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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/72

10:00 a.m., July 15, 1997

Contents

Decision Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman
A.D. Ouattara, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	S.M. Al-Turki
M.-A. Autheman	
	J. Chelsky, Temporary
	W.-D. Donecker
	A. Giustiniani, Temporary
D.Z. Guti	
D. Kaeser	
	O.L. Bernal, Temporary
W. Kiekens	
K. Lissakers	B.S. Newman
	M. Daïri
A.V. Mozhin	A. Vernikov
G. O'Donnell	
A.S. Shaalan	Y.Y. Mohammed
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	B. Andersen
G.F. Taylor	O. Kwon
J.J. Toribio	
J. de Beaufort Wijnholds	
K. Yao	
Y. Yoshimura	
Zamani, A.G.	S. Joyosumarto
	Han M.
A.G. Zoccali	N. Eyzaguirre

R.H. Munzberg, Secretary
S. Bhatia, Assistant

Also Present

European I Department: Y. Horiguchi, Deputy Director; H.M. Flickenschild. European II Department: J. Odling-Smee, Director. External Relations Department: M.E. Hansen, H.P. Puentes, R.W. Russell. Legal Department: F.P. Gianviti, General Counsel; W.E. Holder, Deputy General Counsel; R.C. Baban, R.B. Leckow, D.E. Siegel. Middle Eastern Department: M.A. El-Erian, Deputy Director; V. Sundararajan. Monetary and Exchange Affairs Department: M.I. Blejer, P.T. Downes, R.B. Johnston, A.Y. Kyei, J.E. Leimone, H. Mehran, S.C. Sosa, M.W. Swinburne, N. Tamirisa. Policy Development and Review Department: J.T. Boorman, Director; O. Havrylyshyn, Deputy Director; T.W. Dorsey, A.J.-P. Feler, M. Fisher, J. Lin, L. Nielsen, R.H. Nord, P. Sorsa, S.K. Wajid, A.A. Yousef. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; D. Folkerts-Landau, G.J. Schinasi. Secretary's Department: W.S. Tseng, Deputy Secretary; P. Gotur. Western Hemisphere Department: C. Cha. Office of the Managing Director: O.J. Evans. Advisors to Executive Directors: P.A. Akatu, M. Askari-Rankouhi, S.S. Farid, P.M. Fremann, G.M. Iradian, M.F. Melhem, H. Mori, S. N'guiamba, T. Turner-Huggins. Assistants to Executive Directors: M.A. Cilento, D.A.A. Daco, S. Fukushima, N. Goffinet, W.K. Gruber, J.K. Honeyfield, M.S. Kell, Lai K., J.P. Leijdekker, A. Lucenti, M.Z. Maatan, D. Merino, I. Moon, A.R. Palmason, J. Salleh, O. Schmalzriedt, Zheng H.

1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director stated that he had traveled to Cambridge and London to attend a conference on "The Origins and Management of Financial Crises." The participants had reported in part on research completed under a program funded by the Economic and Social Research Council of Britain, which also studied the role of international institutions in the international system. Participants had presented papers based on both theoretical and empirical analysis. The former set of papers had tried to find a theoretical basis to explain the tendency of markets to overreact to events or to new information. The models showed that markets overreacted when participants drew conclusions from the behavior of others, leading to "herd" behavior. Another paper had focused on insufficient global diversification—a tendency for portfolios to be concentrated in domestic assets. The conclusion was that that, too, was the result of imperfect information. Mr. Masson of the Fund's Research Department had presented an empirical paper on the French franc crisis, in which he argued that the crisis had been caused by incorrect expectations. Barry Eichengreen, currently a visiting scholar at the Fund, had presented a paper along with others—at a panel at which he had been a discussant—on whether currency crises embodied contagion effects. The authors had argued that the risk of contagion existed if a country might be expected to suffer the effects of a currency crisis faced by another country, other factors being equal. The authors had not been satisfied with the paper's conclusion, which had been that trade, rather than similar macroeconomic conditions, explained why countries suffered contagion effects; that is, countries were more likely to face a currency crisis if their trading partners did. The basis for such a conclusion might be the fact that the author's research had ended in 1993 and been limited mainly to EU-related currency crises, and had not therefore taken into account the exchange rate crises in emerging market economies from 1995 to 1997. If data for the period after 1993 had been included, the conclusion would probably have been that similar macroeconomic conditions played a larger role than trade in explaining contagion effects.

The papers presented at the Bank of England had tended to be more policy oriented, the First Deputy Managing Director commented. Mr. Boughton, the Fund's historian, had presented a paper entitled "From Suez to Tequila" on the Fund's role as crisis manager. Mr. Evans, the former Executive Director representing the interests of the United Kingdom at the Fund, had been the discussant for that paper. Andrew Crockett of the Bank for International Settlements had presented a paper on managing the international financial system, and Morris Goldstein of the Institute for International Economics had presented a paper on the need for international banking standards. The questions about the need for a crisis manager, the importance of avoiding moral hazard, and related topics would have been familiar to Directors. The audience had not been as well informed about the current currency crisis in Southeast Asia as he had expected, and in all, the discussions had been somewhat backward looking. He had listened for issues that might have pertained to the Board discussion on capital account convertibility.

He had also met with the Governor of the Bank of England, Mr. George, and they had discussed the events in Southeast Asia, as well as issues relating to Europe and to the United Kingdom, the First Deputy Managing Director concluded. His visit had coincided with a staff mission for the Article IV consultation with the United Kingdom.

2. CAPITAL ACCOUNT CONVERTIBILITY—TRANSITIONAL ARRANGEMENTS, APPROVAL POLICIES, AND FINANCING UNDER AN AMENDMENT OF ARTICLES OF AGREEMENT; AND CAPITAL MOVEMENTS UNDER AN AMENDMENT OF ARTICLES OF AGREEMENT—TREATMENT OF INWARD DIRECT INVESTMENT

The Executive Directors considered a staff paper on capital account convertibility—transitional arrangements, approval policies, and financing under an amendment of the Articles of Agreement (SM/97/173, 7/1/97; and Cor. 1, 7/9/97), together with a staff paper on capital movements under an amendment of the Articles of Agreement—the treatment of inward direct investment (SM/97/168, 6/27/97; Cor. 1, 7/8/97; and Sup. 1, 7/11/97).

Mr. Chelsky, speaking on behalf of Mr. Bernes, made the following statement:

> Once again, the staff has provided us with thought-provoking papers moving us another step closer to the complete picture which we will need to have in mind to reach agreement on an amendment to the Articles to give the Fund appropriate jurisdiction over the capital account. In this regard, I welcome management's assurances that comments at this point will be viewed as preliminary and without prejudice to Directors' final positions. Indeed, this is in keeping with the concern of my Canadian authorities that they be given adequate time to consult from the necessary range of perspectives, not only within the Department of Finance, but among other relevant government departments, before they are asked to take final decisions on proposed amendments.
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> In general, let me re-state my support for a package of amendments that: (1) actively promote capital account liberalization; (2) are sufficiently transparent and consistent with other international agreements; and (3) allow the Fund to provide assistance to its members without unduly jeopardizing its resources.
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> Turning to the treatment of inward direct investment, both the staff and the Executive Board have generally recognized the need to carve-out inward direct investment from the Fund's jurisdiction. This decision was by no means a reflection that liberalization in this area does not have substantial merit, but because efforts in this regard were being addressed elsewhere and the Fund did not have the comparative advantage or institutional structure most appropriate for the associated deliberations. In addition, we realized (rightly) that, among capital movements, inward direct investment was the most politically-sensitive, because, as the staff notes, restrictions imposed on these transactions are usually to address sovereignty concerns, and not for balance of payments reasons. This area is also legally complex and potentially time-consuming, which suggests that extending the Fund's jurisdiction over this area would represent a significant diversion of the focus of this institution.
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> In light of this, my main concern arising from the paper is what might appear (at least on the surface) to be a conflict between Executive Directors' desire to exclude inward direct investment from the Fund's jurisdiction and the

staff's assertion that it has been "agreed" that portfolio investment be included in the Fund's jurisdiction. Portfolio investment, as we know, includes both debt and equity instruments. My understanding is that what distinguishes whether or not "equity" investment is to be considered "portfolio" or "direct" investment is a determination of "effective influence."

Unfortunately, there is no internationally-accepted definition of what constitutes "effective influence." At a purely hypothetical level, a single vote, under the right circumstances, could be enough to provide "effective influence."

The Staff seeks to get around this issue by making use of the "10 percent" threshold recommended by the OECD. It is worth noting that, as the staff points out, the OECD Code, while using the criteria of "effective influence," leaves its definition to members. That this is the case, and that the OECD only recommends a 10 percent threshold, is indicative of the fact that OECD members were unable to agree to a binding threshold and therefore settled on a simple "guideline." I would therefore be hesitant to give greater credence to the 10 percent threshold than is warranted.

Indeed, perhaps a broader issue that we should reflect on, is why any inward direct investment (including equity investment below 10 percent) should be included within the Fund's jurisdiction. The arguments in support of this "partial" inclusion do not appear to be convincing, particularly in light of the staff's stated views on inward direct investment. For example, is there a substantive difference between an equity holding of 9 percent and 11 percent? Is the difference important enough to justify including the former in the Fund's jurisdiction but not the latter? Further, if we carve-out equity investment between 10 and 100 percent of an enterprise, how can we argue that investment between 0 and 10 percent must be included in the Fund's jurisdiction for macroeconomic or balance of payments reasons?

This is not to say that there should be unlimited ability to impose restrictions on any level of inward direct investment. But, as I stated earlier, this issue is being addressed elsewhere. I would therefore hesitate to extend the Fund's jurisdiction in such a way that the Executive Board would be called upon to assess the extent to which such restrictions are appropriate to protect a "compelling (non-economic) national interest." Not only are we not qualified to undertake such deliberations, but the absence of an appeal mechanism and an opportunity for independent judicial review suggest that the Fund does not have the appropriate institutional framework to deal in this area. Either the Fund will need to alter the way in which it operates, or another international arrangement or institution will need to fill this gap.

Interestingly, if we exclude all inward direct investment from the Fund's jurisdiction (including equity portfolio investment), many of the difficulties the staff identifies virtually evaporate. For example, exclusion of all inward direct investment (including portfolio equity investment) would allow us to formulate a single definition of inward direct investment that is based on objective criteria. It would therefore eliminate the "third category" of measures identified by the staff in paragraph 15 (e.g. ceilings on the aggregate holdings by foreigners), the legitimacy of which (at least with respect to the Fund's Articles) would have to otherwise be assessed relative to the reasons for which they were imposed. We would therefore not need to choose between the various (and unsatisfactory) options presented by the staff in paragraphs 17 to 23 since Board approval would not be required for any restriction on inward direct investment.

Such an exclusion would also eliminate a vast paper and time burden that would arise if members were required to make a representation to the Fund every time they imposed a restriction on foreign ownership of domestic enterprises to protect a compelling national interest and the staff and the Executive Board was obliged to review these representations to ensure there were no grounds on which to challenge it. It would also eliminate the need for the Fund to involve itself in issues related to the right of establishment.

My authorities have also raised a number of questions pertaining to the section of paragraph 3 which states that "the measures that would not be included within the Fund's jurisdiction would only be those that are imposed on the making of inward direct investments." First, the use of the word "imposed" suggests we are talking about de jure or explicit restrictions. Given our earlier discussion of the need to take account of implicit restrictions, does this not also refer to de facto measures? If so, should not "are imposed" be replaced by something like "have an impact on" or "apply to?"

Second, and more substantively, the reference to "measures... on the making of inward direct investments" refers to only the creation of the investment and thus suggests that we are placing in the Fund's jurisdiction measures that impact on an investor's ability to conduct business once an investment has been made. This would include, as noted, measures imposed on the liquidation of these investments, which is related to the ability of the investor to operate, use and enjoy their investments. In this regard, I presume the guiding principle in addressing measures in these areas is one of national treatment. Could the staff explain to the Board the impact that including these measures (except, of course, on the payments and transfers associated with liquidation) in the Fund's jurisdiction could have on domestic laws and international and bilateral agreements on expropriation, bankruptcy, and money laundering?

On transitional arrangements, I can accept the thrust of the staff's recommendations in this section, with one exception.

Among the principles advanced to guide the establishment of approval policies is a "no back-sliding provision." This would prohibit members from introducing new restrictions in areas under the Fund's jurisdiction without Fund approval. At the same time, it is suggested that members would be able to "maintain and adapt existing restrictions under the protection of the transitional arrangements." However, we have the interpretation of Article XIV, Section 2, which permits a member to either "relax, intensify, or vary a [current account] restriction" that was in effect when it became a member.

While I can see the rationale for allowing for the maintenance of existing restrictions under transitional arrangements, I am not convinced that allowing members to intensify existing restrictions is consistent with the principle of "no-backsliding." Perhaps a different approach is warranted for capital account jurisdiction. Comment would be appreciated.

The subject of approval policies may be one of the more contentious issues we have to deal with, particularly given the potential for two-way links between the design of an approval policy and the scope of jurisdiction which members conclude is most appropriate for the Fund. For example, if, as proposed above, we exclude all inward direct investment from the Fund's jurisdiction, we will significantly reduce the likelihood that the Executive Board will need to deliberate on the appropriateness of a particular restriction based on considerations outside its area of expertise. Members may therefore feel more comfortable with an approval policy in which there is little or no scope for appeal. Regardless, I do believe we need to look at a range of options for appeals of Board determinations on the appropriateness of various reservations and assess this against the current "no-appeals" approach. I will note, however, that I also see scope for the Fund to maintain the right to make representations to members when the rationale for reservations is in question.

In arriving at a final position on an appropriate approval policy, my Canadian authorities would also like the staff to consider the scope for a carve-out for tax measures as is currently embodied in the FTA and NAFTA. In particular, Canada (and, I understand, other countries) maintains tax disincentives for pension funds and registered retirement savings plans (not motivated by balance of payments concerns) for investment in foreign assets beyond a certain level. How would these be affected by the proposed amendment and could the treatment assigned such measures in the NAFTA also be considered for the Fund's amendment?

I also have a question about the section in paragraph 4. Staff notes that restrictions imposed for nonbalance of payments reasons would be approved "on a longer-term basis." How long a term is envisaged? Would such approval be permanent? If not, how frequently would the staff have to review the appropriateness of measures for which reservations have already been lodged and accepted? What are the resource requirements of such oversight?

I appreciate the staff's clarification of the earlier ambiguity with respect to the implications of conflict between the GATS and an expanded Fund jurisdiction. Since, as the staff makes clear, the GATS only defers to the Fund's jurisdiction as defined in the existing Articles, an amendment to the Articles would necessitate an amendment to the GATS. My understanding is that the GATS has no amending formula and the entire package of agreements would therefore have to be re-opened and re-negotiated if it were to be made consistent with an expanded Fund jurisdiction. History tells us that this will likely be a long and involved process, particularly given the existence of a number of other unresolved issues in the GATS. I would appreciate the staff's view on how the conflict would be dealt with in the period until the two jurisdictions are brought into line (assuming they can be) and how our decisions at this point in time can be shaped so as to minimize the scope for conflict.

With respect to the degree to which the structure of proposed controls would be viewed differently under an approval process, I accept the staff's suggestion that controls that are price-based and transparent should be viewed more favorably than direct quantitative limitations or measures involving a high degree of administrative discretion. However, I am unclear on how we could effectively differentiate between "better" and "more poorly-designed" restrictions? While one might have views on the most-efficient structure of a measure, presumably, the measure would be approved based on the circumstances that gave rise to it.

On the approval of prudential measures, I would suggest that a first step in assessing the extent of the Fund's involvement in this area is to outline for Directors the existing institutional architecture in this area and to describe its various modes of operation. It is only against this backdrop that we can prudently come to a decision on the appropriate role for the Fund in this area. I would ask the staff to prepare such material.

In paragraph 46, the staff suggests that one example of a restriction on capital movements that could be approved for reasons of weakness in markets, instruments, and institutions is constraints on the ability of nonresidents to transact in a new market or instrument locally on the same footing as residents. I fail to see the advantage of permitting such a restriction as the participation of nonresidents would broaden the market and provide it with additional financial resources. Perhaps the nature of such an exemption, or the conditions under which it could be instituted, need to be more narrowly circumscribed.

Finally, the issue of approval policy cannot be divorced from the question of sanctions. That is, Fund disapproval of a restriction is of limited impact if the Fund has no sanctions to impose beyond those which can be applied to program countries. I would like to request that the staff prepare a description of options for Fund sanctions (both existing measures and possibilities), drawing on, and in comparison to, the sanctions available under other international arrangements.

As regards financing, I note that there are a range of views on the impact of capital account liberalization on demand for the Fund's resources. My sense is that, over time, liberalization, and the discipline it brings, will lead to a decrease in the demand for Fund resources. However, over the shorter term, the net impact is more ambiguous. I therefore believe it appropriate for the Fund to have in place adequate safeguards for its resources.

Since it is always best to err on the side of caution in this regard, I support the maintenance of some variation of the injunction against Fund financing of "large or sustained" capital outflows. I do accept the need to use more evenhanded language, such as "payments imbalances" rather than "capital outflows" as well as the refinement to reflect the need to protect "undue" use of the Fund's resources. I presume that this would encompass "sustained" use and express the intent that the "level" of use under these circumstances is closely tied to the extent of the member's efforts to address the underlying structural imbalances in as rapid a manner as is possible.

Mr. Sivaraman made the following statement:

After the complicated paper on "Capital Movements Under an Amendment of the Articles," it is refreshing to read the staff paper SM/97/173 on "Transitional Arrangements Approval Policy and Financing under an Amendment."

The Fund has admirably dealt with current account convertibility issues and have persuaded members to adopt Article VIII. The fact that 131 members have already accepted Article VIII is a standing testimony to the accommodative approach adopted by the Fund and flexibility provided by the Articles. A similar approach to capital account convertibility would be needed to make our goal achievable.

This paper has succinctly brought out issues, the nature of the problems and suggested course of action. It is appreciable that the staff has recognized that movements under capital account have more complexities than current account and that any arrangement that is sought to be made through an amendment to the Articles will have to recognize the differing conditions of member countries and their ability to move on the path of capital account liberalization. It is our firm belief that capital account convertibility is at the end of the tunnel of reforms. Hence, any back track from capital account convertibility after accepting the same would raise serious questions about the entire gamut of reform process and this would also jeopardize the other elements which are already in place. Hence, as indicated in earlier meetings, a more cautious approach is required in moving toward capital account convertibility. Even while making a cautious approach, one has to take into account a number of exogenous developments, the effect of which could be reduced if we have a flexible approach.

My comments on the various issues raised in the papers are as follows.

The general principles that should govern a move toward capital account convertibility could be:

(a) a member should not introduce new restrictions without passing through the approval mechanism as is finally agreed to;

(b) like in current account convertibility, members should have the right to accept the obligations of the new Article by that time when they are ready to accept them without deleterious consequences to the economy affecting macroeconomic stability.

(c) approval policies should be flexible, recognizing the multifarious problems of members who are in different stages of economic development and would require to be treated with sympathy and understanding of their politico economic problems.

In regard to temporary approval policies, as we are not likely to have any permanent approvals, I wonder whether we should use the phrase 'temporary approval policies' or we could rephrase it as 'approval of temporary restrictions' as in most cases they are unlikely to be continued indefinitely by any country which has accepted the move toward capital account convertibility. The approval policies should be designed to accommodate: (a) restrictions on capital outflows for balance of payments reasons including restrictions imposed on an emergency basis—restrictions for prudential and market purposes could come in this category; (b) restrictions required for macroeconomic stabilization purposes; and (c) restrictions based on national and international security considerations.

As to implications, the current Fund-Member relationship in regard to failure to meet the obligations under Article VIII can be justifiably continued in the case of capital account transactions also. It is however expected that such failures would come to the notice of the Executive Board while considering reports of Article IV consultations or at the time of negotiating new arrangements with the Fund.

As to obligations under other international agreements, the Fund has generally accepted arrangements under different bilateral, regional and multilateral agreements having even implications for current account convertibility under Article VIII, similar arrangements need to be worked out in the case of capital account convertibility. To the extent possible, amendment to the Articles should relate to the Fund's jurisdiction over capital movements and avoid conflict with the existing provisions of WTO, GATS and what would be in the proposed Multilateral Agreement on Investment (MAI). It should be possible to come to an agreement in avoiding contradictory provisions in the MAI and the proposed amendment to the Articles of Agreement of the Fund. As the provisions under Article XI of GATS has already taken cognizance of the fact that the Fund could request members to impose controls and Article XII allows a Member to adopt restrictions for serious balance of payments reasons, whether an amendment of GATS is required as mentioned in para 11 is not clear. (Article XI of GATS refers only to the "Articles of the Fund." Articles of the Fund could also refer to amended Articles.)

Concerning the unenforceability of contracts, in the context of the proposed amendment seeking to bring international capital movements within the jurisdiction of the Fund, an issue arises whether the existing Fund provision (Article VIII, Section 2(b)) relating to 'exchange controls' would need to be clarified—whether exchange controls would be limited to capital payments and transfers or would also embrace underlying capital transactions and if so, which transactions. A clarification would be required to bridge the gap in the differing interpretations of this provision. ("Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member").

If Section 2(b) of Article VIII is deleted as is one of the suggestions, would it not be tantamount to diluting the authority of the Fund which could approve the exchange controls in order to protect the macroeconomic stability of a country or for other valid reasons concerning balance of payments. Problems would also arise in the case of restrictions imposed on security considerations. Of course, one advantage in deleting the clause would be the courts will have to decide on the enforceability of exchange contracts on the basis of the date on which the contract came into force. If a contract had come into force when the exchange control regulations were not in place, could it be enforced. Would there be a situation of impossibility of performance? Or would the courts give the benefit to the parties that the contract had come into force prior to the restrictions. Staff may kindly clarify.

Regarding a signaling effect, unlike in the case of current account convertibility where the impact on macroeconomic variables is not that severe, volatile capital movements can have immediate and serious repercussions on the economy. The Fund staff should therefore advise the members concerned as to the appropriate time of signaling to international community of the members' intention to remove restrictions on capital account. As many countries have sequenced reforms in the financial and external sectors, and liberalized capital account in a phased manner, the signaling is more or less automatic. The market should absorb these phased changes hopefully without jerky reactions.

Transitional arrangements should not be rigid and allow enough room for members to order their progress toward capital account convertibility at their pace. A member may notify the Fund of the existing restrictions that they have on capital movements and inform the Fund of their intention to continue with the restrictions. Under the grand fathering clause, any adaptation of the existing restrictions could be notified to the Fund without requirement of Fund approval. However, if any new restrictions are imposed which further tighten capital movements, they could pursue the approval policies. As time and again Governors have called for strengthening of surveillance system, and with the move toward capital account convertibility, this window is open to the Fund staff to have intensive consultation with members who have restrictions on capital movements regarding their justification and continuance in the prevailing circumstances of each country. The Fund staff has usually been unhesitant and candid in rendering advice on this matter. The Fund staff should also examine whether the statistical reporting systems required to keep track of capital movements are properly in place before a member wants to withdraw restrictions. In regard to the Fund making representation to a member to remove restrictions as the Fund perceives that time is opportune for the member to do so, this could be done during Article IV consultations so that members' responses could be adequately obtained and placed before the Board.

I am not in favor of the Fund declaring a member ineligible to use the Fund's resources if the member wants to maintain the restrictions for genuine reasons which the member could explain to the Fund as this will be contrary to the main principle that a member could adopt capital account convertibility at a time they consider appropriate.

On approval policies, I am skeptical as to whether markets would always react positively in the short term after knowing that the Fund was supporting a member in regard to implementation of credible policies to achieve macroeconomic stability. The country would in any case have been exposed to a crisis with reaction in the market taking place swiftly and suddenly as it happened in Mexico and now recently in Thailand, although prompt action by the authorities prevented the deepening of the crisis and also the contagion. Therefore, not much reliance can be placed on the market mechanism correcting itself merely on the fact that the Fund would be supporting a government. The Fund and the member country will have to be prepared for a crisis period, however short it may be, till credibility is restored. It is impossible to imagine a crisis situation when the authorities would not impose any restriction hoping the market to correct it. The Fund therefore may have to recognize the reality that there will be a lapse of time before the authorities' action could take effect to restore market confidence with or without Fund support.

In all restrictions on capital outflows, nondiscrimination amongst Fund members should be emphasized. As regards the period of restriction, it may be difficult to specify it as members, in their own interest, would adopt such measures which would not give wrong signals to the market. As capital account transactions have wider implications for macroeconomic stability, the criteria for approvals have to be broader than in the case of current account transactions *inter alia* taking into account a member's overall economic situation, the state of its financial and capital markets, capability of the central bank to control events both in the monetary and external sectors and last but not least, the country's ability to attract private flows.

The paper has also recognized the fact that approval policies should allow for lapse of time approval for a limited period (say 30 days) upon notification by the member soon after (say within 10 days) the imposition of restriction on an emergency basis. The approvals could require a representation by the members concerned that the controls are temporary and that the restrictions are nondiscriminatory and needed for balance of payments purposes. The Board could also have the option to extend the emergency approval for a further period provided that in its opinion, the authorities were cooperating with the Fund to find a solution to their balance of payments difficulties on a report from the Managing Director. The emergency restrictions could be approved on a lapse of time basis and put up to the Board for discussion. I am not sure whether a 30-day period in a major economic crisis can be considered sufficient for making adjustment measures. In a democratic process, certain things take time for adjustment and members cannot be forced to bypass their normal legislative practices. It is not clear as to what would be the consequences if a country had to prolong the restrictions if it was not in a position, despite best efforts, to stop the slide.

In regard to capital inflows, while physical restrictions are unlikely, countries may resort to higher CRR requirements or tax policies that may tend to inhibit inflows. These are most likely in the case of those countries whose capacity to intervene and sterilize is limited due to lack of instruments or insufficient depth of the financial market. The approval criteria should consider all these aspects.

It is presumed that restrictions would already be in force to permit institutions and market to develop in a country. It is unlikely that countries would impose new restrictions for this purpose now. Discrimination between residents and nonresidents in the financial market would of course require to be justified if they were not in existence before.

Prudential restrictions are normally imposed by the central banks in order to prevent profligacy on the part of the foreign exchange dealers over-exposing their institutions with final consequences on the balance of payments. If a country has already the appropriate regulations in place, prudential norms for governing the foreign exchange operations may not be necessary. However, in the changing circumstances, and the variety and type of instruments that are coming into play in the market, even countries which have no restriction on capital movements may be forced to enforce certain prudential norms. These will have to be fully taken into account while deciding on restriction for prudential purposes. It is better to leave this to the discretion of central banks.

As regards measures introduced for national and international security purposes, members could notify the Fund. I doubt whether the Fund would have the means to examine whether they were justified or not.

In regard to financial support from the Fund, it is necessary for the Fund to make it known to the members that if there is a capital outflow beyond the control of the member to prevent through recognized measures, the Fund would come to their rescue. If members subscribe to an amendment to the Articles of the Fund making capital account convertibility a purpose of the Fund, then it is reasonable for them to expect that the Fund would come to their rescue. As, even now, it is very difficult to distinguish at times of crisis whether the outflow is on account of capital movements or current account transactions, it would be appropriate if Article VI is altered to allow the use of Fund's resources even in the case of large capital outflows as it has been remarked Article VI has not inhibited the Fund in giving support in the context of large capital outflows. We could perhaps delete the word "large" and retain only "sustained" in Article VI. This would give legitimacy to Fund operations in case of large outflows. To what extent Fund support should be extended can always be determined under Article V(4).

The future demand on Fund's resources to meet a crisis of payments in a member country who has liberalized capital movements cannot be easily determined. It can reasonably be expected that both members and the Fund would be alive to any signals of an impending problem and take prompt corrective action to prevent a crisis and the need for large Fund support. Fund's responsibility to watch for signals is not going to be any less than that of member countries. Surveillance mechanism has to be strengthened and our Resident Offices have to be constantly alert to any downside movement in the financial markets of the countries where they are located. In the eventuality of an unavoidable crisis, Fund's support will have to be to the extent to which the country's balance can be restored to normalcy. Swift action by both will reduce the draft on Fund's resources. Fund could suggest restrictive measures to arrest the slide.

Turning to the treatment of inward direct investment, at the beginning of the paper (SM/97/168), a question has been raised as to how the Fund may define inward direct investment and ensure that the measures imposed on such transactions remain outside the jurisdiction of the Fund. However, the definition of inward direct investment proposed to be adopted in the Articles has not been given. The definition contained in the OECD definition of capital movements could be sufficient for our present purposes. It is however seen that some of the elements of the OECD definition such as long-term loan of maturity of five years or more is proposed to be brought within the purview of Fund's Articles, in which case, defining inward direct investment is going to be problematic. How does the staff propose to treat financial transactions relating to inward direct investments when the underlying transactions have been permitted. For example, if a country has permitted acquisition of real estate or investment in real estate by nonresidents, it would mean that they have also permitted the movement of funds for the purpose. Is it the intention of the staff to keep these financial transactions relating to underlying transactions also outside the purview of the Fund? In the case of long-term loans at times there could be provisions in the agreement for conversion into equity. How would these transactions be treated under the proposed Fund provisions?

It is also proposed that the Fund would have within its jurisdiction inward investments where the participation is less than 10 percent. This would involve ascertaining details of transactions as to how many were in the category of 10 percent or less? If the intention is to keep all inward direct investments outside the purview of the Fund it is better not to make such a fine distinction. This view is valid even from cost/benefit angle. The Fund could have within its jurisdiction those financial transactions pertaining to direct inward investment that have been permitted by a country without a distinction, if it does not conflict with the jurisdiction of WTO.

There could also be instances where a country allows such inward direct investments for purchase of real estate subject to local laws where power to regulate such investments might have been vested in the constituent units of the Federation. This fact will have to be recognized in the proposed Amendment of the Articles. Our attention should not get diverted with such issues as in para 36 as there is unlikely to be a situation where investments in local assets have been permitted without a right to conduct a particular business. Foreigners' right of establishment is recognized not only in bilateral and multilateral agreements but also in tax laws. The Fund could do well to keep away from such complications.

In the end, I would suggest that the staff could now prepare a paper bringing out the conceptual framework that has emerged in the Board discussions so far and what further action is needed.

Mr. Wijnholds made the following statement:

While our previous discussion on concepts was necessarily of a highly technical nature, the current set of papers have more economic content. As such, they provide us with a clearer picture of how an expanded jurisdiction would work in practice.

In regard to transitional arrangements and approval policies, as well as the link with other reforms, the amendment enables the Fund to assist and encourage members in achieving capital account liberalization. In performing this role, the current framework of transitional arrangements and approval policies continues to be of value. Therefore, I would agree with staff to stick to the basic principles we apply under our current jurisdiction (e.g. 'grand-fathering', 'no backsliding', etc.).

But the papers also make clear that these principles will have to be adjusted on various counts for our new jurisdiction. Even more so than with the removal of exchange restrictions on current transactions, the process of capital account liberalization should ideally be part of a more general reform agenda. The recent Article IV consultation with India provided a very good example of how capital account liberalization should be 'dovetailed' with other measures. I would agree therefore, to broaden the language contained in Article XIV.2 about the conditions under which members would be expected to remove capital controls. In fact, I would go further than to refer only to the need for a healthy financial sector, as suggested by the staff. A crucial requirement for the sound intermediation of inflows (and as a result for the sustainability of the balance of payments) is that investment decisions are made on the basis of undistorted incentives. This requires an environment of well-functioning markets and appropriate price signals. I think the language on our transitional arrangements should reflect this. Similarly, a rigid time limit for the removal of restrictions under the approval policies might sometimes provide insufficient room for establishing an environment conducive to capital account liberalization.

The 'integrated approach' referred to above is the first-best way to manage international capital movements. In some cases, however, restrictions on capital inflows might constitute a 'second-best' response to problems of macroeconomic management. Whereas restrictions on current account transactions should nearly always be denounced for their distortive effects, some restrictions on capital inflows can be considered in a more benign way. This should be reflected in our approval policies.

In addition, there might be situations in which new restrictions come with new markets. The staff leaves open the possibility to approve such restrictions for members that have accepted the obligations of (the new) Article VI. I do not doubt that a provision would have to be made for these situations. But I am somewhat concerned that an overly lenient approval policy could distort the signaling effect of 'Article VI status'. Therefore, I would find it appropriate to confine the approval of these restrictions to the transitional arrangements only.

There should be room, however, to maintain restrictions under Article VI if these are clearly validated for prudential reasons. But the staff notes that some of these discriminatory practices constitute a 'statement area' between prudential regulations and capital account controls. Here too, I wonder whether it might not be appropriate to be more strict under Article VI than under the transitional arrangements.

In regard to emergency approval, given the nature of modern-day capital markets, there can be times when a country will need to react rapidly to a sudden outflow of capital. I can go along with the procedure for emergency approval proposed by the staff, with two comments.

First, as I noted in one of our earlier discussions, it is clear that members who need to avail themselves of such emergency controls have an imminent problem. It would therefore be appropriate to expect some kind of follow-up discussion after approving these controls. In some cases this will happen automatically, as authorities might want to approach the Fund for assistance. Second, I would hesitate to extend the emergency approval policy to controls on capital inflows. The problems posed by such flows build up gradually, rather than erupt suddenly. This would leave ample opportunity to consult with the Fund. During these consultations, the member and the Fund will have an opportunity to look at alternative measures (e.g., more exchange flexibility, fiscal consolidation, improved supervision), as capital controls are generally only a second-best response.

As to financing under an amendment, the discussion about whether the use of Fund resources will go up or down as a result of capital account liberalization is interesting but inconclusive in my view. In this regard it is important to maintain the principle that Fund credit should play a mainly catalytic role. Clearly the Fund cannot on its own deal with large-scale financial crises. It should nevertheless be recognized that capital flows liberalization can lead to a change in the nature of balance of payments problems.

As regards the question of what to do with Article VI, no easy answer presents itself either. Indeed, the size and speed of capital flows have induced us to take a closer look at our financing policies, especially in the aftermath of the Mexico crisis. In fact, one of the conclusions from these discussions is that a bail-out expectation can induce irresponsible behavior, especially on the creditor side. Therefore, I attach particular importance to retaining a strong "no bail-out message" in the Articles. Especially at a time when we are expanding our jurisdiction to promote capital liberalization, it would provide the wrong signal to remove this message from the Articles. This would also contrast with the spirit of the G10-report on sovereign liquidity crises. I would also note that the current provision has not proven restrictive in practice, and that it does not impose a general prohibition on large purchases. In that light there is some attraction to maintaining Article VI in its present form. I would certainly not favor deleting this article altogether. It has been suggested that such a provision is not really essential since Article V, Section 3(a) already addresses the matter of safeguarding the temporary use of the Fund's resources. However, just as many of us prefer two locks on our door rather than one, I would favor some form of additional safeguard in the area of capital flows when it comes to protecting the scarce resources of the Fund.

In previous Board discussions, a consensus emerged that transactions in the area of inward direct investment should be excluded from the Fund's jurisdiction. Most Directors also agreed that we should strive to define our jurisdiction on the basis of objective criteria, to the extent possible. This will prevent our institution from getting into cumbersome and subjective deliberations on the purposes and effects of certain regulations.

Given these considerations, the staff has tried to carve out foreign direct investment (FDI) on the basis of objective criteria, and concluded that it cannot be done completely. I personally had some sympathy for one of the other options laid out in the paper (in paragraph 18). This option entails carving out what can be carved out on the basis of objective criteria, and leave the rest to the approval policies. This would seem more straightforward. Under this approach, restrictions in the staff's 'third category' would fall in the Fund's jurisdiction, and would be approved to the extent that they apply to certain sensitive industries deemed crucial to the national interest.

The staff proposal seems somewhat more complex to me. But as I noted above, I sympathize with the considerations that gave rise to their proposal, and I am willing to consider this approach. I would note however, that the proposed carve out of restrictions on aggregate foreign ownership seems to go beyond what is necessary. Countries only use such measures to protect national interests in a limited set of strategic industries (e.g. defense, aviation). But, the general carve out proposed by the staff goes beyond this. At the least, I would think that the Fund should be able to prevent the use of this provision for more than just some 'strategic industries'.

It would seem logical to carve out those financial instruments, such as derivatives, that could give rise to a transaction which falls outside of our jurisdiction. Other financial instruments, including those whose value is linked to assets outside our jurisdiction, should be included.

The staff report raises two issues that will have to be more extensively discussed in our September meeting. I would like to make some initial comments.

Clearly, a well-designed amendment will require a comparison with members' obligations under other international agreements. At the same time, I think that our primary concern should be to design an amendment for our own purposes.

Moreover, it seems to me that the intentions or scope of other existing international treaties is quite different than ours. For this reason, I am quite confident that issues of overlap or conflicting obligations can be readily resolved. For instance, negotiations in the MAI seem to lead toward a clear stipulation that Fund-approved restrictions will not be challenged. The GATS primarily covers current account transactions, and the services on each country's 'schedule' constitutes an even more limited set of transactions. Furthermore, the GATS already defers to the Fund under its current jurisdiction, and I would expect that if our members agree to extend the Fund's jurisdiction, the same authorities will not have a problem with adjusting the GATS accordingly.

The unenforceability of contracts is a particularly complex issue. We will have to revisit the possibility of extending the unenforceability of contracts in the next discussion on the amendment, and in the upcoming discussion on lending into arrears. It is somewhat worrisome to see how the provision under Article VIII.2.b can not be uniformly applied. For the time being, let me just note that we might well need this provision to complement an extension of our policy on lending to arrears.

Mr. Shaalan made the following statement:

Let me first affirm that my views at this stage remain of a preliminary nature and are confined to the broad principles of the proposed amendment without touching on all the issues covered in the staff paper. Once we have established the broad outlines, it will be easier to discuss the details of the amendment's provisions.

In regard to treatment of inward direct investment, I see no problem with the two preliminary points noted in the introduction to the staff paper, namely that:

(a) the measures to be excluded from the Fund's jurisdiction would only be those that are imposed on the making of inward direct investments, and that therefore, the Fund would have jurisdiction over measures imposed on the liquidation of investments that were not restricted by the member and on the repatriation of proceeds therefrom.

(b) the measures that may be imposed on the making of inward direct investments and that would therefore lie outside the Fund's jurisdiction would include not only restrictions on the right of foreigners or nonresidents to acquire local assets from nationals or residents of the host country, but also restrictions on the right of foreigners to acquire such assets from other foreigners. In this connection, I believe the staff is also correct to point out that under the proposed amendment restrictions on inward direct investment by foreigners as a group and by nationals of particular countries would fall outside the Fund's jurisdiction.

We also can accept in principle the staff's classification of three categories of restrictions that would fall under the definition of inward direct investment and that should be excluded from Fund jurisdiction, namely:

(a) restrictions imposed on the acquisition of specific capital assets (real estate and nonfinancial intangible assets).

(b) measures imposed on ownership or control of enterprises or other forms of investment in enterprises. While we could consider defining in the amendment what percentage of ownership would constitute "effective influence," we can also foresee possible objections to a precise definition since, as we know , there is in fact no universally agreed upon definition, and it seems likely that countries would want to be able to define "effective influence" for themselves.

(c) measures intended to limit or exclude participation of foreigners in certain enterprises whose activities are regarded as necessary to the preservation of the country's essential interests. This would include restrictions on individual participation of less than what would constitute "effective influence" and restrictions on aggregate foreign participation regardless of amount.

On the structure of the amendment, we see merit in the staff's proposed approach for the first two categories of restrictions, namely to exclude from Fund jurisdiction, in the Articles, restrictions on the acquisition of specific capital assets and on the ownership and control of enterprises and other forms of investment in enterprises. We would prefer to reserve a definitive judgment on the proposal's treatment of the third category at this point. In view of the complexities involved, it seems that we should give serious consideration to an outright exclusion from Fund jurisdiction in the Articles, as proposed for the first two categories. In our view this would be consistent with members' sovereign rights to invoke their "compelling national interest," as they define it, in the imposition of such restrictions and it would avoid putting the Fund in the position of judging the validity of a member's determination of its own national interest (which in any case it is not competent to do). Clearly, the prerogative of defining a country's compelling national interest should remain solidly with the member concerned. Accordingly our view may in fact be closer to the third approach presented in the paper, which provides members with the ability to regulate the making of inward direct investments without Fund involvement.

Finally, on the question of restrictions imposed on the activities of companies in which foreign participation is allowed by the member, our view is that this lies beyond the Fund's jurisdiction.

On transitional arrangements, approval policies and financing under an amendment, generally, we have no problem with the proposal by the staff to base the design of transitional arrangements on the same principles on which the Fund's current policies are based. Therefore we can agree to the principles of: (i) no backsliding, (ii) clear signaling, and (iii) flexibility in approval policies.

It also appears reasonable to apply the existing interpretation of transitional provisions to the Fund's proposed extended jurisdiction. This would mean that transitional provisions would permit a member to relax or intensify an existing capital account restriction while the introduction of a new restriction would require approval by the Fund. We would also stress that the amendment should state that the Fund, in its promotion of capital account liberalization by members, should pay due consideration to the specific circumstances of each member in recommending the pace and sequencing of liberalization measures. A Board decision would then set forth Fund policy in this regard and would be expected to contain what the Fund considers general prerequisites for sustainable capital account liberalization. This decision would serve to guide members and the staff in their consideration of the appropriate timing of a country's acceptance of the obligations. In this connection, we would support the staff's suggestion, to broaden the relevant Articles dealing with the conditions under which a member shall withdraw restrictions maintained under transitional arrangements to include the development of the member's financial system. This would serve to emphasize the importance of appropriate sequencing of capital account liberalization with institutional and structural reforms in the financial sector.

We can generally agree with the staff suggestions on the criteria for the temporary approvals of restrictions for macroeconomic and balance of payments reasons with regard to capital inflows and outflows. We can also see the advisability of allowing for an emergency approval procedure for controls on inflows to the extent that they come under Fund jurisdiction, as well as outflows. We do not, however, see a compelling need for the Fund to prioritize the restrictions that could be approved for balance of payments reasons. The Fund can always advise on what it views as the most appropriate measures under the circumstances of each case, but once the balance of payments justification as defined by the Articles is accepted as legitimate, the judgment should be left to the authorities.

We have some concern with regard to the second area suggested by the staff for coverage by the approval policy, namely market and institutional evolution. While the staff expect resort to temporary restrictions based on the need to develop or strengthen institutions to be limited, we are, nonetheless, concerned that the existence of this provision may undermine the important principle of avoiding premature acceptance of capital account obligations before the proper market and institutional arrangements are in place. The availability of temporary approval of restrictions to allow a member to develop the necessary supporting institutions may weaken the Fund's admonitions against premature capital account liberalization, and could encourage members and Fund staff to hasten acceptance since members could deal with institutional development through temporary approvals. The same concerns could be voiced with regard to the possibility of approval of restrictions on the grounds that there are institutional constraints on the effectiveness of monetary instruments, which is one example provided by the staff of possible prudential reasons for approving a restriction.

Finally, on the implications of the proposed amendment for Fund financing, the staff paper provides an excellent analysis of the important financing issues that flow from a broadening the Fund's jurisdiction. It would appear almost contradictory for the Fund on the one hand to promote capital account convertibility and bring it under its jurisdiction and then not to provide financing to give members the necessary assurance through the provision of Fund resources. I would agree with the staff that while increased access to capital markets would generally tend to reduce the need for Fund financing, it is likely that the ramifications of sudden shifts in market sentiment on capital flows could also mean potentially larger financing requirements from the Fund in individual cases and at particular times. We believe the Fund should be prepared to assist members in such cases, keeping in mind the principle of uniformity of treatment of all members, the effect on the Fund's liquidity position and the capacity to provide financing to other members, as well as the need to adequately safeguard Fund resources. In this connection, an explicit provision allowing the Fund to include the imposition of controls on capital outflows in its conditionality may be desirable. As to the appropriateness of maintaining the injunction against financing "large or sustained" capital outflows, we note the staff's arguments for and against, and can at this time agree either to its modification or to its removal altogether.

Mr. O'Donnell and Mr. Kell submitted the following statement:

I would like to thank the staff for two more very helpful papers. Like the earlier papers, they bring home the complexity of the task we face in extending the Fund's jurisdiction to the Capital Account. Nevertheless, I would stress again that we must not lose sight of the wood for the trees. The goal of agreeing on specific recommendations on key elements of an amendment in time for the Annual Meetings is challenging, but feasible. We should remember that many of the difficult issues that have come to light in our recent discussions can be left for the Commentary that accompanies the Articles, and therefore considered over a longer time scale. "Keep it simple" should remain our motto. In order to help this process, this statement covers the issues in some detail in the hope that the Board discussion can concentrate on the big picture.

In regard to the treatment of inward direct investment, the staff has done a good job in this paper of setting out the issues and offering some very sensible suggestions on how we should proceed.

Experience in the Multilateral Agreement on Investment negotiations suggests that agreeing on definitions and distinctions, on which hard obligations will rest, will not be easy. With this in mind, I hope that we can avoid re-opening much of the debate that has already taken place at the OECD. I understand, for example, that intellectual property rights are causing difficulties for the MAI. We should seek to avoid opening a second front at the Fund.

There are obvious advantages in ensuring consistency between the amended Articles and other international agreements. At the same time, we should remember that there may be legitimate reasons for differences in treatment between agreements. The MAI, for example, aims at investment protection first and liberalization second, whereas the Fund's objective should essentially be one of liberalization. I look forward to the staff addressing these issues in their next paper.

I broadly agree with the staff's three suggested categories of restrictions on inward direct investment. However, I was unclear whether the assets mentioned in paragraph 12 (concerning the first category of restrictions) constituted an exhaustive list, or an illustrative list. I would be grateful if the staff could clarify their suggested approach.

Concerning methodology, I agree with the staff that the best approach is to combine elements of the different options outlined in paragraphs 18-23. The suggested approach for the third category of restrictions is, inevitably, not as elegant as we might like; but I think it strikes the right balance between recognizing legitimate sovereignty concerns while offering some protection against abuse.

Finally, not withstanding the proposed exclusion of inward direct investment from the Fund's jurisdiction, I strongly agree with the staff that members should be dissuaded from restricting inward direct investment for macroeconomic management reasons (paragraph 44 of SM/97/173).

Turning to transitional arrangements, approval policies and financing under an amendment, I broadly agree with the three principles which the staff suggest should guide the design of transitional arrangements and approval policies. I would, however, raise one point about the "No Backsliding" principle. While I can see the merits of this approach, I think we need to be aware of the possible adverse affects on members' willingness to give up restrictions. We do not want to reinforce the fear that once a restriction has been abolished it cannot be reimposed under any circumstances. Rather, we should emphasize that the re-imposition of controls is possible, albeit with Fund approval. In any case, backsliding without very strong justification will be costly for the country itself in terms of reduced credibility. So we may be able to consider a less draconian principle.

I agree that transitional arrangements should be generous, and would strongly endorse the idea that members should, through appropriate reforms (especially to the financial sector), eliminate their reliance on restrictions imposed for macroeconomic and balance of payments reasons before signing up to the capital account equivalent of Article VIII. The Fund has a crucial role to play here. Capital account liberalization can best be encouraged in the context of a continuing dialogue with economic policy makers, through surveillance, and the provision of policy and technical advice. I would also support the staff's suggestion in paragraph 22 (if I have interpreted it correctly) for a full "audit" of a member's financial system before recommending acceptance of the obligations of capital account convertibility.

Needless to say, generous transitional arrangements should not be used as an excuse to delay liberalization. The carrot of access to private capital should be sufficient in itself, but I would support the staff's suggestion of also having a stick in the form of retaining the right, in extremis, to declare a member ineligible to use Fund resources if that member persists in maintaining restrictions after the Fund has made representations that conditions are favorable for liberalization.

On approval policies, I have two general points to make on the (re)imposition of controls. First, if liberalization is well managed then the circumstances in which in which capital controls could usefully be re-introduced should become increasingly rare. As financial markets evolve, controls—particularly those on outflows—will become less effective in the longer run. And where controls have some effect, prolonged use will be distortionary. They certainly cannot contain fundamental imbalances. In sophisticated financial markets, it is doubtful whether capital controls would be effective even in the short run.

Second, restrictions on outflows can in themselves reduce capital inflows (to the extent that investors are worried about the restricting country's investment regime and about repatriation of funds in particular) which would limit any beneficial effects on the balance of payments.

Concerning temporary approval, I agree with the staff that the criteria for approving exchange restrictions—namely, clear balance of payment/ macro-management reasons; temporary in nature; and nondiscriminatory in application— should be applied to restrictions on capital movements. I was also attracted, in principle, to the suggestion that an additional criterion (for restrictions on outflows) should take account of the types of transactions that are restricted, to minimize disruptions to international financial relations. But I would be interested in the staff's views on the extent to which such a criterion could be made operational.

Similarly, I liked the suggestion in paragraph 43 that approval criteria for inflows should reflect a preference for price-based and transparent controls. Is there any reason why such a criterion could not equally be applied to restrictions on outflows?

It is sensible to allow for special approval policies for emergencies, for both outflows and inflows. I can support the staff's suggestions in paragraph 33.

As to market and institutional evolution, I am sympathetic to the point that countries with less developed financial systems should not be unduly penalized by an amendment to the Articles, and that this provides justification for consideration of approvals of restrictions for market and institutional evolution reasons. Nevertheless, I have a couple of concerns about this section of the paper:

First, I wonder whether there is a need for a separate set of approval policies related to market and institutional evolution. Presumably, restrictions for these reasons could be adequately covered either under transitional provisions, or by the provisions for prudential restrictions;

Second, it is easier to understand the case for restrictions on outflows—to husband domestic savings and/or because of inadequate institutional development—than it is to appreciate why nonresidents should be prevented from participating in local markets. I would have thought that allowing foreign participation in local markets would usually help the development of markets and instruments, e.g. by increasing liquidity and importing technology and know-how.

I would be grateful for the staff's comments.

On the issue of prudential restrictions, I was a little disappointed that the staff did not discuss more explicitly the option of taking the carve-out approach, as opposed to the approval policy route, for dealing with prudential restrictions. I can see that the latter approach does offer greater flexibility, which is particularly valuable in the context of rapidly evolving financial markets, and should provide greater protection against abuse. Nevertheless, the carve out approach may avoid difficult conflicts over sovereignty and regulators' rights to regulate. At the very least, I think the staff should do more to assuage possible concerns in this regard.

On the related issue of measures imposed for monetary policy reasons, the preliminary view of my authorities is that a carve out would probably not be appropriate or necessary. (I have, however, raised with the staff the specific issue of whether discrimination between debt instruments of different governments for the purposes of collateral for repo operations would count as a restriction.) I note that the general issue of a monetary policy carve out is being discussed in the MAI where there is some support for exemption from key nondiscrimination obligations. However, providing an exemption implies that central banks might want to discriminate on arbitrary and nonobjective grounds. So we may need to consider this issue more fully.

The staff suggest extending its existing approach for restrictions imposed for national or international security reasons. While I see the need for this, I would appreciate comments from the staff on how to minimize the scope for abuse of this procedure.

As regards implications for Fund resources, I agree with the staff that the net effect of capital account liberalization on the demand for Fund resources is difficult to predict. But we should cross that bridge when we come to it. We should not lose sight of the fact that amending the Fund's Articles will essentially be bringing the de jure into line with the de facto; there should be no presumption that changing the Fund's legal jurisdiction should imply extra Fund resources.

The Fund's efforts should be concentrated on minimizing the risk of large and sudden capital outflows occurring, through surveillance and the provision of sound policy advice. Nevertheless, we have to be prepared for large capital outflows, and the possibility that in some cases the balance of considerations may justify Fund financing. I agree with the staff such a commitment could give some members the confidence to liberalize their capital accounts. But we must always bear in mind the wider consequences of Fund financing in these circumstances, in terms of the possible moral hazard effects on investors and authorities. The Fund should not and could not ever hope to take on the role of underpinning private international capital flows, or of financing all fluctuations in them. Borrowers and investors should be forced to face up fully to the risks involved.

In this context, giving the Fund the option of requesting controls on capital outflows may well be helpful, although all my reservations about the effectiveness and effects of imposing such controls would apply here just as if they were introduced by the country itself.

Finally, on the issue of safeguards for Fund resources, I have some sympathy for the view in the staff paper that reliance on the requirements on the provisions of Article V, and associated Fund policies, could be sufficient; and that consequently Article VI could be redundant. I certainly see presentational attractions in deleting Articles—provided this carries no risks—at the same time as amending or adding to the Articles. But the question of safeguards for Fund resources is clearly a sensitive one, where caution may be important. On this and other issues raised in Directors' statements I look forward to hearing the views of Directors and the staff.

Mr. Taylor made the following statement:

As regards transitional arrangements, approval policies and financing under an amendment, it is important to ensure that transitional arrangements allow countries to proceed with capital account liberalization at a pace that is consistent with the implementation of necessary economic reforms while providing incentives to encourage reform. Approval policies should ensure that restrictions imposed for reasons other than macroeconomic and balance of payments concerns are excluded from the Fund's jurisdiction. Once liberalization initiatives have been undertaken, approval policies need to allow countries to impose capital account restrictions under carefully defined circumstances and in a way that does not completely reverse the process of liberalization.

The principles suggested by the staff for design of transitional arrangements and approval policies, that is: no backsliding; clear signaling; and flexibility in approval policies seem to adequately capture the attributes necessary in the design of transitional provisions and approval policies.

As to transitional arrangements, I welcome the staff's proposal to adopt an approach similar to that used for current account liberalization. I also agree with the suggestion in paragraph 23 of SM/97/173 that the conditions under which a member shall withdraw restrictions be broadened to include a development in the member's financial system as well as its balance of payments position. Past experience highlights the fact that the strength of a member's financial sector is a key factor in its ability to sustain capital account convertibility.

I am inclined to the view that a member availing itself of transitional arrangements should not be allowed to introduce new restrictions without Fund approval, as this may reduce a member's willingness to graduate from the transitional arrangement, and is contrary to the principle of no backsliding. However, I would note that this view is not shared by one of my authorities who considers that members who seek protection under Article XIV should also be allowed to introduce new restrictions without the approval of the Fund in recognition of the rapid changes in the conduct of financial transactions across the globe.

It seems appropriate that the Fund should be able to make representations to a member that conditions are favorable for restrictions to be removed. Consistent with this, I think the Fund should have the option of declaring a member ineligible for use of Fund resources under exceptional circumstances if a member persists in maintaining restrictions following a representation. This is, of course, with the understanding that such an approach for capital transactions may well never be used, as has been the case under the Fund's existing jurisdiction.

On approval policies, first on temporary restrictions on capital outflows, I agree with the staff that the criteria currently used for approving exchange restrictions should also be applied to restrictions on capital movements. However, the description of the first criterion—whether the restriction is "needed for balance of payment purposes"—is somewhat confusing. I would appreciate clarification of whether the staff's efforts would be focused on assessing whether the purpose of the restriction was to protect the balance of payments, or whether the restrictions were, in the staff's opinion, necessary to protect the balance of payments.

The paper (para 32 f.f.) leaves open the issue of whether additional criteria relating to the specific nature of the proposed restriction should be adopted. While, in theory, it would be optimal for the Fund to approve only the least distortionary temporary controls, this approach would further complicate what could already be a difficult decision about whether the restriction is necessary. Furthermore, the paper notes that it is in a member's own interests to adopt the least disruptive measures. I would therefore consider that, where Fund staff believe that a less disruptive control could be used, they advise the country concerned, but that approval be given if the proposed control meets the three criteria outlined.

Recent events in Asia have highlighted the need for any capital account liberalization initiative arrangements to have the flexibility to allow countries to act quickly to stem a strong capital outflow. The suggested policy for emergency temporary approval seems appropriate and reasonable to me in this situation. With reference to para 35, I assume that, however undesirable such action might be, there would be no stipulation that members must avoid recourse to emergency restrictions which might interrupt debt servicing obligations.

One of my authorities would also like to register its concern that if approval policies are determined by the Fund, rather than being specified in the text of the amendment to the Articles, there may be too much room for interpretation by the Fund which could lead to unpredictable and undesirable outcomes.

Second, on temporary restrictions on capital inflows, in general, I am of the view that restrictions on capital inflows and outflows should be treated symmetrically—although, as capital inflows tend to build more gradually, I would expect that, in practice, much less recourse is made to the use of temporary restrictions on capital inflows.

Again, the staff do not reach a conclusion regarding the adoption of other criteria dealing with the 'quality' (specific nature) of the control. Like the controls on capital outflows, my view is that the Fund should express its opinion on whether the proposed controls are the most appropriate ones (and could also do this more generally in a policy document on minimizing the costs of capital controls), but should not further complicate the approval process by adding more variables to what will already be a potentially complex decision.

Third, on approval of restrictions for other reasons, the paper outlines approaches to the approval of restrictions for: market and institutional evolution reasons; prudential reasons; and national or international security reasons.

The approval of these restrictions relies on an assessment of their purpose, which the staff have already indicated is difficult to implement. Nonetheless, in the absence of any more objective criteria upon which we could exclude these restrictions from the liberalization initiative, I consider that the Fund's proposed approach to each of them is adequate.

Regarding implications for fund financing, as the staff has indicated, it is difficult to judge the net effect of capital account liberalization on the use of Fund resources. One would hope that if, as this initiative sets out to achieve, liberalization goes hand in hand with the adoption of sound economic policies advocated by the Fund, this should reduce the vulnerability of members to sudden shifts in investor confidence.

I agree with the staff that the present provision in Article VI that "a member may not use the Fund's general resources to meet a large or sustained outflow of capital," is lacking in operational meaning. However, to reduce the moral hazard problem discussed in paragraph 67 of SM/97/173, I believe that retention of some form of caveat is appropriate as a signal to members and markets that the Fund will not provide financing regardless of the circumstances.

Turning to practical issues, in designing these measures, it would be useful to be able to step forward in time and see whether they will work successfully in practice. For example, will Board members find it difficult to agree on whether a country has a legitimate balance of payments reason for seeking to impose a restriction? Will it be easy to decide whether a capital control is necessary for prevention of a macroeconomic imbalance? The closest we can get answering these and other practical questions is to look at the Fund's experience in implementing transitional arrangements and approval policies for the current account, and by looking at the practices of the OECD. Could the staff provide some insight into these experiences?

I accept the proposal that the Fund should not include inward foreign direct investment within its jurisdiction, and think the three categories in SM/97/168 are operationally useful in this respect.

I am inclined to accept a higher threshold for limitations on aggregate participation of domestic enterprises of, say, up to 25 percent as suggested in Supplement 1 (a threshold which would presumably apply to the third category of restrictions, as well as the second category). In fact, the only questions in Supplement 1 that I would not answer in the affirmative arise on page 2. If the Fund had the power to challenge a representation made by a member that a measure is being imposed to protect the national interest, then I think it would be necessary to have a category of activities (including defense and the media) specifically excluded from possible challenge.

A better approach could be to take up such measures in the context of the surveillance involved in Article IV consultations. After all, inward direct investment makes an important contribution to economic growth. Countries that have liberalized restrictions on foreign direct investment have benefited significantly from the associated flows of technology and managerial expertise that have accompanied such investment. The Fund should be active in promoting the removal of restrictions in foreign direct investment even though they may be excluded from the Fund's formal authority. Some comparative analysis of the degree to which such restrictions are maintained in various countries might be more effective over time than resort to a legal route. (It would follow under this approach that the question in para 6 of Supplement 1, concerning preclusion of right of establishment, need not arise in practice.)

Mr. Al-Turki made the following statement:

The useful papers before us are yet another step in the quest for extending Fund's jurisdiction to cover Capital Account Convertibility. The staff proposals appear, for the most part, to be appropriate. Therefore, I will make a few preliminary remarks.

On the design of transitional arrangements and approval policies, the staff's proposals seem reasonable. The three principles of no backsliding, clear signaling, and flexibility in approval policies provide the right balance between fostering capital account convertibility and being mindful of the differing circumstances of members. I still, however, have some concerns regarding the approval of prudential restrictions. Indeed, determining whether a prudential regulation is in place for balance of payments purposes or not is a matter of judgment and may become a contentious issue.

I agree that the interpretation of the transitional provisions under the Fund's existing jurisdiction as permitting a member to relax or intensify an existing restriction should apply to the Fund's extended jurisdiction.

On temporary approvals, I agree on the need, in some cases, for approval of restrictions on capital outflows on an emergency basis. A case could also be made for emergency approval procedures for controls on capital inflows. It would be expected, however, that those cases would be few.

On the approval of restrictions, I believe that a very flexible approach is preferable, especially in the case of prudential regulations. If prudential regulations are to be covered, they should be treated on par with those maintained for national security. Here, I support extending the existing procedures for restrictions maintained for national and international security.

On the issue of financing, I agree that the net effect of the amendment on the use of Fund resources is difficult to judge. However, given the transitional arrangements and approval policies proposed in staff papers, I expect the net effect to be small. This does not mean that financial crises will not occur and that in certain cases the Fund's temporary support may not end up being relatively large. At the same time, it is critical that the Fund's role remains catalytic. The Fund should not even be perceived as providing a bailout for private investors. Therefore, I believe it is important not to eliminate the present injunction in the Articles against Fund financing of large or sustained capital outflows.

Regarding inward direct investment, like Mr. Shaalan I agree with the two preliminary points noted in the introduction to the staff paper. I also broadly agree with the classification of restrictions that falls under the definition of inward direct investment and would thus be excluded from Fund jurisdiction. Here, however, I have some sympathy with some of the issues raised in Mr. Chelsky's statement. Therefore, it is essential to provide members with the utmost flexibility in regulating the making of inward direct investments without the Fund's involvement. It is clear that restrictions on such investments are for reasons other than macroeconomic or balance of payments. Thus, an approach which would permit a member to lodge a reservation with respect to any restrictions on direct foreign investment on the ground of protecting the national interest appears reasonable. Indeed, I strongly believe that determining what is or is not in the national interest of a member is the prerogative of that member. Involving the Fund in this issue can only be counterproductive.

On foreigner's right of establishment, I believe that this should stay outside the Fund's jurisdiction.

Mr. Zoccali and Mr. Eyzaguirre submitted the following statement:

At the outset, we would like to express our broad agreement with the thrust of the proposed transitional arrangements, approval policies and approach to financing, contained in SM/97/173. Moreover, we feel optimistic that this new framework will promote further reforms in the member countries and will prevent them from unnecessarily postponing desirable structural reforms and/or resorting to inefficient measures to address issues related with balance of payments and macroeconomic management problems.

Having said this, however, we deem it important to fine-tune concepts and procedures to the maximum extent possible with the fullest involvement of our capitals in order to reach a proper balance between the liberalization incentive that the amendment should have and the pace of liberalization.

We consider that capital account liberalization is a complex process that requires a harmonious set of reforms and that it would be undesirable to rush reforms that fail to address all issues in an integral fashion. The signaling toward liberalization also has to be clear. Every effort should be made to avoid an amendment that provides margin for unnecessary delays. It seems to us that the proper balance between promotion and caution will be determined to a large extent by the rigor and operational value of the concepts we are dealing with today, as well as by the flexibility that is built-in to accommodate new market and institutional developments that may pose different challenges for an adequate regulatory framework for financial markets. While the principal risk could be to dilute the necessary signaling of the amendment if too much emphasis is given to accommodate differences, the complex nature of financial markets and their impressive capability to circumvent regulations, including appropriate ones, should prevent us from designing a straight-jacket that confines member countries' room for maneuver, to solely monetary, fiscal, and exchange rate policies when trying to prevent or address financial turbulence. Sound fundamentals are no doubt a necessary condition for financial stability. However, we should keep in mind that they are not always sufficient. We will confine the rest of our comments to selected questions raised by the staff.

With regard to the principles that will govern the transitional arrangements and approval policies, we agree with the proposed architecture. No backsliding constitutes in our view a central piece of the incentive structure. Interpretation problems may, nevertheless, arise in the practical differentiation between adapting and adopting a measure. The paper states that a measure will be considered a new restriction whenever it is imposed on previously unrestricted payments and transfers. However, it is well known that markets rapidly find ways to circumvent controls; therefore, a country trying to enforce a control by closing loopholes may need to extend a measure without changing its nature. Will those practices be considered a new restriction? On the other hand, are we comfortable with giving automatic approval to an intensification of controls? We believe that both intensification as well as extension of controls to close loopholes may deserve a special, albeit not automatic, treatment.

With respect to transitional arrangements, we find them appropriate and sufficiently flexible. Members should be expected to accept the obligations when they are in the position to confidently "avoid reliance on restrictions imposed for macroeconomic and balance of payments reasons." To increase confidence and encourage members to go for early acceptance it may, however, prove helpful although difficult to spell out what is meant by "macroeconomic and balance of payments reasons." For instance, a regulation governing the open positions of banks in foreign currency does not fall into that category, despite the fact that by limiting the consequences of significant exchange rate volatility, which otherwise could result in fiscal losses through the deposit insurance scheme, this regulation also diminishes the possibility of bank failures. In that regard, such a prudential regulation has much to do with macroeconomic management. Furthermore, the vulnerability of banks to exchange and interest rate movements is not limited to the matching of their own maturity positions, but also depends on whether their corporate borrowers are mismatched. For financial stability purposes, therefore, it may be prudent to dissuade mismatches not just of banks but also other economic agents. In that case, are we dealing with a restriction? Since it is difficult to draw the line between macro management and prudential reasons, one may need to look at whether a regulation is meant to be complementary to sound macro policies or, on the contrary, is intended to delay macro adjustment. Compliance with international "best practices" in assessing macro performance may be helpful to differentiate between a regulation established for prudential reasons from one imposed to deal with macroeconomic management.

Concerning temporary approvals for macroeconomic and balance of payments reasons, applying the existing criteria on current international payments and transfers is deemed appropriate for the approval of restrictions on capital outflows and inflows. We also consider that there would be a need for emergency approval procedures for controls on capital outflows and inflows. In this regard, however, we do not yet see clearly what would be the appropriate balance between emphasizing the temporary nature of an emergency restriction, and letting the markets know that authorities are constrained by their need to obtain permission for an eventual extension of the restriction, thus reducing its effectiveness. While we are conscious that too permissive a period when allowing for a lapse-of-time approval may induce member countries imposing controls to make intensive use of this facility, we also consider that a 30-day period is too short to ascertain its effectiveness.

With regard to favorable considerations in the approval criteria, we agree that such should be the case when dealing with controls imposed to limit short-term speculative inflows, and with price-based and transparent controls. More generally, controls on capital inflows should be viewed more favorably than controls affecting outflows. At any rate, as in the case of current transactions, we favor separating a country's eligibility for Fund resources and the state of compliance of the outstanding capital account regulations under the amended articles.

With respect to the approach for approval of restrictions for market and institution evolution reasons, while it entails the danger of abuse it may also give member countries the required room to confront new challenges. The speed of financial market evolution is normally faster than the regulator's ability to move. Moreover, new regulations need sometimes to be accompanied by new institutional developments, which may take time. Therefore, to account for the differences in the speed of adjustment, the amended articles should provide flexibility to accommodate these situations. The case of a sudden and sustained wave of capital inflows may be one of these situations. To confront this issue, members may need to resort to higher liquidity requirements, greater flexibility in their real exchange rate, encourage financial and real investments of residents abroad, develop derivatives to allow traders to hedge currency risk, provide new regulations for financial intermediaries, with some of them going beyond international "best practices" given the special features of emerging markets. Certainly all of that cannot be accomplished in the short run.

Restrictions for market and institutional evolution reasons, as well as for prudential purposes, should both be assessed under a different track than that used to gauge restrictions falling under the procedure for temporary approval imposed for balance of payments reasons. The reasons are different and the length of time of the approval should be considerably longer. However, we strongly believe that the existence of "best practices" and norms, and the country's capacity to implement these norms, should constitute significant elements by which to judge this type of regulations. The Fund should represent to member countries, in the context of surveillance, the need to accommodate the regulations to "best international practices," and to modify norms and regulations that impose more burden to economic agents than is strictly needed. In any event, the fact that these types of regulations are normally designed to dampen systemic risk, makes them very similar in nature to those imposed for macro management reasons. Again, further elaboration of this issue may be appropriate.

With respect to the extension of the present policy of granting nontemporary approval for restrictions imposed for national and international security reasons, we find ourselves in broad agreement with the staff provided that strict selective criteria are implemented to avoid abuse.

Although increased access to capital markets may tend to reduce the need for the use of Fund resources in "normal" circumstances, the magnitude and volatility of capital flows may result in increased pressure over members exchange rates and balance of payments. The Fund should be ready to step in. Thus, we see a case for a stronger Fund to deal, inter alia, with sudden shifts in risk perception and changes in creditors' relative rates of return. Enlarged potential access financing would assist in the elimination of restrictions which fall within the Fund's new mandate.

While we recognize that increasing Fund's liquidity could engender moral hazard, we see this to be more clearly the case for creditors. It is hard to believe that member countries will soften their macro discipline on the basis of the potential access to a stronger Fund. Countries know fully well the meaning of conditionality and this should be in of itself a sufficient disincentive. Nevertheless, since lending practices may sometimes tend to relax discipline, the Fund's involvement in sound banking practices and a close follow-up of international agreements is deemed necessary. We also feel uncomfortable with the retention of the "large and sustained outflows" language. If we are encouraging countries to liberalize, we should be prepared for this type of development. We believe that Article V, Section 3(a) should suffice in order to establish adequate safeguards and provide sufficient protection for the Fund's resources.

We disagree with allowing the Fund the possibility of requesting members to impose controls on capital outflows. It is certainly paradoxical to grant the Fund power to impose restrictions on outflows while, at the same time, denying it to the members, without prior approval. Besides, it would constitute a confusing signal for the liberalization efforts.

Finally, we consider exclusion of the making of inward direct investment from Fund's jurisdiction to be justified to the extent that the principal reason for restrictions in this area is not usually related to macroeconomic and balance of payments motives but to countries' desire to preserve their sovereignty. The proposed approach will in fact leave to members the possibility of excluding any type of restrictions on inward direct investment from Fund's jurisdiction through the lodging of representations to the Fund that such restrictions are imposed in order to protect compelling national interests. The envisaged power to be granted to the Fund to challenge those representations through special majority, when there is ground to doubt their legitimacy, may serve to allay fears of abuse but it will do little, for all practical purposes, to avoid recourse to those measures if a member views them as desirable. This liberal treatment of restrictions on inward direct investment raises some questions particularly when the paper itself acknowledges that sometimes members may impose restrictions for motives such as the promotion of employment, which are closer to the macroeconomic domain than to the political or sovereignty one. In any event, the fact that other agreements govern the foreign direct investment in general makes the envisaged exclusion of the Fund less of a problem and we, therefore, agree with the proposed approach. Mr. Chelsky's suggestion that all inward direct investment, including equity portfolio investment, be excluded from Fund's jurisdiction is appealing because it entails a reduction of Board's involvement. We wonder, however, if by excluding equity portfolio investment we may not be forced to exclude other financial assets that give rise to capital inflows such as debt obligations or deposit accounts. We should avoid that our initial intention to exclude inward foreign direct investment could well end up excluding all capital inflows, which seems contrary to our purpose. Staff comments would be appreciated.

Mr. Daïri made the following statement:

In regards to the treatment of inward direct investment, we concur with the staff's view that members would have the right to discriminate against foreigners as a group, in the making of inward direct investment, but we cannot support discrimination against nationals of particular countries unless justified by compelling national security reasons or by reciprocity clauses under bilateral or other multilateral agreements.

Regarding the categories of restrictions to be excluded, we agree with the definition of the first category, i.e. restrictions on the foreign ownership of real estate. However, we can support the exclusion of nonfinancial intangible assets such as intellectual property rights, only if they are imposed for noneconomic reasons such as national security. Whether they are classified as current or capital transactions, the Fund should aim at liberalization of acquisition of intellectual property rights. Furthermore, the acquisition of security interests in real estate should be treated as a straightforward asset acquisition.

We agree with the definition of the second category of restrictions as related to ownership or control of enterprises, including a threshold of equity or voting power for control of enterprises or other forms of investment, even though we would favor a higher threshold than the 10 percent suggested by the staff.

Regarding the third category of measures aimed at limiting or excluding the participation of foreigners in local enterprise activities which are regarded as necessary to the preservation of the country's essential interests, such restrictions should be kept at a minimum. It does not seem appropriate to leave it completely to member countries to limit acquisition of interest in any local enterprise. Not only should the list of local enterprises concerned be strictly defined, but discrimination between countries other than for compelling national security reasons should be prohibited.

On the methodology, we support the first option that recognizes the right of members to impose restrictions of the first two categories, but that does not permit imposition of restrictions of the third category without the approval of the Fund. We cannot support the second option that gives the Board the power to change the balance of rights and obligations under the Articles. The third option, that leaves the issue in the hands of members, would not provide the certainty of the first option and may lead to abuse.

For the reasons explained above, we consider that the proposed approach for the structure of the amendment does not seem fully appropriate. While we can support the exclusion of the first two categories of restrictions subject to the reservations indicated above, the scope of discretion regarding the third category seems excessive. The reason of compelling national interest cannot be invoked too frequently to justify restrictions. The voting structure in the Fund does not provide assurances that all members' representations regarding compelling national interest would be treated in an evenhanded manner. Moreover, there is not enough certainty that the proposed approach would prohibit discrimination among members that is not truly related to compelling national security reasons. Perhaps, it would be instructive to review Fund experience under Decision 144; the provisions of the decision itself requires that "The Fund will review the operation of this decision periodically...." After 45 years, it may be the right time to review this decision, not only for its implications for current account but also to draw lessons for designing the provisions of the proposed amendment.

As regards transitional arrangements, on common principles and related issues, we consider that the issue of the right of establishment deserves a close attention in view of the risk of discrimination among members. Restrictions on the right of members to exclude enterprises with foreign participation fall under the GATS agreement and are not to be treated as restrictions on capital transactions. Furthermore, such restrictions do not relate to international transactions and should be outside Fund's jurisdiction.

The issue of whether it is appropriate to build upon the principles underlying the Fund's existing jurisdiction for the design of transitional arrangements, and approval policies should not be settled a priori. In light of the scope of the intended amendment and the particular circumstances of members, it is important for the Board to tailor its position in this regard.

In view of the complexity of and the risks attached to capital account liberalization, member countries should have the right to withhold their acceptance of the provisions of the new obligations until they are satisfied that conditions for such a move are fully met. Unless an appropriate balance is achieved between the scope of the jurisdiction and the design of transitional arrangements, and approval policies, including sufficient flexibility, the international community may have to wait several decades before witnessing any meaningful number of members accepting such obligations. In that case, doubts would legitimately arise on the usefulness of such an amendment.

This being said, we agree on the principles for Fund approval that, first, there would be no backsliding. Second, that the acceptance of the obligations of the new article would reflect the strength of the member's position, and the confidence that restrictions will not be imposed for balance of payments or macroeconomic reasons. Finally, that flexibility will be applied in approval policies including: I) temporary approval policies for restrictions on capital outflows for balance of payments reasons, with special provisions for emergency situations, as well as for restrictions on capital inflows for macroeconomic policy purposes; ii) approval of restrictions justified by the context of market development and liberalization or by prudential considerations and, iii) special provisions for restrictions imposed for national and international security considerations.

While we agree that the treatment of new restrictions imposed on capital transactions should have the same effect on Fund's arrangements as restrictions on current transactions, it does not seem appropriate to include elimination of restrictions among performance criteria for Fund arrangements.

That a member does not eliminate restrictions on capital accounts or does not accept obligations under the proposed amendment would only mean that it is not yet confident that the conditions are met. We look forward to the forthcoming paper on the relations between the proposed amendment and members' obligations under bilateral, regional or other multilateral agreements.

In view of the signaling effect of the transitional arrangements and approval policies, there is a need for a flexible approach. While members should be encouraged to begin eliminating restrictions before formal acceptance of the new obligations, the Fund should be cautious in its advice. Excessive pressure should not be exerted on members either in the context of surveillance or in the framework of Fund arrangements.

We can support the proposed framework for transitional arrangements built upon the existing provisions relating to current transactions. However, in view of the scope of the new jurisdiction, greater reliance should be placed on members' own conviction that the conditions for acceptance of obligation are met. We do not support extension to capital transactions of the Fund's authority to make representation to a member that conditions are favorable for the general or partial abandonment of restrictions, and to declare a member ineligible if it maintains such restrictions after Fund's representation.

In respect of approval policies, we can endorse the criteria for temporary approval of restrictions imposed or intensified on capital outflows in the face of pressing balance of payment or macroeconomic management problems, namely that they are needed for balance of payments purposes, are temporary, and do not discriminate among Fund members. We concur with the staff that it is in the member's own interest to adopt measures that would be least disruptive to its international financial relations and that temporary ex ante controls (on new transactions) would be preferable to restrictions on vested rights. We also agree that careful consideration should be given to the cost of additional adjustment compared to the cost of the interruption of vested rights. Regarding procedures for temporary approval we concur with the staff that such restrictions need not be approved by the Fund prior to their imposition. However, we do not see how to ensure, in the context of emergency provisions, that debtors are allowed to continue to meet their external debt service obligations without interruption as suggested by the staff.

We continue to believe that temporary control on capital inflows may be justified in some circumstances pending the introduction of the necessary macroeconomic adjustment. The imposition or intensification of such restrictions should not be subject to prior Fund approval. Regarding approval criteria, and in addition to those related to domestic liquidity and/or exchange rate management, an additional criterion could be that the restriction is aimed at avoiding an excessive increase in equity prices in the context of large inflows of portfolio investment. Such inflows do not always reflect positive perceptions of the recipient's medium term prospects but may also be short-term speculative transactions.

Members, particularly the developing countries may need to impose restrictions on capital movements in the process of financial market development and to limit the vulnerability of the financial system. Such restrictions may be imposed for a longer time than the previous categories, pending the achievement of a strong financial system. We agree that approval of such restrictions should be based on the assessment of the members' on-going reforms in these areas.

As regard the approval of restrictions for prudential and other purposes, we believe that, unless it can be well established that they are effectively imposed for balance of payments reasons, such restrictions should not fall within Fund's jurisdiction. Protection of domestic institutions or private savings may have to be assumed by member's government in the early stages of development pending the dissemination of financial skills and information, and exposure to market conditions. The recent pyramid-scheme crisis in Albania strengthens the case for an appropriate regulatory framework that may at times justify restrictions. It is not always possible to rely on the existence of alternative measures based on best practices or norms to achieve the same prudential result without recourse to restrictions. Best practices and norms cannot be introduced irrespective of the member's institutional and regulatory framework and the degree of awareness of market participants. With respect to restrictions imposed for monetary control purposes, they should remain outside Fund's jurisdiction in the same way as those imposed for fiscal purposes, for instance.

Turning to implications for Fund financing, the drafting of Article VI suggests that Fund financing of capital outflows is permitted with some limitations related to the size and duration of the outflows. These limitations are understandable in view of the Fund's role under the Articles to finance current account transactions and to avoid the imposition of restrictions on such transactions. The issue takes on a new dimension when capital account liberalization is expected to be included under Fund's jurisdiction. The case for greater Fund involvement in the financing of capital outflows is even stronger in a liberalized capital transactions regime because the shocks to an economy with open capital account could be more severe than otherwise.

The arguments put forward to support limited demand for Fund resources in the context of capital account liberalization are not fully convincing. That countries find easy access to markets to finance higher current account deficits does not mean that these countries will not be exposed to changes in market sentiments as a result of domestic or external developments. The number of countries that have arranged alternative mechanisms of financing, such as lines of credit with commercial banks or swap arrangements with central banks, is still limited. Moreover, the reliability of such arrangements in face of severe foreign exchange crisis is not well established.

It does not seem appropriate for the Fund to recommend imposition of restrictions or other controls, as a temporary measure, to limit the use of its resources. Members would be reluctant to commit themselves to capital account liberalization if their confidence in the availability of Fund financing is undermined by the possibility that the Fund would recommend restrictions as a substitute for financing. We also consider that the limitation of Article VI regarding the financing of large or sustained outflows of capital should be deleted in view of the inclusion of capital account liberalization within Fund's jurisdiction and the safeguards for protection of Fund's resources included in Article V, Section 3(a).

The General Counsel noted that a number of central banks entered into open market transactions with domestic banks and not with foreign banks and, in that context, the question was raised as to whether this practice was discriminatory and constituted a restriction under the proposed approach. His view was that proprietary actions—that is, actions taken by a government on its own account—would not constitute a restriction. Thus, the current practice of banks entering into transactions only with domestic banks would not constitute a restriction under the proposed approach. The question of the distinction between the liberalization of transactions and the right of establishment was a more difficult question, and, in particular, raised a number of questions relating to tax treatment. With respect to current payments, the Fund took the view that an exchange restriction did not arise where a member taxes nonresident income at rates which differ from those that apply to resident income. If, however, a member imposed a tax on the transfer abroad of the net income earned by nonresidents, that would be a restriction because it would affect the transfer of income. A similar approach could be envisaged under the amendment for capital account transactions. The staff could return to that issue in a subsequent paper.

The Director of the Policy Development and Review Department observed that the staff envisaged that restrictions imposed for nonbalance of payments reasons, such as restrictions for prudential reasons, would be approved for a longer-term period than other restrictions. Under such an approach, it was envisaged that the measures a member was considering introducing would be compared with the "best practices" designed by other agencies and institutions. If a country already had in place those "best practices," the staff would recommend approval of the measures on a longer-term basis. That issue would require further consideration, but one possibility was to provide in the amended Articles for longer-term approval of prudential measures, and to review that policy over time.

In determining whether a measure constituted a restriction or not, the staff's assessment would be based on the nature of the measure itself, and not on the purpose of the measure, the Director stated. Once the determination had been made as to whether the measure was indeed a restriction, the next step would be to determine whether or not the Fund should approve the restriction. That determination would depend on whether the restriction was nondiscriminatory, temporary, and invoked for balance of payments reasons. The staff envisaged that approval would be for a period of about two years, and would also involve an assessment of whether the authorities had in place other policy measures that would render the restriction unnecessary after a period of two years. In making an assessment as to whether the measure was necessary to protect the balance of payments, a judgment would need to be made about whether other complementary measures were also being taken in order to safeguard the balance of payments.

Directors differed on whether approval criteria should include the nature of the restrictions a member was imposing, the Director noted. That issue would need to be considered further, but the staff considered that transparent and price-based measures would be preferable. Moreover, measures that interfered with "vested rights," such as contractual debt service payments and measures that lead to the accumulation of arrears, should be eschewed. That policy would also need to be reviewed over time.

The transitional arrangements would cover only those restrictions that were in place when the amendment came into effect, the Director of the Policy Development and Review Department observed. Arrangements would vary from member to member, as each member would have different restrictions in place. Ironically, the most developed countries might have more restrictions in place than developing countries at the time the amendment came into effect because of their relatively better developed financial systems. Members that wished to give up the right to avail themselves of the transitional arrangements and accept the obligations under the Articles, would need to have well-developed financial markets and institutions so that they would be unlikely to need to resort to restrictions for market and institutional evolution reasons, which would be subject to Fund approval.

The staff representative from the Monetary and Exchange Affairs Department stated that material had been prepared by the staff on the framework for prudential regulations and the coordination between different institutions with respect to prudential measures and harmonization of "best practices." Consideration would be given to making the material available in the context of the forthcoming staff paper.

Mr. Sivaraman observed that, in discussing the question of the right of establishment, the staff might also wish to discuss the tax treatment of foreign companies. Countries' tax laws differentiated between companies based on the nature of the enterprise, that is, whether they were permanent, temporary, incorporated, etcetera. Often countries had derogation provisions so that companies were not taxed twice. Thus, there could be a difference between how the law treated enterprises for tax purposes and what was agreed between countries.

Mr. Autheman made the following statement:

> Thanks to the depth of the coverage by the authors of grays, I will limit my remarks to a few aspects where my views differ slightly from those of the staff. Let me start by pointing out that I am in agreement with the main recommendation—that is, that it would be appropriate to apply the existing criteria for the temporary approval of restrictions on current international payments and transfers to the approval of restrictions on capital outflows. The difficulty is to decide how we are going to deal with exceptions to the principles we are supporting.
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> Basically, we have three options. One is the restriction approval policy, which is a case-by-case approval, a judgment closely and narrowly guided by our mandate, and which is temporary and transitional in its purpose. It is clearly well designed for all restrictions related to macroeconomic and balance of payments purposes. We have two other approaches. One is to grant some form of general and lasting approval on the grounds that the policy purposes which are behind the restriction are legitimate, and another is to grant the exception in the Articles themselves.
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> We should treat differently inward investment, on the one hand, where the exception to the freedom of capital movement would be granted in the

Articles, and general restrictions motivated by prudential or security purposes where the exception would result from a benevolent approval policy, some form of general waiver, following internationally agreed standards. Indeed, Mr. O'Donnell raised the issue when suggesting that prudential restrictions could be treated through a carve-out as inward investment and not through an approval policy.

I see a danger in having too general an exception for inward investment. Indeed, the amendments would say that we support liberalization of capital movement, but all restrictions related to inward investment which would be of a general character can be decided by countries without the Fund being involved. What is striking in the staff paper is that the Fund would have to approve specific targeted restrictions but not general restrictions, such as that forbidding foreign investors from owning more than 10 percent of a domestic company.

We all know that this is a starting point with which we have to live. It would not be realistic in the present world to try to go further. We also all know that we are not the best forum to negotiate evolutions of this situation. I personally think that it would be wiser to treat inward investment as prudential regulations and security regulations—that is, to follow the route of a general waiver. We could agree on an approval policy open to all members, reflecting present international understanding, trying also to reflect the best practice which may have developed in regional forums, and acknowledging that this policy may be changed in the future, depending on the evolution of international consensus.

This is my main difference of opinion with the staff paper. For the next 5 or 10 years, it would not make a major change. I am not asking for a change of approach. But if we consider that we are intending to legislate, let us say, for 50 years, I would be reluctant to endorse an amendment to the Articles where we would restrict our capacity to foster the freeing of foreign investment, knowing that our policy advice has precisely emphasized that the openness to foreign direct investment is one of the most positive policy measures that a country can take.

I have not commented on the fourth possibility for general approval, which is the reference to market and institution development. My suggestion is that we could use this purpose to address the no-backsliding issue raised by Mr. O'Donnell. I share his sense that we cannot apply as rigidly the no-backsliding principle for capital movements as for current transactions. Indeed, by identifying the need in some cases to request temporary exceptional capital controls, the staff itself acknowledges it, but I would think that an exception to the no-backsliding principle could be or should be motivated by considerations related to the weakness of the market and institutional environment.

One final comment on large and sustained capital outflows. I could live with the present Articles, since we have interpreted them in such a way which makes it possible to support countries where capital outflows appear very large and apparently sustained. Indeed, one of our most important programs is with a country with a sustained current account surplus. So it seems to me that we have found a way to interpret our Articles which is satisfactory. I would also be reluctant to abandon this safeguard because we need to keep some bail-out clause. But I would not object to a change of wording in order to reflect our practice, such as the one proposed by the staff.

Mr. Toribio made the following statement:

The staff paper on "Capital Movements Under an Amendment of the Articles" constitutes a reasonable point of departure to continue meaningful discussions about issues we have already faced at previous board meetings. After reading it, I was, however, left with the impression of being confronted with at least two pieces written by different people with diverse approaches and even distinctive writing styles.

The first part, covering Section II ("Overview of the Design and Implications of Transitional Provisions and Approval Policies") seems to respond to a purely juridical point of view, from which several issues arise and about which some comments will be made by this chair. Let me, however, start with a general observation that may serve as a background for subsequent remarks. The authors of this first section refer more than once (Paragraphs 3, 4, 18, and 73) to the "complexities" of capital movements, as if they were trying to underline the cumbersome side of our task ahead. In fact, capital transactions may not be necessarily trivial, but I am afraid that an excessive insistence on legal complications may lead us to the wrong conclusion that capital account convertibility embodies greater difficulties than current account liberalization offered at the time of adopting our Articles of Agreement more than fifty years ago. Freedom of capital (and current account) movements constitutes the "natural" state of affairs. What becomes unduly complex is not liberalization by itself, but the cumulative and often incoherent set of restrictions that plague international financial transactions today. It is not infrequent, for instance, that countries which impose inward capital controls on grounds of an excessive liquidity have, at the same time, outward restrictions that prevented an automatic balance of its external accounts. Trying to liberalize capital movements, we are not getting unnecessarily involved in a particularly complex issue. We are, on the contrary, struggling to simplify international monetary transactions by removing complicated restrictions already existing. It is certainly worth the effort.

With that background consideration, let me now reflect on some specific issues for discussion raised by the several authors of the paper. I will add at the end one comment on the direct investment issue, as well.

I entirely agree with the staff on the need to accept transitional arrangements and to design appropriate approval policies for subsequent restrictions. As for transitional arrangements, the principles of "no backsliding" and "signaling to markets" seem appropriate, as they are explained by the staff. The first principle means that a country should not go back establishing restrictions once they are removed; the second means that the same country should not precipitate to remove restrictions it may still need. The combination of both principles generates a balanced and sensible approach to the issue of capital account convertibility. Perhaps the only doubts may come from the possibility of intensifying existing transitional restrictions and the extent to which it may violate the principle of "no backsliding," a question that should be examined carefully.

Approval policies for the establishment of new restrictions after the removal of the initial ones should, of course, be flexible, but with a clear conscience of their exceptional character, so as not taking for granted that restrictions which impose a burden on other countries (as they always do) are going to be automatically accepted by the international financial community. The burden of the proof corresponds to the country that intends to trespass the general rule of free capital movements, although the Fund should, of course, try to apply an attitude of understanding to the country's problems. Macroeconomic management, balance of payments difficulties, new financial markets or products, and prudential measures are, as suggested by the paper, acceptable grounds for considering the establishment of temporal restrictions where no other solutions are available. But they should not necessarily be an alibi for any arbitrary introduction of obstacles to the ordinary state of affairs because, at the end, somebody else will necessarily have to pay a price for the distortions.

The paper suggests that in imposing temporary restrictions (either in capital inflows or outflows) countries should follow a policy of "non-discrimination," as they theoretically do now in the case of current transactions. But that may be simply impossible. A restriction is always a discrimination, by its very nature. For instance, a pension fund of a multinational company may try to balance its multi currency commitments by investing in different capital markets. If it is prevented from doing so by artificial controls, its participants will be discriminated with respect to other retired people whose pensions do not depend on multi currency investments, whatever the nationality of one and the others. We have grown so accustomed to think that international investments affect only to a few wealthy people that we may lose sight of the fact that the real payers of the restrictions bill are usually middle-class investors in mutual funds, as well as pensioners and retired workers through their pension institutions. That is why, in my opinion, our efforts should not be directed to the impossible task of avoiding the discriminatory effects of restrictions (it would be a lost battle), but to make those distortions as exceptional as possible.

Restrictions for new market and/or institutional evolution also pose some problems whose complexity arises, once again, from the restrictions themselves not from the liberalization of markets we intend to promote. It is, for instance, possible that, as the staff suggests, a regulatory authority may face difficulties in assessing the financial strength of a foreign company before allowing its securities to be quoted in newly created domestic financial markets. But the case should not be generalized because those assessment problems are usually associated to the degree of disclosure of the company not to the fact of being foreign or national. It may be much more difficult to get information about an obscure domestic corporation than about a foreign blue chip, which is well-known to anyone.

Something similar could be said about the attempt to prevent national institutional investors from buying financial assets in international markets under the argument that foreign stock exchanges are riskier or less known than domestic markets. Are really the New York Stock Exchange or la Bourse de Paris unknown to any one worldwide? Is it not a narrow national stock exchange more volatile and, therefore, riskier than wider and deeper financial markets? Who is, again, going to pay the price of those distortions in terms of higher risk and smaller return for investments? Those are relevant questions that deserve a clear answer before taking a final decision on the establishment of institutional restrictions to capital movements.

The staff paper demands the opinion of Directors on three other points: first, whether the Fund should be allowed—or even compelled—by the new amendment to request members to impose controls on capital outflows; second, whether capital account liberalization may increase the demand for Fund's resources; and, third, whether our Articles of Agreement should keep preventing the Fund from financing large or substantial capital flows.

With respect to the first question, my opinion is that the Fund should very seldom take the initiative in imposing capital controls to any country. Our attitude must usually be limited to consider proposals of that type when made by national authorities themselves. I recognize, however, that such a mandate is already imposed by the Articles of Agreement and that there may be some reluctance to remove it but, as a minimum, the exceptionality of that provision should be emphasized, whatever the legal formula finally chosen.

The second question (possible effects of capital liberalization on demand for Fund resources) is, in my opinion, well addressed by the staff paper. In fact, whereas the opening of international financial markets may reduce the demand for Fund's resources under normal circumstances, the Fund must be prepared for cases of unusually intense crises that may generate a large demand for its financial resources.

With regard to the third question (prohibition of the Fund financing of "large or sustained" capital outflows), I also agree with the staff on the need to, at least, reformulate the injunction through a new wording, better adapted to present circumstances. The new formulation should, in my opinion, refer to foreign imbalances in general, not specifically to capital transactions. It should make possible to finance and participate in financing large (although not necessarily "sustained") balance of payments disequilibria. It should also make clear that the fundamental goal of the injunction is to protect the financial balance of the Fund, not to prevent the involvement of the institution in a particular kind of financial transaction, whether it belongs to current or to capital account.

I have very few comments to make on the paper about the "Treatment of Inward Direct Investment," which I found, in general, to be clear, concise, and well-focused. I would prefer not to enter into a discussion about the reasons for the regulation of inward direct investment. This is a point on which I would have some reservations with the way it has been formulated by the staff, but my disagreements would not alter a basic coincidence with the much more fundamental issues of the staff paper. In particular, I would fully endorse the approach proposed by the staff to make sure that the Fund's jurisdiction does not extend to restrictions on inward direct investments. That approach combines elements of three alternatives previously explained. It recognizes the right of members to regulate the foreign acquisition of specific capital assets and to impose restrictions to ownership or control of enterprises, while leaving the Fund the faculty of challenging, by a qualified majority, the establishment of restrictions in portfolio investments not clearly related to the preservation of a country's essential interests. I think it is a well-balanced solution on which to base a general consensus.

Finally I would like to inquire where are we expected to go from here, what new steps should we take and/or what new topics should be submitted for discussion before we define a final position of this Board about capital account convertibility prior to the Hong Kong meetings which could, in my opinion, make in this respect a substantial contribution to general economic progress.

Mr. Kiekens made the following statement:

It is my impression that the staff behaves like a nurse who accompanies a patient to the operating room. She tries to calm him by assuring him that the operation will be painless and explaining how his post-operative care will be handled. It is indeed not easy to convince ministers of finance and governors of central banks that they can more confidently remove restrictions on capital movements by reassuring them that from then on, they will no longer be able to reintroduce restrictions without the Fund's approval.

The most effective way to promote the removal of capital restrictions is for the Fund to provide policy advice and technical assistance to prepare the conditions that allow sustainable liberalization, rather than emphasizing its rule-making authority. The staff rightly stresses that members need to have a healthy financial sector in place before capital flows can be liberalized. Mr. Wijnholds rightly observes that the intermediation of inflows also requires that investment decisions be made on the basis of undistorted incentives. This in turn requires the recipient country to have an environment of well functioning markets and appropriate price signals. For my part, I would like to add that preventing disruptive capital movements equally requires properly functioning capital markets at the international level. The Fund must take this into account, not only when advising members on the removal of restrictions, but also for avoiding the moral hazard that would arise from creating the expectation that the Fund will finance large capital outflows in times of distress. I will revisit this latter point when discussing the amendment of Article VI, to give the Fund the authority, as under the present Article XIV, to compel members to remove capital account restrictions, on pain of losing access to the Fund's general resources, is clearly of less importance. One can even wonder whether, for the promotion of capital account convertibility, the Fund even needs such an authority.

Much more important is the requirement that members obtain Fund approval before introducing new restrictions on capital movements. This lies at the heart of the Fund's jurisdiction. It will promote capital account liberalization. The protection investors obtain from the Fund's approval policy will increase the size of capital movements and make them more stable. The whole financial community will benefit, including first and foremost the country that opens its capital markets. However, to bring about these benefits, the Fund's approval policy should be neither too flexible nor too rigid.

Although the staff is calming our authorities by promising flexibility, a careful reading of the papers shows that the policies being contemplated are appropriately strict, which is not surprising, since the staff relies heavily on all the wisdom embodied in the Fund's jurisprudence up to now. Although I broadly agree with the staff's proposals, I must discuss some points where my views diverge.

The most important point on which I disagree with the staff goes back to our most recent discussion. It has to do with the scope of the Fund's jurisdiction. It has significant implications for the design of the transitional arrangements and more importantly for the approval policies. Moreover, it will affect the drafting of the amendment itself.

In its paper on the scope of the Fund's jurisdiction, the staff proposed that the decision whether a measure constitutes a forbidden restriction should be based on the objective nature of the measure rather than on its purpose. Consequently, the Fund's jurisdiction would extend to the widest possible array of restrictions, regardless of whether they intend to deal with actual or potential balance of payments problems, macroeconomic management, prudential regulation or other sectoral policies, domestic or international security, or any other purpose of public interest. We risk undertaking more than we can deliver. And indeed, the staff tries to handle this great mass of material not only by appropriate exclusions, such as Foreign Direct Investments, but also by granting open-ended and nontemporary approvals to cover restrictions that are irrelevant, or only slightly relevant, to the Fund's purposes. However, the staff's further considerations in the papers on those nontemporary approvals of restrictions related to prudential supervision show that those approvals are not merely a marginal control of disguised balance of payments restrictions, but a substantive determination of whether the prudential restriction is not being carried too far because it exceeds generally accepted standards of supervision. I wonder whether by doing so, the Fund is not trespassing on the GATS's domain of promoting the liberalization of international trade of services.

How the Fund should deal with restrictions of international capital movements should depend on the purposes of the measures. I would therefore repeat the proposal I advanced at our last meeting, to limit, in the Articles of Agreement, the Fund's jurisdiction to restrictions imposed for reasons of balance of payments or macroeconomic management. For these restrictions, I can almost entirely agree with the transitional arrangements and approval policies proposed by the staff. They are very closely modeled on the approval policies already developed for restrictions on current transfers and payments.

However, like other Directors, I am not sure that we must continue the present interpretation that "adapting existing restrictions to changing circumstances" under the transitional arrangements allows a country to make them more restrictive. As was done for the stand-still provisions in the Treaty establishing the European Community, such modifications should be limited to what is necessary to preserve their effectiveness under changed circumstances. But because this issue does not affect the text of the amendment, we need not seek a consensus now.

I recognize the need for members to be able to introduce, in emergencies, restrictions on capital movement to or from third countries. The staff suggests a lapse-of-time procedure for approving emergency restrictions for a limited period—say up to 30 days. In addition, the staff suggests that member should notify the Fund of such restrictions within 10 days after they are imposed. This proposal is not entirely satisfactory, or perhaps not entirely clear. Will the Board's approval of the emergency restriction take effect from the day of the Board's action, or will it be retroactive to the date the member imposed the restriction? I would like to suggest that we grant members the right, on the grounds of emergency, to impose temporary restrictions provided the Fund is informed of such actions, at the latest, on the date they enter into force. The imposition of such restrictions would be deemed to be consistent with the Article of Agreement, and hence deemed to be approved, as long as the Fund does not explicitly decide to refuse its approval. Such a refusal would not be retroactive. Consequently, emergency restrictions could be upheld in foreign courts under Article VIII, Section 2(b), even for transactions that took place prior to the Fund's decision not to approve the restrictions.

On the implications of the amendment for Fund financing, I have the following comments.

Making the promotion of free capital movements a purpose of the Fund should be accompanied by a broadening of members' access to Fund resources for the financing of the balance of payments needs, whether they are caused by a deficit in the current account, or by capital account transactions.

Of course the conditions of Article V, Section 3(a) should continue to apply, and the Executive Board will continue to require adequate safeguards for the use of Fund resources. Article VI, insofar as it prohibits the financing of sustained capital outflows, seems to be made redundant by the requirement that the Fund's resources can only be used temporarily.

More delicate is the question whether the prohibition against financing large capital outflows should be abandoned. I agree with other Directors on the need to prevent moral hazard, particularly in connection with creditors who assume that their claims are protected by the Fund's willingness to finance large capital outflows. One approach is to rely fully on the wisdom of the Executive Board—or should I say of the Managing Director—to ensure compliance with Article V, Section 3(a), requiring adequate safeguards to ensure temporary use of Fund resources and avoid undermining market discipline. The other approach is to maintain an additional rule prohibiting the financing of large amounts, or to use Mr. Wijnholds's metaphor, to have "two locks on the door."

I think the Fund's actual policies are more important for preventing moral hazard than a legal arrangement, which could turn out to be either too restrictive or ineffectual. Experience shows that Article VI is a second lock, but one that opens to the same key as the first lock, since it is the same Executive Board that decides, with the same majority, and without any possible recourse, on the conditionality and on what constitutes "a large amount" under Article VI. A more effective second lock would be to require a stronger majority for the Board to approve "large" accesses.

The staff has tried to define inward foreign direct investment on the basis of objective criteria and has concluded that this cannot be done completely. The staff paper demonstrates that such a definition is a complex undertaking and will require flexibility to adjust our approach to the evolving market structures and operations. I think the best approach is to give the Fund, via its Articles of Agreement, the authority to define foreign direct investments which fall outside its jurisdiction over capital account convertibility.

Ms. Lissakers made the following statement:

We are making good progress in coming to grips with the many complexities of this proposed amendment. We agree with the broad approach taken by the staff in the paper that an amendment should build on the Fund's existing approach to current transactions, and this would involve broad transitional arrangements and flexible approval policies. We recognize, as does the staff paper, that capital movements introduce a number of complexities that are not present in the current transactions, and that our approach to the amendment will have to reflect that reality in our approach, for example, to prudential issues and to national security and other matters. Nevertheless, we should not lose sight as we try to accommodate all these complexities of the ultimate objective, which is an orderly liberalization of capital movements internationally.

On the specific questions raised in the paper, starting with inward direct investment, I share some of the concerns raised by other colleagues about a blanket exemption. Carving out inward direct investment completely from the Fund's jurisdiction would certainly simplify matters in some ways. But the fact is, as Mr. Kiekens just said, it is not so easy to have a clear definition of what kinds of transactions would be exempt. For example, modern investment agreements define direct investment in terms of kinds of assets, classes of assets, and under the staff approach, restrictions on foreign ownership of specific capital assets would fall outside Fund jurisdiction. But the types of capital assets that would be covered is unclear. In fact, I do not think there is any agreed international listing of such assets. Similarly, the staff would exclude restrictions on the ownership or control of an enterprise defined by the 10 percent limit. Again, there is no firm agreed international principle on whether or not this actually constitutes effective ownership control. An alternative approach to what the staff suggest might be to allow the member itself to determine which inward direct investments would be excluded from Fund jurisdiction. We would not go as far as Mr. Chelsky in leaving the Fund with no role in this area at all, including in the area of portfolio investment. The Fund should be able to challenge a member's claim either because of the nature of the asset being excluded or based on an assessment of the degree of control being exercised. The Fund could publish an illustrative list of assets that would be assumed generally to be outside its jurisdiction. But, the Executive Board could obviously reject a member's assertion regarding the jurisdictional line. Certainly, a member should be required to advise the Fund of its definition of inward direct investment if we go this route, and report restrictions on inward direct investment for periodic review, provided that would not impose an excessive burden on the Fund, and obviously refrain from imposing restrictions which would discriminate among Fund members.

On transitional arrangements, we agree that there is a need for a broad transitional arrangement to take account of the different economic and institutional circumstances of members. The transitional arrangements for current account restrictions, which the staff propose to replicate for capital movements, provide members with a general exemption with respect to existing restrictions and wide discretion on the timing and scope of future liberalization. This approach has been effective in preventing backsliding on current restrictions, but it also has not offered very strong incentives for countries to move from a transitional status to the acceptance of the full liberalization obligation. I think it would be unfortunate if it took us another 50 years before a large majority of the Fund members accepted capital account liberalization. So we may want to reconsider our present rather laissez-faire approach in the event that a member persists in retaining restrictions following representation by the Fund that those restrictions are no longer justifiable under the transition principles and consider possible ineligibility to use Fund resources or even invocation of the provisions of Article XXVI, which we have not invoked on current restrictions.

As our approach to transitional arrangements in the existing Articles is all or nothing, you either have no unapproved restrictions under Article VIII, or you retain unapproved restrictions under Article XIV. It might be useful to consider an in-between measure which would encourage members to accept a higher level of liberalization while allowing them to retain a few specific, particularly sensitive measures without having to rely on the broad exemption provided by the transitional arrangement. The Fund would retain the right to review the remaining restrictions regularly, and could make representations to the member when the Fund considers that the restrictions are no longer necessary.

On approval policies, we are in broad agreement with the staff's approach concerning restrictions on capital outflows for balance of payments purposes and restrictions on capital inflows for macroeconomic reasons. However, it may be a bit artificial to assign specific purposes to controls on capital flows which themselves are the result of inconsistencies between domestic and external policies, rather than macroeconomic or balance of payments considerations alone. Nevertheless, I think the principles outlined by the staff this morning about nondiscrimination, a strong case that these temporary restrictions are essential to achieve the economic adjustment to correct the underlying problem, and obviously that all restrictions would be reported promptly to the Fund.

On the distinction the staff proposes to make between controls on the freedom to undertake a transaction and the subsequent related payments and transfers seems to us to conflict somewhat with the general principle that all elements of the balance of payments should be treated more or less uniformly. We know that some of our trade and investment colleagues take a somewhat different view on this issue, and we look forward to the staff paper on the institutional jurisdictional issues as between the Fund and others in this area.

On the staff's approach regarding new restrictions for market or institutional evolutionary reasons, we have some problems. It strikes us that the concept is quite ambiguous, and would involve difficult and perhaps subjective judgments that are quite country specific. It seems to us that such market or institutional exemptions should be treated either under the transitional arrangements or under the prudential rubric rather than by trying to establish a new class of approvable controls. I think we risk putting a very large loop hole in what we are trying to do.

We also have some reservations about the staff's approach to national security measures. We recognize that the present Articles provide for a Fund role in this area relating to current account transactions. The Fund, I believe, has in practice not questioned a member's invocation of the national security provisions in the Articles. We would support an approach to capital account transactions that ensures that a member's interpretation of its national security interests would not be open to challenge by the Fund. As with the current account, of course, a member should be required to notify the Fund promptly of such restrictions to ensure transparency.

On prudential measures, we certainly appreciate that such measures may at times raise questions about purpose and effect, and whether or not they are in conflict with the objective of capital liberalization. But it is also the fact that the Fund is not really well positioned, either by mandate or expertise, to render judgments on specific prudential measures. In these circumstances, the challenge is obviously to ensure that the pursuit of capital account liberalization respects the legitimate prudential concerns of responsible authorities in these areas. This strongly suggests that the Fund's approval policy should carry a presumption in favor of a member's claim. With regard to measures for monetary control purposes, the Fund clearly has both mandate and expertise regarding such measures. We would, however, appreciate a little more information on the nature of such measures and the rationale for discriminatory application before taking a firm position in this area.

On the implications for Fund financing, we do not think that there should be a presumption in the amendment that capital account liberalization will increase the general demand for Fund financing. There may be individual cases where capital outflows will give rise to demand for extraordinary access to Fund resources, particularly where a systemic threat is involved. We think that these can be addressed through the Fund's access policies and other measures.

With regard to Article VI, it seems to us that retaining the prohibition against Fund financing of large and sustained capital outflows, contradicts the approach we are now taking which is to treat current and capital account transactions in a parallel way, in a symmetric way. Indeed, I think we all recognize it is becoming increasingly difficult to make a distinction between current and the capital transactions, which is one of the reasons we find some definitional difficulties in trying to draw lines about what we leave out of our jurisdiction. On its face, it would seem to us to be somewhat contradictory to retain that language. I believe we need to think about revising or modifying Article VI in this regard. Now, we certainly share members' concerns about safeguarding the Fund's resources, but we think that can be done under other Articles and Fund policies, and I think in this context that we should revisit the question of higher charges for extraordinary access. Pricing is an effective constraint on excessive or sustained use of Fund resources. We have debated it, but I think as we work through the implications of this capital account liberalization effort, we should revisit this issue as an alternative to having this prohibition, which, as Mr. Autheman observed, has not always been followed to the letter. We should make sure that the Articles are consistent with Fund practice and realistic.

With regard to the Fund's having the right to request a country to impose capital controls in an emergency or as part of a Fund program, I think it is on the one hand contradictory to have the Fund insist on the imposition of controls which we say are contrary to the purposes of the Fund; on the other hand, one can certainly foresee circumstances under which it might be a sensible component on a temporary basis in an adjustment program. So I do not think we should necessarily tie our hands and say that we could never support or request a country to adopt such controls on a temporary basis as part of an adjustment effort. It is a tricky issue, and I would say we want to keep this one under consideration.

Again, on the question of sanctions, it seems to us that the implications for Fund approval of transitional measures and capital account policies are enormous, and the economic implications outside the Fund are very large. So it seems to us that we should take another look at our practices with regard to sanctions for countries that violate the Fund's recommendations and the Board's position on restrictions, and if we disapprove of restrictions, whether or not we should in fact, as others have suggested, bar access to Fund resources or, indeed, trigger sanctions under Article XXVI.

Mr. Donecker made the following statement:

First, I would like to thank staff for the excellent, well written, and concise papers on difficult and complex issues. The papers provide indeed a good basis for today's discussion. In general, I can endorse the paper's main orientation and recommendations. However, since many questions raised in the papers deserve further detailed consideration as already mentioned by several of our colleagues, my comments, today, can only be of a preliminary nature. I regret that I was unable to catch some of my colleagues' statement papers, since I was held up with other urgent business. I wonder about the effectiveness of our procedure of issuing late grays here though.

Let me begin with some comments on the first paper, namely, The Treatment of Inward Direct Investment.

I had the impression, that in principle, we had already agreed on the exclusion of inward direct investment from the Fund's prospective jurisdiction. There are, indeed, convincing reasons to exclude those transactions. Restrictions on these flows are frequently imposed for reasons other than macroeconomic and balance of payments management, for example, to preserve sovereignty: real estate, companies involved in military production, airline industry, shipping. To involve the Fund in this area would, indeed, risk getting involved in political considerations.

The question, however, is, how to ensure, in practice, that the Fund's jurisdiction will not extend to restrictions on inward direct investments. The answer to this question is, indeed, difficult since we have to deal with different types of restrictions. Here too, the devil is in the details.

As the staff has pointed out (17 ff.), there are several different options available to ensure that Fund jurisdiction will not extend to restrictions on inward direct investments. However, since none of these various options are entirely satisfactory, an approach as suggested in Section 24 that combines elements of these various options appears to be appropriate.

As far as the first two types (categories) of restrictions are concerned, i.e., restrictions on the acquisition of specific capital assets, for example, real estate, and restrictions of individual participation of 10 percent or more in enterprises,

We can go along with the proposed approach to exclude these restrictions from Fund's jurisdiction. Since these types of restrictions can be defined on the basis of objective criteria, this approach seems to ensure equal-treatment among the Fund-members. At the same time, this approach has also the advantage to be transparent and simple, and thus, avoids to add too much to the future additional workload on Fund's staff.

In contrast to this, however, further clarification is needed before we can support the staff's proposed approach with respect to the residual measures falling within the third type (category) of restrictions, i.e., restrictions on individual participation of less than 10 percent, and restrictions on aggregate holdings below a specified level (10 percent or higher).

On the one hand, these restrictions can be regarded as measures imposed on the making of "portfolio investments," and thus, should be inside of the Fund's jurisdiction. On the other hand, however, the reasons for the imposition of these measures would seem to justify their remaining outside of the Fund's jurisdiction.

According to the staff's proposal, this type of restrictions which cannot be defined on the basis of objective criteria but only on the basis of purposes would be subject to Fund jurisdiction unless the member, imposing such restrictions, represented to the Fund that these restrictions were being imposed in order to protect a compelling national interest. In this context, it is also proposed to give the Fund the power to challenge any representation made by a member, and thereby bringing the measure back within the jurisdiction of the Fund.

While the proposal that this power would require a 70 percent majority appears to be a good basis, further clarification is needed, in particular, with regard to the following two considerations:

First, the proposed procedure to challenge any representation requires a case-by-case decision on whether the imposed restriction is "appropriate" or not. This procedure, however, would imply the risk to involve the Fund in difficult political considerations—not covered by its monetary mandate—for example, in defining what are strategic key enterprises. May I recall that one major reason to explicitly exclude inward direct investment from the Fund's prospective jurisdictions was just the intention to avoid any Fund involvement in such political debates. In addition, like Mr. Chelsky and others, I am also concerned about the possible implications of such a procedure for the future workload for the staff, as well as for this Board.

Second, in our view, further clarification is also needed with respect to the possible consequences for other members if the Fund does not challenge a representation made by one member, and, thus, accepts that the representation would have the effect of taking the measure outside of Fund jurisdiction. What would be the implication for other members having imposed or considering to impose the same measures ? Would these measures also be excluded from the Fund's jurisdiction?

In light of these considerations, it appears to be necessary to further study the implications of the proposed procedure in order to ensure equal treatment among all members.

Let me now turn to the proposed issues for discussion sections 71-78 of the Capital Account Convertibility Paper.

First, I have no problem endorsing the staff's proposed principles for the design of Transitional Arrangements and Approval Policies, i.e., the principles of no backsliding, clear signaling, and flexibility in approval policies should also apply to the Fund's extended jurisdiction.

On Transitional Arrangements, I can endorse the proposed approach that the existing transitional provisions should also apply to the Fund's extended jurisdiction thus permitting a member to relax or intensify an existing restriction, while the introduction of a new restriction would require approval by the Fund. In this context, I concur with the staff that a broader scope of criteria will be needed when assessing the conditions under which a member should be encouraged to further liberalize its capital account. In order to achieve a durable liberalization, an appropriate sequencing of capital account liberalization with institutional and structural reforms in the financial sector is, indeed, crucial.

Furthermore, I also concur with the staff that the future Approval Policy will have to take account of the complexities of capital movements, the specifics of the case, as well as the purpose of the restriction. In this context, however, I wonder whether, among the proposed four areas that approval policy would need to cover, it will be possible to distinguish with sufficient precision between "restrictions for market and institutional evolution reasons" and "restrictions for prudential reasons." In practice, such a distinction may be very difficult.

Concerning temporary approvals, we can also endorse the proposed criteria for approving restrictions both on capital outflows and inflows i.e., that the measures are necessary for balance of payments reasons, temporary and nondiscriminatory. With regard to capital inflows, in the context of an emergency, however, the proposed approval criterion that the measure is needed for reasons of domestic liquidity and/or exchange rate management, should not be misunderstood or misused so as to sanction an insufficiently flexible exchange rate policy. In our view, in most cases, difficulties in managing surges in capital inflows can be put down to the fact that the monetary authorities are not willing to let the exchange rate appreciate.

Having said this, we generally welcome the staff's suggestion that restrictions on capital flows introduced in the context of an emergency need not to be approved by the Fund prior to their imposition, since, within the framework of liberalized capital movements, sizable and volatile capital flows can, in some instances, require a quick policy response in order to limit their potential damage. In this context, the proposed procedure for approving such restrictions on a lapse-of-time basis appears to be appropriate. However, in this context, it is my understanding that in cases where the proposed 30-day approval period turns out to be too short, the imposed measures are not deemed to be automatically approved, but that the Board will have the option to extend the period for emergency approval on the basis of a paper which clearly describes the reasons for an extension of the approval-period.

With regard to the approval of restrictions for market and institutional evolution, prudential, as well as for national or international security reasons, in principle, I can endorse the suggested approaches. In our view, however, it is important that, in general, maintaining financial market stability must have priority over a fast pace of liberalization.

In addition, I should like to comment on some further specific issues for clarification:

First, as I have already mentioned, I wonder, whether it is possible to distinguish between "restrictions for market and institutional evolution reasons" and "restrictions for prudential reasons." In practice, such a differentiation may be very difficult.

Second, in our view, the proposed policy for prudential measures should also extend to measures imposed for monetary control purposes.

Third, as regards the length of period for the approval of measures that are taken for prudential reasons, in principle, I can go along with the staff's suggested approach in Section 51 that determination of the length could be made dependent on whether, first, there are alternative, generally accepted best practices or norms to achieve the same prudential result without the need to impose a restriction; and, second, the extent to which the country has the capacity to implement these norms. The application of this approach may involve the Fund, much more than before, in debates on the implementation of prudential standards. In our view, this appears to be acceptable only as far as this approach would not lead to collisions with the primarily responsible supervisory bodies, such as the Basle Committee for Banking Supervision, for instance. The Fund has no "rule making authority" in the field of supervision, nor should the Fund get any such authority (BMF).

For example, institutional investors, such as insurance companies and investment funds, have to meet certain requirements on their foreign financial investments for prudential reasons. In this context, section 50 of the staff paper could give rise to the interpretation that such measures would require an assessment by the Fund. If this were the case, however, I would find it very difficult to support this approach.

Furthermore, it is our understanding that the expression "best practices" does refer to the implementation of prudential standards, and not to the management of individual financial institutions. In this context, it is possible that alternative "best practices" do indeed exist.

In addition, the prospective the Fund mandate must fit into the framework of already existing agreements on capital movements. According to the GATS, in general, measures imposed for prudential reasons are carved-out, unless these measures serve protectionist purposes. In case that the Fund would apply the GATS-approach, measures imposed for prudential and not for protectionist reasons would have to be approved by the Fund even without a time-limit. In assessing which measures should be classified as "protectionist," the following principles could be taken into consideration:

As far as the measures concerned are based on internationally agreed prudential standards (EU, Joint Forum, Basle Committee, IOSCO, IAIS etc.), these measures should not be considered to be protectionist.

The Fund should adhere to its previous approach and refer, to the extend possible, to objective criteria.

Let me now turn to the issues for discussion with regard to the Implications for Fund Financing:

First, on Section 76: Yes, I can endorse the staff's suggestion that in some cases, in the context of conditionality, the Fund may need to request members to impose controls on capital outflows. This authority would need to be made explicit in the Articles. In our view, it is very important to provide respectively maintain adequate safeguards for the Fund's resources.

Finally, with regard to the possible net effect of the amendment on the use of Fund resources, I think we have to be very careful here. In our view, the liberalization of capital movements can only be a lasting success if it does not increase negative moral hazard effects on investors and authorities. I fully share the view that the Fund should not even be perceived as providing a bailout for private investors. Under no circumstances should we allow that credit and exchange rate risks are shifted from market participants to the Fund. According to the staff, it appears to be likely that the liberalization of capital flows under the amendment will tend to increase the need for use of Fund resources. This, however, would, at the same time, indicate that the global monetary system would become less efficient and less stable and thus would put into question the purpose of the proposed amendment. In this context, I should like to add that the cancellation of the existing injunction in Article VI against Fund financing of large or sustained capital outflows would clearly give a wrong signal. Here I beg to differ from Mr. Kiekens's position. His argument that the fact that all Fund assistance is only temporary provides an adequate safeguard, is not convincing. Let me just mention the case of Sudan here.

Furthermore, in our view, there seems to be a fundamental inconsistency: On the one hand, the staff shares the view that steps to liberalize capital movements should only be carried out if and when the necessary institutional and structural preconditions are met. On the other hand, however, the assumption of an increased tendency toward a larger need for use of Fund resources is much more based on cases where less developed and thus vulnerable financial systems and inconsistent macro policies are going hand in hand with an obviously too early liberalization of capital movements.

I fully agree with Mr. Al-Turki that it is of critical importance that the Fund's role remains catalytic. Borrowers and investors should face up fully to the risks involved.

In our view, the central contribution of the Fund to promote capital account convertibility should be seen in its effective surveillance over members' economic policies and structural reforms. Within this framework the

Fund and each member have to work toward an appropriate sequencing of capital account liberalization with institutional and structural reforms in the financial sector. This should take place as I have just said within the framework of prudential standards, comprehensive, effective supervision and an appropriate macroeconomic policy mix, that is aimed at securing a sustainable balance of payments.

Thus the demand for Fund resources should be rather lower in this brave new world of increasingly liberalized capital flows, effective supervision of the banking sector and strengthened Fund surveillance—opposite!

Mr. Kaeser made the following statement:

As to the treatment of inward direct investment, most of the transactions imposed on this type of transaction are unrelated to balance of payments or macroeconomic management. In addition, the liberalization of inward foreign direct investment is the central purpose of a number of foreign investment agreements, and would also become comprehensive in the proposed Multilateral Agreement on Investment. The methodology that the Fund has adopted under its current jurisdiction in the determination of restrictions could serve as a guideline for the amendment. Objective criteria should, therefore, be identified in order to define as precisely as possible the transaction to be excluded from the Fund's jurisdiction. This strategy seems easily applicable in the case of the first two types of restriction identified by the paper, restriction imposed on the acquisition of specific capital assets, such as real estate, or measures imposed on ownership of enterprises by individual investors can be defined with certainty. In this respect, I agree that for the sake of simplicity, the OECD recommendation for defining effective influence be adopted by the Fund. In this case, an investor holding 10 percent or more of the total ordinary share of voting power will be considered as having an effective control over the enterprise. However, measures intended to limit or exclude the participation of foreigners in those domestic enterprises whose activities are regarded as necessary to the preservation of the country's essential interest raises difficulties. The 10 percent level suggested by the staff also in this case is probably inappropriate because it does not give the country concerned sufficient protection. A clear definition of the activities that may be covered by the clause of national interests could be agreed upon. But I wonder if we have to worry so much about this kind of restriction. Such a restriction reduces the demand for the share of the protected enterprises and has negative effects on their price. This punishment by the market is in itself a strong disincentive against an extensive use of the clause of national interests. After all, the role of the Fund is to advise countries wishing to take advantage of the liberalization of capital transaction, but not to force them to do so, if they prefer to bear the cost of the restriction. My approach would, therefore, be to make liberalization less, compulsory, less legalistic than the one of some colleagues who are clearly concerned by the interest of the investor and maybe more than by the interests of the recipients.

I agree that members should not be permitted to impose controls on inward foreign direct investment in a manner that restricts other transactions or payments and transfers that are covered under the Articles. Regarding foreigner's right of establishment, I share the staff's assessment that the Fund needs not to become involved in this matter. As the staff points out, this issue is normally covered by bilateral regional or multilateral agreements.

Turning now to the second paper, I share the staff view that it would be useful to build upon the principle underlying the Fund's existing jurisdiction when designing the transitional arrangements and approval policies under the amendment. The three basic principles of no backsliding, clear signaling, and flexible approval policies have allowed the design of a consistent framework for the Fund's current activity and should be taken up in the amendment. The objective of the amendment is to encourage member countries to adopt full capital account convertibility, and allow them to signal to the market their commitment. The notification by a member to the Fund that it accepts the obligations of capital account liberalization should, therefore, signal a clear commitment by the authorities to avoid restriction to the extent possible. If this signal is to be credible, the introduction of new restrictions should be clearly discouraged. There is, thus, a clear connection between no backsliding and signaling.

Concerning the transitional arrangement, the Fund should not impose capital account liberalization to any member. Each member country should be free to set its own pace. Members should, therefore, be able to retain their present regime, temporarily, phasing out the existing restriction only once the needed preconditions are met. It is, therefore, important that the staff advises the member to give up the protection of transitional arrangements only when they are in a sufficiently strong position to confidently avoid reliance on restrictions imposed for macroeconomic and balance of payments reasons. In assessing this position, the staff should pay due attention to sequencing issues and institutional problems.

Turning now to the approval policies, as experience has shown the recourse to temporary controls can on occasion provide some breathing room or breathing space, while the necessary fundamental policy adjustments are put in place. In assessing whether it would be appropriate to impose such measures, we agree with the staff's proposal to apply the existing criteria for approving exchange restrictions. Restrictions on capital outflows should be temporary, nondiscriminatory, and imposed for balance of payments purposes. With regard to restrictions on capital inflow, we agree that the balance of payments criterion needs to be adopted. The approval criterion could be in this case that the measure was justified for reasons of the macroeconomic management. Concerning emergency temporary approval, I do not see any good reason why capital inflows should be excluded. I would be in favor of an emergency approval policy not only for capital outflows, but also for capital inflow.

Concerning the financing under a Fund amendment, I belong to the group of those who think that the market does not learn much by mistakes. It is clear that the Fund will be exposed to large financing requests in case of financial crisis. However, the Fund should not give to the market the impression that it will bailout investors, it should not create moral hazard, it should not be seen as a lender of last resort, or as having the capacity to repay. Therefore, I think we should retain some protection against an excessive use of Fund resources. Article V, Section 3 and 4 gives us some safeguards against an excessive use of Fund resources, but like Mr. Wijnholds I prefer to have two locks on my door rather than one, and I feel some attraction in retaining at least partly Article VI in its present form. There is no contradiction, in my view, between the liberalization of capital transactions and a restrictive definition of the role of the Fund with respect of financing capital outflows. If we have to scrap an article of agreement, we could look at the Article VII, dealing with the replenishment and scarce currencies.

Mr. Giustiniani made the following statement:

The two documents prepared by the staff for today's discussion raise an array of sensitive issues that need to be carefully weighted for their potential implications, not only on the membership but also the Fund itself and on particular aspects of the normal Fund activities.

On the issue of the treatment of inward direct investment, I share most of the concerns expressed by Mr. Bernes in his statement. Therefore, I will just restate the difficulties in achieving a broadly agreeable definition of foreign direct investment based on objective criteria. One of the consequences of the increasing securitization of capital flows and the growing number of international investors is the progressive blurring of the distinction between direct and portfolio investment. Not only is it possible to exert an effective influence on the management of an enterprise with a small participation to the capital of the enterprise concerned, but the growing revitalization of capital markets also allows the rapid mobilization of large equity position. Hence, the size of the participation may no longer represent a good proxy of the willingness of the investor to establish lasting economic relations with the undertaking. Therefore, I am hesitant to consider the possible use of specific thresholds, say 10 percent, of foreign participation in order to define an inward direct investment. However, I wonder whether the exclusion of all inward direct investment, including equity portfolio investment, may be considered the appropriate solution to this problem. And, therefore, I wonder whether at the end the only viable solution may be the one adopted by the OECD which leaves the definition to the country themselves. But this is an issue to which we have to come back later on.

Let me then turn to the second document that goes to the core of the ongoing exercise of amending the Articles. The aim of an amendment of the Articles is not only to extend Fund jurisdiction to capital transactions, but also to provide the array of incentives and obligations intended to promote the orderly liberalization of capital account transactions by member countries. The system of reservation to the general obligation of removing restrictions on capital account transactions and the role of the Fund in providing the necessary financial support in case of balance of payments problems represents two key elements of such a framework. I will then focus my comments on these two aspects of the problem.

As far as the system of reservation is concerned, I cannot but agree with the staff on the main principle on which the proposed transition provision and approval policies are based. However, I wonder whether the principle of no backsliding needs to be better qualified in order not to represent an intentional obstacle to the progressive dismantling of restrictive measures. In the OECD, liberalization of capital movements, the list of international operations to which the general liberalization obligations apply is divided into two lists according to the maturity of the operation, and to the possibility of reimposing reservations once it has been withdrawn. This possibility is limited to transactions included in List B, i.e., short-term financial operations and nonresident acquisition of real estate. A more restrictive procedure is envisaged in the case whereby a member country needs to impose restriction on an operation, following List A. If I understood correctly, this difference in the authorization procedure tries to encourage the removal of reservations maintained by members for precautionary reasons in order to leave room for the imposition of restrictions in the future. At the same time, the system provides a sort of safety net in the case of short-term financial flows. Therefore, I wonder whether it would be possible to maintain in the proposed amendment such a flexibility in adopting the scope of reservations to the nature of the transaction concerned. In this regard, I am a bit puzzled by the preference expressed by the staff in paragraph 32 for the imposition of temporary ex ante controls, and I think further explanation would be appreciated on these things, because I do not understand very well if ex ante was intended just in the sense of preserving vested interests, or was some sort of a precautionary measure, already in place. On the issue of restriction for market and institutional reasons, and for prudential reasons, I share the concerns already expressed by Ms. Lissakers.

Consequently, I will go straight to the point of the implication for Fund financing.

I believe that in order to allow the Fund to pursue its mandate of fostering international financial stability in a world of potential volatile capital flows, it would appear desirable to allow member countries experiencing balance of payments difficulties generated by capital outflows to have access to Fund resources. Even though the limitation imposed by Article VI has not prevented the Fund from providing financial assistance in case of large capital flows, I believe that an appropriate redrafting of the Article is warranted. The possibility of using Fund resources in case of balance of payments difficulties generated by capital outflows exacerbates the risk of moral hazard. It is therefore necessary to underscore that, as emphasized by the G-10 report on the resolution of the liquidity crisis, neither debtor countries nor their creditors should expect to be isolated from adverse financial consequences by the provision of large official—in this case, multilateral—financing in the event of a crisis.

The problem of moral hazard raises the issue or at least makes more compelling the issue of adequate safeguards. In this case, certainly the first thing that comes to mind is the need for strengthening Fund surveillance. But I am also thinking whether this is not going to affect other aspects of the Fund's normal activity. For example, I would just put forward one thought about conditionality. In a new environment of growing capital markets' globalization, consideration should be given to the possibility of shifting the emphasis of conditionality from ex post, i.e., when the need for financial assistance has already emerged, to ex ante. In this case, the acceptance of Fund conditionality by a country would signal to the market the government's continuing commitment to sound economic policy even though there is no need, or no immediate need, for Fund financing. This would also allow us to better understand, in the case of a crisis, whether this was due to a market failure, because the market picked up the bad equilibria, or if it was due to a policy failure, in the sense that the government did not follow the right policies. I believe that consideration should be given to these other aspects of current account convertibility.

Mr. Bernal made the following statement:

We find the paper's proposals regarding the principles that should be applied in respect of transitional arrangements and approval policies under an amendment on capital account convertibility helpful, although we naturally also have a number of questions. This paper proposes that there should be no backsliding; in other words, a member who has abandoned capital account restrictions should not be entitled to reinstate them without Fund approval. It is for consideration whether such a rule should apply without exception. The paper proposes, furthermore, that members should be entitled to accept the obligations of the amendment, but should not be advised to do so until they felt in a sufficiently strong position to be able to expect not to need to return to the protection of transitional arrangements, and this seems reasonable. Additionally, the paper suggests that there should be flexibility regarding the approval policies, and this seems eminently reasonable. Accordingly, there should be the possibility of temporary approval for restrictions on capital outflows, including approval on an emergency basis and restrictions on capital inflows for macroeconomic policy purposes. It should be possible for countries to get approval for new restrictions in the overall context of market developments and liberalization. There should be broad scope for the approval of prudential restrictions, although most prudential measures would not give rise to restrictions in the technical sense of the term. Furthermore, security restrictions should remain outside the Fund's jurisdiction, or at least be given the overwhelming benefit of the doubt.

Transitional provisions regarding current account restrictions permit intensification and relaxation of existing restrictions without Fund approval while new restrictions do require approval. The same rule could be applied to capital movements under an amendment. But for members that have not accepted the obligation of capital account liberalization, we feel that exemption from approval on a temporary basis should be permissible also for new capital account restrictions.

Where the demand for outflow restrictions arises for balance of payments reasons, the present criteria could be applied, i.e. when a restriction was necessary for balance of payments reasons, was temporary, and was nondiscriminatory as between member countries. There might also be need for emergency procedures. Regarding inflow restrictions, if necessary for reasons of macroeconomic management, temporary and nondiscriminatory, these could also be tolerated. It should be possible to have restrictions imposed on capital inflows at least temporarily exempt from Fund jurisdiction.

Regarding approaches to the approval of restrictions for market and institutional evolution, prudential and security reasons, we would suggest the following: the extent to which members should be allowed to impose restrictions for the reasons mentioned once they have accepted the obligation to liberalize capital movements cannot be formulated in any simple way. The length of period for approval of measures taken for prudential reasons or maintained because of institutional constraints on the effectiveness of monetary instruments should be limited so as not to exceed the likely period of their effectiveness. Security restrictions should remain outside the Fund's jurisdiction, or at least be given the overwhelming benefit of the doubt. It is for consideration whether the Fund should be entitled to require members to impose controls on capital outflows. If a member should be unable to make such controls effective, such a requirement would be of no value. The question would then arise whether the Fund would be entitled to refuse a member access to its resources. The Fund would have to be prepared to provide larger amounts of temporary financing in support of members' adjustment policies in cases where the supply of private financing is sharply curtailed.

Regarding retention in the Articles of the present injunction against Fund financing of large capital outflows, it may be acceptable to rely on other provisions of the Articles, and in particular on Fund policies for assurances regarding adequate safeguards for the temporary use of Fund resources.

There has been a considerable convergence of opinion regarding the regulation of inward direct investment. The principal motive is political: the prevention of foreigners from owning certain types of assets or gaining control of particular domestic enterprises. These measures do not relate to a country's balance of payments and, therefore, are directed against foreigners rather than nonresidents. The question arises whether such measures should remain outside the jurisdiction of the Fund, and, if so, how could this limitation best be formulated. There appear to be three basic types of restrictions which could be considered in this context. The first category comprises restrictions on specific capital assets, for example foreign ownership of real estate and nonfinancial intangible assets such as intellectual property rights, and possibly certain lease-hold interests. It has been suggested that the acquisition of security interests in real estate should not be included. This seems reasonable. A second category are measures imposed on ownership or control of investment, except portfolio investment in enterprises. This comprises direct investment defined as enabling the foreign investor to exercise an effective influence on the management of the investment, which would become the reason for the exclusion. It has also been recommended that effective influence be understood as an interest of 10 percent or more of voting power. The third category would be measures defined to exclude the participation of foreigners in local enterprises regarded as necessary to the preservation of the country's essential interests. These measures are designed to ensure minimum levels of national ownership in certain local enterprises. Executive Directors agreed that the proposed amendment should grant the Fund jurisdiction over the making of portfolio investments, but there might still be reasons for their remaining outside the Fund's jurisdiction. Care would have to be taken that only those restrictions on portfolio investment remain outside the Fund's jurisdiction which fall within the third category.

The methods available to the Fund to ensure that its jurisdiction does not extend to restrictions on inward direct investment can be described in different terms. First, the right to regulate inward direct investment could be inscribed in the Articles and defined in objective terms, but only the first two categories discussed—specific assets; 10 percent or more participation in enterprises—could be considered, as the third category cannot be defined in terms of objective criteria. The first two categories would be exempt from Fund restrictions, but the same technique could not be used to exempt from the Fund's jurisdiction the third category defined by its purpose. In order to deal with this third category, the Fund could simply recognize the right of members to impose any measures necessary to regulate foreign ownership of investments and empower the Fund, perhaps with a special majority, to specify the measures that members may employ for this purpose. Such a broad power would, however, be somewhat unusual. A third approach would give members entire freedom to regulate inward direct investments. This freedom would be exercised by lodging a reservation against any inward direct investment. In this way, the matter would be taken outside the Fund's jurisdiction. What could be considered a disadvantage of this method would be that there would be no means of challenging the reservation. It would be relatively simple to exempt from the Fund's jurisdiction restrictions of inward investments regarding the first two categories described. The third category defined by purpose of resources would have to be dealt with by reservation. To avoid abuse, the Fund could be given the power, by a special majority, to challenge any such reservation. It is for consideration whether the importance of exemption from Fund jurisdiction would be so great or the chance of abuse so frequent that we should use this method rather than simply give blanket approval to any exemption of inward direct investment from the Fund's jurisdiction requested by a concerned member. There are additional problems which could be brought up in this connection. Simplicity should be the governing consideration.

Mr. Han made the following statement:

I thank the staff for providing us with two important papers on capital account convertibility for today's discussion. As I said in my previous statement, my comments today are still preliminary. I would also reiterate the general principles for capital account convertibility—to avoid overlapping and conflict with other international agreements, to adhere to objective criteria for implementing the various policies under the capital account convertibility, to apply the principles successfully used for current account convertibility, and to ensure the availability of Fund financial resources to the members as a result of capital account convertibility.

With regard to the treatment of inward direct investment, as I understand from the previous meeting, the exclusion of inward direct investment has been the general view of Directors. As the staff split inward direct investment into three categories, I support the exclusion of the first two categories of restriction from the Fund jurisdiction. As for restrictions falling into the third category, I am concerned about the applicability of the proposal made by the staff. First, I share Mr. Chelsky's view that the reasons to regard the equity investment between 0 to 10 percent as portfolio investment are not entirely convincing. Therefore, I would like to ask the staff what concept of portfolio investment we are using in this context. Furthermore, the concept of effective influence may vary from country to country and from time to time. Second, the most direct reason for the exclusion of inward direct investment is the fear that consideration of national interest may be subject to judgment by an international organization. Therefore, I do not see why restriction on equity investment between 0 to 10 percent will be free from the national interest concern. Third, the establishment of a Fund verdict procedure by 70 percent voting—or whatever improvement on this procedure may be—will not avoid carrying the risk of discretionary judgment and involvement in sovereignty issues, which is obviously beyond the Fund's mandate. As Mr. Chelsky convincingly argued, the cost of identifying the nonnational security reason for the third category in terms of tremendous work and legal ambiguity will be much larger than the benefits derived from this approach. Therefore, for the simplicity and transparency in the treatment of inward direct investment, we favor the approach to exclude the restriction of the third category from jurisdiction.

As for the transitional arrangement and approval policies, we generally agree with the three main principles set out in Paragraph 4 of the SM/97/193, in the spirit of allowing the member countries whose conditions are not ripe for capital account convertibility to keep the existing restrictions and seek Fund approval for the new restrictions. In particular, I would like to stress the importance of the third principle—the flexibility principle. Due to the complexity of the restrictions under the capital account, new capital restrictions may emerge with the market and institutional evolution. For example, the introduction of financial derivative products may be accompanied by some new restrictions in light of prudential consideration. It is also true that many countries undergoing rapid and significant transformation from planned to market economies usually impose transitional restrictions when doing away with old restrictions. In other words, when old restrictions are removed, it is difficult for them to jump directly to entirely free capital movement with only one step. Such transitional restrictions are usually important for these countries to precede steadily in their reform effort and should, therefore, be approved with the understanding that these countries are making progress toward capital account convertibility. We also agree that the restrictions on capital movement should be judged on the basis of whether they are for balance of payments reasons, and whether they are temporary and nondiscriminatory. However, as these criteria may be more difficult to find an objective base than in the case of current account convertibility, I would like to hear from the staff on how to ensure the objectivity of these criteria.

Furthermore, given the complexities in a move toward capital account convertibility, countries in transitional arrangements should be allowed sufficient autonomy to decide the strategies and time framework toward capital account convertibility. We find it difficult for the Fund to set the time framework for member countries for such practice, because it is complicated by what the objective is to judge that a country is ready to remove all restrictions.

With regard to emergency restrictions on capital inflow, it is desirable that approval policies should allow timely and efficient approval with full attention to the real situations in member countries. Concerning the emergency restrictions on capital outflow, it is also desirable to establish the approval policies, which can be based on the criteria of macroeconomic management considerations. This component can also facilitate the symmetry structure of the approval policies.

With this general position, I would like to make some specific remarks on the transitional arrangement. On paragraph 23, the staff indicated that it may be appropriate to broaden the conditions under which a member shall withdraw restrictions maintained under the transitional arrangements to encompass the development of the member's financial system. Can the staff give us some idea on how to broaden these conditions? On paragraph 32, the staff suggested three supplemented criteria to judge whether transactions are restricted. I have difficulty in grasping the sense of how these points could be used as criteria. Staff elaboration is welcome.

On financing under an amendment, we are of the view that the Fund's role in providing financial assistance to promote capital account convertibility should be increased parallel to the extension of its jurisdiction. It should be noted that given the complexities of capital account movement, the adjustment difficulties of a member country to lead the economy out of an emergency once they no longer have restrictions are more severe than in the case of current account. We also found successful adjustment usually took place with some restrictions on capital account. In this regard, we should avoid the over optimistic expectation that the policy adjustment measures, once in place, will take effect in the short run in the context of free capital movements. Therefore, it is important to carefully design the financing policies under the capital account convertibility. In particular, we agree that Fund financing to member countries in the context of capital account convertibility could be on a case-by-case basis. However, this should not jeopardize the equal treatment principle of the Articles. The conditionalities attached to the financing, with the purpose of guaranteeing the safety of Fund resources, should not be overplayed, for in the case of emergency it is usually difficult to judge whether the member can change the situation in the short term.

Mr. Andersen made the following statement:

In view of the regrettable short time period our home authorities have had to consider the many important issues at hand, I would like to emphasize the preliminary character of my comments which are concentrated on some of the broader issues raised in the papers for today's discussion.

First, some general remarks on our approach and procedures. While we welcome that the current set of papers has more economic content, we are still somewhat concerned about the excessive legal details in the documents. As mentioned by our UK colleagues, we must not loose sight of the woods for the trees, and we may well enhance our progress if we now try to concentrate on the key principles of an amendment and soon get some more concrete legal text on the table in order for us to respond appropriately to the mandate we have for the Hong Kong meetings. With that in mind we should also try to concentrate on the principles behind the amendment, while the precise procedures for implementing the changes to the Articles can be worked out as more experience is gained. In particular, when restrictions do not have a macroeconomic impact, we must be careful not to embark upon lengthy procedures for getting restrictions approved or discussions in the Board of the continued relevance of existing restrictions. Moreover, I think it is important to preserve the general character of the Articles and to keep the amendment simple. When bringing the de jure into line with the de facto, it is important to ensure that de facto in the future doesn't become weaker than de facto is at present, and if we are too specific about all the details, we are not only running the risk that we create too many loopholes at the outset but also that some of the details may become obsolete at a later stage. Further on the approach, we agree with extending the current framework to the capital account, even if there may not be perfect symmetry and more flexibility may be called for. If we follow the good tradition of concerning the Fund only with balance of payments and other macroeconomic issues, there is probably little if any need to complicate the matter by carving out explicitly limited areas of jurisdiction. Also, I agree that it is important to ensure that the amended Articles are consistent with other international agreements and that the Fund shall complement but not duplicate the work of the MAI and WTO.

Let me now turn to some of the more specific issues raised by the staff.

On whether to carve our inward foreign direct investment from the Fund's jurisdiction over the capital account, the staff and others have raised many interesting aspects which needs careful consideration. However, there may still be merits in looking into whether the solution perhaps best suited to preserve the general character of the Articles, and to take care if the problems of definition as referred to by Ms. Lissakers and Mr. Kiekens, would be not to state the exclusion of such investments explicitly in the Articles. At the same time, I would like to join Mr. Taylor in his emphasis on that inward direct investments of the makes an important contribution to economic growth, including through the associated flows of technology and managerial expertise accompanying such investments as we have seen not least in many transition economies, and that this needs to be reflected in our surveillance activities. Should we proceed along the lines suggested by the staff, we can agree with the classification of restrictions on inward direct investment into the suggested three categories and on the suggested treatment of measures falling within the first two categories. Regarding the third category, however, we doubt that the evaluation of national interests is an area where the Fund should be given a special competence. Therefore, we are not convinced that the Fund should be given the right to challenge the restriction by a majority voting in the Board. Rather, the Fund should demand transparency and the member's explanation.

Regarding transitional arrangements, there is a need for appropriate sequencing of capital account liberalization with institutional and structural reform in the financial sector. However, when capital restrictions are applied for balance of payments and macroeconomic reasons, they should be temporary and limited, and the staff's approach in that regard appears to be well balanced.

This brings me to approval policies where I agree with the principles of no backsliding, clear signaling and appropriate flexibility. However, the term "approval" might need further clarification. Emphasis should clearly be on the macroeconomic and balance of payments area. As regards institutional evolution and prudential regulation, even if their functioning is a condition for capital liberalization, the Fund does not have a specific authority in this field and, therefore, rather than "approving" restrictions with reference to these areas, it might be more precise to say that the Fund can "accept" the proposition of the member country after having considered explanations offered by the member country, in line with the fact that the Fund hasn't competence or expertise to evaluate specific prudential measures, as also stressed by Ms. Lissakers, Mr. Donecker and a few others. Moreover, when discussing the principles, recourse to restrictions for market and institutional evolution, prudential, and national or international security reasons, have a rationale, and we do not wish to rule them out. However, we are concerned about the possible abuse in their application. In this respect, transparency is, of course, crucial. The fact that the country concerned makes a representation on the grounds of prudential or security reasons should not preempt the staffs analysis based on macroeconomic considerations.

Finally, regarding the implications for Fund financing, it is difficult to see why making de jure into line with de facto should have a significant impact on the financing per se. Rather, the globalization of money and capital markets may have an impact, although difficult to estimate. As mentioned by Mr. Taylor, we need to do our utmost to ensure that liberalization goes hand in hand with the adoption of sound economic policies which should reduce the vulnerability of members to sudden shifts in investor confidence. At the same time the need for a well-capitalized Fund in order to be in a position to deal with large and hopefully isolated cases of emergency financing needs to be reiterated. While it may indeed be justified to adjust the language somewhat in the Articles to reflect what we actually are doing, as mentioned by Mr. Autheman, I also agree that it is important for the Fund to have in place adequate safeguards for its resources. We must bear in mind possible moral hazard effects, and I would agree with Mr. Wijnholds that it is important to retain a strong "no bail-out message" in the Articles, and to ensure that the Fund's catalytic role is kept intact. As a central banker, I have some sympathy not only for having two locks on the door, but also to have an effective alarm system and a dog of an appropriate size. Finally, the principle of evenhandedness is important when it comes to situations where the Fund may consider whether to recommend the member to impose restrictions. In that context, we should also reflect further on the consequences of the Fund requesting restrictions leading to private foreign investors being directly affected.

Mr. Yao made the following statement:

When I approached my authorities for the first time with the issue of capital account convertibility, I felt like the nurse that Mr. Kiekens was referring to in his statement, trying to reassure my authorities as to what are the implications of this subject. In that context, countries in my constituency welcome this discussion, as transitional arrangements are particularly relevant to their current situation. They believe that the success of the process of liberalization of the capital account would depend critically on this arrangement. Hence, the Fund must pay due attention to the differing initial situations prevailing in member countries.

Transitional arrangements and some flexibility in approval policies are needed in countries whose economic and financial situations are not well developed. In designing transitional arrangements and approval policies, the Fund should draw on its experience with restrictions on current account transactions. In this regard, this chair supports the basic principles of no backsliding, signaling, and flexibility in approval policies. Under signaling, the staff stated that members will be advised to accept the obligation of capital liberalization when they were in sufficiently strong positions. I would be interested in knowing the view of the staff on the conditions required for countries to be judged as having sufficiently strong positions and who will decide whether or not these conditions have been met by a member country. In other words, the point my authorities are raising is that they do not want to be forced toward a capital account convertibility process. They want to move at their own pace.

As regards approval policies, my authorities are of the view that they should be applied flexibly, and the restrictions should be seen as temporary and nondiscriminatory. Regarding emergency temporary approval, they agree that members should be able to introduce restrictions on capital movements during a crisis situation, particularly for countries that are presently developing financial markets and—they add—without prior Fund approval for a specific time period. The 30 days proposed by the staff seems reasonable to this chair. However, the required period should be determined on a case-by-case basis, taking into account the degree of cooperation between the Fund and the member country. A longer period should therefore be granted in appropriate circumstances.

For countries that are in the process of developing financial markets and whose financial systems are still vulnerable to external shocks, the imposition of restrictions on capital movements may be justified. Most developing countries, in particular countries in my constituency, fall within this category, and the situation should be looked at carefully. To approve a restriction imposed by these countries, I agree that it would be necessary for the Fund to assess the authorities' effort to place the country in a position to observe the obligation for liberalization of capital movements. Such effort could include an improvement of the soundness of the banking system and the development of institutions that are required to regulate domestic capital markets. In that context, they believe that Fund technical assistance will be of critical importance.

Concerning the impact of free capital movements on the demand for Fund financing, I agree with the staff that while access to capital markets may tend to reduce the need for the use of Fund resources, a shift in business confidence could put a strain on a member's balance of payments and requires substantial financing, including from the Fund. I therefore believe that the existence of volatile capital flows may require the Fund to provide large amounts of temporary financing, as the Mexican crisis has shown. To deal with such volatile capital movements, the Fund needs to make provision in order to be prepared to face effectively financial crisis situations in member countries.

Finally, on the treatment of inward direct investment, I have no comment at this point, because my authorities are presently discussing issues related to direct investment in general. However, I would like to raise the following point. Since presently we are moving toward what is well known as strategic alliance between firms that has taken place, I tend to agree with Mr. Chelsky that a 10 percent threshold may not be a good indication of effective influence of an investment by foreigners.

Mr. Yoshimura made the following statement:

Let me begin by commending the staff for presenting such well-organized, readable papers on the issues of inward direct investment, transitional arrangements, and approval policies. As was the case at the time of the last Board meeting, my authorities have expressed their concern that they need more time to examine the contents of the papers in detail. The papers are quite technical, and it will not be easy for my authorities to reach a conclusion quickly. Thus, I would like to note that the views I am expressing today are preliminary ones.

At the outset, I would like to confirm our support for excluding inward direct investment from the Fund's jurisdiction. By doing so, we can limit the Fund's involvement in the capital account issue to macroeconomic and financial aspects. Then we can focus on transitional arrangements and approval policies from a macroeconomic and financial point of view.

As I stated at the last Board meeting, it is not only the balance of payments factor which could justify transitional arrangements and approval policies. I certainly welcome Mr. Kiekens's change of position this time to include the macroeconomic factors. Also, this paper explicitly analyzes the way temporary restrictions on capital inflows should be handled from a macroeconomic standpoint, and I certainly welcome that. However, when we examine this subject, I still think that we should look at it from a broader perspective, taking into consideration the stability of the international financial system. If we look at recent developments in Thailand and the Philippines, can we be so confident that transitional or temporary measures should be examined solely from the standpoint of their impact on the country taking such measures, whether concerning the balance of payments or the macro economy? When we consider restrictions on the current account, we usually need not worry so much about their international implications, but can concentrate on their effects on the country concerned. On the other hand, problems of the capital account are brought about by international capital movements, and the international dimension is inherent in their character. Furthermore, their contagion effect on other countries is a fashionable theme, as the Chairman explained at the beginning in our recent discussion.

First, on inward direct investment, I welcome the paper's intention to define inward direct investment as objectively as possible, as well as to classify types of inward direct investment in three categories. On the first category, I can go along with the idea of including in this category foreign ownership of real estate and nonfinancial assets, for example intellectual property rights. On the second category, I think it is difficult to clearly determine what percentage of interest acquisition should be regarded as having effective influence. I thus think that flexibility should be granted to member countries in determining what should be regarded as "effective influence" and thus what is regarded as inward direct investment. Moreover, there will be some cases where granting loans should also be regarded as inward direct investment. Let us say an investor who holds equity in an enterprise up to a level that does not constitute an effective influence in terms of equity holdings grants a long-term loan with favorable terms to an enterprise. The enterprise may then feel somewhat constrained in acting against the investor's will. In such circumstances, it would be reasonable to say that this investor has an effective influence. I would welcome the staff comments on this point.

By the same token, on the third category, determining what should be included in this category is hard, because of the difficulty of setting an appropriate threshold for aggregate foreign ownership. It would be better to give member countries the authority to determine the scope of this category and to give the Fund authority to challenge restrictions only when it is apparent that the restrictions in question are not imposed for national interest reasons but rather for balance of payments or macroeconomic management reasons.

On transitional arrangements and approval policies, the staff paper's suggestion on their design seems reasonable. The transitional arrangements, under which members can maintain existing restrictions but cannot introduce new ones, appears appropriate. Other proposals in the paper on transitional arrangements, such as broadening conditions under which a member shall withdraw restrictions and conferring authority on the Fund to make representation for members' abandonment of restrictions when appropriate, seem reasonable.

I can go along with the three proposed criteria for approval of restrictions on capital outflows, as well as the introduction of emergency temporary approval. As to capital inflows, I have no problem with the proposed criteria, which are similar to those for capital outflows. I think that emergency temporary approval should be introduced for capital inflows as well, because there could be a situation where rapid and massive capital inflows could harm macroeconomic conditions so fast that ex-ante approval could not properly address the situation. In order to cope with the speculative inflow of capital, a sense of surprise is sometimes a necessary ingredient of the countermeasures, and I think the authorities should have a free hand in case of emergency, provided it is only temporary.

I support the introduction of approval of restrictions for market and institutional evolution reasons. The system of financial markets and institutions cannot be directly introduced from outside. While developed financial markets and advanced financial institutions can be used for reference or comparison purposes, developing and transitional countries have to develop their own financial markets and institutions. The specific conditions of each economy affect the development of a national financial system, and financial integrity, which is indispensable to the sound management of a national economy, should be established while respecting and maintaining the national character in the system. Therefore, temporary arrangements for the development of financial markets and institutions can be justified. The measures should be transparent, however, and only for the period required by the evolution of markets and institutions. The Fund should be able to closely monitor the situation to determine whether there are grounds for maintaining such restrictions. While it is important to avoid excessive protection of infant financial markets, longer periods for restrictions than under the current procedures could be acceptable if we take into account the fact that aspects of institution-building are involved in the evolution.

Prudential restrictions should be approved so that members can fulfill their responsibility to secure financial soundness. As the staff paper proposes, the extent to which prudential restrictions should be approved will depend on consideration of various factors, such as the existence of alternatives, the capacity of members to attain prudential results, and the development and harmonization of international regulatory and supervisory practices. I also recognize the need for approval of monetary control measures maintained because of institutional constraints on the effectiveness of monetary instruments. However, this should be accompanied by similar approval policies to those for prudential restrictions.

Approval of restrictions for reasons of national and international security should be accepted. I can support employing the existing procedures in approving these restrictions, which will allow the Fund to notify its objection if it is absolutely necessary.

On the implications of capital account liberalization for the Fund's financing, it is true that predicting the net effect of the amendment on the demand for the Fund's resources is extremely difficult. But it is also true that, against the background of recent liberalized and globalized international financial markets, rapid and massive movements of funds and destabilization of international financial markets could occur with changes in economic conditions and in investor sentiment, as we saw during the Mexican crisis and more recently in Thailand and the Philippines. Thus, I think it is necessary for the Fund to have authority to request members to impose controls on capital outflows in case of emergency, and for this authority to be explicit in the Articles. The present injunction against Fund financing of large or sustained capital outflows, on the other hand, may not have to be maintained now that, as the staff paper states, there are safeguards in Article V and the Fund has authority to impose restrictions on capital outflows. I personally think one lock may be enough to protect Fund safety, provided that an effective surveillance system is there.

Finally, on the legal issue concerning the relationship with GATS, I would like to ask the same question that I raised last time. Mr. Chelsky raised the same point in his statement. The paper on the transitional arrangements says that the GATS defers only to the Fund's existing jurisdiction, which is different from what I understood was explained by the staff at the last Board discussion. I would like to ask the staff to clarify whether or not the GATS will defer to the Fund's jurisdiction after the amendment comes into effect.

Mrs. Guti made the following statement:

We also wish to thank the staff for the useful set of papers that have been considered this morning. Like others, our views can only be preliminary at this stage.

By and large, the approach recommended by the staff seems to offer a pragmatic way for determining which measures imposed by member countries on inward direct investment are outside the jurisdiction of the Fund. An important element in the approach is the proposed categorization of restrictions on inward direct investment into the three types. The staff has suggested some objective criteria by which to define the measures that should fall into the first category, which I find useful. However, I am not in a position to commit my authorities with regard to the specifics on, for example, the threshold for effective influence, as it applies to measures in the second category. In this connection, it seems to me that it may be easier to make progress if each member is left free to determine its own threshold than to get all countries to agree on a common threshold.

As regards the third category, I find aspects of the proposal by the staff appealing. Countries would set their own limits on aggregate holdings by foreigners in enterprises operating in areas considered to be of compelling national interest. This would include total exclusion as the country sees fit, and also any residual measures falling into this category would be subject to Fund jurisdiction unless the member imposing such a restriction represents to the Fund that the restrictions were being imposed to protect vital national interests. The Articles would permit a member to make such representation any time. However, it is proposed to give the Fund the power to challenge the representation made by a member on the grounds that the relevant measure was not being imposed to protect a compelling national interest, but really for reasons related to balance of payments or macroeconomic management. It is also proposed that by special majority such a challenge would bring the measures back within the jurisdiction of the Fund. While this aspect of the proposal seems to have some merit in principle, I have some difficulties and I would find it difficult to endorse it at this stage. I would need to look at it more closely.

The staff has proposed some qualifications to the exclusion of inward direct investment from the Fund's jurisdiction with which members should comply under an amendment of the Articles. The first three of these appear to present no major problems. As regards the fourth, which deals with foreign ownership of local enterprises and foreigners' right of establishment, I am inclined to the view that this should be outside the jurisdiction of the Fund. First, I think that if the Fund has jurisdiction in this situation, this would in fact limit the legitimate right of members to protect some activities considered to be of compelling national interest from foreign involvement. Second, as noted by the staff, the forum for agreement on foreigners' rights of establishment is the GATS, and the Fund, I believe, may not need to get involved in this area.

Turning to the issues of the transitional arrangements and approval policies, the staff has put forward suggestions that, on the whole, reflect a careful balance of the important considerations. They are right to stress the need to take account of the different starting points of the membership, the evolving nature of their financial markets and instruments, the need for prudential controls and their changing circumstances. It is only in the context of these that an orderly liberalization of capital movements can be successfully pursued.

I can endorse the principles suggested by the staff for structuring the transitional provisions under an amendment. First, members would be able to adopt existing restrictions on capital movements but would require Fund approval of new restrictions, and second the idea that members would be advised to give up transitional arrangements by accepting obligations of capital liberalization. I would, however, stress the need for flexibility and caution. As suggested by the staff, members should be advised to accept obligations of capital liberalization only when they are in a sufficiently strong position to confidently avoid reliance on restrictions imposed for macroeconomic and balance of payments reasons. I consider the set of rules provided in Article XIV on transitional arrangements under the existing Articles largely adequate. I also find the current interpretation given to the expression "adapt to changing circumstances" broadly acceptable. As to the approach to be followed by the Fund in promoting orderly capital movements, I would like to underscore the following points raised by the staff. First, careful attention would need to be paid to the sequencing and pacing of capital account liberalization in order to take proper account of the specific circumstances and policies of individual countries. Second, the Fund's strategy must continue to emphasize persuasion over compulsion. In this regard, I wonder if it is necessary to retain the provision that allows the Fund to declare a member ineligible to use Fund resources for failing to abandon restrictions following representation to the member to do so.

I find the proposals regarding the various approval policies and procedures broadly acceptable. In particular, these relate to emergency temporary approval, temporary restrictions on capital inflows, restrictions for market and institutional evolution reasons, and prudential and other restrictions and measures introduced for national and international security purposes. The staff has provided a useful analysis of the implications for Fund financing of the liberalization of capital flows. A good part of this analysis is conjectural, but I agree with the staff that liberalization would likely increase the tendency toward larger current account deficits. The Fund would therefore need to be prepared to provide much larger temporary financing in support of members' adjustment policies in cases where this supply of private capital is significantly and abruptly curtailed, and where the country is prepared to implement the adjustment policies needed. The Fund's readiness to assist in such situations would greatly encourage members to liberalize capital movements.

After adjourning at 1:00 p.m., the meeting reconvened at 2:35.

Mr. Mozhin made the following statement:

I believe that the staff has again provided us with a sensible set of proposals. At this stage of our deliberations, I can tentatively support most of them. My following remarks will be of only marginal value, or should I say marginal utility. Let me, nevertheless, offer my brief comments in the same sequence as issues were raised in the staff paper.

I support the principles to be reflected in the design of transitional arrangements and approval policies, which are no back sliding, clear signaling, and flexibility in approval policies. In my opinion, the proposals before us do indeed reflect these basic principles. The concept of transitional arrangements is clearly very important, as, like Mr. Sivaraman, I believe that capital account convertibility is at the end of the tunnel of reforms. It is clear that many Fund members will have to remain under transitional arrangements for a rather lengthy period. In that connection, I believe that the role of the Fund is not only in encouraging members to move quickly to capital account convertibility, but also in discouraging them from doing it prematurely, before they really become ready. The question I have is whether, upon entering of the amendment into force, all members will be expected automatically to accept obligations under transitional arrangements, including the principle of no backsliding, or they will be allowed to take some time before deciding to avail themselves of these arrangements. I would appreciate staff comments.

With respect to approval policies, I have no objections to the main areas that are expected to be covered. Restrictions imposed for macro-economic and balance of payments reasons should be dealt with on the basis of temporary approvals provided that these restrictions are both temporary and nondiscriminatory. I also agree with the concept of emergency restrictions and the procedure proposed for their treatment. I do not expect much use of restrictions for market and institutional evolution reasons, as members should be addressing these issues prior to their acceptance of full obligations under capital account convertibility. However, it is important that members should have recourse to these restrictions, as it would provide them with additional confidence.

As for restrictions imposed for prudential and national and international security reasons, I believe that the Fund should largely rely on the judgment of the national authorities. Although this may provide some room for possible abuse, I do not see any sensible alternative. I believe that in these matters the Fund's policy should be based on persuasion rather than pressure. After all, the liberalization of capital account transactions is in the interest of Fund members themselves.

I agree that a likely consequence of the liberalization of capital flows under the amendment would be an increased tendency toward larger current account deficits. Accordingly, I believe that the Fund should be prepared to provide larger amounts of temporary financing in cases of abrupt changes in the directions of capital flows. At the same time, it is clear that such financing should not be either unconditional or unlimited. I believe that Article V, section 3(a), together with the Fund's policies on conditionality and excess, provide sufficient safeguard for the temporary use of the Fund's general resources. In that respect, I do not see much merit in retaining the present injunction against Fund financing of large or sustained capital outflows. At the same time, it is clearly necessary to make clear that no bail-out by the Fund should be expected either by creditors or by debtors.

As for the treatment of inward direct investment, I am very much attracted by the simple and straightforward proposal of Mr. Chelsky, which is to exclude all inward equity investments from the Fund's jurisdiction. It is widely recognized that it is extremely difficult to distinguish between direct and portfolio equity investment, and the concept of effective influence is only a partial and not entirely satisfactory solution. I do not think that the Fund's policy should be based on such an imprecise definition. The exclusion of all inward equity investments would not really weaken the purpose of the amendment, as such restrictions are not imposed for macroeconomic management or balance of payments reasons.

Mr. Joyosumarto made the following statement:

I welcome today's discussion in our effort to identify common ground and to enhance our understanding on those issues before attempt to amend the Articles, to allow proper Fund jurisdiction over capital movements should proceed. Let me put to record that my views are also preliminary.

At the last Board meeting on capital movements, most Directors, including from this Chair, felt that inward direct investment should fall outside the Fund's jurisdiction in all respect. The staff in their latest paper proposed to bring into Fund jurisdiction the inward direct investments that fall within the second and third categories of restrictions to the extent that such investment would not give the foreign investors any 'effective influence' in the management of the local enterprises of a country. They also highlighted a number of complex issues. The coverage by the Fund of inward direct investment under the third category could always be circumvented by the members' argument of the protection of national interests. I am not clear as to the proposal to empower the Board to challenge any such representation made by a member. Is the Board going to challenge every representation? What would be the implication to Fund resources in establishing whether or not these restrictions are meant to protect compelling national interest.

Therefore, I believe that there should be flexibility in the exercise of Fund jurisdiction over inward direct investment. Restrictions are normally imposed for prudential and security reasons or to safeguard national interests. Accordingly, matters relating to inward direct investment should remain within the jurisdiction of individual members. To achieve this, it would be useful to have clear-cut exception clauses in the Articles, to identify areas where flexibility is allowed. Such clauses could be modeled along those accorded by the WTO whereby imposition of restrictions for prudential or national interests cannot be challenged. Individual countries have a right to determine which forms of inward direct investment they wish to permit. At the same time, we recognize that the investor's interest should be protected. In this regard, it would be appropriate to extend Fund jurisdiction over inward and outward payments and transfers that are associated with inward direct investments that governments have previously approved.

In general, I am agreeable that the design of transitional arrangements and approval policies should be based on the broad principles that have been proposed by the staff, namely, flexibility in approval policies, clear signaling and no backsliding. As this Chair has stressed in the past, the move toward capital account liberalization should be a gradual and cautious process. The intention as embedded in paragraph 21 that the Fund will assist member countries technically in liberalizing their capital account in an orderly manner, taking into account the particular circumstances of each country, is most welcome. I would like to emphasize here that member countries should not be pressured into accepting the obligations of capital account convertibility. They should only be encouraged to do so when their institutional framework and economy are sufficiently strong.

On the approval policy, we concur with the staff proposal that such policy should cover restrictions for macroeconomic and balance of payments reasons, and for market and institution evolution, prudential, and national and international security. With respect to restrictions for macroeconomic and balance of payments reasons, member countries should have the flexibility to impose temporary capital controls to deal with a crisis originating from substantial capital outflow as well as capital inflow without prior Fund approval. I support the proposal for the lapse-of-time approval upon notification by the member soon after the imposition of the emergency restrictions, and the option to extend the duration of an emergency restriction where necessary. Such approval could be for an initial period of 30 days, and renewable for further periods of 30 days on a lapse-of-time basis. The assumption here is that the Board will approve the requests on capital control. In this context, could the staff elaborate what will happen in situations where the Board does not approve these requests.

> Similar approval procedures should be developed for restrictions for market and institutional evolution and prudential and other restrictions, with an extended period of approval, where appropriate, while procedures that already exist to handle measures on the bases of national and international security reasons under existing jurisdiction could be applied for Fund jurisdiction over capital movements. I wish to seek staff clarification on how the Fund intends to enforce the distinction between capital controls imposed for prudential versus macroeconomic and balance of payments reasons. Usually prudential concerns arise due to the need to ensure macroeconomic stability and avert balance of payments problems.
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> I wish to reiterate here that with the extension of Fund jurisdiction over the capital account, the Fund has a moral responsibility to assist members that face difficulties arising from their efforts to follow Fund advice to liberalize. Given the volatile nature of capital flows, the Fund must stand ready to provide larger amounts of temporary financing to support members that face difficulties arising from the capital account. In this regard, the Fund's Articles of Agreement should drop its present injunction against Fund financing of large or sustained capital outflows. The existing safeguards for the temporary use of Fund resources are adequate.

Mr. Daïri asked whether it would be possible to have a post-ratification transition period, that is, a lag between the ratification of the amendment and the coming into effect of the amendment. As the staff had mentioned, developing countries had less developed financial systems, so they would need time to refine their regulations. Provision of a post-ratification period would hasten ratification by members, because it would give them time to take stock of their financial systems.

Mr. Eyzaguirre wondered whether the Fund's approach to capital account problems had in fact changed over the years in light of the experiences of Mexico, Thailand, and the Czech Republic.

Ms. Lissakers urged those Directors who favored maintaining the injunction against financing capital account outflows to reconsider their position. In her view, it was very important that the amended Articles should be consistent; Directors had already agreed that Article I should be modified to accord equal treatment to capital flows and to trade flows. Thus, it would inconsistent to retain Article VI, which allowed Fund resources to be used to finance members' balance of payments problems arising from the current account, but not those emanating from the capital account. Article I (v) stated that the purpose of the Fund was "to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." That paragraph did not distinguish between current account and capital account balance of payments problems. The Articles reflected the working of the international monetary system of the time, when capital controls were the rule and not the exception. However, in considering capital account convertibility, Directors acknowledged that the international monetary system had undergone fundamental change since the Articles were framed, in particular cross-border flows of investment were as critical to world prosperity as the cross-border movement of goods and services.

Moreover, it would be useful to examine what was meant by the phrase "to give confidence to members," Ms. Lissakers continued. With the liberalization of capital accounts there could well be instances in which a rather large use of Fund resources would be necessary to give members such confidence. The Fund would need to make a judgment on how large Fund financing would need to be in that context. That did not mean that over time use of Fund resources would be greater, but it was to be expected that large-scale support would be needed at times, because the magnitude of a crisis was bound to be greater in an environment of free capital movements. The Fund should be less concerned about whether a member's balance of payments problems was a current or capital account problem; the goal of Fund support should be to discourage members from large or sustained use of Fund resources. It was for that reason that she had suggested revisiting the issue of higher charges for exceptional access to Fund resources.

Mr. Daïri observed that, while he agreed with Ms. Lissakers on the issue of Fund financing, he could not agree with her on the need to impose higher charges for countries with exceptional access to Fund resources. Furthermore, under an amendment of the Articles, the Fund should be precluded from recommending capital controls as a substitute for Fund financing. It would not be appropriate for the Fund, on the one hand, to ask members to impose controls, and on the other, to recommend capital account liberalization.

Mr. Shaalan said that he welcomed Ms. Lissakers's comments, with the exception of the one on higher charges.

Mr. Donecker remarked that there was a significant difference between a balance of payments problem on the current account and one on the capital account; indeed the turnover in foreign exchange markets far exceeded the size of transactions on the current account. In view of the magnitude of capital flows and the potential risks to the Fund's resources in assisting members to cope with large amounts of volatile flows, there should be safeguards against undue use of Fund resources, and he therefore favored maintaining Article VI, possibly in an amended form.

Mr. Kaeser said that capital account liberalization might not be consistent with Article I, which stated that the purpose of the Fund was to promote exchange stability and shorten the duration, and lessen the degree, of disequilibrium in members' balance of payments. Nevertheless, that was no reason for the Fund not to encourage members to liberalize capital movements. On the financing issue, there was no contradiction between promoting capital account liberalization and setting limits to the extent to which the Fund would support a member facing capital outflow problems. Article VI could be modified somewhat, but it was important to maintain the injunction against Fund financing of large or sustained outflows.

Mr. Toribio noted that the Board should take a decision as soon as possible as to whether or not to retain Article VI in its present form. He agreed with Ms. Lissakers that it was difficult to distinguish between a balance of payments problem on the current account and one on the capital account. In the case of Thailand, and Mexico earlier, they had not asked themselves whether the problem was in the current or capital account. Usually, problems of that nature originated in the current account, but inevitably, and quickly, they evolved into capital account problems as capital flowed out of the country. Whether—and to what extent—the Fund should support a country facing such problems was a more critical question, in his view. Finally, he did not agree with Ms. Lissakers on levying a higher charge on members with exceptional access to Fund resources; there were other ways to limit the use of Fund resources.

Mr. Autheman welcomed Ms. Lissakers's suggestion to revisit the issue of higher charges. While the purpose of Article VI was to prevent Fund financing of capital outflows, in practice, as the Fund's support for the Philippines had shown, the Fund did support members trying to cope with portfolio outflows. He agreed that the wording of Article VI should be changed. If the Committee of Interpretation were to meet today it would conclude that according to the provisions of Article VI, the Fund could finance large or sustained capital outflows, but not both. Indeed, the Fund had in some cases provided financing in response to large outflows that were not sustained outflows, and in other cases, the Fund had supported sustained outflows that were not large. Fund financing should keep in mind the three principles: no backsliding, the signaling effect, and flexibility. In particular, he agreed with Mr. Donecker that a modified Article VI could have a signaling effect.

Mr. Sivaraman noted that it was important to bear in mind that several countries had already begun to liberalize capital movements. The magnitude of capital flows into emerging market economies—about $266 billion—suggested that those countries would liberalize irrespective of whether the Fund amended its Articles. The Fund had recently decided to enter into that sphere and to include capital account convertibility within its jurisdiction. It was only appropriate then that it should provide some sort of safety net for countries that were undertaking capital account convertibility. Members should be given the confidence that, if they faced problems—particularly problems that were not the result of their policy choices—the Fund would stand ready to assist them. It was important that the Fund be flexible in that regard, and he agreed with Ms. Lissakers that Directors should consider that issue closely. It was difficult to define precisely either "large" or "sustained." A sustained outflow would presumably end when a country's reserves had been depleted; thus, even sustained outflows would not be endless.

Mr. O'Donnell considered that a market-based approach would call for levying higher charges on large-scale use of Fund resources. Article VI prohibited the Fund from supporting large "and" sustained outflows, but not large "or" sustained outflows. He wondered whether the Fund had violated Article VI in the past. With respect to Mr. Sivaraman's point about sustained outflows, he considered that the recent widespread use of derivative instruments made it possible for outflows to exceed a country's reserves; thus, outflows might not be limited by the size of a country's reserves.

Ms. Lissakers remarked that by not amending Article VI there was a danger that there would be a contradiction between Article VI and Article I. The amended Articles should give the Fund the ability to respond to members' problems by providing support for a country's balance of payments problems. On a related issue, some Directors had raised an important point about what kind of exchange rate regime would be appropriate in a world of free capital movements. Her conclusion from the experiences of Mexico and Thailand was that fixed exchange rate regimes were not appropriate for an extended period of time in a world of free capital movements.

Mr. Eyzaguirre said that he agreed with Ms. Lissakers that flexibility in exchange rate regimes was important. The experiences of Thailand and Mexico showed how quickly problems at the level of banks and corporations could degenerate into a problem involving the entire financial sector. He wondered whether there were some "best practices" in industrial countries that could be applied to emerging market economies that faced volatile capital flows.

Mr. Andersen said that he believed that fixed exchange rate regimes could be very beneficial for a country provided that the supporting financial policies—particularly incomes policy—were in place.

Mr. Yoshimura said that he agreed with Mr. Donecker that the sheer volume of capital movements set capital markets apart from other markets. However, he differed from Mr. Donecker in that he believed that, because volatile movements could pose a threat to the stability of the international monetary system, it was important to have some arrangement in place that would provide countries with financial support in the event that they were faced with large or sustained capital outflows. Thus, he did not see the need to retain Article VI. At the same time, the Fund should have the option of asking members to impose controls.

Mr. Toribio, referring to Mr. O'Donnell's remarks, said that he considered that instead of levying higher charges on members for large-scale use of Fund resources, an option might be to ration the use of Fund resources, which would also be a market-based approach. The issue was not one of charges, but of financing capital outflows, and the amount of financing the Fund should provide in that context.

Mr. Shaalan remarked that moral hazard could be avoided by including in the amended Articles a provision that stated that due regard would be paid to the catalytic role of Fund financing.

Mr. Kaeser observed that Ms. Lissakers had suggested that Article VI be deleted and instead a provision for higher charges be introduced. He would be willing to support that if there was agreement on higher charges. In the past, it had not been possible to obtain the necessary majority for it.

Mr. Chelsky noted that the staff could perhaps propose some wording that would strike a balance between the need to avoid moral hazard and the need to make available Fund resources to members facing capital outflows. Directors were in agreement that their discussions should not lose sight of the ultimate objective, which was to liberalize capital movements. Moreover, all agreed that the amendment should be as simple as possible. The differences of view were over the extent of Fund jurisdiction. It was important not to isolate the issue of Fund jurisdiction from the other issues—approval policies, the availability of staff resources, and the priorities of the institution in the period ahead. The Fund could only encourage members to comply with the Articles through its surveillance activity, technical assistance, and conditionality on the use of its resources. As there was no provision in the Fund's Articles for sanctions to be imposed on members for noncompliance, it would not be useful to look for ways to close every loophole.

The Fund's jurisdiction over the current account emanated from Article I, which gave the Fund the mandate to promote liberalization of the current account, and from the fact that there was no provision in the Articles allowing members to impose restrictions on the current account, Mr. Chelsky observed. The combination of the two had been interpreted to mean that the Fund's conditionality included liberalization of the current account. He wondered whether a similar approach could be used for the capital account, by amending Article I to include capital account liberalization under the Fund's mandate and by excluding from the

Articles any provision allowing members to impose controls on the capital account. That would be no different substantively from the approval polices that the staff was proposing, because in both cases the Fund could not enforce compliance. Furthermore, the elaborate approval polices would be time consuming, would use up scarce resources, and would mean that the Fund would have to make judgments on issues beyond its area of expertise.

The Director of the Policy Development and Review Department noted that the principle that restrictions be nondiscriminatory meant that a member could not introduce restrictions on the capital account that had the effect of discriminating among Fund members. The focus was therefore not on discrimination within a member country, where domestic regulatory rules often discriminated between institutions or corporations or individuals.

Ms. Lissakers was suggesting that members accept the obligations of capital account convertibility even if they had some restrictions in place, the Director continued. That was the case with current account restrictions: members could accept the obligations of Article VIII, while retaining restrictions that they had under the transitional arrangements or indeed restrictions that had been imposed subsequent to the list of restrictions that had been approved under the transitional arrangements. The staff's view was that if the intention were to achieve a credible signaling effect by accepting the obligations of convertibility, it would be preferable for a member to have as few restrictions as possible in place, and preferably no restrictions. Of course, the member would have to have in place fairly well developed financial markets and institutions and sound macroeconomic policies. Some Directors had referred to the need for capital account convertibility to be part of a broad reform package, so that once a member had accepted the obligations, it would be unlikely to want to resort to new restrictions. The issue of sanctions raised by Mr. Chelsky would need to be discussed at a later stage; the staff found pertinent Ms. Lissakers's point on the need to have sanctions so that a member who had accepted the obligations of convertibility did not have in place restrictions that were not approved by the Fund. Indeed, careful consideration would need to be given to how Article VIII 2(b) would apply to the capital account. The Article had not been interpreted uniformly in members' courts, but a strict interpretation would mean that a member who imposed a restriction that was approved by the Fund was afforded some protection by Article VIII 2(b), while a member who had unapproved restrictions would not enjoy the same protection—that in itself would be a powerful sanction.

The staff proposed that the approach that had been used for current account convertibility could also be used for capital account convertibility, the Director of the Policy Development and Review Department stated. For the current account, a member could accept either the obligations of Article VIII or avail itself of the transitional arrangements under Article XIV. Thus, members belonged to either of the two categories: Article VIII or Article XIV. There was no provision for a third category of members who might be in the process of changing to the transitional arrangements. While such an option might be explored for the capital account, it was unclear what it would achieve. The purpose of transitional arrangements was to allow those members who were not ready to accept the obligations of convertibility at the time of the ratification of the amendment to retain restrictions for a temporary period. New restrictions introduced after that would be subject to Fund approval.

Mr. Daïri remarked that he was not suggesting a process of changing to the transitional arrangements, but whether it would be possible to have a time lag between the ratification of the amendment and the time it came into effect, to allow members time to take stock of their financial systems.

The Director of the Policy Development and Review Department observed that, while such an option was conceivable, it raised questions about whether the intention was to encourage members to move to capital account convertibility. Ms. Lissakers had stressed that membership should not take as long to move to capital account convertibility as it had to move to current account convertibility. Moreover, it was unclear what could be achieved with a two-to-three-year time lag between the ratification of the amendment and its enforcement. The two-to-three-year time period would not determine whether members availed themselves of the transitional arrangements or accepted the obligations of convertibility because it was unlikely that in such a short time period, they would be able to develop the financial systems and macroeconomic policymaking capacity that were essential for liberalization. Indeed, the experiences of Thailand and Mexico had brought to the fore the importance of having in place sound financial systems prior to capital account convertibility. Several countries' financial systems had been too weak and had not been able to cope with capital flows, which inevitably accompanied capital account convertibility.

Ms. Lissakers observed that, while it was important to have a sound financial system in place prior to capital account convertibility, it was also important to recognize that the weaknesses in the financial systems were often not apparent until the country opened up its capital account. It was virtually impossible to have a completely damage-resistant banking system, and to have that as a prerequisite to capital account convertibility would only delay convertibility.

Mr. Mozhin wondered whether, in the absence of a time lag between ratification of the amendment and its enforcement, members might be discouraged from ratifying the amendment. Several countries were at an early stage of liberalizing capital movements and might wish to have in place restrictions, without seeking Fund approval, and for them a period of stocktaking would be useful.

Ms. Lissakers remarked that that argument was similar to the "infant industry" argument in trade, which was used to justify protectionist trade policies. The problem was that industries were never ready to compete until trade was liberalized.

Mr. Autheman said that Mr. Mozhin's point should be considered further. After all, the intention behind the amendment was not to encourage countries to seek Fund approval for new restrictions after the amendment came into effect. Thus, it made sense to give countries some time to determine which restrictions they would need, and those could be covered under the transitional arrangements.

The Acting Chairman observed that that was akin to countries binding themselves to maintaining higher tariffs to give themselves a margin of maneuver in case they needed to use them. With capital controls, the effect would be to encourage members to have more restrictions than they would have otherwise.

Mr. Eyzaguirre commented that there was a risk in the opposite direction as well, namely, that members might prematurely accept the obligations of convertibility in the hope of gaining favorable premia on interest rates.

Mr. Daïri remarked that the reason for a stocktaking period before the amendment came into effect was to tackle the inequity between developed and developing countries. Under the staff's approach, the developed countries would be able to maintain the restrictions that had evolved over time; developing countries, however, at a less advanced stage of financial market development, had not yet been able to develop the restrictions that they might need. A period of stocktaking would thus enable them to determine which restrictions they would need.

Mr. Sivaraman asked whether, in the staff's view, the amendment of the Articles would speed up the process of liberalizing capital movements, or the complex approval procedures and the possibility of sanctions and higher charges would make countries more cautious, thereby slowing the pace of liberalization.

The Director of the Policy Development and Review Department noted that the appropriate pacing and sequencing of the liberalization of capital movements was critical. The staff was not proposing that members hasten to accept the obligations of freedom of capital movements; at the same time, as Ms. Lissakers had noted, an overly cautious approach would delay liberalization unduly. A number of Directors had noted the importance of members having well-developed financial markets and institutions, arguing that restrictions maintained for market and institutional development reasons should be covered under the transitional arrangements. Under the staff's proposed approach, at the time of the amendment, a member would be able to maintain restrictions that already existed by availing itself of the transitional arrangements; new restrictions introduced subsequently would require Fund approval. Mr. Daïri and Mr. Mozhin were arguing that there should be an interlude between the ratification and enforcement of the amendment to give members time to introduce restrictions for market and institutional development reasons without seeking Fund approval. It was very important to bear in mind the potentially negative signaling effect created by members taking different routes to liberalization. It was difficult to ascertain whether members would become more cautious in their approach toward liberalization because of the various features of the amendment or because of the experiences of countries that had already liberalized capital movements. The emphasis on establishing the necessary institutions before moving to liberalization was important, and could make members more cautious. It was to be hoped that it would have the more positive effect of encouraging members to seek technical assistance to establish the necessary preconditions. Liberalization would bring with it large capital flows, higher investment, and more growth, and he would hope that that would encourage countries to move toward greater liberalization.

The staff was suggesting that consideration might be given to modifying the language of Article VI, the Director continued. The Fund should give confidence to members who accepted the obligations to liberalize capital movements that it would provide support if needed. Fund support would also have an important signaling effect. As had been noted, if Article VI were maintained in its present form, it would be somewhat inconsistent with the other Articles that would be amended. At the same time, there would need to be adequate safeguards for Fund resources. Moreover, the distinction between current account and capital account balance of payments problems was not clear cut. The Fund in fact had provided financing for large capital flows; it had not done so for sustained capital flows, however. Most cases of prolonged use of Fund resources had involved Fund financing for sustained current account deficits, in conjunction with financing from other creditors. Many of those countries had ESAF-supported programs. As the staff had noted in the paper, the Fund could not provide support to members facing sustained capital outflows, because Fund support required countries to adopt appropriate policies, which should stem the outflows. However, there could be circumstances in which the Fund would need to provide financing for large capital outflows, and on that issue, there were differences of view among Directors. That was related to whether there should be a provision in the Articles enabling the Fund to request a member to impose capital controls when financing and adjustment were inadequate to stem capital outflows. That issue would also need to be discussed further.

The approval criteria would involve an element of judgment, the Director of the Policy Development and Review Department noted. In particular, whether a restriction was for balance of payments reasons or was temporary would involve a subjective assessment about the restrictions and the efficacy of policies adopted. However, whether or not a restriction was discriminatory could be determined objectively.

The General Counsel noted that it had been suggested that, rather than extend Fund jurisdiction to the capital account, an alternative approach would be to rely on Fund conditionality and sanctions to liberalize capital movements. First, such an approach would introduce a dual standard in the Fund's membership: those members who used Fund resources would be subject to conditionality and would be required to liberalize capital movements, while those who did not use Fund resources would have no obligation to do the same. That would be an egregious case of dual standards. Second, the conditionality under the current Articles relating to trade liberalization was grounded both in the purposes of the Fund, Article I, and in the obligations of members to liberalize payments and transfers related to the current account. Under the alternative approach for the capital account, there would be no obligation on the part of the member to liberalize capital movements. It would be unique in the history of international treaties for the Fund to have as one of its purposes the liberalization of capital movements, without having a corresponding obligation on the part of members. Third, if the Fund were to use conditionality to liberalize capital movements, members should have the right to have access to full Fund financing.

Mr. Chelsky said that he had suggested the alternative approach because that seemed to be a simpler way than the staff's approach to liberalizing capital movements. He was not certain how such an approach would create a dual standard while the staff's approach of approval policies would not; under both approaches, borrowing members were subject to conditionality while nonborrowing members were not. Moreover, it was unclear why, under the alternative approach, conditionality would entail full Fund financing for members. He wondered whether the same was true for the current account.

The General Counsel replied that, with respect to the current account, there was no prohibition against Fund financing of large unsustained outflows, subject to the Fund's policies on use of Fund resources, as stated in Article V, Section 3(a). On the dual standard, to the extent that the Articles included an obligation for members to move to capital account convertibility, all members were subject to the same standard. The use of Fund conditionality would be an additional element in liberalizing capital movements. However, without any obligation on the part of all members to liberalize, the use of the conditionality instrument alone would subject borrowing members to a different standard than nonborrowing members.

Mr. Kaeser remarked that, if liberalization were in the interest of a member, there would be no need for sanctions; however, if it were in the interest of capital markets or investors, there might be a rationale in using sanctions to oblige a member to liberalize.

The General Counsel observed that what was beneficial for a member was also beneficial for the international community at large. The Interim Committee had taken the view that liberalizing capital movements was in the interest of the international community.

Unlike Article XII of GATS, Article XI of GATS did not take into account the consequences of extension of Fund jurisdiction over the capital account, the General Counsel observed. Article XI of GATS specifically reserved the rights and obligations of Fund members under the Articles with respect to current payments and transfers. With respect to capital transfers, however, apart from restrictions that were consistent with Article XII of GATS, only those restrictions that were introduced at the request of the Fund were protected. The latter was a moot concession because the Fund had never requested a member to impose controls. The Fund staff had made that point when Article XI of GATS was being drafted. The staff had also made the point that the Fund had not yet clarified the extent of its authority over capital movements under Article IV. Finally, the staff had emphasized that the Fund's jurisdiction in the future might include capital movements; therefore, there should be provision under the GATS to defer to the Fund when the latter approved a member's restrictions. However, those points had not been taken into account. Thus, Article XI of GATS only deferred to the Fund for current account transactions and contained no explicit provision for possible evolution of the Fund's jurisdiction to approve restrictions on capital movements. Article XII of GATS, in contrast, contained reference to a number of conditions that had to met, including consistency with the Fund's Articles. As normally understood in international law, a reference to consistency with a treaty or foreign law included possible future amendments thereto. Thus, in a conflict of laws treaty, the concept of a contract consistent with the laws of a foreign country included not only those contracts that were consistent with the laws of the country at the time the treaty entered into force, but also those that were consistent with the laws of the country as they may be amended.

Mr. Daïri remarked that there should be a clear delineation between the responsibilities of the Fund and GATS. The staff raised the question whether measures by members to limit the involvement of enterprises with foreign ownership in certain activities should be treated as a restriction. His view was that it should not, because those measures were not international transactions. Those kinds of restrictions should fall within the jurisdiction of GATS, but not the Fund.

The General Counsel observed that they would need to return to issues dealing with the WTO and Fund jurisdictions later. Directors had commented on the distinction between inward direct investment and equity investment, which had been based on the OECD classification. However, there was one major difference between the OECD's classification and the staff's proposed classification. The OECD code on liberalization of capital movements was not based on a legal distinction between obligations concerning inward direct investment and portfolio investment; it was a classification for statistical purposes. OECD members had an obligation to liberalize both direct and portfolio investments. However, in the Fund's case, the Interim Committee had said that inward direct investment should be excluded from the Fund's jurisdiction. Therefore the distinction for statistical purposes in the OECD had legal consequences in the Fund's case. To some extent all classifications, legal and statistical, were arbitrary. At the same time, if a distinction was to have some meaning, it was important to define the categories. In the OECD, as the distinction was for statistical purposes only and had no legal consequences, members were free to draw the line above which a foreign investment was considered direct investment. In the Fund's case, the practice thus far had been that obligations for all members should be uniform; therefore, it should not be left to each member to determine the threshold above which an investment would be inward direct investment, and would therefore be excluded from Fund jurisdiction, and below which an investment would be considered portfolio investment, and would therefore fall within Fund jurisdiction.

Mr. Sivaraman asked how the Fund would handle a case in which a nonresident took control over an enterprise through portfolio investments, as had happened in several countries, including industrial countries. In such a case, the distinction between inward direct and portfolio investment ceased to exist.

The General Counsel replied that that would not occur if it were agreed that equity participation below 10 percent did not constitute a large enough share to exercise control over an enterprise. Moreover, a country could always invoke the "compelling national interest" argument to restrict portfolio investment for an equity participation of less than 10 percent, by notifying the Fund. But that should be done in exceptional circumstances. To some extent, the 10 percent threshold to distinguish inward direct investment from portfolio investment was arbitrary, and the threshold could well have been 9 or 11 percent, but it was important to have some objective criterion.

It was suggested that a loan extended by a parent company to a subsidiary should also be regarded as inward direct investment if it led to the former exercising effective influence over the latter, the General Counsel continued. The same was true for banks that made loans to companies. If loans were considered inward direct investment and were kept outside the purview of Fund jurisdiction, one might well question whether the Fund's intention was in fact to liberalize outflows and inflows, or whether the intention was only to liberalize outflows. If it were left to each member to define what constituted inward direct investment and would therefore fall outside Fund jurisdiction, a member could deem an outflow to be an inflow, and the Fund would not be able to challenge it, jeopardizing the goal of greater liberalization. The Board had a serious issue to consider, namely, the extent to which it would wish to give full discretion to members to decide what their obligations would be under an amendment to the Articles. The staff believed that there had to be some flexibility, but at the same time, it was important to have some objective criteria.

Mr. O'Donnell remarked that if it were left to a member to determine whether a restriction were in the national interest, that could lead to a situation whereby all restrictions were deemed in the national interest, and therefore were kept outside Fund jurisdiction.

Mr. Chelsky wondered why a distinction for statistical purposes, which was quite arbitrary, was being used to determine the extent of Fund jurisdiction over foreign investment, when determination was supposed to be based on the nature of the investment.

The General Counsel observed that it was important to recognize that members would wish to retain their sovereignty over strategic or essential activities. Under the staff's approach, the intention was to liberalize capital movements and not to affect a member's right to limit foreigners' right to establishment. The staff would cover that issue in another paper.

It was important to have objective criteria to determine members' obligations with respect to liberalizing capital inflows, the General Counsel continued. That was the staff's approach, and that was the reason it had not suggested defining restrictions on the basis of their purposes or effects. The staff recognized that the objective criteria were somewhat arbitrary; however, unless there was some agreed-upon definition, there would be no objective criteria and members' obligations would be determined subjectively. The staff wished to limit subjectivity to the third category of restrictions, that is, restrictions on participation of less than 10 percent. Those would fall within Fund jurisdiction unless a member made a representation to the Fund, and a special majority would be required for the Fund to challenge the representation, which would be based on an assessment by the Fund that the restrictions were not imposed for compelling national interest reasons but for balance of payments or macroeconomic reasons. The rationale for the staff's approach was also based on the signaling effect of liberalization. The OECD's code of liberalization was not intended to have a signaling effect; perhaps the fact that the membership was limited to industrial countries might in itself have a signaling effect. However, the OECD code was so complex that it was difficult to have a clear picture of members' commitments. The staff's proposed approach of members availing themselves of transitional arrangements under Article XIV or accepting the obligations of Article VIII was clear cut and sent a clear signal to markets. That was the reason the staff was arguing for an objective definition of inward direct investment, recognizing that in some cases it would be difficult to have completely objective criteria.

Mr. Mozhin wondered what the staff's view was on Mr. Chelsky's proposal to exclude equity investment from the Fund's jurisdiction.

Mr. Yoshimura remarked that in some cases loans might also be regarded as inward direct investment. For example, an investor might hold an equity in an enterprise that was not large enough to constitute "effective influence" in terms of equity holding, but the investor might exercise effective influence because it had provided the loan on a favorable basis. Thus, loans should also fall within the category of inward direct investment.

The General Counsel noted that there was no clear-cut distinction between loans and equity investment. If the criterion were "effective influence," then at least certain loans would fall into that category. The question was the extent to which the Fund wished to rely on objective criteria.

Mr. Autheman remarked that the danger in carving out of the Fund's jurisdiction first direct investment, then portfolio investment—because it was similar to inward direct investment—and then loans—because they qualified as equity investment—was that very little would be left within the Fund's jurisdiction.

Mr. Taylor, concurring with Mr. Autheman, noted that Mr. Yoshimura's example was one of several. It was important to have some objective criteria to define inward direct investment and the scope of Fund jurisdiction. The issues were complex, and national interest was a subjective concept, thus it would not be easy to come up with objective criteria. They would need to give those issues some more thought and return to discuss them at a later stage.

Mr. Chelsky observed that the issue was whether or not the Fund had the expertise and the appropriate institutional mechanisms to determine whether capital inflows fell into the category of inward direct investment or into the category of portfolio investment. The Fund's comparative advantage was not in that sphere, in his view.

The General Counsel observed that the Fund's goal, as distinct from the MAI or the GATS, was to promote capital account liberalization, and not foreigners' right of establishment. The staff would return to the issue in a subsequent paper.

Ms. Lissakers asked the staff to specify the cases in which the Fund by a special majority could challenge a member's representation.

The General Counsel observed that that would apply to the third category. Thus, if a member decided to restrict portfolio investments on the grounds that such a restriction was necessary to protect a compelling national interest, even if such investments did not give foreign investors "effective influence," the member would need to notify the Fund. The Fund could challenge that representation, if a special majority were obtained.

Ms. Lissakers asked whether any national security assertion could be challenged by the Fund with a special majority.

The General Counsel remarked that Decision No. 144 applied to all restrictions on payments and transfers for current international transactions that were imposed for national security reasons. Since the Fund could not, by its own decisions, change the majorities specified in the Articles, only a majority of the votes cast was sufficient to challenge a member's representation under Decision No. 144. The concept of "compelling" national interest would partly overlap with the national security procedure if Decision No. 144 were extended to capital movements, but there would be three differences: the declaration of compelling national interest could cover situations broader than national security; it would only apply to inward capital movements that would otherwise be subject to Fund jurisdiction (i.e., portfolio investments); the declaration could only be challenged if the special majority required by the Articles were obtained.

Mr. Shaalan asked the staff to clarify the difference between invoking the "national security" clause and the "compelling national security" clause.

The General Counsel explained that the latter afforded the member making a representation greater protection as a special majority would be required to challenge it.

Ms. Lissakers wondered why a special majority would be required to challenge restrictions on portfolio investment, but not to challenge restrictions on all other capital account transactions.

The General Counsel responded that as inward direct investment was a sensitive area, members might want the additional protection afforded by a special majority. The staff was trying to strike a balance between providing members some protection and giving the Fund jurisdiction over inward direct investment. Under the staff's approach, inward direct investment would be carved out of the Fund's jurisdiction, and only portfolio investment—equity participation of, say, less than 10 percent—would fall within Fund jurisdiction. Moreover, outward capital transactions were not dissimilar to current account payments and transfers. A balance of payments problem caused by current account outflows was no different from one caused by capital outflows. Thus, the national security clause, as laid out in Decision No. 144, could be invoked for both.

Ms. Lissakers remarked that the Board would need to revisit the issue of the type of investments that would be carved out of the Fund's jurisdiction. Consideration might also need to be given to having a special majority to challenge all restrictions for national security reasons.

Mr. Autheman observed that the staff was proposing a rather complex procedure for approval of restrictions. There now appeared to be four different policies for restrictions: (i) they could be excluded from Fund jurisdiction; (ii) they could be covered under the "compelling national security interest" clause; (iii) they could be covered under the "national security interest" clause under existing procedures; and (in) they could be covered under the general approval policies for restrictions on capital movements. The problem with the staff's approach was that it excluded from Fund jurisdiction the most important element of liberalization, and one that had beneficial effects on countries' growth—inward direct investment. He would reiterate his proposal that perhaps a far simpler approach would be to grant a general waiver with respect to those restrictions on inward direct investment on which there was an international consensus. The waiver could be reviewed periodically as consensus evolved on which restrictions should be subject to waiver.

Mr. Mozhin wondered whether it would be better to include all inward direct investment under Fund jurisdiction and to address restrictions on national security grounds through a waiver or some other similar procedure.

Ms. Lissakers agreed with Mr. Autheman that the drawback of the staff's approach was that by carving out from Fund jurisdiction inward direct investment it was excluding liberalization of capital flows that were of great value to members.

Mr. Sivaraman said that he agreed with Mr. Mozhin that they should reconsider the principle to exclude inward direct investment from Fund jurisdiction. If inward direct investment, portfolio investment, and loans were excluded from Fund jurisdiction, they would be excluding virtually every form of direct investment from Fund jurisdiction. Restrictions imposed for national security reasons could be addressed through a waiver, in his view.

Mr. Daïri commented that there was merit in considering Mr. Mozhin's and Mr. Sivaraman's proposal for waivers. However, a waiver should require a special majority, that is, higher than a simple majority, so that it reflected the consensus view. He also wished to reiterate the point that perhaps it was time to review Decision No. 144. It had been 45 years since the decision had been adopted, and a review was long overdue.

Mr. Yoshimura observed that their discussion on defining inward direct investment and the scope of the Fund's jurisdiction reminded him of the discussions on the MAI. The participants at those discussions had found it difficult to delineate equity and portfolio investment and loans from equity investment, and they had ended up with the broadest possible definition of direct investment. He was somewhat concerned that, by going down the same path, the Fund's jurisdiction would overlap with that of the MAI.

Ms. Lissakers asked whether the following approach was feasible: all inward direct investment would be covered under Fund jurisdiction, and the Fund could defer to the MAI and other international bodies in approving restrictions.

The Director of the Policy Development and Review Department noted that the MAI was under negotiation by a small group of countries, and it was not clear what the outcome would be. Moreover, even if the MAI were to be addressed by the WTO, the WTO did not have the universal membership of the Fund. It was difficult to see how the MAI could apply to all Fund members. More important, the purposes of the MAI and the Fund were completely different: the MAI was aimed at protecting investors' rights, as were several other bilateral agreements; the Fund's goal was to liberalize capital movements, and depending on the nature of the carve-out, foreign investment as well. Thus there was a significant difference between the MAI and liberalization under the Fund's Articles in terms of form and substance.

Mr. Autheman clarified that his proposal was that there should be no exception under the Articles and that the obligation to liberalize capital movements should be general and unrestricted. At the same time, there could be a special approval policy of a general character to address issues that had an impact on capital movements, such as prudential regulations and regulations of inward direct investment. Therefore, there would be two approval policies for restrictions: the specific case-by-case approval policy that would apply to each and every restriction and a general waiver, which would try to capture the international consensus of the time, and which would apply to prudential regulations and inward direct investment.

The Director of the Policy Development and Review Department noted that the question was whether or not to carve out inward direct investment from the Fund's jurisdiction for all times, particularly as it would be very difficult after that to change the scope of the Fund's jurisdiction. They would need to consider the issue carefully. On Mr. Autheman's proposal, he wondered whether such an approach would eliminate the need to have a threshold to determine which restrictions would be covered under a waiver; in his view it would not, nor would it eliminate the need for an approval policy. Furthermore, under that approach too, a member could make a representation that a particular restriction qualified for a waiver; and members would have the option of justifying restrictions on "compelling national interest" grounds. Thus, all the contentious issues that were raised by the staff's approach would remain even if Mr. Autheman's approach were adopted.

Mr. Chelsky, asked whether under the staff's proposed approach, the Fund would have any leverage over a member whose representation justifying a restriction was challenged by the Fund.

The General Counsel noted that a restriction that was unapproved by the Fund would be inconsistent with the Articles and would not be recognized by the courts of other countries under Article VIII, Section 2(b), if there were litigation on that point. While it was true that, unlike domestic law, international law could not be enforced through the use of force, at the same time, and contrary to popular belief, countries did attach great importance to the perceptions of the international community and did not wish to be seen as not complying with their international obligations. Moreover, there was a system of sanctions in the Fund and a procedure to deal with violations of obligations. First, the Managing Director could report to the Board and make a complaint when a member was not in compliance with its obligations, and sanctions could follow. In the past, it had been unnecessary to resort to sanctions in the area of exchange restrictions, as discussions between the member and the staff, followed when necessary by the Managing Director's report to the Board, had by itself been an effective tool.

Ms. Honeyfield said that it would be useful if the staff were to give an indication of the next steps envisaged—both for the period prior to the Annual Meetings and for the longer term—with regard to the capital account discussions.

The Directors agreed to conclude the discussion on July 18, 1997.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/97/71 (7/14/97) and EBM/97/72 (7/15/97).

3. BENIN—ENHANCED STRUCTURAL ADJUSTMENT FACILITY—REVIEW UNDER FIRST ANNUAL ARRANGEMENT

1. Benin has consulted with the Fund in accordance with paragraph 2(d) of the first annual arrangement for Benin under the Enhanced Structural Adjustment Facility (ESAF) (EBS/96/127, Sup. 1, 9/3/96) and paragraph 5 of the letter of the Minister of Finance of Benin dated July 30, 1996.

2. The letter of the Minister of Finance of Benin dated June 20, 1997 shall be attached to the first annual ESAF Arrangement for Benin, and the letter dated July 30, 1996 shall be read as supplemented by the letter of June 20, 1997.

3. Accordingly, the indicators referred to in paragraphs 34 and 35 of the first annual ESAF Arrangement shall comprehend the benchmarks for June 1997 set out in Table 1 annexed to the letter of June 20, 1997.

4. The Fund determines that the midterm review envisaged in paragraph 2(d) of the first annual ESAF Arrangement is completed and, notwithstanding the nonobservance of the structural performance criteria regarding the updating of the administrative status of civil servants and the updating of the civil service roster, and the establishment of a quarterly monitoring system of treasury payments specified in paragraph 2(b)(iii) and (iv) of the first annual ESAF Arrangement, Benin may request the second loan under the arrangement. (EBS/97/119, 6/30/97)

Decision No. 11539-(97/72), adopted
July 10, 1997
effective July 14, 1997

APPROVAL: November 10, 1997

REINHARD H. MUNZBERG
Secretary