked, "Look, we would like a part to be placed in a Swiss bank account." I said, "Fine." But what alarmed me was the percentage indicated--it was 75. In the North African country, it was 66 2/3. In India, with all the restrictions, it was about 40 as black and 60 as white and the premium on foreign exchange was 25 percent. In this country, which had introduced full capital account convertibility, the amount that was asked to be put in the Swiss bank account was 75, clearly because capital account convertibility was not in sync with the developments in the rest of the economy, including the tax rates.

There is not much merit in our going in for a capital account convertibility of this type which this Western European country had in 1987.

Ms. Lissakers observed that the American Depository Receipt was actually a mechanism to facilitate, not hinder, the raising of equity capital in U.S. markets. The ADR had been designed as a mechanism to overcome the difficulty of transferring speedily the ownership of equities from the home country of the issuing company to foreign investors.

Mr. N'Guiamba made the following statement:

The papers prepared by the staff review the experiences of both industrial and developing countries in liberalizing capital outflows and inflows. We note that the pace and sequencing of the adoption of capital account liberalization measures have varied from country to country, and that the approaches of many countries have made a difference between short-term and long-term capital movements.

The main issues we must address today are (1) whether countries which have not yet made significant progress in the area of capital account liberalization can draw useful lessons from the experiences of other countries; and (2) whether there is a need for the Fund to increase its involvement in member countries through specific advice in this area.

This chair strongly supports the liberalization of the capital account of all countries, as soon as they become part of integrated global capital markets. The integration of a country into global capital markets is not easy to achieve, however, because it requires that domestic assets become near substitutes for foreign assets. For that to happen, the country must have a strong financial and banking system whose instruments, particularly interest rates, can be used to effectively affect the direction of capital movements at any time.

This being the case, we are of the view that the capital account liberalization must be an integral part of the reform of a country's financial system. It should be preceded by structural reforms whose aim is to make domestic enterprises more efficient and increase the international competitiveness of the economy as a whole. These structural changes should be accompanied by an appropriate mix of monetary and fiscal policies to increase foreign investment confidence. As soon as a strong financial system has been put in place, and the economy has become internationally more competitive, a country can organize a domestic assets market and then proceed with the liberalization of capital movements, beginning with long-term capital. These steps are likely to make the process of capital account liberalization less painful.

However, we do believe that countries should be appropriately equipped to deal with adverse effects of speculative short-term capital movements, even if it means the imposition of temporary capital controls. A number of countries seem to have been successful with such controls in the recent past.

As regards the possibility of extending the existing Fund mandate to also cover capital account transactions, we believe that this should be done carefully. We are of the view that Fund involvement should be done on a case-by-case basis, preferably in the framework of Article IV consultations or negotiations of an adjustment program. While advising member countries in this area, we agree with some speakers that the Fund should also highlight the potential risks associated with the liberalization of the capital account. We also share the view that a temporary reimposition of capital controls should be possible, without prior approval by the Fund, when countries are faced with wide fluctuations in their short-term capital movements that may jeopardize the stability of their exchange rates.

Mr. Dlamini made the following statement:

Capital account liberalization is an acceptable objective, and many countries are moving in this direction. Some see it as a means of creating a more favorable environment for foreign direct investment, and, in a number of these countries, the investment code makes specific reference to the freedom to repatriate profits and dividends.

The lesson from experience in capital account convertibility is varied. The approach of the industrialized countries has been gradual, with liberalization following broad-based trade and domestic financial reforms. There is evidence to suggest that moving too quickly may cause problems, if the liberalization is not supported by fundamental reform. At the same time, some countries have succeeded in moving relatively rapidly; however, this has been done in the context of a comprehensive adjustment effort.

Based on the evidence, I have two basic observations. There is no one approach to capital account liberalization; the matter must be dealt with on a case-by-case basis. The importance of complementary policies is unquestionable. Mr. Mirakhor has given some examples in which some form of capital control might help a country move closer toward achieving macroeconomic stability. It would appear that countries should first try to achieve some degree of macroeconomic stability as well as a strong balance of payments position before being encouraged to move toward capital account convertibility. It is also necessary to have in place an appropriate regulatory and supervisory framework for the financial system to prevent the taking of undue risks in a situation where capital movement is free.

Even as countries liberalize their capital accounts, there should be room for the reimposition of controls. However, such reimposition could lead to the intensification of pressure as market participants perceive the authorities to be abandoning their policy of liberalization.

The Acting Chairman stated that an important question that speakers had asked was why it had taken industrial countries so long to liberalize the capital account, and why it would be now appropriate to move more rapidly in that area. A related issue was whether or not an amendment of the Articles was needed for the Fund to deal effectively with the issues of capital account liberalization, and whether such an amendment was feasible given the nuances of the preconditions and sequencing issues involved in capital account liberalization. A number of questions had also been raised about the moral hazard implications of Fund financial support for capital account liberalization.

The Director of the Monetary and Exchange Affairs Department stated that one strand of the remarks of Directors appeared to have been that, whatever it was that the Fund should do on capital account liberalization, it could do already under the existing Articles of Agreement and existing procedures. Another strand was that, given that many countries had already liberalized the capital account, there was no need to alter the Fund's jurisdiction in respect of the capital account.

In his view, there were a number of reasons for arguing that the extension of Fund jurisdiction over capital account transactions was important, the Director continued. Under the present system, decisions on capital account liberalization were left to each country's discretion. Other than the definition of current account transactions--in the Articles of Agreement (Article XXX(d))--which encompassed certain items usually considered capital account transactions--the Fund's code of conduct gave the institution no jurisdiction with regard to the capital account. Providing the Fund with jurisdiction in that area would give it a justification for monitoring progress in capital account liberalization; and it was his understanding that there was general agreement about the economic advantages of such a liberalization. Needless to say, the jurisdiction would have to be applied with discretion, but that had been the Fund's practice with respect to the current account throughout its history. Current account liberalization was not made automatic or compulsory by the Fund.

Under current practices, the Fund could recommend capital account liberalization, and make its case on grounds of economic analysis, the Director considered. However, the current practice did not provide the Fund with any basis for influencing effectively what a country's plans might be for capital account liberalization; those plans remained very much within the discretion of the country. If the Executive Board were given jurisdiction over capital account transactions, then it would be the Fund membership that would have the initiative and the discretion rather than the individual member; that was an important distinction, in his view.

It had not been the Fund's practice, in the exercise of its jurisdiction over current account transactions, to make countries undertake capital account liberalization regardless of the circumstances, such as the starting conditions or the desired pace and sequencing of liberalization measures, the Director noted. Decisions on capital account opening needed to be taken case by case.

Many speakers had pointed to a strong supervisory framework and a liberal domestic financial sector as prerequisites for capital account liberalization, the Director continued, and these were, indeed, important considerations. However, as Ms. Lissakers and other Directors had mentioned, the interactive nature of the process needed to be borne in mind. For example, sometimes capital account liberalization, because it would be necessary to ensure a liberal domestic financial setting. There was thus no single sequential order applicable in all circumstances.

With respect to the positions on how to proceed, the Director went on, he recognized that most Executive Directors had opted for the staff's second alternative--adapting existing surveillance procedures and technical assistance to promote more actively capital account liberalization. As Mr. Mesaki had noted, there was not that much difference between the second and third approaches, except for the important issue he had stressed at the outset, that is, who would exercise the discretion--the individual country, in the case of the second alternative, or the Fund's Board, in the case of the third alternative. Giving the initiative to the Board would not, after all, imply that, in certain circumstances, a country that had liberalized its capital account would be precluded from taking any action in respect of the capital account. Rather, the Fund would exercise the same degree of restraint as it had exercised historically in the matter of its jurisdiction over current account restrictions. In that area, the Fund allowed for the maintenance of those controls that a country already had in place, and also for the temporary reintroduction of controls whenever they were necessary, but such allowances were subject to an explanation from the member of why the measures were needed and how they were going to be made temporary, as a basis for a decision on their approval by the Board.

Capital account liberalization did not necessarily mean that countries would need more Fund financing, the Director explained. However, with open capital accounts, the likely scale of balance of payments problems would grow. The basis for the linkage between capital account convertibility and Fund resources was that the Fund should be in a position to lend support to members when they faced problems in the process of liberalization. Having said that, however, it might very well be the case that, after capital account convertibility was implemented, countries would not need to come to the Fund for resources. For example, industrial countries had not found it necessary to come to the Fund for resources following the liberalization of their capital accounts.

With respect to the issue of moral hazard, there was always moral hazard in official financing, in general and in financing by the Fund, in particular, the Director pointed out. As for the Fund, the instrument used to contain moral hazard was conditionality. The staff was not advocating an increase in the resources of the Fund and in access to those resources without conditionality. Clearly, there was an important challenge there, because the conditionality that would be applicable to a capital account problem might be of a different nature from that associated with the current account, thus calling for a close examination of what would be the proper procedures, but that was a separate issue. With an appropriate design and implementation of conditionality, the issue of moral hazard would be dealt with.

The proposal to extend the Fund's jurisdiction to the capital account was a step that followed logically from the Bretton Woods scheme, the Director considered. That scheme had emphasized current account opening, because that had been the most urgent concern at the time, as the world had just gone through a time when trade and current account flows had been disrupted or stopped. Capital flows had yet to acquire importance and the capital account had not been viewed with the same concern at that juncture. But as current accounts were opened, it had soon become clear that capital account liberalization would have to follow. Indeed, the inclusion in Article XXX(d) of the Articles of Agreement of certain capital account items reflected the linkage perceived between certain capital account transactions and those in the current account.

As the Chairman had noted, industrial countries had taken a long time to liberalize their capital accounts, the Director said. However, it needed to be borne in mind that conditions in the world economy had changed greatly in the period since the liberalization of industrial country capital accounts. Moreover, the fact that it had taken industrial countries so long had not been the result of a deliberate decision taken to that effect, but rather a result of the circumstances of the times. Another reason might be the Keynesian consensus of the 1940s and 1950s, so to speak, which envisaged a large role for the government in economic activity. That, in turn, led to a desire in national governments to keep a measure of independence in economic policy, which was sought through capital controls. At the time, these controls were also seen as necessary for the system of fixed exchange rates. Thus, the dilemma had been that the aim of the Articles of current account liberalization--which would increase interdependence and lessen the degree of autonomy of economic policy--had to be tempered with the acceptance of capital controls--which served to restrain interdependence and enhance policy autonomy. The Bretton Woods system had since changed from fixed to flexible exchange rates. In that context, the question could well be raised why countries had not then eliminated capital controls, which, with exchange rate flexibility, should have become less relevant.

Some capital account liberalization had occurred as a result of the liberalization of the current account, the Director argued. Also, the emphasis had moved recently from government policy to market forces as the key element in the economic process. In that setting, countries participating in the system could hardly afford to take 20 or 25 years to liberalize their capital account. That notwithstanding, should the Fund be given jurisdiction in respect of the capital account, there would remain flexibility with regard to the length of the period of liberalization. After all, some Fund members had not yet undertaken current account convertibility.

His strongest argument in favor of extending the Fund's jurisdiction to the capital account was that a code of conduct more and more divorced from reality became less and less credible, the Director concluded. Perhaps the most important factor in moving toward Fund jurisdiction over capital account liberalization was the signaling effect that such a move would have.

In his view, the Fund as an institution should have a presence in the capital transactions area. In such a case, the staff would coordinate with the OECD, the EU, and the World Trade Organization in its work on capital account liberalization issues. In that area, the OECD's experience, for example, was much broader than the Fund's, and the Fund would benefit from it.

Ms. Lissakers observed that the structure and means of financing government deficits had been one of the factors entering into the pace of liberalization of capital accounts by the industrial countries. Once a government found it desirable and necessary to tap private foreign capital in order to finance budget deficits, there would be little choice but to open the capital account, because it would be difficult otherwise to attract investors to buy the government's securitized debt. For a long period after World War II foreign support for budget deficits had come in the form of official transfers, at which time there had been no need for linkage with the market. At present, governments relied to a large extent on private capital financing to finance budget deficits. That would seem to create the conditions necessary for capital account liberalization over the long term.

Mr. Esdar commented that another reason why it had taken industrial countries so long to liberalize their capital accounts was because they had simply misjudged the value of controls. Often, the controls had not worked as intended. For example, in the 1970s, Germany had attempted to establish taxes on short-term capital inflows, partly in order to maintain an inappropriate exchange rate. In the event, the taxes had failed, and the exchange rate had adjusted anyway. Controls had also sometimes been set in place in order to protect domestic markets; that had been the main impetus for the creation of Eurodollar markets. Once again, the controls had not had their intended effect. Finally, he would observe that the experience of the industrial countries should not always be set up as a benchmark against which the progress of others should be compared. After all, it had taken some industrial countries more than one thousand years to adopt a democratic form of government, and he would not argue that such a leisurely timetable should necessarily be adhered to by other countries in moving toward democratic systems.

Mr. Berrizbeitia commented that the relative magnitudes of the problem of capital markets and individual economies needed to be borne in mind. To use an analogy, it took many hits for a wrecking ball to destroy a large steel framed building, but perhaps only a single hit to destroy a small wood frame house. In the same way, the magnitudes of the capital flows moving around the world needed to be compared with the size of the economy involved. It was for that reason that he had some hesitations about across the board capital account liberalization regardless of the particular circumstances of the country. Perhaps the staff could discuss that issue.

The Director of the Monetary and Exchange Affairs Department said that the size of the economy in comparison with the size of capital flows did make a difference. The size of the economy was one of the important elements in determining the appropriate approach to use to move toward capital account liberalization. It was necessary to judge on a case by case basis, and the gradual approach that Mr. Berrizbeitia had implied could certainly be entertained. The specific characteristics of a country always needed to be taken into account.

There was a clear link between capital account opening and surveillance, the Director pointed out. Surveillance was another of the elements concerning which the size of countries mattered. If surveillance was effective in the world of capital account integration, then the problems facing the smaller economy should not be overwhelming. If there were no major imbalances in the system, then there should not be huge flows of capital going into and out of a small economy and creating problems.

The staff representative from the Legal Department, responding to a question from Mrs. Cheong about the consultations between the Fund and the WTO in the context of the implementation of members' obligations with respect to capital account liberalization, said that there was a safeguard provision in the General Agreement on Trade in Services (GATS) under which members that had committed themselves to liberalizing specific capital transactions related to services--for example, insurance--could reintroduce restrictions to the extent that there was an adequate justification. The criteria for justification under Article XII of the GATS was serious "balance of payments and external financial difficulties." A determination would have to be made whether or not that condition existed. With respect to both current and capital account transactions, to the extent that an obligation existed with respect to the capital account transactions, the Fund's finding as to whether or not a balance of payments problem existed was virtually conclusive. The relevant text of the GATS stated: In such consultations, all findings of statistical and other facts presented by the Fund relating to foreign exchange, monetary reserves, and balance of payments shall be accepted and conclusions shall be based on the assessment by the Fund of the balance of payments and external financial situation of the consulting member.

Mrs. Cheong observed that, under the Fund's present Articles, while the Fund's ruling on the balance of payments need would be upheld by the dispute panel in the WTO, she wondered whether the Fund had jurisdiction to rule on the reimposition of a particular exchange control measure, since Article VI stated that the Fund had no such jurisdiction.

The staff representative from the Legal Department explained that, to the extent that there was a capital account transaction, the Fund's determination related only to the balance of payments finding, because the Fund had no jurisdiction with respect to capital account restrictions that had been imposed at the initiative of the member. However, the definition of current payments in the Fund encompassed some transactions that economists would normally consider to be capital transactions. Subject to that qualification, the Fund's jurisdiction under Article VIII was limited to current account transactions. Therefore, if the Fund was consulting with the GATT on capital restrictions, the determination would, in general, be relevant only with respect to the balance of payments determination.

Mr. Kiekens commented that Article VI gave the Fund the right to request a member to reintroduce restrictions on capital account transactions. Article VI prohibited a member from using Fund resources to finance large or sustained capital outflows, and the Fund could request a member to exercise controls to prevent its resources from being used in that way.

Some Directors had seen no need to change Article VI, Section 1, on the grounds that the solution was policy adjustment rather than additional financing, Mr. Kiekens recalled. It had also been observed that, during the debt crisis of the 1980s, the Fund had been involved largely with adjustment, not financing. However, the balance of payments crisis of Mexico had demonstrated clearly that, in order to prevent a temporary inconvertibility of the peso, the financing of large capital flows was unavoidable. Those flows had been, and were being, financed by the U.S. Treasury and, to a certain extent, by the Fund. The Fund had also been discussing an increase in the General Arrangements to Borrow (GAB) largely because of the experience in Mexico. To the extent that a case could be made for the proposition that Mexico should have been financed not by the U.S. Treasury, but through a mechanism such as the GAB, it was clear that Article VI should have been applied--allowing restrictions that obviated the financing of capital outflows by the Fund. Assuming capital account liberalization, there would be no need to make a distinction between the Fund's involvement in financing the current account and financing the capital account. The experiences of Mexico and Turkey showed that it was often easier to effect a turn-around in the current account than renewed access to international financial markets. For all of those reasons, he saw no justification for maintaining the prohibition against the financing of capital outflows by the Fund under Article VI. He therefore advocated abolishing Article VI.

Ms. Lissakers said that she wondered whether the World Trade Organization currently had greater and more explicit jurisdiction over capital account transactions than did the Fund.

The staff representative from the Legal Department replied that the nature of the legal system in the Fund and in the GATT and the GATS was different. The degree to which members have obligations with respect to trade and services and capital transactions was limited to the schedule of commitments that they had negotiated under the auspices of the WTO. However, it was fair to say that some of the schedules that had been agreed included the liberalization of capital transactions--both the underlying transactions and the payments and transfers to which they related. The Fund's jurisdiction under Article VIII was indeed limited to current account transactions, albeit defined broadly to include some transactions, such as payments for the repayment of principal on loans, that would normally be considered to be capital transactions. However, those obligations applied broadly to all members and were not based on bilaterally negotiation schedules.

Mr. Geethakrishnan observed that Mr. Kiekens had pointed out that if GAB facilities had been available for Mexico, Article VI would have barred Mexico accessing them. He wondered whether it followed that Article VI also barred Mexico from accessing the $17.5 billion of Fund resources to which it was supposed to be entitled, and whether the Fund had made a mistake in that respect.

Mrs. Cheong stated that, in her opinion, the WTO had no jurisdiction whatsoever over the capital account. Rather, the strength of the measures to move to capital account convertibility depended on what individual members had agreed to in negotiations with other parties to the WTO agreements. There should thus be no fear that the WTO had more control over capital transactions than the Fund. In fact, the Fund had greater control, because it could recommend the liberalization of capital account transactions in the context of its Article IV consultations with members, a mechanism that was not available to the WTO.

The staff representative from the Policy Development and Review Department stated that the arrangement with Mexico had been structured so that Mexico would have a balance in its balance of payments through the course of the year. Fund financing was not intended to finance capital outflow but, rather, to build up Mexico's gross international reserves.

The Acting Chairman made the following summing up:

> The Executive Directors welcomed the opportunity to review the recent experience of the Fund's membership with capital account liberalization and to discuss the Fund's role in promoting capital account convertibility.
>
> Directors noted the marked trend evident in both developed and developing countries to liberalize capital controls. Most Directors supported the view that restrictions on capital outflows had proven largely ineffective, because of difficulties in enforcing them in highly integrated international markets. In particular, such controls were seen to be incapable of preventing the outflow of domestic savings or of delaying the need for fundamental policy adjustments.
>
> Directors underscored the beneficial effects for growth and investment of private capital inflows, which had become larger and more widespread as a result of confidence in increasingly liberalized financial markets and stepped-up stabilization efforts. However, they noted that a growing number of countries had experienced surges in those inflows that had sometimes complicated macroeconomic management. Although acknowledging that steps to deter capital inflows might, on occasion, provide

breathing room in dealing with market disruptions, most Directors emphasized that such disincentives or controls should not be used as a substitute for more fundamental policy adjustments. Directors pointed to the potential distortionary effects of such measures, as well as to their typically growing ineffectiveness over time.

A number of Directors emphasized that capital account liberalization, particularly in less developed countries, should proceed gradually, with adequate attention to differing conditions among individual countries. Although agreeing that capital account liberalization had welfare-enhancing effects, they emphasized that the existence of an adequately strong and well-supervised financial system, in particular, was essential for the nondisruptive removal of capital controls.

Referring to the gradual pace of capital account liberalization in many industrial countries in past decades, many speakers emphasized that fundamentally changed circumstances made a gradual approach more difficult at present, in view of the limited effectiveness of restrictions and controls. All speakers agreed that controls should not--and in fact could no longer--support inefficient policies, and that capital account convertibility was desirable per se.

In discussing the sequencing of capital account liberalization, Directors noted that international capital flows were highly sensitive to yields, and that realistic, internationally competitive exchange rates and interest rates were crucial. To that end, prior or parallel development of financial market instruments was very desirable. Some speakers also emphasized the catalytic effect of capital account liberalization in spurring structural adjustment and reform and improving financial sector supervision. Directors emphasized the importance of introducing and sustaining firm stabilization policies as a complement to the opening of the capital account, and pointed to the need for the increased adaptability of fiscal policy, in particular, to changing external conditions in an environment of free capital flows.

Directors underscored the importance under a liberalized capital account of strengthened prudential management and information systems in the financial sector. Directors welcomed the steps that a number of countries had taken to accelerate improvements in these systems in parallel with, and in some cases prior to, capital account liberalization. Directors called for a stronger Fund role in promoting and assisting the improved effectiveness of the prudential systems.

Directors agreed that the global economic environment had changed radically since the adoption of the original Articles of Agreement and their amendment in the 1970s, and that capital account movements had assumed greater importance. In that connection, they supported a strengthening of the Fund's surveillance and technical assistance activities in encouraging and supporting capital account liberalization. Such an approach was seen as complementing the procedures in place for encouraging the transition to current account convertibility. Directors generally supported fuller treatment of capital account issues in Article IV consultations and in technical assistance support.

Although the Fund's traditional focus under Article VIII had been on controls and incentives affecting foreign exchange transactions, Directors noted that the scope and definition of capital controls was much broader. The coverage of the existing OECD code was generally viewed as appropriate for the Fund's focus in that area.

In considering whether to amend the Articles to extend Fund jurisdiction to capital account issues, most Directors took the view that sufficient scope was available to the Fund under the present Articles and under the surveillance decision to accommodate increased emphasis on capital account issues. It was agreed to review, say, before the end of 1996, the Fund's experience with the enhanced policies and procedures regarding the capital account described in the preceding paragraphs, which would also give an opportunity to reassess the case for an amendment of the Articles.

Directors noted the potential implications of capital account liberalization for Fund financing. The Board would have an opportunity to come back to that issue in its discussion in the following week on the role of Fund financing and its interaction with adjustment and surveillance. There was broad support for the publication of the staff papers after their revision to take account of the Board's discussion.

Ms. Lissakers commented that her authorities would not rule out further consideration of an amendment of the Articles at a relatively early date. The current discussion was the first concentrated one that the Board had had on the matter of extending the Fund's jurisdiction to the capital account. The presumption should not be that the Board would not take it up again until after two or three years. The Board could return to it after six months or a year, at which time the Fund would have begun to have some experience with the sharpened consultation procedures in respect of capital account liberalization. Indeed, depending upon how the debate on orderly debt workout procedures went, it might be necessary to accelerate consideration of the issue. She would prefer not to have a firm decision on the timing, but rather a general presumption that the Board would revisit the issue sooner rather than later.

Mr. Kiekens said that he agreed with Ms. Lissakers on that point, especially in light of the convincing remarks made by the Director of the Monetary and Exchange Affairs Department in reply to the Board's discussion.

Mr. Shields said that he also agreed with Ms. Lissakers with respect to the timing of the next discussion on capital account liberalization.

The Executive Directors then concluded for the time being their consideration of capital account convertibility.

After adjourning at 1:00 p.m., the meeting reconvened at 2:30 p.m.

The Deputy Managing Director, Mr. Ouattara, assumed the chair.

2. CZECH REPUBLIC - 1995 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1995 Article IV consultation with the Czech Republic (SM/95/167, 7/7/95). They also had before them a background paper containing studies by the staff (SM/95/171, 7/18/95).

The staff representative from the European I Department remarked that the staff report should have made reference to the existence of a multiple currency practice subject to approval under Article VIII, which had arisen from the operation of the bilateral payments arrangement with Slovakia. That multiple currency practice had been identified during a technical assistance mission earlier in 1995. The Czech authorities had notified the Slovak Republic that the bilateral payments arrangement would be terminated effective September 30, 1995.

Mr. Mirakhor wondered whether the staff recommended approval of the multiple currency practice.

The staff representative from the European I Department replied that it was a discriminatory currency practice, and that approval could not be recommended. There was no need for a change in the decision for the Article IV consultation, but the staff had wanted to note for the record that that multiple currency practice existed.

Mr. Kiekens made the following statement:

> The staff report gives a well-balanced analysis of the economic situation and the main issues facing the Czech economy, and my authorities are in general agreement with its main conclusions and recommendations.

In 1994, the Czech economy recorded its first positive growth since 1989. Driven by domestic demand, GDP grew by 2.6 percent, and available data indicate that the growth of economy continues in 1995 as well. Preliminary estimates show real GDP increasing by 3.9 percent, and domestic demand by 15 percent, in the first quarter of 1995. These increases were mainly driven by a 21.1 percent rise in fixed capital investment and a rapid buildup of inventories, with household consumption increasing by only 3.3 percent and consumption by the Government falling by 5.9 percent. Positive growth is continuing in the second quarter as well. From January to May 1995, industrial production rose by 4.8 percent and construction by 8.9 percent, compared to the same period last year.

The acceleration of growth in late 1994 and 1995 coincided with a sudden weakening of the trade balance resulting from a deceleration in the growth of exports, and especially from a surge of imports. In the first five months of 1995, with exports only 3.1 percent and imports 36.4 percent higher than during the same period last year, the trade balance deficit rose to Kc 38.8 billion, although strong receipts from tourism held down the current account deficit for January-April to only some Kc 11 billion--or about 1 percent of annual GDP in 1994. These figures are only preliminary, however, and according to the officials of the Czech National Bank, the final data may show a substantially lower trade deficit.

Possible reasons for the rapid rise in imports include the increased investment demand connected with the revival of the economy, the rapid growth of wages, and the real appreciation of the currency. The weakening of exports is harder to explain, but reduced competitiveness, increased domestic demand, and a reorientation of producers from foreign markets toward less demanding domestic markets may play a role.

Although total imports have accelerated substantially in recent months, the structure of these imports changed little. Compared with 1994, the share in total imports of consumer goods dipped from 26 percent to 24.8 percent, and the share of production inputs rose from 43 percent to 45.2 percent. The share of imports of investment goods fell from 31 percent to 30 percent even though the need to modernize and restructure Czech industry would perhaps have called for an increased share. However, even though investments in total imports declined slightly in relative terms, they increased substantially in absolute terms.

At the end of June 1995, year-to-year inflation remained unchanged at 10 percent. As the staff notes, there is a certain persistence in the underlying core rate of inflation, which is one of the reasons for the Czech National Bank's June decision to tighten monetary conditions. An important factor driving the continuing increase of prices is the rapid growth of wages. In the year ending May 1995, the average industrial wage increased by 20.7 percent and the average construction wage by 19 percent, which implies a real wage growth of about 10 percent.

Despite these wage developments, the Government decided in July 1995 to abolish the wage regulation that had been in place since mid-1993. Its effectiveness had been minimal: in 1994, only about 3 percent of the regulated firms were fined for excess wage growth, although the number of firms with wage growth exceeding the guidelines was much larger. The risk that ending wage regulation will add to inflation is considered small, as the wage contracts for 1995 have already been signed, and the growth of labor productivity is beginning to accelerate. Moreover, the regulation did not impose a very binding constraint in any case.

The conduct of monetary policy is complicated by the continuation of foreign capital inflows that the Czech National Bank can only partially sterilize. As a result, the money supply is expanding faster than assumed in the monetary program. In response to this expansion, the Czech National Bank decided in June 1995 to tighten liquidity by unifying the required minimum reserves of commercial banks--which in effect increased their reserve requirement--and by raising the discount and Lombard rates. In contrast to previous years, during its 1995 mid-year review of monetary policy the Czech National Bank left the intermediate target for M2 unchanged. Although it is early to assess fully the impact of these measures, they have contributed to tightening of conditions on the money market, raising interest rates by about 1 percentage point.

The staff recommends that the central bank should begin to pay interest on the required minimum reserves of the commercial banks. However, my authorities do not consider this to be appropriate at the moment. They recognize that unremunerated reserves represent de facto taxation of the banking sector, increasing the costs of bank intermediation and ultimately raising the costs of loans to enterprises. However, because the support that fiscal policy can give to sterilization is limited, most of the work must be accomplished by monetary policy. Unremunerated reserves increase the financial room for the Czech National Bank's sterilization efforts, while effectively distributing their costs to banks and, ultimately, to enterprises and consumers. To the extent that capital inflows will abate in the future, it will become possible to consider reducing the level of the unremunerated reserves, or remunerating them.

My authorities agree with the staff's assessment of their exchange rate policies. There is a consensus that a nominal exchange rate revaluation would clearly be inappropriate at present, because it would further accelerate the real appreciation and could further weaken exports and the trade balance. However, it is less clear, as the staff argues, that widening the fluctuation band of the koruna would inevitably cause the exchange rate to rise sharply to the upper ceiling and thus lead to a nominal appreciation. In 1994, when the current account deficit was smaller and capital inflows were already strong, it could have been argued that market expectations were skewed toward an appreciation. Now, however, with the trade balance continuing to deteriorate and the current account deficit in January-April 1995 reaching about two thirds of its total for all of 1994, expectations of appreciation are no longer certain, and widening the band could easily increase uncertainty about the exchange rate and reduce capital inflows. Nevertheless, my authorities are in complete agreement with the staff that widening the band should not be seen as a substitute for needed structural reforms aimed at enhancing the efficiency of the financial sector, reducing the costs of domestic intermediation, and shrinking that part of the capital inflows triggered by these inefficiencies.

In September, the Parliament is expected to approve the new version of the Foreign Exchange Act that would give the Czech National Bank additional tools for limiting the inflow of short-term foreign capital. The most important of these is the introduction of the reserve requirements on foreign borrowings by both banks and nonbank entities. The staff also states that my authorities are planning to institute administrative approval procedures in order to slow down short-term foreign borrowing by nonbank entities. We would like to make it clear that as yet, no decision has been made to use these procedures, although if the strong inflow of short-term capital continues after passage of the act, the authorities may consider implementing such measures. By then, there will also be more information about the effectiveness of the other recently announced measures for slowing down capital inflows.

After several episodes of small bank failures in 1994, the situation in the banking sector is now relatively stable. Although the share of risk-weighted bad loans in total bank assets is still high, it is no longer increasing. Moreover, the high volume of risk-weighted bad loans is largely due to past decisions and not new decisions on the part of the banks: as time passes, more loans are falling into categories with higher risk classifications. The staff suggests that another round of across-the-board bank balance sheet cleanups may be desirable, but at present this option strikes my authorities as neither desirable nor feasible. They would rather pursue an individual approach to troubled banks by encouraging mergers, perhaps with the aid of the Konsolidacni Bank.

The 1995 budget has been formulated and approved as balanced. The staff once more expects that this year's budget will record a deficit of 0.9 percent of GDP. Although it is true that some additional budgetary expenditures were recently authorized, my authorities now believe that the additional net effect on the 1995 budget will be less than the Kc 18 billion that they reported earlier to the staff. Moreover, revenue collection has been more satisfactory than expected. During the first half of 1995, revenues reached Kc 211.1 billion, or 51.3 percent of the budget target for 1995, while expenditures amounted to Kc 200.7 billion, or 48.7 percent of the budgeted amount. The budget continues to record a surplus of about Kc 10 billion. My authorities are ready to take the measures needed to reduce spending to ensure that the objective of a balanced budget is met.

In 1996, the budget will be again formulated as balanced, and it is assumed that both revenues and expenditures as a share of GDP will be reduced by 1.5 to 2 percentage points. Because in 1996 the National Property Fund will stop providing financial assistance to the budget to pay interest costs of servicing public debt, some re-prioritization and reduction of expenditures will be needed to achieve these objectives. The Government plans a nominal reduction of the already-low subsidies to enterprises, a rationalization and real reduction of public consumption, and a selective reduction of employment in the state administration.

Finally, it is the intention of my authorities to accept the obligations of Article VIII as soon as the Parliament approves the new Foreign Exchange Act toward the end of September.

Mr. Schoenberg made the following statement:

I would like to welcome the ongoing strong efforts of the Czech authorities to proceed with the transition process, which have produced an impressive record, increasingly honored by capital markets.

As I am basically in agreement with the thrust of the staff appraisal, I would like to dwell on three specific topics that deserve special attention.

The first issue concerns exchange rate policy and its consequences for monetary policy. Because the Czech economy shows clear signs of overheating, economic policies must focus more strongly on inflationary developments and address decisively its roots in order to redirect the economy onto a more sustainable path. For that purpose, the picture that the staff presents of the situation and its recommendations for addressing the problem do not match perfectly. If monetary policy is overburdened with the objective of achieving two conflicting goals, namely, an exchange rate objective and a monetary expansion target--as it is in the Czech Republic--the adoption of capital controls cannot provide sustainable solutions. The situation in the country, a pegged exchange rate and massive capital inflows, forces the authorities into an uncomfortable reactive position and occupies them with closing new loopholes, as market participants are discovering constantly. It seems very hard, if not almost impossible, for the authorities to win that game, particularly if markets have a clear perception that an appreciation of the currency will be ultimately unavoidable. The staff seems to confirm that view--at least indirectly--when stating that the adoption of an exchange rate band would result in an immediate appreciation of the currency.

In a situation in which the full sterilization of capital inflows proves elusive, in which the share of foreign assets in the central bank's balance sheet increases rapidly, and in which, therefore, monetary aggregates are by and large out of control, the authorities probably should stop dealing with symptoms and turn to the causes. We would like to propose a more flexible approach to exchange rate policy, which may be expected to be followed--at least temporarily--by a nominal appreciation of the koruna. This may be a cause for concern to the authorities when looking at the competitiveness of the tradable goods sector, but, in any event, without further progress in reducing the inflation rate the Czech Republic will face an appreciation, not in nominal but in real terms. The situation in the Czech Republic resembles to some extent the position of Germany in the late 1960s and early 1970s where earlier massive capital inflows slowed down substantially once the exchange rate was allowed to move to a level more in line with fundamentals and to levels accepted by markets. The result was also a freeing of monetary policy, which from then on could concentrate on its main goal of keeping inflation in check. That contributed to stabilizing the real exchange rate, which is, of course, the more relevant measure for competitiveness than the nominal exchange rate.

The alternative strategy, which is apparently favored by the staff, is a much tighter monetary policy--which would mean higher interest rates--and a budget surplus would only make the Czech Republic still more attractive as a target for capital exports especially as many observers expect an upgrading of the country's credit standing by major rating agencies in the near future. Also proposals such as overfunding the budget deficit in order to support monetary policy only constitute attempts to cure symptoms. Although we agree with the staff that capital controls can serve to buy time for more fundamental corrections, we believe that now is the time to really implement such corrections. In present circumstances, such corrections should mean a more flexible exchange rate, wage restraint, and accelerated structural reforms.

My second topic concerns the enterprise sector. The financial problems of the enterprise sector seem to be closely related to recent wage developments. It is quite worrisome to read in the background paper about the decapitalization of enterprises taking place in order to finance current expenditures. This method has proved in other countries to be one of the most successful ways to ruin a company! We urge the authorities to exercise closer scrutiny of wage developments to ensure that wage increases stay in line with productivity. A more moderate wage development would also act as a counterbalancing force in the event of a currency appreciation leaving workers' real standard of living largely unaffected. However, the two factors may balance out.

Another worrisome aspect seems to be the payment arrears between enterprises and between enterprises and banks, and the high share of bad loans in banks' portfolios, which at end-1994 was estimated at almost 40 percent. Without going into details, I would like to stress the need to address these important issues in the interest of a further successful transition process and an effective monetary policy.

My last topic concerns the pension system, which was described by the staff as "inefficient, inequitable, and in danger of insolvency in the not too distant future." As many industrialized countries have been facing social problems in recent years in trying to scale back their pension system to return to a sound financial footing, it appears advisable to address these problems as early as possible. Once beneficiaries get used to a comfortable level of social payments, regardless of the associated financing problems, it has proved extremely difficult politically to make the necessary adjustments.

Mr. Autheman made the following statement:

I would first like to commend once more the Czech authorities for their remarkable economic recovery. The staff report stresses the remaining areas of concern, with a particular accent on the still high rate of inflation, the constraints put on monetary policy by large capital inflows, and the deterioration of the external account.

It is appropriate that in present circumstances the appearance of a non-negligible current account deficit, coupled with large capital inflows, a substantial share of which are short term, raises caution if not concern.

Yet one should be wary of drawing parallels with a situation which may be, in fact, quite different. The figures presented in the staff report and in the buff of Messrs. Kiekens and Jonas paint a picture of a broadly based domestic expansion, reflecting growing confidence both by households and firms, which may be adjusting to, if not anticipating, a permanently higher level of domestic consumption. It is not surprising that this movement is accompanied by a surge in imports, well balanced between consumption goods, basic and intermediate inputs, and investment goods.

I appreciate the caution expressed by the staff appraisal. I do not share all of these conclusions, and will address, as Mr. Schoenberg, the issue of the exchange rate policy. But I wonder whether the analysis is 100 percent right. Should we be alarmed by a current account deficit expected to reach 3.6 percent of GDP this year? And is the economy overheating at a growth rate of 4 percent?

I will run the risk of answering no and not obviously. I would not have dared run the risk of looking like a Czech dove at a time when it is more respectful to be perceived as a post-Mexico hawk had I not been comforted by a recent working paper circulated in quite a timely fashion earlier this week. This paper by Messrs. Calvo et al on "Capital Flows in Central and Eastern Europe: Evidence and Policy Options" discusses at some length the impact of capital inflows in the Czech Republic. There is no originality to my questions. I am just borrowing from another staff paper, which in my view presents an alternate view which deserves consideration.

On the current account, while vigilance is clearly necessary, I am somewhat comforted by indications that the growing deficit is expected to be accompanied by a sharp increase in private domestic investment from 14.4 percent of GDP in 1993 to 17.2 in 1994, and, as foreseen, 20.2 percent in 1995--I am taking advantage of Mr. Kafka's absence to quote figures--and by the fact that foreign direct investment is expected to remain very strong in 1995.

On growth, a rate of 4 percent does not appear extraordinary for an economy like the Czech Republic. If anything, over the medium term the existing human capital and the build-up of physical capital and the convergence of the Czech economy towards that of its main economic partners should translate into a rate of growth above 4 percent.

What conclusion would I be tempted to draw? First, I am not fully convinced that there is a need at this time to forcibly reduce domestic absorption and, thus, to significantly tighten fiscal policy. Of course, I agree that fiscal policy should not make the conduct of monetary policy more difficult and that fiscal relaxation should not be tolerated. It would be particularly out of place in an environment where a surge in capital inflows has made unavoidable, from the point of view of the authorities, the introduction of capital controls. In short, I favor pursuit of a fiscal stance achieved in the two previous years.

Second, given the already tight macroeconomic stance, the relative fragility of the financial system, and the need for the authorities to buy some time before addressing the exchange rate policy in a different way, I can understand the reasons which led to the imposition of controls on short-term capital inflows, especially under the prospect of the rapid introduction of reserve requirements on foreign borrowings as a substitute to the measures taken last June.

Third, I am not convinced by the view expressed in the staff appraisal that the main aim of a policy response to the capital inflows should be to limit further real appreciation of the koruna, for the reason expressed by Mr. Schoenberg that a reluctance to tolerate such appreciation could only lead to greater inflationary pressures or to greater inflows, but also for other reasons.

While I agree that the slowdown in the growth of exports could raise questions about external competitiveness, I think that it could also be a reflection of the diversion of domestic output to the domestic market due to the rapid growth of domestic demand, and to the expectation of a faster growth of the overall economy. Therefore, I could see a permanent case for a real appreciation of the exchange rate over time, and consider that it is preferable that the nominal component of its appreciation be more important.

Thus, as long as the Czech economy can be expected to improve its productivity, which, of course, implies a better control of wages, I do not see danger in the proposal to widen the fluctuation band of the koruna in order to allow a nominal appreciation of the exchange rate.

Of course, such policy will not be successful if the Czech authorities do not address faster some remaining structural issues. And here, to cut short my statement, I agree with the point made by Mr. Schoenberg that the expectation that growth prospects of the Czech economy may be better in the coming years relies on the ability of the Czech authorities to accelerate the structural reform of the corporate sector.

So I am aware that this is a situation which calls for cautious attention and close surveillance by the Fund, but I would be reluctant to qualify too early the evolution presently seen in the Czech Republic as dangerous. And I think that the alternative analysis developed in the working paper by Mr. Calvo deserves serious consideration.

Mr. Kyriacou made the following statement:

At the outset, let me congratulate the authorities for their achievements since the introduction of reforms. The real GDP performance of 1994 and 1995, as well as the strengthening of reserves, reflects to a great extent these vital accomplishments. However, as the staff report clearly demonstrates, a number of problems are eminent, my statement will focus on these problems.

Although the authorities are willing to use both fiscal and monetary tightening to combat the lingering problem of inflation, they are faced with the reality that the first policy option is weakening owing to domestic pressures, while the latter is hampered by the strengthening of capital inflows. This, of course, highlights the importance of urgently addressing the issue of capital inflows with additional instruments, such as structural reforms and exchange rate policy. Before discussing the issue of large capital inflows, let me first briefly comment on fiscal and monetary policies.

Until recently, fiscal policy has been appropriately controlled, as reflected by the fiscal surpluses recorded in 1993 and 1994. Signs of deviation from this tight policy, however, seem to have surfaced in 1995. As the staff notes, the recent decision of the Government to increase spending is untimely, as it comes at a time when growth is accelerating, large capital inflows persist, and signs of overheating are lingering. The staff's comments on the prospects for a balanced budget in 1995--as suggested by Mr. Kiekens--would be appreciated.

As regards monetary policy, large capital inflows are hampering the effectiveness of sterilization and limiting the potential for further tightening. These constraints have forced the authorities to "accept rates of growth of money near the more optimistic end of estimates of money demand," thus effectively making the 10 percent inflation estimate for 1995 a floor rather than a target. This is, at best, risky; it raises concerns about the prospects of combating inflation and underlines the urgency with which the issue of large capital inflows should be addressed.

Turning to the central issue of capital inflows and the intriguing challenge it poses to the authorities, in view of the limited effectiveness of fiscal and monetary policies, structural reforms--particularly in the banking sector--and the exchange rate policy are, in effect, the available policy options. The authorities, supported by the staff, emphasize structural reforms, in combination with fiscal and monetary policies. They also indicate that they do not intend at present to use the exchange rate policy option, which is a decision that could be challenged.

In terms of structural reforms, it is well documented in the background paper that, to a considerable extent, interest rate differentials with those abroad reflect distortions from weaknesses in the intermediation process. This underscores the urgency of addressing distortions in the banking sector. Although the authorities are to be commended for the recent introduction of a significant measure that aims at relieving the bank's tax burden on unpaid interest, they should also be urged to proceed more rapidly with reforms, in line with the staff's advice, keeping in mind the positive chain effects that the elimination of these distortions will have on the economy.

Even though, as mentioned, the authorities do not intend at present to use the exchange rate policy option to manage capital inflows, fearing that exports would deteriorate further with chain effects on growth, unemployment, fiscal balances and the overall stability of the economy, a consideration of nominal appreciation, perhaps through an adoption of a wider band, should not be disregarded. First, real appreciation is already on its way through price increases, with no readily perceived prospects that wages or prices will come under firm control soon. Second, because a considerable portion of the surge in inflows is short term--part of which is most likely speculative--a credible market-clearing nominal appreciation should slow down capital inflows by virtue of removing a major incentive. Third, as mentioned, the effectiveness of fiscal and monetary policy is limited, and fourth, nominal appreciation is not meant to be a substitute for the strong structural adjustment efforts underlined by the staff. Instead both options can be--and should be--pursued concurrently.

Finally, as regards capital controls, in view of their unavoidability under the present circumstances, the staff's advice concerning their temporary and market-based nature seems appropriate. In addition, the authorities' intention to relax a number of controls on capital outflows in the near future is welcome.

Mr. Lvin made the following statement:

An expression of admiration for the consistent reform policies of the Czech authorities has become traditional at Board meetings, and there is probably nothing to add to the various compliments and greetings we have sent to the Czech authorities over the last years--except to note that these compliments seem to remain valid and fully justified.

Nevertheless, a serious discussion about some puzzling issues that have emerged in the course of the Czech reform would be of interest.

Most of the controversial issues relate to the balance of payments and to monetary policy. For instance, the sudden--though widely announced--deterioration of the trade balance is regarded as a matter of concern, and discussions with the authorities seem to focus on how to deal with capital inflows. However, the trade deficit looks less dramatic if one concentrates on the overall current account balance, rather than on the more narrowly defined trade balanceone should concentrate on the overall current account balance, rather than on the more narrowly defined trade balance. The Czech Republic--located in the heart of Europe and having one of the world's most beautiful capitals--is far from having exhausted the growth potential of its tourist industry, and considering the trade and services balances combined seems natural in this case.

One should also consider that the current account balance reflects the preferences and judgments of the authorities. We used to praise small and medium-size countries, in particular, that vigorously promoted export expansion, but having a strong positive trade balance can reflect an underconsumption on the part of the domestic population. While this is not the case in the Czech Republic, where the resumption of economic growth is strongly supported by domestic demand, it is up to the Czech authorities to decide whether they have a mandate to improve the trade balance by promoting exports at the price of compressing domestic consumption.

The underlying concern is that the effect of the external balances on the exchange rate and monetary policy is uncertain. However, that uncertainty is directly linked to the ambiguity inherent in the authorities' desire to pursue two paradoxical goals simultaneously: that is, to defend the pegged exchange rate and to fight inflation. These are not compatible policies, and one could have expected the staff to make this point openly in the main paper, and not only in the background one. The relevant chapter in the latter vividly demonstrates how adherence to these two goals has forced the Czech National Bank to adopt, over time, various measures of sterilization and domestic credit suppression.

Thus far, the Czech Republic can be added to the already extensive list of countries that have tried--and eventually failed--to fight capital inflows. While this fight is justified on the ground of combating persistent inflation, one may ask whether a 10 percent yearly inflation over three years is really alarming in such a country. According to the staff papers, the average monthly salary at the end of 1994 stood at an approximate level of less than US$300. It could be argued that such a level--under the pegged exchange regime, and for the European country which was among the most prosperous in the world 60 years ago and still has the brightest opportunities for early European integration--implies further substantial appreciation. The staff argues that inflation so far has been spread rather evenly across various groups of goods. It would be interesting, however, to compare price movements and differentials between imported and domestic goods.

As it had been decided to act conservatively when fixing the exchange rate--and this conservatism was fully justified by the state of foreign exchange reserves and many surrounding uncertainties--some corrective inflation was unavoidable and should have been anticipated. The fiscal performance of the Czech Republic was exemplary by all the transition economy standards, and perhaps the best and simplest way to bring inflation down rapidly would have been to allow it to unwind freely.

We support the decision to abolish the cautious and controversial wage controls which the authorities had chosen and which had no apparent positive effect on inflation. These controls have become irrelevant, as wages have grown anyway and as a new ownership structure has been put in place.

The purpose of introducing new capital controls instead, as if to leave the total amount of regulation in the economy unchanged, seems unclear. It would have been more consistent with the general thrust of the Czech reform if such capital controls had been introduced at the beginning and then modified, eased, and subsequently abolished over time. At this stage of reform, however, they may be seen as a step back, thus fueling undesirable expectations. It may be useful to recall that Chile, for example, is a successful reform country whose consistent way of fighting short-term speculative inflows is often cited, yet it has long experienced inflation far in excess of 10 percent a year.

On the other hand, the possible abandonment by the Czech National Bank of the discretionary interest rate and bank reserve policy would result, aside from a temporary price increase, in diminishing attractiveness for purely speculative short-term foreign capital. That is probably the only way to verify whether the capital inflows are really of a speculative nature. It is not easy to condemn increased foreign borrowing costs as simply the result of difficulties in the domestic banking system. On the contrary, such borrowing helps to alleviate these difficulties, and thus need not to be discouraged provided such borrowing carries no state guarantees.

Also, it is interesting to learn from Table 4.2 of the background paper that despite the large capital inflows, the short-term foreign exchange liabilities of the banking system are still less than its foreign exchange assets. Perhaps one should consider the possibility that the recent surge in capital inflows might be due, largely, to the more rational composition of the commercial banks' balance sheets. If a more neutral policy toward the monetary aggregate and toward interest rates was adopted, a new wave of the state-initiated clean-up of the commercial banks' balance sheets would not be appropriate. We are very pleased to know that such a clean-up is viewed by the authorities as neither desirable nor feasible.

We do not mean to give lessons to the Czech authorities. Their achievements are indisputable. Instead, we have tried to focus on issues that will continue to be of great importance to all the transition economies. We believe that the staff papers and statement encourage an open discussion, and we would appreciate further comments on these issues by the staff and Mr. Kiekens.

We wish the Czech authorities further success in their bold policies and we fully support the proposed decision.

Mr. Newman made the following statement:

The steady and recently surging pattern of capital inflows into the Czech Republic has attracted particular attention. These flows reflect a number of factors--both welcome and unwelcome--with a number of consequences--both welcome and unwelcome. In many respects, the flows represent a vote of confidence in Czech policies and prospects--particularly regarding stabilization successes. At the same time, they have highlighted weaknesses in the economy and posed significant policy challenges. The challenge is to address the unwelcome consequences, which include the monetary complications associated with the run-up in liquidity, with measures that focus on the unwelcome factors, which include various structural problems afflicting the banking and enterprise sectors as well as perhaps an undervalued exchange rate.

It is of some concern, therefore, that the Czech authorities appear inclined to opt for a second best policy response--capital controls--to the capital inflow "problem." As the staff stresses, a basic correction in underlying policies is clearly preferable. Given the Czech authorities' apparent political constraints to taking the high road, however, a new-found pragmaticism is evident in staff's relatively accommodative stance vis a vis capital controls. In this case, we wonder if a dose of the old orthodoxy might be more appropriate. We are not convinced, for example, that avoiding a nominal appreciation of the currency should constitute a core aim of policy. Similarly, we are not convinced that the imposition of capital controls would buy time for measures to address the more fundamental distortions. It could serve to perpetuate such practices. A central question is whether capital controls are a safety valve for sub-par banking and enterprise performance (as well as an untimely fiscal stimulus), and whether the more appropriate safety valve for addressing inflow-related imbalances is the exchange rate and the adjustment it would enforce? Given the presumptions against capital controls, a rather heavy burden of proof exists for those seeking to justify them; that case remains to be made.

The "problems" presented by capital inflows need to be viewed in context. On the one hand, these flows, until recently, have constituted predominantly foreign direct investment, portfolio investment, and other long-term flows. They have not funded an explosion in the current account deficit. To the contrary, it is official reserves that have accumulated at a massive pace as the current account has largely hovered around a balanced position. This reflects both the general strength of fiscal performance as well as the slow recovery in investment.

The tension such flows produce between competitiveness concerns and price stabilization goals are not new for the Czech economy. Czech inflation has settled-in at around 10 percent. Foreign inflows have been the sole source of increases in reserve money in recent years. As the background paper notes, CNB open-market operations are only partially effective in sterilizing the resulting interventions necessary to maintain the peg. As a result, money growth has exceeded targets. This has been absorbed to some extent by rising money demand, but underlying price pressures suggest the desirability of a tighter stance.

What is new is the surge in speculative inflows. This seems to have tipped the scales in favor of capital controls owing to the size of the flows as well as specific volatility and prudential concerns associated with the financial sector. Under the circumstances, the staff paper gives the impression of a narrow range of options leading almost inexorably toward capital controls. It seems to us that more attention could have been paid to a "first-best" package as well as to the costs of the "second-best" option. In addition, there is the question of whether the controls might just produce a recomposition of flows, in which case certain banking concerns might be alleviated, while monetary complications persist.

The authorities do not have any easy options. On the monetary side, higher interest rates and higher reserve requirements could well generate further inflows. On the fiscal side, a tighter budget could offer some relief, but is politically tough given approaching elections. Similarly, structural measures to improve banking and enterprise performance and reduce existing distortions would address a key concern associated with inflows, but, again, could involve politically untimely dislocations as well as take time. As the saying goes, however, "no pain, no gain."

The key option that has been resisted is a nominal appreciation of the currency. This warrants further examination in our view. The perception in international financial markets that the koruna remains undervalued--due to purchasing price parity calculations and strong external performance--has led to the surge in speculative inflows. Allowing for a nominal appreciation of the exchange rate would cool this source of inflows and advance monetary objectives.

The virtues of a nominal appreciation, however, have been subsumed by competitiveness concerns. Price rises are seen as the preferred mode of real appreciation. Nominal appreciation, it is feared, could risk an overshooting of the equilibrium exchange rate (an elusive target), damage competitiveness and adjustment efforts, and result in a substantial swing in the current account. These are not unreasonable concerns, but they appear overdone. Also, accommodating price-led real appreciation runs the risk of inertial inflation effects. This may be of particular relevance to the Czech situation, given persistent wage pressures and the unevenness of enterprise restructuring.

Moreover, the competitiveness issue may be clouded by rather static notions of where the equilibrium exchange rate lies. It may be true that the "headroom" provided enterprises by an initially undervalued exchange rate is running out. However, the substantial scope for structural changes and shifts in comparative advantage may tolerate more latitude in the exchange rate. Nominal appreciation could speed the adjustment process. It would almost certainly involve larger current account deficits. However, if the result is quicker resort to "first-best" policies, then there should not be the presumption that the real inward transfer of resources made possible by continued inflows is a "problem."

To sum-up, we are less sanguine than the staff that the attainment of "first-best" policies is likely to be well-served by capital controls. In our view, another layer of distortions is being added to the economy. We are more inclined to light a fire under the adjustment process by allowing the exchange rate some upward movement. In addition, we see little reason to accommodate election year political expediency by not urging more in the way of offsetting fiscal actions. In short, we would urge greater focus on "first-best" policies. In addition, there should be a bit more discussion of the downside risks of the policy mix, including capital controls, currently being pursued.

Mrs. Cheong made the following statement:

Relative to a number of transition countries, the Czech Republic has made strong progress in its macroeconomic stabilization. Developments in recent months, however, indicate that the adjustment effort needs further commitment for the economy to progress toward a sustainable high growth path. Although growth is still relatively low, the economy seems to show signs of overheating. Nevertheless, in view of the confidence in the economy--evidenced from capital inflows--early correction of the problem will make adjustment easier. Although recognizing that reducing inflation and containing the capital inflows would still be the main objective of macroeconomic policy, I fully concur with the staff's advice for a more ambitious policy mix, including a tightening of monetary and fiscal policies combined with an effective enterprise restructuring. I would, however, not rule out further work in the exchange rate area.

In the management of capital inflows, the Czech Republic could benefit from experience of many other countries. In this regard, the dilemma facing monetary policy is twofold. On the one hand, tightening monetary policy will push interest rates upwards and widen interest differentials, thereby intensifying capital inflows. On the other hand, higher interest rates will constrain credit expansion for new investments to support the economic recovery. The latter could be mitigated to the extent that the shift in financing away from domestic credit to foreign borrowing has been in productive investment. However, this can only be determined by a differentiation of the ownership and maturities of inflows by the bank and nonbank sectors. Inflows owing to banking enterprises may indicate short-term borrowing by banks, proceeds of which are sterilized by the central bank. Banks, therefore, made gains at the expense of the central bank. In view of some expectation of exchange rate appreciation, these borrowings could have been made against forward sales of export proceeds. If this is not the case, then the increase in reserves would be due mainly to net increase in liabilities of the banking system, a situation that requires closer monitoring. In either case, I would share the authorities' sentiments against paying interest on reserves requirement.

Foreign borrowing by the nonbank sector should be differentiated by maturities. If such inflows by the private sector are long term--whether borrowing or equity--they should be absorbed and sterilized. The issue then is to develop more instruments for the central bank to sterilize. At the same time, if private borrowings are short term, it could reflect speculative arbitrage flows, so that the policy response should be different.

These developments in the external sector would have some bearing on the exchange rate. I recognize that the authorities face a difficult choice between two important objectives: managing capital inflows and maintaining competitiveness. Although excessive capital flows, depending on the nature of inflows, can be a short-term phenomenon that could be resolved by temporary measures, ensuring competitiveness is a long-term issue that would strengthen underlying economic fundamentals. Somehow, in this case, I am not certain that appreciation of the exchange rate will undermine competitiveness. As we know, the problem with an exchange peg is the difficult task of assessing the optimum level of the peg. The views of some officials who favor an exchange rate band may deserve further consideration. I can understand the staff's concern that the subsequent nominal appreciation would worsen the external balance, but, if the exchange rate level is not consistent with economic fundamentals, there could be greater adverse implications on long-term growth prospects. I wonder whether the issue of competitiveness of exports would be better addressed through concerted efforts to reduce cost-push inflation. A primary area is to address wage increases; the average increase of 18 1/2 percent is very high and should be corrected through decisive measures. I would even go so far as to recommend freezing wages, at least during the critical transition period.

I agree with the staff that fiscal policy will have to play a greater role in relieving the burden of monetary policy. In this regard, I share the staff's concern in regard to the recent adoption of an expansionary fiscal stance. The decision to spend previously accumulated budget surpluses is inappropriate, as the surpluses should be perceived as an accumulation of government savings that should not be spent but rather considered as a stabilizing factor. In the short term, there is a pressing need to accumulate surpluses through current expenditures cuts. I can go along with such cuts being partly transferred to capital expenditures, to improve infrastructure in order to promote investments.

Over the longer term, it is also desirable that the authorities implement budget reform targeted toward promoting growth of the private sector. This would complement the restructuring of public enterprises, which should reduce the role of the public sector in economic activities. The share of fiscal operation in economic activities, which had remained roughly constant at around 50 percent of GDP over the past three years, should be reduced to ensure that the public sector does not crowd out further development of the private sector.

In closing, I welcome the authorities' intention to move to Article VIII status.

Mr. Hettiarachchi made the following statement:

The Czech Republic has come a long way, and its performance in the last few years, especially following the stand-by arrangement, has been very encouraging. However, it would appear that the first test phase for the country and its authorities has just begun. Signs of considerable macroeconomic stresses are setting in, and increasing pressures of domestic demand and foreign capital inflows are beginning to appear in the economic scene. The country is now facing the rigors of a competitive world.

Table 2 of the staff report shows that short-term capital inflows in the Czech economy during the first quarter of 1995 have nearly doubled over the last year's entire total. Is this situation sustainable, given the low level of absorption of capital in these types of economies? It seems to create challenges for both monetary policy and exchange rate policy, as evident from Messrs. Kiekens's and Jonas' statements. Is this capital inflow in response to a market speculation that the Koruna is going to be appreciated, or it is due to a more fundamental favorable factor? Whatever it is, it would appear that the short-term capital flows problem require close scrutiny, given the challenges that it extends to monetary policy.

The Czech Republic seems to have many policy issues that need to be resolved conclusively, and here comes the question of political commitment. One such issue concerns wage structures. The cost-push inflation that this feature is causing seems to be undoing all the good work that had been done in the past by way of tightening of monetary policy in curbing inflation. Remaining at 10 percent over the last two years, the inflation would have reduced the competitiveness of the economy, without causing undue hardships to different income classes in the economy. It should be emphasized that linking annual wage increases to productivity or profitability, or any other indicator of enhanced output, rather than to a compensation of inflation through continuously reviewed wage contracts, might help to curb continuing inflationary tendencies in the economy. Otherwise, the country can get into a continuous wage-push inflationary spiral.

On the foreign exchange front, I agree with Messrs Kiekens and Jonas that by expanding the band one cannot be sure that the exchange rate will jump to the upper fringes of the band as stated by the Staff. There are sufficient factors in the economy that are working for a movement in the other direction, such as the weak export growth to convertible currency areas, rising imports and continuing inflation. And once the proposed Foreign Exchange Act is passed in the Parliament, making way for current account convertibility, further pressures are likely to emerge. Besides, with inflation running at the 10 percent level, allowing the exchange rate to appreciate is not in the best interests of safeguarding the export sector.

Lastly, I would like to turn to the public enterprise reforms. The transfers to the enterprises are not likely to abate in the near future. The Table on fiscal operations shows almost the same amount of current transfers in this year as in previous years. The expenditure to the extent of about 3 percent of GDP on current account enterprises transfers is probably due to continuous wage increases. It may be desirable for Czech economy to implement a program for a speedy scaling down of these transfers, which will also help in tightening fiscal policy, as the staff has recommended.

With these remarks I wish the authorities well.

Mr. Guzmán made the following statement:

The resumption of economic growth was one of the outstanding features of the evolution of the Czech economy in 1994. After recording an accumulated decline of nearly 23 percent during the period 1991-1993, GDP showed a real increase of 2.6 percent in 1994. The behavior of other economic variables was also favorable: public finances recorded a surplus, inflation fell to the targeted ranges, and a large accumulation of international reserves was observed. Driven by a combination of factors, among them expectations of an appreciation of the koruna, inflows of foreign capital surged to an impressive 11.8 percent of GDP in 1994, and they accelerated further in the first months of this year to figures estimated at over 20 percent of GDP. In this context, macroeconomic management has been complicated and the authorities are faced with significant policy challenges. I would like to comment briefly on some of these.

One of the dangers accompanying capital inflows of this size is the possibility of overheating the economy. Although it is difficult to make a definite assessment at this stage, both the staff report and the statement by Mr. Kiekens suggest that the pickup of domestic demand is too strong. Consequently, the implementation of measures aimed at the adverse impact of capital inflows on internal demand is of the utmost importance.

It is evident, as the staff points out, that a tight monetary policy must be at the center of this effort. But it is also true that the margins of maneuver for an effective monetary policy role in counteracting the impact of capital flows are not very wide. In this respect, I wish to point out that, according to the staff's estimate, up to 65 percent of domestic monetary operations can be offset by capital inflows. Furthermore, it seems difficult to conceive a monetary policy capable of sterilizing inflows, such as those observed during 1994 or the first quarter of 1995. Clearly, monetary policy alone cannot achieve this.

I agree that capital controls can be useful as a temporary measure to contain short-term capital inflows. Nevertheless, from a macroeconomic management point of view, the most important support to monetary policy must come from the fiscal side. In fact, fiscal adjustment would represent one of the most efficient means of offsetting the adverse effect of capital inflows in the

Czech Republic. In this context, easing the fiscal stance at this stage would substantially complicate the macroeconomic situation. The commitment of the Czech authorities to take any measures needed to ensure that the objective of a balanced budget is met is welcome.

Turning to exchange rate policy, I understand the concerns of the staff with respect to the implications of a further real appreciation of the koruna. But, a number of factors support the adoption of an exchange rate band.

First, introducing some flexibility to the exchange rate would contribute to discourage capital inflows and would provide more independence to monetary policy. Second, maintaining the present regime will not avoid an additional real appreciation of the currency. In fact, because, as explained in the report, there is a strong sentiment that the koruna is undervalued, resisting a nominal appreciation might further exacerbate capital inflows. Consequently, the pressures on the real exchange rate would not materialize through a nominal appreciation, but rather through a higher rate of inflation. Third, with the growing external deficit and the potential for fluctuations in capital movements, it would seem more prudent to exit the peg at an early stage. I would appreciate it if the staff would comment on these issues.

I agree with the staff that the external outlook for 1995 is uncertain. In fact, I do not consider unlikely a current account deficit well above the 3.6 percent of GDP projected in the report, in the face of the expected magnitude of capital inflows for the year. The adoption of any measures required to ensure the preservation of domestic balance is essential to avoid the growing external imbalance from becoming a source of difficulties.

The evolution of wages is another worrisome area. Real wages increased by an accumulated 23 percent from 1992 to 1994 and by a further 7 percent in annual terms in the first quarter of this year. This is indeed fueling inflation, domestic demand, and the real appreciation of the koruna. Perhaps the staff can provide an update of wage developments and elaborate on its suggestions to deal with this problem within a short time frame.

In general, I share the staff's views with respect to structural reform. I would only add that the increase of the unemployment rate in 1994 and 1995, despite the upturn in economic activity, is somehow puzzling and points to the existence of structural rigidities in the labor market. I wonder what measures are being taken to address this problem.

Finally, I wish to commend the Czech authorities for their decision to accept the obligations of Article VIII in coming months.

The staff representative from the European I Department remarked that the Working Paper referred to by Mr. Autheman had been kept in mind when the staff had analyzed the impact of the capital inflows and whether the economy was overheating.

It was unclear whether or not the economy was overheating, the staff representative considered. During the course of the mission, the indicators had pointed in different directions. A rate of growth of 4 percent for the Czech Republic was not excessive, and there was room for tremendous expansion over time as investment picked up and the restructuring of enterprises proceeded. However, it was necessary to caution against relying excessively on the figures on the national accounts for the first quarter mentioned in Mr. Kiekens's statement. It had been noted in the staff paper that the national accounts, and the quarterly accounts in particular, had significant problems. In fact, the staff did not use the quarterly GDP figures, whose components were even more erratic, in its own work when looking, for example, at the evolution of velocity.

The staff had been concerned about the rapidly increasing retail sales, the accelerating wage increases, and the rising import figures, the staff representative recalled. The latter had been extremely high in the first quarter and had continued to rise in the second quarter of the year. Imports were broadly balanced between consumption and investment, which was consistent with their respective shares in total demand. Overall, that suggested quite a rapid increase in consumption.

Against that background, fiscal policy had turned more expansionary with the authorities' decision to spend the accumulated surplus, and the growth of liquidity had been accelerating in the first quarter of the year, the staff representative noted. That pointed to the possibility of not only a rapid, but also an accelerating, growth of domestic demand, weighted especially on the consumption side. In fact, the available information indicated that inflation not only was not coming down, but in fact seemed to be accelerating.

There had been sufficient concern to gear the discussion with the authorities toward the risks of an overheating economy, the staff representative observed. The words that had been used in Prague were that the balance of risk was in that direction. That message had been strengthened in the staff report, given the subsequent information that had been received.

The staff had the same information as Mr. Kiekens on the stronger-than-anticipated performance of revenue in 1995, the staff representative remarked. There was little data on its components, but it was not reassuring that it might be due to wage taxes and social security contributions, because wages continued to increase quite rapidly.

A proposal was being formulated by the Ministry of Finance, for submission to the cabinet in August, that would attempt to achieve a better fiscal outcome in 1995 than had been anticipated at the time of the mission, the staff representative observed. It proposed to use the extra revenues to achieve enough of a current surplus in 1995 to offset the earlier decision to spend previously accumulated surpluses. That would improve the fiscal balance, relative to what the staff had indicated in its report, by close to 1 percent of GDP. It was hoped that that proposal would be approved by the cabinet and the parliament. Given the earlier decision to spend previously accumulated surpluses, however, that approval was uncertain.

The staff did not disagree with the Directors who had argued that the capital controls were not sustainable, and that some structural corrections were needed because the controls would become increasingly inefficient, the staff representative stated. Nevertheless, the staff shared the concern of the authorities with regard to the impact of an exchange rate appreciation. That reflected the apprehension of the staff concerning the banks and trade developments, including the very large increase in imports and the significant slowdown in exports. Preliminary data suggested that the export decline had been concentrated in the industrial sector in particular, where losses in competitiveness would have been expected to have a greater impact. That situation seemed to present the same combination of elements as that experienced in the 1920s, when an appreciation in response to capital inflows had led to an export slump and a banking crisis.

The capital inflows were not all speculative, as much of the longer-term inflows resulted from inefficiencies in the banking system, the staff representative considered. Rather than an appreciation of the currency to deal with those inflows, it was preferable to deal with the inefficiencies themselves. The attention of the authorities had been called to that point.

Mr. Kiekens had indicated in his statement that there was no intention to deal with the bad loans in the commercial banks' books given the moral hazard involved, the staff representative recalled. That was unfortunate, because dealing with the bad loan problem would lessen the capital flow problem.

Capital inflows, which had already been very large in 1994, at close to 12 percent of GDP in the first quarter of the year, had jumped to more than 20 percent of GDP in late 1994 and in the first quarter of 1995, the staff representative remarked. Most of that recent increase had been due to short-term speculative capital inflows, which might be easily reversible. However, effective responses to such a surge had been limited. Considering the size of the capital inflow, freeing the exchange rate could have led to a very large nominal appreciation that could have created significant problems in the restructuring process.

The question of widening the exchange rate band had been approached from that perspective, the staff representative added. While it was true that, in principle, a widening of the band could help, it had not seemed appropriate in view of the circumstances at that time. A widening of the band would have pushed the exchange rate rapidly against the outer edge of the band, and would not have created the kind of uncertainty on the exchange rate that proponents of the bands would have hoped for, an uncertainty that would have reduced the market's attraction for the koruna.

Mr. Newman observed that conditions in the Czech economy suggested that an appreciation would occur sooner or later, and it seemed that continued resistance to it was the surest way of intensifying speculative capital flows. In that context, he wondered why the staff thought that capital flows would likely be reversed.

The staff representative from the European I Department remarked that the envisaged widening of the band would not have stopped the capital inflow or changed market expectations.

Mr. Newman wondered whether a free float might be appropriate.

The staff representative from the European I Department replied that the staff believed that a free float was inappropriate because of concerns about the rapidly deteriorating trade situation and the health of enterprises and of the banks.

Mr. Schoenberg remarked that he shared Mr. Newman's concerns, and that he found the staff's views on that matter particularly unconvincing. The argument that flexibility in the exchange rate might raise the risk of a strong appreciation and subsequently--if the capital inflows stopped--corresponding strong depreciation, was particularly unconvincing because the policy advice given by the staff--tighter monetary and fiscal policies--was the type of advice that tended to encourage additional capital inflows. Experience showed that the more successful countries were in their stabilization efforts, the more capital inflows they attracted. He did not see how the staff's recommendation could work.

The staff representative from the European I Department pointed out that it was a matter not only of tightening monetary policy, but also of changing the mix of financial policies, with a tightening of fiscal policy as well.

Mr. Schoenberg noted that the thrust of the staff's recommendations, which asked for more efforts to tighten financial policies, would create conditions that would induce more capital inflows by making the country more attractive.

Mrs. Cheong remarked that it might be unwise to appreciate the exchange rate on the basis of capital inflows only, and without having tried to decipher the nature of those inflows. In Malaysia, which had identified a significant part of the inflows as speculative, tighter monetary policies and a subsequent appreciation of the exchange rate had led to outflows, but mostly of speculative short-term capital from investors that had wanted to take advantage of both the exchange rate and interest rate differential. The country did not want such funds anyway, as they were pure financial flows that did not contribute to the real economy and could be destabilizing.

Mr. Autheman remarked that, like Mr. Schoenberg, he was puzzled that it had been decided to rely on tighter monetary and fiscal policy exclusively, instead of using a tighter exchange rate policy to keep a reasonable mix of monetary and fiscal policy. The inflow of capital reflected an expectation of stronger profitability of the Czech economy. If that expectation was right, there was a good case for using the exchange rate both as a way to reduce the pressure on the economy and to accompany that increased profitability. Moreover, even if one was skeptical of the wisdom of market expectations--fearing that the economy was not as competitive as the market thought, or that the prospects for stronger growth remained uncertain--there was a case for resisting a market-led appreciation, which could lead later to an exchange rate crisis, when the market corrected its overestimation, and increase the risk of a surge in inflation afterward.

Mr. Newman wondered whether the authorities had been proposing to go to a band as the next strategy, and whether the staff had talked them out of it.

The staff representative from the European I Department noted that it was important to consider whether the source of pressures on the exchange rate was market expectation of stronger profitability. There was no question that a large appreciation would take place in the transition economies during the transition process, both as a result of changes in the relative prices of tradables and nontradables and because of gains in productivity.

Throughout 1994 and part of 1993, there had been a delay in the recovery of investment in the Czech Republic, and that had led to a current account surplus, the staff representative recalled. There had also been a large surplus on the capital account, owing primarily to foreign borrowing by enterprises because of the inefficiencies of the domestic banking system, the lack of transformation of maturities, and the wide spread between the lending and deposit rate. The latter resulted both from provisioning by banks trying to improve their portfolio and from tax-related distortions in the system that made interest on bad loans--both unpaid and never to be paid-- subject to income tax. That large spread had led the enterprises to borrow abroad, and to borrow in longer maturities, strengthening the capital account of the balance of payments. Very large capital inflows had begun when the foreign and local banks had realized that the balance of payments surplus was such that the exchange rate would have to appreciate. The resultant large flows had created the threat of losing monetary control.

The staff had tried to stress to the authorities that that was a short-term phenomenon, and that it was necessary to eliminate the distortions that were leading to the underlying longer-term inflow, so as to weaken the capital inflows, the staff representative remarked.

The staff had not talked the authorities out of widening the band, but had asked whether the authorities thought that a widening of the band would help in a situation in which there would be no fiscal support, and in fact an easing of fiscal policy, the staff representative observed.

Mr. Newman said that he agreed that implementing the underlying policies would reduce the capital flows and result in the desired current account deficit and level of investment flows. However, resisting an exchange rate appreciation might slow the adjustment process by making it easier for inefficient firms to stay in business, and by reducing the pressures on banks to correct their portfolio problems and enabling them to maintain inefficient maturity transformation operations. That would lead to the opposite of the desired results of effecting underlying fundamental changes.

Mr. Schoenberg observed that capital inflows into the Czech Republic were fairly stable, as it was one of the favorite countries for western European investors who wanted to invest in the area of transformation countries. Pending a complete reversal of policies in the Czech Republic, it did not seem likely that the view of those investors would change over the next years.

The staff representative from the European I Department remarked that the staff was not concerned about foreign direct investment or about the enterprises borrowing abroad. The concern was that short-term money was being brought in large amounts. For instance, in November 1994, every single foreign branch of German banks had brought between $25 million and $75 million. The Czech banks had also initiated large inflows in January 1995.

The staff had argued that portfolio investment in sound enterprises--in enterprises that were compensating for the inefficiencies of the domestic banking system--was a very positive development that should not be discouraged, the staff representative noted. Nevertheless, the cumulative impact of that kind of sound investment over a period of time had contributed to the expectation that an appreciation was unavoidable, which in turn, had formed the impetus for subsequent large flows of purely speculative investment.

Mr. Lvin wondered whether it was possible to imagine a strategy in which the authorities gave up an active monetary, interest rate, and reserve policy, causing interest rates to slowly move down and leading to the reversal of speculative capital inflows, with beneficial effects to the Czech economy. The low level of wages in the Czech Republic made the population less sensitive to an inflation in the range of 10 percent a year than in some adjacent western European countries.

The staff representative from the European I Department remarked that the staff had been concerned that inflation might move in the opposite direction.

Wages were continuing to increase at a rate of about 20 percent, which was about the rate of increase in the first quarter of 1995, the staff representative observed. Whether wages would be brought down quickly hinged on whether there could be an effective strengthening of enterprise governance. In that regard, the staff had focused on the areas of disclosure and bankruptcies. Low wages were standard in the transition economies, as reflected in the difference between the purchasing power parity (PPP) and the market exchange rate. Over time there would be a real appreciation. However, what the economy could absorb at any particular moment needed to be carefully assessed. If wages were very low for most Czech enterprises, then profitability should be very high, when in fact, profitability was very low, and worsening. Pending the restructuring and the improvement in the efficiency of the Czech enterprises, those low wages were needed for a Czech enterprise to be competitive and profitable. The wages were only truly advantageous for foreign investors who brought in high technology ventures. Those investors could earn large profits. Over time, as efficiency improved, it would be possible to increase wages and to narrow the gap between the PPP and market rates. Until then, however, low wages were not clear-cut evidence that the exchange rate was significantly undervalued.

Ms. Grikinyté made the following statement:

> The Czech Republic continues to be an undoubtedly successful reformer among countries in transition, owing to its reform achievements and its macroeconomic stability. This success allows higher standards to be sought for further performance, and thus a more critical evaluation of developments. Therefore I found the staff report extremely candid and the concerns raised highly accurate.
>
> The achievements in the Czech Republic have been repaid with investor interest. As we can see, foreign capital inflows are surging, thus speeding up economic growth in the country but, at the same time, creating problems, the solution to which is actually the core of today's discussion. As I broadly agree with the staff appraisal and with most of what other speakers have said, I will limit myself to some issues of concern which are necessary to emphasize. Before I turn to the concerns, let me, however, first welcome the fact that a new Foreign Exchange Act is under discussion in the Parliament, and that the authorities intend to accept the Article VIII obligations.

On the structural side, the Czech Republic seems to be lagging. This fact impedes other developments, makes the transformation process of the economy more lengthy, and puts a heavy burden on different sectors of the economy. Therefore, I urge the authorities to proceed boldly with measures to strengthen enterprises' governance and induce a more speedy restructuring. Proper legislation is a necessary condition for creating a favorable environment for restructuring, and laws concerning the Investment Privatization Funds could be improved. The legal prevention of greater concentration of ownership and the close direct and indirect links between banks and industry hinder restructuring. The loss of competitiveness because of rapid real wage growth and the real appreciation of the koruna underscores the need to proceed more quickly with restructuring of enterprises.

The fiscal policy anticipated for 1996 seems to be quite alarming, owing to already excessive liquidity in the economy. Therefore, I completely endorse the staff's concerns with the authorities' decision to adopt expansionary fiscal activities.

Challenges to monetary policy are very serious in the face of large capital inflows and inflation pressures. Monetary policy faces a familiar dilemma in deciding how to choose between the need to contain inflation and the need to not trigger further capital inflows. The Czech National Bank has to a large extent concentrated its efforts in fighting the consequences--by sterilization of capital inflows--rather than in the underlying causes, which appears to be more expensive than effective. The recent intention of the authorities to impose controls on capital inflows is also an administrative measure to fight consequences. Fiscal policy must work in tandem with monetary policy to preserve the fixed exchange rate in its anchor role. Thus, the authorities should promptly follow the staff's advice to tighten the fiscal policy stance substantially. A tighter fiscal policy stance should be accompanied by more speedy structural reforms, especially in the banking sector. The considerable spread between bank lending and deposit rates, as well as the growth of the share of nonperforming loans, is a sign of underlying systemic problems, and calls for decisive actions to restructure the banking sector.

There is no shortage of problems in the transition process, as transition goes on in all sectors of the economy at the same time. Therefore, I wish the Czech Republic authorities good luck in meeting the existing and forthcoming challenges and in keeping the image they have.

Mr. Cippa made the following statement:

The recovery of the Czech economy, in a context of successful stabilization and relatively low unemployment, is inspiring. Without either the financial or the moral support of a Fund-supported program, the Czech Republic continues to generate the confidence of the international financial community and attract large capital inflows--indeed, more capital inflows than probably desirable. Overheating seems to be the current challenge for the Czech economy, with inflation sticking stubbornly at 10 percent and the current account deteriorating quickly. We broadly share the staff's assessment of the policy dilemmas faced by the Czech authorities.

It would be appropriate to further tighten monetary policy, especially in view of the current and prospective increases in public expenditures. Reducing inflation is of particular importance if the nominal anchor is to be maintained without endangering Czech competitiveness and thereby contributing to a further deterioration of the current account. Even if at this point financial markets seem to be under the impression that an appreciation, rather than a depreciation, of the koruna would be in order, excessive real appreciation of the exchange rate and ensuing deterioration of the trade balance could quickly reverse expectations. At the same time, even modestly tightening monetary policy may well further exacerbate capital inflows--as has recently been the case--rendering sterilization more and more costly.

It is not my intention to reopen the interesting discussion on the appropriate exchange rate policy to follow, but it seems quite clear that under present circumstances the room for exchange rate adjustment is quite limited. We can therefore understand and support the temporary use of capital controls, even if only to save time for a more fundamental correction. However, we assume that the authorities would simultaneously be dealing with the banking sector problems that are contributing to capital inflows by creating incentives for enterprises to borrow abroad. If the reluctance of banks to extend long-term credit would seem to be largely unavoidable in a risky transition environment, it would still be important to remove any regulatory impediments to maturity transformation, such as the limit on the ratio of long-term assets to long-term liabilities.

Also, the high intermediation costs arising from the need to provision for "bad loans" and from tax distortions would appear to be an area in which the authorities could play a more active role. We welcome the Government's decision to forward legislation to Parliament aimed at giving banks greater latitude in writing down bad loans against provisions, and hope that further measures along these lines can be taken soon which will make the banking sector more competitive.

Mr. Tahara made the following statement:

First of all, I would like to commend the authorities for having achieved economic stability by implementing a program of economic reform. Real GDP growth turned positive in 1994 after five years of negative growth, the inflation rate was reduced from 18.2 percent in 1993 to 10.2 percent in 1994, and external reserves continue to increase with the extensive capital inflows. There are several points of concern, however, regarding macroeconomic policies.

The inflation rate, although reduced from the 1993 level, is still high, partly owing to continued large capital inflows and to a rapid increase in wages that is ahead of productivity gains. This will undermine economic stability and cause deterioration of economic growth by increasing the real exchange rate. It is desirable, therefore, for the authorities to adopt a well-balanced policy mix by tightening monetary and fiscal policy. The authorities' recent intention to spend accumulated fiscal surpluses is not appropriate in this regard: fiscal expansion will exacerbate demand pressure, which will cause further inflation. Moreover, as the staff rightly points out, the surpluses are coming from the overheated domestic demand, which in turn is due to large capital inflows and is therefore somewhat temporary. I therefore share the staff's view that the authorities should not have used the surplus this year.

The report also points out that the authorities are under strong pressure to reduce taxes and expand expenditures, which will enlarge the fiscal deficit. I strongly urge them to balance the budget as soon as possible.

As for structural reform, weak enterprise governance is a serious concern. It is commendable in this respect that the authorities have established a legal framework to strengthen the disclosure requirement.

The banking sector's bad loan problem is contributing to the high cost of intermediation, which will hamper the efficient use of financial resources. Further recapitalization of the banks will be required for the establishment of a sound banking sector, one that will facilitate sustainable economic growth through improvement in the efficiency of intermediation.

Lastly, I strongly urge the authorities to successfully overcome these difficulties and to establish a firm foundation for sustainable economic growth.

Mr. Hammoudi made the following statement:

The authorities are to be commended for their steadfast implementation of strong economic reforms. In less time than estimated, they were able to transform the economy and introduce markets forces. Furthermore, in 1994, positive growth was attained for the first time since 1989, and this trend is continuing in the first quarter of 1995, largely as a result of booming domestic demand. However, increased consumption and investment have generated an increase in imports volume of 12 percent while growth of exports volume contracted to 3 percent owing to diminishing trade with the Slovak Republic and a slowdown in exports in convertible currencies. Although this has weakened the current account balance, foreign reserves have further increased, despite a large early repurchase to the Fund, as a result of large capital inflows. Inflation remains high at 10 percent, fueled by excessive money growth, partly related to capital inflows, and excessive wage increases.

As we are in broad agreement with the staff appraisal, our comments will be brief.

It is vital that strict fiscal and monetary policies be implemented if financial stabilization is to be achieved. In this context, we welcome the authorities' intention to limit money growth to 14-17 percent in 1995 and to lower fiscal deficit in 1996.

Concerning capital inflows, it is expected that the authorities will continue to implement the sterilization scheme to limit the effect of these inflows on interest rates. The decision is in the right direction, as it will also contain the possible inflationary pressures of such inflows. The introduction of capital controls, supported by the staff, will give the authorities the necessary respite to develop appropriate policy response.

A stronger fiscal consolidation is called for to support the sterilization effort and avoid appreciation of the currency. The staff rightly points to the risks attached to the recent decision to spend accumulated budgetary surpluses. The medium-term projections also indicate the need for a tighter fiscal policy.

With wages increasing more rapidly than productivity gains, in addition to the koruna appreciation, competitiveness is at stake. Therefore, enterprises should further improve their efficiency through better quality and lower unit labor costs. To reinvigorate the economy, the authorities are also well advised to continue their structural reforms with the objective of modernizing the financial system. Furthermore, it is vital that privatization be completed in order to enhance efficiency in the enterprise sector. In this regard, an adequate legal and commercial environment will certainly contribute to strengthening corporate governance and improving transparency in the economy.

With these remarks, we support the proposed decision.

Mr. Estrella made the following statement:

With regard to the appropriate response to capital inflows, it is important to know that about "40 percent of net foreign capital inflows in 1994 constituted borrowing abroad by Czech enterprises." These inflows mainly reflect substitution between domestic and foreign credit. This is happening because domestic banks are not lending money with a long-term maturity. In conclusion, for the medium-term, the best way to reduce these capital inflows is by reinforcing the national banking system to increase maturity lending. However, for the short-term, as the staff suggested, a temporary control on capital inflows is recommended.

Mr. Kiekens thanked his colleagues for their positive assessment of the Czech performance and for their useful suggestions and recommendations. The Czech authorities appreciated the discussions they had had in Prague with the members of the mission. It had been an occasion for elevated, professional discussions on complex issues, and they were grateful for that opportunity and for the clear report that had been received in the Board.

He recalled that Mr. Schoenberg had advised the authorities to cope not with the symptoms of capital inflows, but with the causes, Mr. Kiekens remarked. Many Directors had suggested an increase in the nominal exchange rate. The cause of the capital inflows, however, was not the underappreciated exchange rate, but the structural problems and inefficiencies in the banking sector, which, as Mr. Estrella and the staff had noted, caused Czech enterprises to borrow in foreign currencies.

There was an expectation that the exchange rate might appreciate, Mr. Kiekens noted. However, the evolution of the trade balance seemed to show that the exchange rate was not undervalued, and that there were increasing problems with competitiveness--caused, in part, by a large increase in nominal and real wages.

The Acting Chairman made the following summing up:

Executive Directors commended the Czech authorities on their remarkable economic achievements: economic growth had resumed, and progress in financial stabilization had been sustained in 1994. However, Directors observed that signs had emerged that the economy might be overheating, that the growing interest sensitivity of capital inflows within the fixed exchange rate framework had continued to complicate monetary management, and that enterprise restructuring had been lagging.

Accordingly, Directors stressed the need to strengthen policies to achieve an early slowing of inflation and wage increases, while removing the distortions that contributed to the capital inflow. Departing from the advice offered by the staff, a number of speakers took the view that a more flexible exchange rate policy was called for. A nominal appreciation, those Directors emphasized, was preferable to a real appreciation of the currency that would come about as a result of inflation. Several speakers advocated the introduction of an exchange rate band.

Directors observed that a rapid increase of real wages had been a major factor behind the deterioration in competitiveness of domestic enterprises. To keep wage inflation in check and maintain competitiveness, Directors considered it critical that enterprise restructuring be accelerated. In that context, they welcomed the proposal under consideration to strengthen financial disclosure requirements for investment privatization funds and enterprises, and to strengthen corporate governance.

Directors emphasized that lowering inflation and preventing inflationary expectations from becoming entrenched would also require cautious financial policies. They welcomed the intention of the authorities to keep monetary growth within the initial target range of 14-17 percent for 1995.

Directors noted that the general government budget was projected to be in deficit in 1995, after recording surpluses in the preceding two years. They expressed concern at the adoption of an expansionary fiscal stance, when the economic recovery was already under way, and when domestic absorption was being fuelled by large capital inflows. Most speakers advocated that, in those circumstances, an early tightening of the stance of fiscal policy was warranted.

Directors noted that capital inflows were being encouraged by insufficient maturity transformation by domestic banks and by large interest rate spreads. They urged the authorities to address any large problem of impaired loans in bank portfolios and implement measures to eliminate the inefficiencies and distortions in the financial system, which had raised the domestic cost of capital. In that context, they welcomed the recent introduction of new loan write-off rules for banks.

Directors noted the introduction of controls on capital inflows, which had been resorted to in view of the constraints on the early use of other policy instruments. They believed that, in the event that controls were needed, they ought to be market based and should not discriminate across borrowers. Directors, several of whom called into question the efficiency of capital controls, stressed that controls could only be a temporary measure pending more fundamental correction in policies, because of the progressive ineffectiveness of controls over time and the allocative inefficiencies associated with them.

Finally, Directors commended the Czech authorities for their intention to accept at an early date the obligations of Article VIII, Sections 2, 3 and 4 of the Articles of Agreement.

It is expected that the next Article IV consultation with the Czech Republic will be held on the standard 12-month cycle.

The Executive Board adopted the following decision:

1. The Fund takes this decision in concluding the 1995 Article XIV consultation with the Czech Republic, in light of the 1995 Article IV consultation with the Czech Republic conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The exchange restrictions maintained by the Czech Republic in accordance with Article XIV, Section 2 are described in SM/95/167. The Fund welcomes the Czech Republic's intention to remove these exchange restrictions in the near future.

Decision No. 11039-(95/73), adopted
July 28, 1995

3. KINGDOM OF THE NETHERLANDS - ARUBA - ARTICLE IV CONSULTATION DISCUSSIONS HELD IN 1995

The Executive Directors considered the staff report for the Article IV consultation discussions held in 1995 with Aruba (SM/95/165, 7/7/95). They also had before them background papers on recent economic developments in Aruba (SM/95/172, 7/18/95; and Cor. 1, 7/24/95).

Mr. Wijnholds made the following statement:

The staff appraisal quite aptly states that "Aruba is facing the strains of success." At the time when Aruba gained a more independent status within the Kingdom--status aparte--some ten years ago, its economy was in severe stress. Unemployment was, for instance, 20 percent, and probably nobody expected the very high growth figures of the end of the 1980s and the beginning of the 1990s. The Aruban Government used, in particular, fiscal incentives to further develop and stimulate the tourism sector. As a result, tourism became the catalyzer of high annual growth, with the construction and retail sectors as the main "beneficiaries." Also, the reopening of the oil-refinery fostered economic development.

In a short period of time, the economy started to show signs of overheating reflected by labor and housing shortages. One of the results was that inflation swelled to a level somewhat higher than in the United States, to whose currency the Aruban florin is pegged.

The Aruban Government realizes that the economy has been growing at too high a speed, and it intends to aim at more moderate growth in the coming years. In this light, the Government considers its plans--including the support for further structural development and diversification of the economy--achievable. It realizes that major efforts are required to consolidate the gains made so far, efforts that lie in the fiscal area and in the field of the labor and housing markets.

Measures have been taken to contain government spending in 1995, and a further reduction by 10 percent is perceived for 1996. Room for expenditure cuts is mainly found by reducing the number of civil servants--wages and salaries account for about 50 percent of total expenditures. This policy also helps to ease strains on the labor market. It is important to note that the Government has stopped the practice of providing tax holidays and guarantees. Some tax incentives are kept for further diversifying the economy, for instance, in telecommunications. Moreover, the Government is pursuing active labor market policies. In order to alleviate labor market conditions, it aims at encouraging "outsiders," that is, females, people on welfare, expatriates currently living in the Netherlands, to join the labor force, and at increasing labor productivity.

Recent information about inflation shows that, measured over a 12-month period, consumer prices rose by 3.3 percent, while the annual average increase amounted to 5.3 percent. Price indices have been affected by the increase--July 1993--and subsequent removal--October 1994--of import duties.

As regards the framework of monetary policy, the Aruban central bank is well aware of the shortcomings of the present credit ceiling system. To make the system more flexible, it has recently introduced some reforms, such as permitting banks to trade among themselves unused positions under the ceilings, and bringing mortgage lending under the ceilings. However, the Central Bank notes that owing to the absence of well-functioning financial markets and concerns about the Central Bank's profitability, the practical effectiveness of more market-oriented instruments of monetary policy is limited.

Finally, the Aruban authorities realize that there still exist shortcomings in the availability of reliable data; they intend to continue their efforts to improve statistics.

Mr. Clark made the following statement:

I commend the staff for the concise and well-written report.

It is true that Aruba is facing the strains of success; however, this is surely a preferable position to facing the strains of failure. Aruba's is a position that most of my Caribbean authorities would relish: strong growth, virtually no unemployment, and fiscal balance.

The key issue would seem to be sustainability. Aruba is at a critical juncture where much could be done in the near term to improve the prospects for sustainability. The alternative, climbing inflation and its negative implications for competitiveness, growth, and stability, is clearly present. In this regard, I fully support the staff appraisal.

I am unsure how the staff managed to produce such a coherent report in view of the dearth of data. Clearly, Aruba illustrates the importance of our discussion on improving data (Informal Session 95/7, 7/26/95), and is also a good example of the status and institutional capacities in small, island states. I welcome the authorities' intentions to improve statistics, particularly in the areas that will shed light on Aruba's competitiveness--a crucial indicator in the tourist-competitive Caribbean. I wonder whether the authorities have made requests for technical assistance in this area. If the situation is like that in some of my constituencies, a small amount could go a long way.

On fiscal policy, the concerns raised by the staff should receive close attention. The fiscal target for 1995 should provide less stimulus to the economy, particularly in view of the existing pressures on domestic resources and the inability of monetary policy to play an effective dampening role. The target for 1996 appears laudable, but I agree with the staff that the means to achieve a 10 percent reduction in expenditures appear unrealistic.

Moreover, I note the very ambitious plans outlined in the staff report to establish a broad social safety net. Although this is a worthy goal and should be pursued, I would like to know what time frame the Government has in mind. The structure and allocation of expenditure should be improved. and considerable thought should be given to the medium-term affordability of these programs--Aruba is a small country with a relatively narrow economic base, vulnerable to external shocks. From the experience in my constituency, the authorities should proceed slowly in this field.

The source of financing, "cutting waste in government," is a universal, but an unreliable, source--especially if, according to the staff report, it is intended to finance infrastructure as well as a massive expansion of residential housing stock.

The work under way to reduce the civil service deserves praise and encouragement. On the method I have two questions: first, how will the lump sum severance package be financed this year, and second, why is this being recorded off-budget? I would also encourage the authorities to evaluate seriously the administration and allocation of remaining staff to ensure an effective utilization of resources.

On monetary policy, the challenge facing Aruba's authorities is well known in my constituency. The features of Aruba's financial system make the application of a responsive market-instrument driven monetary policy difficult and sometimes impractical. A fixed exchange rate, which has served Aruba well, and a small economy with only a few banks mean that careful thought must be given to the pace and extent of moving to a market-based approach.

In this sense, the staff has struck a good balance, recognizing the constraints yet making useful suggestions that would allow greater flexibility within the existing framework. In particular, it was suggested that more active use be made of reserve requirements and official interest rates, and that there was a need to reduce the role of credit ceilings and find ways for the Central Bank to absorb liquidity. Remuneration on bank deposits should help to ensure the profitability of the Central Bank.

It should be stressed, however, that the current overheating pressures in the economy could overwhelm the existing tools of monetary policy, inducing the authorities to resort to more capital controls. Although I agree with the staff that Aruba should move toward the liberalization of capital movements, I would suggest at this stage placing priority on improving the responsiveness and flexibility of monetary policy rather than on concerns about capital controls. Improving the effectiveness of monetary policy should help to remove the source of the perceived need for controls.

Finally, I wondered whether there were any environmental issues that are or should be considered by the authorities. Most small Caribbean islands have fairly fragile ecosystems, and in view of the recent rapid growth and capital investment in Aruba, environmental considerations should be watched closely.

Mr. Ramdas made the following statement:

Although growth has slowed down somewhat since the high growth rates experienced after the 1986 recession, the strains of Aruba's rapid growth in a relatively short period of time are becoming more evident--a high level of imported labor has become necessary, a housing shortage seems to be evident, and inflationary pressures are increasing. With a good outlook for growth, supported particularly by the continuing strength of the tourism sector, the climate is favorable to attempt more meaningful structural adjustments to steer the economy along a more sustainable course.

Two areas on which we would like to comment are the conduct of monetary policy and the outlook for fiscal management. The authorities' experience with use of credit ceilings and moral suasion as techniques of monetary management has been largely successful in meeting their primary objective of maintaining the fixed exchange rate for the Aruban florin.

In targeting the money stock the Central Bank intends to pursue a more restrictive policy in granting licenses for capital inflows. In evaluating such projects when the economy is operating under various constraints, noncompetitive prices, wages, and interest rates are likely to be used. Nonmarket valuation could lead to inefficient use of resources, such as excess capacity or the building of too many hotels and too few houses, or even too many houses. A more liberal system could reduce such inefficiencies.

In the fiscal area, the projected 1995 budget is showing a small surplus based on the 1994 outturn. The budget surplus would be higher if reduction in the size of the civil service also required proportionate reduction in expenditures on the real quantities of goods and services.

The severance package provides a strong incentive for skilled workers to leave with a lump sum salary of 1 1/2 years. For workers at the lower end of the pay scale, the planned increase in minimum wage and the 30 percent rise in pension benefits provide strong incentives to remain in government employment. We urge the authorities to seek to retain skilled personnel needed to improve the quality of government services. As a cautionary note, voluntary departure schemes may not give rise to the desired results.

With respect to social policy areas that are likely to have budgetary consequences, the 30 percent increase in pension benefits to be financed by a 3.5 percent increase in employer contributions should also satisfy prudential guidelines. In this context, incentives for personal retirement accounts and employee contributions could be explored further.

The looming housing shortage is being addressed by plans to build 5,000 houses for a large segment of the population. Support in this area should be a part of the social safety net program, targeted to low-income families.

The private sector should be encouraged to explore opportunities in the private residential housing market. In hotel construction, the reduction in issuing government guarantees after the failure of three hotel projects between 1990-92 is an appropriate step.

We wish the new Government success in implementing its programs and urge the authorities to consolidate their efforts to improve statistical data coverage. We thank the staff for being resourceful in working with the available data.

Mr. Alemán made the following statement:

After years of impressive growth, the economy of Aruba entered a sustainable path of growth, declining under 2 percent in 1993 and rebounding with a real expansion of its GDP of 6 percent in 1994. Even taking into account the present "strain of success," the performance of the economy of Aruba has been remarkable.

However, the speed of growth has caused overheating of the economy, resulting in an inflation rate that was above that prevailing in the United States and vis-à-vis its competitor neighbors which produced a negative impact on the competitiveness of Aruba's main activities. These inflationary pressures and tight conditions in the labor market should be tackled carefully, because they can damage not only the future of tourism but of the whole economy.

My remarks will be made on three points: fiscal policy, monetary policy, and structural policy.

On fiscal policy, we fully agree with the staff that the current inflationary pressure can be alleviated only by a tighter financial policy, as part of a further consolidation in government public expenditures. This requires the restraining of aggregate demand expansion with a moderation of government support to economic development and public investment.

Further reduction of public expenditures through decreasing public sector staffing should be carefully planned. This program should evaluate the risks of losing highly qualified people as a result of its enforcement.

On monetary policy, the ceiling on domestic credit expansion seems to have been useful in achieving the target of maintaining a strong net foreign assets position to defend the fixed exchange rate against the U.S. dollar. However, the management of monetary policy in the next years will be more complicated if the authorities do not quickly implement the use of market-oriented instruments. In this regard, the Central Bank needs to absorb market liquidity without compromising its independence in order to have a flexible monetary policy. We would appreciate further comments of the staff on this issue.

On monetary policy, it is clear, as it was in the previous review of Aruba's economy, that shortages in the labor market are a serious constraint. Planned investments in infrastructure and social programs can increase the present labor market imbalances. The authorities' concern in regard to immigration policy and improvement in productivity is understandable as an alternative to sustain the high rate of economic growth and maintain Aruba's external competitiveness in the short run. However, we fully agree with the staff appraisal that moderate growth objectives should be programmed in order not to endanger Aruba's economic development.

Finally, we would like to emphasize strongly the need to improve the statistics and economic data and to congratulate the staff for its excellent work on Aruba's economic performance.

With these remarks, we commend the authorities of Aruba for their economic results.

Mrs. Gonzalez made the following statement:

Aruba is one of the few members of the Fund that is on a 24-month Article IV consultation cycle. Given the small size and fundamental soundness of the economy, this longer cycle seems to be appropriate, and it is an interesting example of how the Fund can tailor the way it conducts bilateral surveillance to fit the circumstances of individual countries. However, headquarters-based monitoring in between formal consultations depends on the quality and timeliness of data available to the staff, and I would be grateful if the staff could indicate whether there are any concerns in this area. I would suspect there are, given the many problems that the staff identified in the report.

I share the staff's concern that there are a number of risks in the policy objectives being pursued by the Aruban authorities. One risk is the highly activist role envisaged for the Government, which would provide incentives for investment in new areas of activity, move the tourist industry up market, and support the massive expansion of the residential housing stock. It is not at all clear why such an interventionist approach would be desirable, as previous--and unfortunate--experience with investment guarantees suggests that a more cautious approach should be adopted. In the medium term, a dynamic private sector responsive to market prices is likely to be the best assurance of diversification and sustained high-quality growth. Furthermore, the shorter-term effects of these measures would make the necessary tightening of fiscal policy much more difficult--and such a fiscal contraction is required to reduce inflationary pressures and ensure that competitiveness is maintained. Capital and credit controls seem unlikely to be effective and they impose substantial costs on the economy. The authorities' indication that they are planning significant cuts in expenditure in 1996 is welcome. I urge them to ensure that this occurs.

Finally, I wish the Aruban authorities well in their endeavors.

Ms. Brettschneider made the following statement:

I have little to add to what previous speakers have said, and I can associate myself with the views expressed by Mr. Clark and most of the views expressed by other speakers. I am in broad agreement with the staff's analysis and recommendations.

I would make only two brief points, the first of which pertains to development of off-shore finance in Aruba. Specifically, I join the staff in cautioning the authorities against further rapid development of off-shore finance activities. My authorities are very concerned that loose supervision of Aruba-exempt companies has contributed to growing evidence of money laundering activities through these enterprises. The staff's concern that the quality and integrity of off-shore finance activities could be compromised if current trends continue is one we share.

Second, I appreciated the clear presentation of statistical issues and the status of data reporting contained in Appendix III. The authorities' plans to improve the quality of macroeconomic data and the transparency of the fiscal accounts is most welcome. Substantial progress in this area will be crucial in order to provide policymakers with the best information on which to base policy decisions.

The staff representative from the European I Department, replying to Mr. Clark's remarks on the dearth of data, noted that this was due, in part, to the limited technical capabilities and the very small size of Aruba's public service, as well as turnover that made it difficult to maintain continuity in statistical systems.

Aruba had received technical assistance from the Fund in the past and, subsequently, from the Netherlands authorities, the staff representative noted. Moreover, the authorities had expressed an interest in receiving a general purpose statistical mission from the Fund within the following year.

In reply to Mr. Clark's queries regarding fiscal policy, the staff representative observed that the details of the 1996 budget were not available yet, and it was unclear at that stage how much additional spending could be financed through the planned cuts in government waste. The authorities had not indicated what element of public expenditure would be involved in carrying out their various social and other initiatives. Some might be paid for through increases in premiums for pension plans or through an injection of general budgetary resources.

The cost of the lump-sum package for severance in the public service was recorded off-budget, because the authorities had built up reserves, counted them as capital expenditures, and authorized their disbursement in 1994, the staff representative explained. Thus, while the actual disbursement of the funds had occurred in 1995, it did not appear in the 1995 budget.

In reply to Mr. Clark's question about environmental concerns, the staff representative noted the implications of rapid growth in such a small island, in particular with regard to limited space, but also to a limited water supply, given that Aruba was essentially a desert island. The fact that the two main industries centered on tourism, which was environmentally sensitive, and oil refineries, which characteristically entailed some environmental risks, also raised potential concerns with regard to the need for environmental safeguards.

Responding to Mr. Ramdas's suggestion that reducing the number of public servants could lead to lower expenditures on goods and services, the staff representative said that not enough data was available to analyze that possibility. There was no consistent time series on government spending in different categories, and it was impossible to evaluate what the pattern had been in terms of either complementarity or substitutability of personnel and goods and services expenditures.

In response to Mr. Aleman's request for elaboration on the distortionary effects of the ceilings on domestic credit expansion, the staff representative observed that one obvious distortion was the ossification of the market shares in the banking sector, with the tendency toward disintermediation as banks accumulated excess liquidity and rationed credit. Borrowers were thus induced to go outside of the banking sector, as were depositors, who found that they could not achieve an adequate rate of return on bank deposits.

The authorities recognized the drawbacks of the credit ceilings, the staff representative noted, but they were concerned about the difficulty of establishing competitive financial markets in such a small system. Auctions of treasury bills or repurchase agreements, for example, might draw only four or five bidders. Thus, it appeared difficult to move toward a more liberalized environment.

The authorities' rationale for restricting banks' holdings of liquid funds abroad, rather than offering a competitive interest rate to induce them to hold these funds at the Central Bank, reflected concern about maintaining the profitability of the Central Bank and ensuring its independence, the staff representative observed. The staff did not share the view that below-market interest rates on excess reserves were needed to address this concern, and noted that maintaining profitability could be achieved by tiering the structure of interest rates on different categories of required and excess reserves at the Central Bank.

In reply to Mrs. Gonzalez's question about the implications of the 24-month consultation cycle, the staff representative noted that more frequent visits to Aruba or a shorter consultation cycle would not make up for the inadequacy of the available data. The problem was not that the data were not being supplied to the Fund, but simply that the data did not exist. Moreover, in the years when there was no Article IV consultation with Aruba, the staff had conducted a one-day visit to Aruba in conjunction with the Article IV consultation with the neighboring Netherlands Antilles. That was a way of keeping in touch with the authorities and addressing some of the salient issues in surveillance.

Mr. Wijnholds thanked the Executive Directors for their useful remarks and for the interest that they had shown in Aruba, which was doing a little too well in some aspects and could perhaps do more in others. Their remarks would be passed on to the authorities. He also thanked the staff, on behalf of the Aruban authorities, for its excellent work and analysis.

The authorities' instruments of monetary policy were far from perfect, but alternatives were not easy to develop given the constraints imposed by the smallness of the economy, Mr. Wijnholds considered. While the staff might not agree that restricting banks' ability to hold liquid funds abroad was necessary to maintain the profitability of the Central Bank, he noted that they did share the view that there was a need for an independent Central Bank. That independence was important in an environment such as that of Aruba.

All speakers had mentioned the need to improve data collection and statistics, and that concern would be conveyed to the authorities, Mr. Wijnholds noted.

On the issue of the environment, he would personally investigate the possibility of emerging environmental problems on his next visit to Aruba, Mr. Wijnholds added.

The Acting Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the staff appraisal. Directors noted Aruba's remarkable growth rates since the slump in the mid-1980s, and the virtual elimination of unemployment. At the same time, they cautioned that there were clear signs that the economy was facing supply constraints, and the buildup of inflationary pressures posed a threat to Aruba's competitiveness. Directors emphasized that a more restrictive fiscal policy and less ambitious plans in the area of economic development were called for. Directors also cautioned that the authorities' medium-term growth objectives were based on a number of optimistic assumptions, and would likely place additional strains on Aruba's resources.

Directors were concerned about the expansionary stance of fiscal policy. For 1995, there were considerable risks that projected expenditure savings would not materialize. Directors welcomed the deep cuts in overall government expenditure planned for 1996, but cautioned that those plans appeared to be incompatible with the ambitious government policies in several areas. Speakers also doubted the effectiveness of the voluntary departure scheme to reduce the size of the civil service.

Directors noted that domestic credit targeting was an important instrument in support of the fixed exchange rate objectives, but the quantitative nature of the credit controls was likely to result in distortions. Although welcoming recent measures to introduce some flexibility into the system, Directors pointed out that there was considerable scope to move further in the direction of market-based monetary policy and the development of a domestic money market. However, in view of the openness of the Aruban economy, Directors emphasized that gearing monetary policy toward restraining aggregate demand via stricter controls on capital inflows would likely prove ineffective. It was also emphasized that improved supervision was called for over Aruban off-shore finance activities.

Directors welcomed the authorities' planned improvements in economic statistics and emphasized that further improvements would be needed to provide an adequate statistical base for economic policymaking and surveillance.

It was agreed that the next Article IV consultation discussion with Aruba would be held on the 24-month cycle.

4. CENTRAL AFRICAN REPUBLIC - OVERDUE FINANCIAL OBLIGATIONS - REPORT BY DEPUTY MANAGING DIRECTOR

The Acting Chairman recalled that the Central African Republic had had overdue financial obligations to the Fund since June 3, 1995, and that in mid-July, the Executive Board had agreed to a short delay before holding a consultation and sending the required communications to selected Fund Governors concerning those arrears. At that time, Mr. Narvekar had informed Directors that several initiatives were under way to facilitate the settlement of the overdue obligations by the Central African Republic.

Since then, the Central African Republic had sent a payment equal to SDR 623,095, which had been received on Monday, July 24, the Acting Chairman noted. That payment left a balance of arrears of SDR 564,906. Moreover, that morning, the Managing Director had received a facsimile from the Minister of Finance of the Central African Republic that said that a payment to the Fund of CFAF 200 million, equivalent to approximately SDR 267,000, was being arranged immediately, and that the balance of arrears that would remain--about SDR 297,500--would be settled the following week.

It had been agreed in mid-July that, in the event that the Central African Republic did not settle its arrears by end-July, the Managing Director would consult with the Executive Board on the sending of communications to selected Fund Governors, the Acting Chairman recalled. However, in light of the new circumstances, he suggested that the Board proceed with its consultation--in accordance with the procedures for dealing with arrears cases endorsed by the Board in 1989--but that the dispatch of the communications be delayed until the end of the following week, and that they be sent only if the Central African Republic had not cleared its arrears by that time.

In the event that the arrears were not settled by Friday, August 4, 1995, the Managing Director would send a communication to the Governors for the countries that were the Central African Republic's major bilateral creditors and donors, and to other members of the constituency to which the Central African Republic belonged, the Acting Chairman continued. In that communication, the Managing Director would emphasize that action had to be taken by the authorities immediately to prevent the overdue obligations from reaching a magnitude that would make their clearance more difficult.

The Managing Director would also request that the Governors encourage and facilitate the efforts of the Central African Republic to effect full and prompt settlement of its overdue financial obligations to the Fund, and that Governors request their governments to use their good offices to impress upon the Central African Republic's authorities the importance of immediate action in that respect, the Acting Chairman added.

He hoped that developments in the following few days would make it unnecessary to send these communications, the Acting Chairman observed. Failing that, it was hoped that the Central African Republic would settle its overdue financial obligations in the near future, thereby avoiding the need for the issuance of a complaint, and that it would settle future obligations promptly as they fell due.

The Executive Directors agreed with the Acting Chairman's proposal.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/72 (7/27/95) and EBM/95/73 (7/28/95).

5. RUSSIAN FEDERATION - REVIEW UNDER STAND-BY ARRANGEMENT

1. The Russian Federation has consulted with the Fund in accordance with paragraph 3(c) of the stand-by arrangement for the Russian Federation (EBS/95/46, Sup. 3) and Section XII of the Annex to the Statement on Economic Policies for 1995 attached to the letter from the Chairman of the Government of the Russian Federation dated March 14, 1995.

2. The Fund decides that the third review contemplated in paragraph 3(c) of the stand-by arrangement for the Russian Federation is completed. (EBS/95/121, 7/25/95)

Decision No. 11040-(95/73), adopted
July 27, 1995

6. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAM/95/123 (7/24/95) is approved.

APPROVAL: February 20, 1997

REINHARD H. MUNZBERG
Secretary