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August 1, 1994

To: Members of the Executive Board

From: The Secretary

Subject: Issues and Developments in the International Exchange and Payments System

Attached for consideration by the Executive Directors is a paper on issues and developments in the international exchange and payments system which, together with the staff statement outlining and setting priorities with respect to the specific issues contained in the above paper (BUFF/94/76, 8/1/94), will be discussed in a seminar on a date to be announced. Conclusions and issues for discussion appear on pages 51-55.

Mr. Quirk (ext. 38520) or Mr. Huh (ext. 38566) is available to answer technical or factual questions relating to this paper.

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INTERNATIONAL MONETARY FUND

Issues and Developments in the International Exchange and Payments Systems

Prepared by the Monetary and Exchange Affairs Department
(In consultation with other Departments)

Approved by Manuel Guitián

July 29, 1994

Contents | Page

Contents | Page

I. Introduction

This paper updates and reviews developments in the international exchange and payments system and the implications for the work of the Fund. 1/ It is intended to complement the biennial trade survey, 2/ and the country surveys of the Annual Report on Exchange Arrangements and Exchange Restrictions, 1994 (forthcoming).

The paper is organized as follows: Section II provides an overview of main developments and issues. Progress toward the objective of current account convertibility framed in Article VIII of the Fund's Articles of Agreement is surveyed in Section III. Section IV reviews developments in Fund members' exchange controls on international capital transfers and issues involved in liberalizing them. Trends in regimes for managing exchange rates, including forward and multiple exchange rate regimes, are analyzed in Section V. Section VI examines recent developments and issues in bilateral and regional cross-border payments arrangements, including those in the Baltic States, Russia, and other countries of the Former Soviet Union. Section VII briefly examines the Fund's technical assistance role in the exchange and payments area. Finally, Section VIII sets out some conclusions and issues for discussion.

Supplement 1 to the paper will provide background information, including aspects of technical assistance on exchange regimes provided to Fund member countries and statistical appendices: summary listings of recent measures affecting exchange regimes taken by individual Fund members and inventories of multiple exchange rate regimes and regional payments arrangements in effect at present.

1/ The last biennial survey of exchange regimes, "Developments in the International Exchange and Payments System", was published in the IMF's World Economic and Financial Surveys series in June 1992. The present paper represents the third in this series, first published separately in 1989. Previously, the exchange system surveys had been published as Part One of the IMF's Annual Reports on Exchange Arrangements and Exchange Restrictions (AREAER). The present paper draws on the information contained in the 1992 and 1993 AREAER's, and in the regular quarterly reports provided to the Executive Board on changes in exchange rate arrangements. The issues that it addresses have emerged in staff discussions and reports for Article IV consultations and in technical assistance discussions with Fund members on exchange and payments systems. In preparing this paper, the staff has also had at its disposal reports of the Organization for Economic Cooperation and Development (OECD) and European Union (EU) on policies for capital controls in the respective member countries of those organizations. Unless otherwise specified, data is for end-1993; or end-1992 where it depends on the coverage of the most recent AREAER.

2/ See "Comprehensive Trade Paper - Issues Paper", SM/94/192 (7/19/94) and Supplements 1-3.

II. Overview

Continued integration of global financial markets and parallel developments in domestic financial systems was reflected in further liberalization of Fund members' exchange systems in the early 1990s. The trend toward open financial systems has been particularly evident in industrial countries, where the process of foreign exchange market liberalization was virtually completed by 1990. Only a few of the smaller industrial countries continue to maintain any form of controls on foreign exchange transactions, other than for prudential purposes. The freeing of exchange controls by individual countries was not accompanied in general by a weakening of their overall balance of payments, although it had been widely believed that this would inevitably result from liberalization in countries with weak external positions. Moreover, gains were made in the efficiency of allocation of capital. It should be emphasized, however, that freedom from exchange controls did not mean full freedom for international capital flows. In most industrial countries, controls and incentives remained on the underlying transactions, if not on the associated foreign exchange transactions. Restrictions on foreign direct and portfolio investment affect the mobility of capital, and together with differential tax treatments, they continue to limit the efficiencies already gained from decontrol of foreign exchange markets. Likewise, continued trade protectionism is effected not through exchange controls, but through trade policy and the customs mechanisms in particular. However, recent progress under the Uruguay Round now offers hope that the elimination of protectionism at the trade level will catch up, so that convertibility in the goods markets will match the high degree of currency convertibility that has emerged over the last decade or so.

In the developing countries, an accelerating trend toward liberalization of international payments and transfers has reflected a growing recognition that exchange restrictions are an inefficient and largely ineffective way to achieve their intended objectives--to limit outflows of foreign exchange, protect certain classes of imports or exports, or even raise tax revenue. It has also reflected a strengthening of domestic financial markets and progress toward market-based instruments of monetary and exchange policies to achieve external and internal balance. Developments in Latin America in the 1980s have underlined the difficulty of enforcing exchange controls, because many countries with seemingly comprehensive systems of exchange controls experienced massive capital flight. A second major reason for reduced recourse to exchange restrictions by developing countries has been greater flexibility and realism of exchange rate policies, and generally sounder macroeconomic policies, in the aftermath of the debt crisis. Such policies have enabled countries to restore vitality to the balance of payments without incurring the inefficiencies of exchange restrictions, both in terms of resource allocation and the heavy administrative costs. There is evidence that eliminating exchange restrictions can even help strengthen the balance of payments in the short run--when the measures are taken as part of a comprehensive adjustment package. A growing number of developing countries have eliminated all exchange restrictions as part of the package of macroeconomic adjustment and have experienced a rapid turnaround to net capital inflows. Reflows of capital were prompted by the greater confidence, and because transferring and keeping capital offshore to evade restrictions was no longer profitable when yields on domestic assets rose as a result of improved exchange and interest rate policies. It has become increasingly evident that progress toward convertibility and well functioning exchange markets requires internally consistent and mutually reinforcing reforms of exchange control regime, exchange rate system and exchange market structures on the one hand, and supporting reforms of the monetary control system on the other. Effectiveness of such structural reforms needs to be underpinned by sound macroeconomic policies.

Previous biennial surveys have noted the close link between the adoption of market-oriented exchange rates and the lifting of exchange restrictions. 1/ The present study notes that comprehensive foreign exchange control systems relying on foreign exchange budgeting have all but disappeared, being maintained now in fewer than ten member countries. The new liberalism is evident in the very few measures to tighten exchange controls taken by the developing countries in 1991 and 1992, as reported by the Fund in the AREAERs. On the other hand, there was an acceleration of liberalizing measures, particularly those affecting current invisibles payments, although much remains to be done.

Exchange regimes in developing countries evoke two remaining concerns: one to do with the Fund's jurisdiction, the other connected mainly with the aftermath of the debt crisis. Despite the trend toward currency convertibility, a large number of Fund members continue to maintain exchange restrictions, either inconsistent with the Fund's Article VIII, or for a very long time under the transitional arrangements of the Fund's Article XIV. 2/ Only about one third of developing countries have

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1/ See "Developments in the International Exchange and Trade Systems", World Economic and Financial Surveys, IMF, September 1989, and "Developments in Exchange and Payments Systems", World Economic and Financial Surveys, IMF, June 1992.

2/ A number of staff papers prepared for the Executive Board in recent years have addressed policies for specific forms of exchange controls, including multiple exchange rates, bilateral payments arrangements and countertrade, and external payments arrears. "Review of Experience with Multiple Exchange Rate Regimes", SM/84/64 (3/19/84); "Review of Multiple Exchange Rate Regimes--Background information", SM/84/65 (3/20/84); "Multiple Currency Practices Applicable Solely to Capital Transactions", SM/85/19 (1/16/85); "Review of Bilateral Payments Arrangements, 1976-81", SM/82/169 (8/17/82) (includes discussion of Fund policies on countertrade); "External Payments Arrears of Fund Members, 1985-86", EBS/86/261, and Sup. 1, (12/1/86) (see also EBS/84/155, EBS/85/12, and EBS/82/57). General policies for exchange controls have been addressed in the biennial exchange system surveys, such as the present one, and previous to these surveys, in Part One of the AREAERs.

accepted the obligations of the Fund's Article VIII, and of those countries, about one sixth have actually reimposed exchange restrictions inconsistent with their obligations under Article VIII. In response to this situation, the Executive Board in 1992 called for measures to accelerate the process of accepting Article VIII obligations. Intensified procedures have since been adopted by the Fund staff with the aim of monitoring and addressing issues of Article VIII acceptance in all Fund consultations. As a result of these intensified procedures, an additional 19 developing countries accepted the obligations of the Fund's Article VIII in 1993 and the first seven months of 1994; over one half of the Fund membership has now accepted the obligations of Article VIII.

The second main area of concern relates to the continuing ad hoc restrictions on the availability of foreign exchange maintained by a number of countries evidenced by external payments arrears. The status of external arrears was monitored in a series of Executive Board review papers in the 1980s that emphasized the drawbacks of arrears, both for the countries maintaining them and for the international payments system as a whole.

Exchange rate arrangements under the amended Articles have remained diverse, consistent with the freedom of members under Article IV to choose their own regime. While the general character of the international system, as described by the preponderance of cross-border transactions between the major countries, is a floating system, almost one half of the Fund membership maintains some form of fixed exchange rate arrangement. The case-by-case approach implied by such an international regime is also broadly consistent with the present state of policy cooperation and coordination. In part, the growing recourse to floating rates by developing countries has reflected continuing transition in stabilization and reforms. In a number of countries it has been the result of a heightened awareness in the aftermath of the debt crisis that out-of-line exchange rates result in increasing disintermediation of foreign exchange through parallel markets, and balance of payments crises. In other countries, the floating systems have been a response to uncertainties in the early stages of transition to market-based economies.

One common theme is that the existence of a range of feasible exchange rate regimes tailored to individual countries' situations, coupled with a better balance between domestic demand and absorption, has increasingly obviated the need for exchange controls to offset the impact of domestic policy shortcomings. In some instances, as with tariffs replacing quantitative import controls, dual exchange rates can play a role in the transition to a liberalized exchange and trade regime. Virtually all cases of recent multiple exchange rates have fallen into this transitional category.

Bilateralism and regionalism in payments had declined substantially among Fund members in recent years, so that the proportion of world trade conducted under the official mechanisms is probably less than 1 percent. However, with the accession into Fund membership of formerly centrally planned economies and the breakup of the U.S.S.R. into separate sovereign states (FSU), there was initially a renewed increase in the use of official bilateral payment arrangements by members, although not for the global payments system as a whole. Countertrade and barter trade arrangements have since become important for Eastern European and FSU countries, in part substituting for the previous official regional payments mechanisms in the transition to market-based payments. Elsewhere, the recourse to barter and countertrade, which emerged during the debt crisis as normal payment mechanisms broke down under pressure from arrears, has been much reduced.

III. Progress Toward Current Account Convertibility

1. Recent trends in exchange restrictions

Virtually all of the industrial countries have for some time been free from exchange restrictions relating to trade in goods and services, as had been envisaged in the Fund's Articles of Agreement--largely for fear that such controls would impede the increasingly sophisticated and efficient operation of the foreign exchange and domestic financial markets. In the case of developing countries' exchange systems, similar liberalizing tendencies were evident, but at a slower pace. Strong efforts have been made in many developing countries to shift from import-substitution policies, implemented in large measure by exchange controls, to encouraging growth of exports. Under severe pressure to reverse the effects of the debt crisis, many of the developing countries also took steps to open up their economies and strengthen competitiveness in the 1980s. Indications are that this process has accelerated further in the early 1990s. Nevertheless, as is the case in industrial countries, customs-based import controls have remained a dominant feature of virtually all developing countries' external sectors.

Progress has also been made toward the goal of current account convertibility embodied in the Fund's Articles of Agreement. However, unlike the industrial countries, relatively few developing countries have eliminated all exchange restrictions subject to approval obligations under the Fund's Article VIII (Table 1). This has been in part an indirect result of the continuing widespread use of capital controls by this group of countries--unlike the industrial countries that have virtually abandoned exchange controls on capital--because some members have considered it difficult to separate effectively nontrade current account transactions from capital transactions in administering the controls.

Table 1. Countries Availing Themselves of the Transitional Arrangement of Article XIV, as of July 29, 1994 1/

	Department						
	AFR	CTA	EU1	EU2	MED	SEA	WHD
1. Free of Articles VIII and XIV restrictions	Benin 2/ Burkina Faso 2/ Cameroon 2/ Central African Republic 2/ Chad 2/ Congo 2/ Côte d'Ivoire 2/ Equatorial Guinea 2/ Gabon 2/ Mali 2/ Niger 2/ Senegal 2/ Togo 2/			Estonia		Western Samoa	Paraguay
2. Maintaining Article VIII and/or Article XIV restrictions	Angola Botswana Burundi Cape Verde Comoros Ethiopia Guinea Guinea-Bissau Liberia Lesotho Madagascar Malawi Mozambique Namibia Nigeria Rwanda Sao Tome and Principe Sierra Leone Tanzania Zaire Zambia Zimbabwe	Bhutan Cambodia China India Lao, People's Democratic Republic Myanmar Viet Nam	Albania Bulgaria Croatia Czech Republic Hungary Macedonia, former Yugoslav Republic of Malta Poland Romania Slovak Republic Slovenia	Armenia Azerbaijan Belarus Georgia Kazakhstan Kyrgyz Republic Moldova Russia Tajikistan Turkmenistan Ukraine Uzbekistan	Afghanistan Algeria Egypt Iran, I.R. of Iraq Jordan Libya Mauritania Somalia Sudan Syria Yemen	Maldives Mongolia Philippines	Brazil Colombia

Source: Monetary and Exchange Affairs Department.

1/ New members which have not yet notified the Fund of their status under Article XIV are classified in category 2.
2/ Members of the BCEAO and the BEAC suspended the repurchase of CFA franc bank notes circulating outside the territories of the CFA franc zone. The staff is in the process of assessing the jurisdictional implications of this measure.

a. Developments in controls on import payments 1/

Comprehensive foreign exchange budgets, including budgets for imports, have traditionally represented the strictest form of exchange restriction. As a result of the divergent trends described above, such budgets were in operation by end-1992 in only 14 developing countries. 2/ In contrast, some form of import licensing requirements other than exchange controls were maintained by nearly all Fund members, both industrial and developing, indicating that virtually all quantitative restrictions on imports now fall under the heading of trade rather than exchange policy. The import controls are maintained for a variety of balance of payments and nonbalance of payments reasons, and take the form of either a "negative list" (i.e., all imports are permitted unless specifically prohibited or are subject to prior approval) or a "positive list" (i.e., all imports are prohibited unless specifically approved). Nearly three quarters of the members administer a negative list regime 3/ or an open general license (OGL) regime, under

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1/ Exchange controls affecting exports or export receipts do not fall within the meaning of current account convertibility under the Fund's Article VIII. The major types of exchange control governing export transactions are repatriation and surrender requirements on foreign exchange receipts. Although these controls fall outside the jurisdiction of the Fund, unless multiple currency practices are involved, they are subject to careful surveillance by the Fund as a form of capital control (see Section IV), and because a system of exchange controls on current international payments and transfers relies on centralization of foreign exchange receipts. Fiscal incentives for exports, such as exemptions from taxes and special credit facilities, were identified to be in use by some 40 members at the end of 1992, and some 50 members were imposing export taxes or other fees for revenue purposes. Nearly three quarters of the Fund membership (129 countries) maintained controls on exports, either through licensing requirements with or without explicit quotas, or through specific prior authorization requirements for exports of certain products. The controls in most of these countries, both developed and developing, were administered only for specific products, or products involved in bilateral trade arrangements.

2/ Algeria, Angola, Cambodia, Chad, People's Republic of China, Islamic Republic of Iran, Iraq, Mongolia, Myanmar, Sao Tome and Principe, Suriname, Syrian Arab Republic, Republic of Yemen, and Zimbabwe. (Some of these members have since liberalized some or all of the restrictions, including Algeria, Cambodia, Islamic Republic of Iran, and Zimbabwe.)

3/ Negative list regimes are much simpler to administer and tend to be more liberal, as the list of restricted or prohibited imports can be kept short and discretionary and administrative decisions regarding license issuance need not be made. Negative import regimes are commonly applied by members that are restricting or prohibiting imports for nonbalance of payments reasons, e.g., protection of domestic producers or for phytosanitary purposes.

which import licenses are issued automatically for a range of products, but few of these involve exchange restrictions.

There was a clearly discernible trend toward continued liberalization of quantitative import controls during 1991-92. Of 61 countries, including both developed and developing countries that modified their import control regimes, the vast majority (40) of countries liberalized or eliminated specific quantitative controls on imports, whereas only 6 countries tightened them. Fifteen countries introduced measures both liberalizing and tightening the quantitative controls on imports during this period.

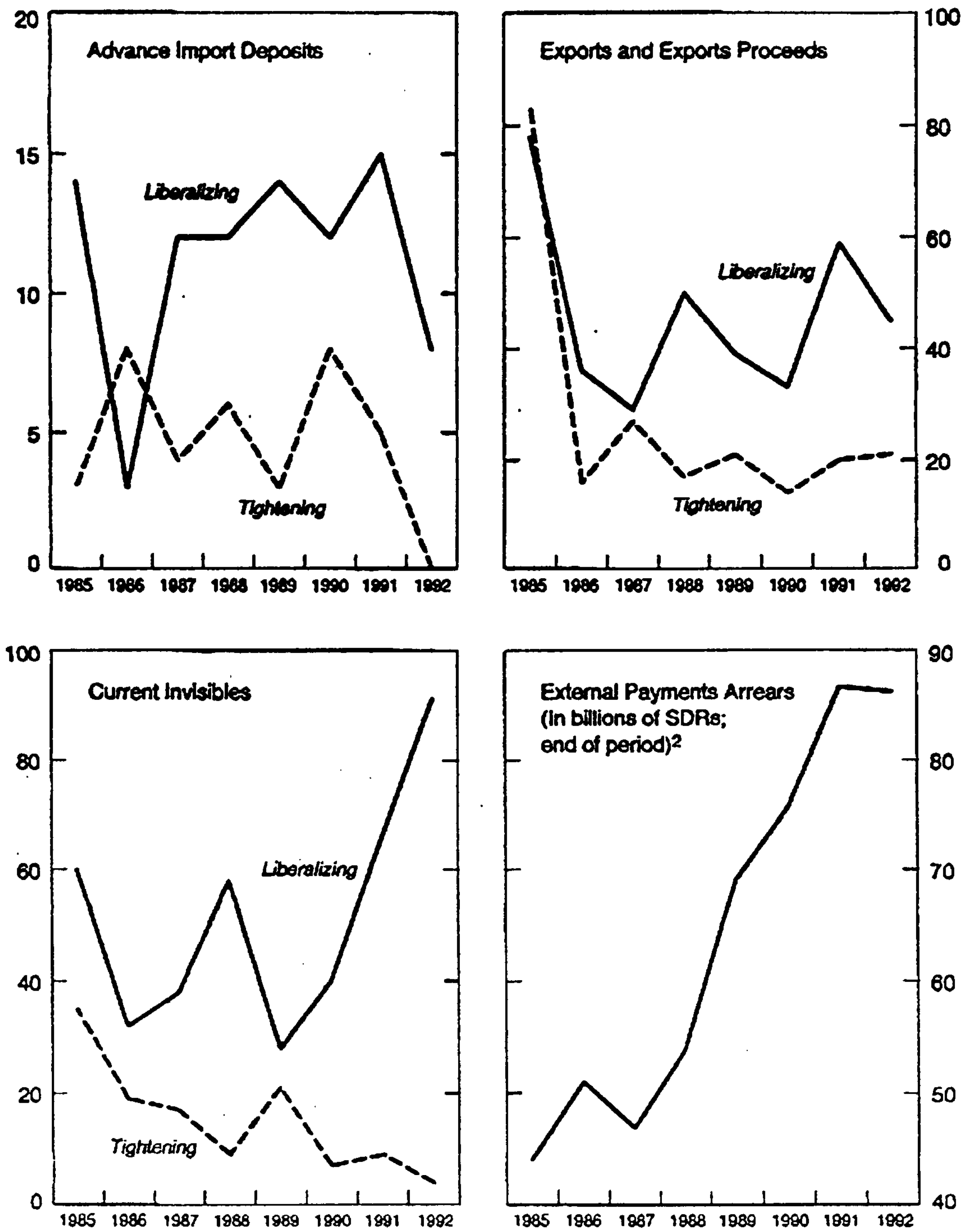
Quantitative import controls administered through the foreign exchange system are supplemented by other exchange-based measures in some developing countries. Such measures include multiple exchange rates for imports and other exchange-based import taxes and subsidies, advance import deposit requirements, and various administrative measures and ad hoc restrictions on provision of foreign exchange for imports reflected in external payments arrears.

Multiple exchange rate systems are used in relatively few countries specifically to tax or subsidize imports--in about one third of the 44 countries maintaining multiple exchange rates at the end of 1993. 1/ In all but two cases, Tanzania and Uganda, the relatively appreciated official exchange rate was applied to a particular category of imports, usually so-called essential or priority imports. The multiple rates were therefore directed largely to subsidizing certain imports, not for purposes of quantitative import controls. Most of these systems have represented a transitional stage in exchange rate adjustment, and a number of multiple exchange rate practices have been eliminated recently, including those maintained by Angola, Cambodia, Nepal, and very recently, Suriname and Zimbabwe.

The use of advance import deposit requirements has declined further in recent years (Chart 1). No industrial countries require such deposits, and the number of developing countries imposing the requirements declined from 21 at end-1990 to 16 by end-1992. Administrative measures intended to control import transactions were in force in 67 members as of end-1992. The measures include a prior authorization requirement for certain types of imports; preshipment inspection of imports with respect to invoice price, quality, and quantity of imports; and controls on the methods of import settlement, i.e., regulations on the use of letters of credit, minimum financing requirements, use of suppliers' credits, and domestic bank domiciliation requirements. Although not necessarily involving exchange restrictions, the measures often have a restrictive or taxing effect on imports, due to cumbersome administration compared to relatively simple customs/payments procedures used elsewhere.

1/ For a general discussion of multiple exchange rates, see Section V.3.

Chart 1
Restrictive Measures on Current Account, 1985–92[1]
(Number of Measures)



Sources: IMF, AREAER 1986–93 and staff reports.
[1]These trends do not purport to indicate the economic significance of the measures taken over the period; however, they can provide an overall sense of whether member countries are taking more or less restrictive measures.
[2]Figures in national currencies converted to SDRs in some instances. Figures have been calculated from flow data.

b. Controls affecting invisible transactions

Restrictions on invisible payments and transfers are diverse, covering limits on foreign exchange that can be purchased for cross-border transport and freight charges, tourism and business travel, medical expenses, education expenses, subscriptions to magazines and periodicals, advertising expenses, royalties, insurance premia, services provided by banks and other financial institutions, family maintenance, repatriation of earnings from investments, including profits and dividends from foreign direct investments, and interest payments on external debt. 1/

Invisible payments and transfers that are associated with trade-related transactions (such as insurance and freight) are relatively easy to monitor, and they are usually treated in the same way as their physical counterparts for purposes of exchange control. Other invisible payments and transfers relating to nontrade transactions are more difficult to control, because documentation for foreign exchange applications can more easily be falsified and provide channels for capital flight. Because of their dependence on foreign exchange mechanisms and documentation, controls on invisible cross-border transactions most often involve exchange restrictions subject to the Fund's Article VIII. Liberalization of exchange controls on invisibles has been less extensive, reflecting continuing concerns with balance of payments impact and capital flight. At the end of 1992, restrictions on current invisible payments and transfers were maintained by 83 Fund members. In most cases, quantitative limits were established for the main forms of transactions, such as travel, but in a few countries foreign exchange was provided on a case-by-case discretionary basis. For example, the limits established on medical expenses were usually not quantitative, as only 14 member countries imposed quantitative limits and provision of foreign exchange was considered on a case-by-case basis in 62 countries.

Transfers of profits and dividends earned on foreign direct investments are subject to control in relatively few countries--20 members. The limitations take the form either of a maximum percentage per annum of the original investment, or limitations arising from the phasing of transfers. These controls are intended mainly to ensure that illegal capital transfers are not involved and that required tax payments are made. However, they can involve undue delays and thus have an unintended chilling effect on inward direct investment, and an adverse impact on the balance of payments and imports of needed technology.

As Chart 1 shows, measures liberalizing current invisible payments and transfers have continued to outnumber measures tightening them by a wide margin since 1989. During 1991-92, 36 countries modified foreign exchange regulations to liberalize these controls, in most cases to raise the limits

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1/ Restrictions on debt payments associated with external payments arrears and debt restructuring arrangements are discussed in Section III.1.c. below.

on the allowances, but in some 5 countries to eliminate quantitative limits on some or all invisible payments and transfers. It is noteworthy that there was only one instance in which controls on invisible payments and transfers were tightened during 1991-92. Outward payments and transfers for services rendered by nonresidents, including the remittances of profits and dividends, were liberalized by 23 countries during 1991-92. In three countries, the controls were either unambiguously tightened or a mix of both tightening and liberalizing measures was taken. Controls affecting imports and exports of bank notes, and the holding of foreign bank notes domestically, were liberalized in 24 countries and tightened in four. Measures both tightening and liberalizing controls at the same time were introduced in three countries.

c. External payments arrears

External payment arrears grew rapidly in the early 1980s with the onset of the debt crisis. Payments arrears are a particularly severe form of exchange restriction because of their disorderly and often discriminatory nature, which strikes at the very effectiveness of the international system of contracts and payments. Payments arrears are considered evidence of an exchange restriction subject to the Fund's jurisdiction when they result from limits imposed by government, or its interfering with the availability of foreign exchange to make payments for current international transactions when they full due, or with the timely transfers of the proceeds of such transactions.

The Fund has paid close attention to the policies of members that have been responsible for the emergence of payments arrears, and has consistently followed the practice of not approving under its Article VIII exchange restrictions evidenced by arrears, unless a satisfactory program for their reduction or elimination is in place. Payments arrears are reduced or eliminated by cash payments or by rescheduling, most often by a combination of both.

Overall external payments arrears of Fund members are estimated to have increased substantially during the period 1990-92, after declining by SDR 10 billion at end-1989 from the peak of SDR 45 billion in 1986. 1/ They are estimated to have totaled SDR 82 billion at the end of 1991, more than twice the amount recorded in 1987. However, the total amount of external payments arrears at the end of 1992 is estimated at SDR 82 billion, the same as at the end of the preceding year, which may indicate that the net accumulation of arrears has leveled off for the time being.

1/ Data for external payments arrears discussed in this section include arrears caused by exchange restrictions on current international payments or transfers, as well as arrears on financial obligations of which the obligor is the government (defaults), that are not subject to the Fund's jurisdiction.

The number of Fund members with external payments arrears continued to increase during the period 1991-92, totaling 66 in 1992. By comparison, in 1986 when the value of arrears previously peaked, the number of countries that had arrears was 57. Moreover, the countries of this group have changed little, so that only a few countries have eliminated their external arrears, underlining the extreme difficulty of restoring a country's international financial relations once arrears have been incurred.

Large increases in arrears responsible for this rising trend since the mid-1980s were recorded in 11 countries: Angola, Bulgaria, Ecuador, Nicaragua, Panama, Peru, Poland, Russian Federation, Sudan, Viet Nam, and Zaïre, with the largest increase in Sudan (SDR 10 billion). The highest level was in Brazil at end-1991 (SDR 14 billion), although this amount has since been sharply reduced. Significant reductions in Egypt, Nigeria, South Africa, and Venezuela tended to be offset both by the underlying global trend, and by the accession to Fund membership of large countries with serious balance of payments problems.

2. Jurisdictional developments

Policies to ensure current account convertibility lie at the heart of the Fund's purposes, and have been reviewed in a number of Executive Board papers in the 1980s. A primary purpose of the Fund is "to assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade" (Article I(iv) of the Articles of Agreement). Article VIII of the Articles of Agreement enjoins members from imposing restrictions on the making of payments and transfers for current international transactions (Section 2(a)) or engaging in discriminatory currency arrangements or multiple currency practices (Section 3) unless the measure is authorized by the Articles of Agreement or approved by the Fund. Members are permitted, as a transitional measure under Article XIV, Section 2 and without Fund approval, to maintain and adapt to changing circumstances exchange restrictions that were in effect on the date on which they joined the Fund, but members that are maintaining restrictions under this Article must consult with the Fund annually as to their further retention, and they are expected to withdraw these restrictions as soon as their balance of payments position permits. Article XIV does not permit either a reimposition of pre-existing restrictive exchange practices once they have been eliminated, or the introduction of new ones. Moreover, under certain circumstances, an adaptation, e.g., an expansion of the scope of restrictions that are maintained under Article XIV, may be considered an imposition of restrictions, and the measure will thus fall within the purview of Article VIII and be subject to approval by the Fund.

a. Progress in acceptance of Article VIII obligations

Members may accept the obligations of Article VIII, Sections 2, 3, and 4 at any time. However, when the acceptance of the obligations of Article VIII is contemplated by a member, the practice is for the Fund staff to examine all aspects of the member's exchange system in order to ascertain whether the restrictive exchange measures maintained under Article XIV have been eliminated, whether or not there would be any exchange measures that would become subject to the jurisdiction of the Fund under Article VIII, and the member's balance of payments outlook. 1/ Normally, the Fund would encourage a member to eliminate all restrictive exchange measures that would require the approval of the Fund prior to accepting Article VIII obligations. If any such measures are not to be eliminated, the Fund's policy has been that maintenance of the measures would be approved for a short period, provided that a firm and realistic time limit for their elimination has been established by the authorities in the country concerned.

The Fund staff also analyses the member's prospective balance of payments position in order to be satisfied that the member is not likely to need recourse to restrictive exchange measures in the foreseeable future following the acceptance of the obligations of Article VIII. When all issues relevant to the country's exchange system have been examined, the member is advised formally, and then it may notify the Fund of its acceptance of the obligations of Article VIII, and the Executive Board adopts a decision noting the action taken by the member. By accepting the obligations of Article VIII, members give confidence to the international financial community that they will pursue sound economic policies to obviate the need for restrictions on current international transactions, and will thereby contribute to the objective of a multilateral payments system.

Despite the fact that Fund members are expected to avail themselves of transitional arrangements under Article XIV, Section 2 only on a temporary basis, and accept the obligations of Article VIII status as soon as conditions permit, members have been reluctant historically to abandon transitional status under Article XIV and to accept the obligations of Article VIII, and have done so at the rate of less than two members per year since the inception of the Fund. In January 1993, the Chairman's summing up at the conclusion of the biennial review of the Fund's Surveillance Policy accordingly called for an acceleration of Article VIII acceptances. Since early 1993, the staff has intensified its efforts and the rate of

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1/ This is to give effect to Executive Board Decision No. 1034 (60/27), adopted June 1, 1960, which states that "it would be desirable that, as far as possible [members] eliminate measures that would require the approval of the Fund,...".

Article VIII acceptance has gone up six times and a further 19 members have accepted Article VIII obligations, bringing the total of Article VIII members to 93 by July 29, 1994. 1/

As a result of these steps, 6 of the 19 Article XIV members that had systems virtually free of restrictions on payments or transfers for current international transactions at the end of 1992, have now accepted Article VIII obligations (Barbados, The Gambia, Lithuania, and Micronesia (both new members), Mauritius, and Trinidad and Tobago). Those countries using the CFA franc and Western Samoa have not to date. Another 13 members (Bangladesh, Ghana, Grenada, Israel, Kenya, Latvia, Lebanon, Morocco, Nepal, Pakistan, Sri Lanka, Tunisia, and Uganda) eliminated exchange restrictions in the process of accepting Article VIII obligations. As of July 1994, members that have accepted the obligations of Article VIII, Sections 2, 3, and 4 represented 52 percent of the total membership. This ratio would be somewhat higher (i.e., 56 percent) if the independent states of the former U.S.S.R. that joined the Fund since 1992 with restrictive exchange control regimes are excluded from the total number of members. By comparison, at the end of 1985, members that had accepted Article VIII obligations numbered 60, or 40 percent of the total membership.

Implementation of the Fund's policies in the area of exchange restrictions on current international payments and transfers addresses the following three important questions: (1) what transactions are to be treated as constituting current transactions, as opposed to capital transactions, and what measures are to be considered as restrictive exchange practices; (2) under what conditions should a restrictive exchange measure be approved; and (3) what is the time period that may be considered reasonable, or the circumstances to be deemed appropriate, for a member to cease to avail itself of the transitional arrangements under Article XIV?

With regard to the first question, Article XXX(d) lists the following four categories of transactions that are considered to constitute payments and transfers for current transactions for purposes of Article VIII: (1) all payments due in connection with foreign trade, other current business, including services, and normal short-term banking and credit facilities; (2) payments due as interest on loans and as net income from

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1/ The new Article VIII members and their dates of acceptance are: The Gambia, Morocco, and Tunisia (January 1993); Micronesia (June 1993); Lebanon (July 1993); Israel and Mauritius (September 1993); Barbados (November 1993); Trinidad and Tobago (December 1993); Grenada (January 1994); Ghana (February 1994); Sri Lanka (March 1994); Bangladesh and Uganda (April 1994); Lithuania and Nepal (May 1994); Kenya and Latvia (June 1994); and Pakistan (July 1994). Four members accepted Article VIII obligations in 1992, and three of them were countries which did not have any exchange restrictions when they joined the Fund: Marshall Islands (May 1992); Switzerland (May 1992); and San Marino (September 1992). See Table 1 for a listing of remaining Article XIV members.

other investments; (3) payments of moderate amount for amortization of loans or for depreciation of direct investments; and (4) moderate remittances for family living expenses. Certain types of transactions that are treated as capital transactions in normal balance of payments compilations are therefore considered to be current account transactions under the Fund's Articles. 1/ However, these categories are simply examples, because the Fund can, after consultation with a member, determine whether certain specific transactions are to be considered current or capital account transactions. As regards the measures to be deemed to give rise to an exchange restriction under Article VIII, the Fund's policies are guided by the principle that a direct governmental limitation on the availability or use of foreign exchange for current international transactions would constitute a restrictive exchange measure. 2/

The main issues that are considered by the Fund in deciding whether or not temporary approval of a restrictive exchange measure is to be granted are: (1) the seriousness of the member's balance of payments position and the prospects for improvement; (2) the discriminatory nature of the measure; (3) the length of time during which a measure has been in effect (and in instances where approval has been granted, the length of the period during which approval has been outstanding), and the member's intentions and specific plans regarding simplification or elimination of the measure. In all cases, approval is granted on a temporary basis, i.e., up to the end of a specified calendar date or completion of the next Article IV consultation or program review. Approval of a restrictive exchange measure would imply that the Fund has recognized that the member has a need for the measure to deal with a balance of payments problem. The Fund does not normally approve exchange restrictions that are maintained for nonbalance of payments reasons or those that are administered discriminatorily between members, except in the case of exchange restrictions that are introduced solely to preserve national or international security. 3/

1/ Amortization of loans and depreciation of direct investment are regarded as a capital transaction in the balance of payments. All remittances representing a transfer of income between residents and nonresidents are regarded as current transactions in the balance of payments.

2/ Executive Board Decision No. 1034-(60/27), adopted June 1, 1960.

3/ Executive Board Decision No. 144-(52/51), adopted August 14, 1952, provides that restrictions notified to the Fund pursuant to this Decision are approved for purposes of Article VIII, Section 2, unless the Fund informs the member within 30 days after receiving the notice that it is not satisfied that such restrictions are proposed solely to preserve national or international security. In recent years, many members notified the Fund of exchange restrictions imposed against Iraq, Haiti, Libyan Arab Jamahiriya, and the Federal Republic of Yugoslavia (Serbia and Montenegro) under this Decision.

No policy has been established by the Fund regarding the length of period during which a member can maintain Article XIV status. However, members are expected to avail themselves of the transitional provisions of this Article only temporarily and to withdraw restrictions maintained under the Article as soon as possible by implementing macroeconomic policies that will obviate the need for such restrictions.

b. Policies to accelerate progress toward current account convertibility

Previous papers in this biennial series have noted the limited progress in moving from the transitional arrangements of Article XIV to the obligations of the Fund's Article VIII. The general liberalization of exchange systems that has accelerated since the mid-1980s has led to an improved environment for accepting the obligations of Article VIII in a number of countries. Increased experience with liberalized systems in developing countries led the staff to adopt in early 1993 a new strategy for encouraging members to accept the obligations of Article VIII. It is increasingly thought that, although the view that exchange restrictions are inefficient has been a basic tenet of the Fund's Articles, a strengthening of the rationale for more rapid elimination of exchange restrictions and shorter Article XIV transition has been provided by the developments in the international payments mechanisms, particularly over the last decade. As discussed in Section IV below, a growing number of nonindustrial countries have eliminated all exchange restrictions as part of a comprehensive package of macroeconomic adjustment and have experienced a rapid turnaround in capital flows generated by greater confidence and by the liberalization itself.

Restrictions on trade are now effected mainly by customs rather than exchange mechanisms so that remaining exchange controls subject to Article VIII are almost exclusively limited to services-related transactions that are relatively minor in most developing countries. This development carries the implication that, in accordance with the fundamental assumption of the Fund's Articles, members should normally be able to settle their balance of payments without recourse to exchange restrictions. Removal of services-related exchange restrictions has been accomplished in two ways. The first, and simplest administratively, has been to eliminate simultaneously exchange controls on both current and capital account transactions. This confers on the country the full efficiency benefits of exchange market liberalization.

In the second approach, where capital controls are retained, there is a technical question of how to segment the exchange control system--with current account restrictions defined according to the Fund's Article XXX on the one side, and all other restrictions on the other. This has been accomplished in a number of countries by adopting a so-called bona fides approach to service transactions. Under this approach, authorized foreign exchange dealers are delegated to approve foreign exchange automatically up to certain limits, but to check requests above those limits to ensure that they are not being used as a vehicle to avoid controls on capital transfers (with "capital" defined for this purpose by the Fund's Article XXX). Thus, a number of Fund members that administer exchange controls on current payments or transfers that involve such "indicative limits" on foreign exchange have been considered to have an exchange system that is free of restrictions on current international transactions, and have accepted Article VIII obligations. The members have stated that requests for purchases of foreign exchange in excess of "indicative limits" are approved or authorized without delay under the existing exchange control regulations when the bona fide character of such requests is verified (illegal capital transactions are considered not to be involved). Having made this official statement, it would be the responsibility of the country authorities to implement the policy, and the staff must assume that the bona fide test is in practice applied objectively unless information to the contrary becomes available.

A key aspect of the strategy to accelerate Article VIII acceptances has been to sharpen the focus of Article IV consultation discussions on the issue of Article VIII restrictions. It has been emphasized that, for members that no longer maintain exchange restrictions under the transitional arguments of Article XIV, Section 2, virtually no benefit is gained from their continuing to avail themselves of such transitional arrangements. Whether or not they have formally accepted the obligations of Article VIII, any exchange restriction imposed after the date of membership is subject to the approval of the Fund under Article VIII. Accordingly, these countries are encouraged to accept immediately the obligations of Article VIII following an in-depth review by the staff of their exchange system in order to ascertain the absence of any exchange restrictions. If the staff verifies that no exchange restrictions remain in existence, it then explains to the authorities that their status under the Articles would be represented more accurately if they were to accept the obligations of Article VIII. 1/

Complementarity of the Fund Articles and the GATT in dealing with restrictions in the external sector, coupled with the recent developments in the Uruguay round, is another reason cited by the staff for accelerating progress in a number of developing countries that are members of both

1/ In a few instances, acceptance of Article VIII obligations has been encouraged by the Fund in the presence of remaining Article VIII restrictions--providing that these are relatively minor and have a clear-cut timetable for their removal (e.g., Bangladesh and Mauritius).

organizations, or intend to be. 1/ Restrictions maintained through both the customs and exchange systems can represent forms of protectionism that have been widely shown to adversely affect global output growth and development of trade relations.

Article XIV, Section 3 provides that the Fund may, if it deems the action necessary in exceptional circumstances, make formal representations to any member that conditions are favorable for the withdrawal of any particular restriction. However, the Fund has thus far preferred instead to seek the elimination of exchange restrictions through the consultation and technical assistance processes and by applying conditionality in Fund-supported programs. In all cases, the staff discusses with the country a timetable for the elimination of restrictions consistent with the implementation of macroeconomic policies, including appropriate exchange rate policies, which would place the country in a position to accept the obligations of Article VIII without subsequent resort to exchange restrictions. Staff reports contain a summary description of the member's exchange system, including a brief listing of exchange restrictions that are maintained under the provisions of Article XIV or are subject to approval under Article VIII. The staff appraisal section of the reports also provides in most instances discussion of the basis for approval or nonapproval. Under existing guidelines, assessments in staff reports are to include an indication of the suggested time frame of the Articles XIV and VIII restrictions and its acceptance of Article VIII. In cases where it is not judged feasible to provide a specific time frame, the outcome of discussions and the reasons for the authorities delaying is noted in the assessment.

IV. The Question of Capital Account Convertibility

The importance of international capital movements has long been recognized. First, international capital movements provide vital support to the multilateral trading system. This support comes not only in the form of short-term trade finance, but also in the transfer of financial resources from countries with current account surpluses to ones with current account

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1/ As of May 1993, 87 developing countries were members of GATT; in addition, 22 other developing countries observe the regulations of GATT, although they did not subscribe to GATT membership. (These numbers exclude Aruba, the Netherlands Antilles, and Hong Kong, for which the Articles of the Fund have been accepted by the Kingdom of the Netherlands and the United Kingdom, respectively.) Of those developing countries that are members of GATT, all except Cuba are also members of the Fund. On the other hand, 69 developing countries that are members of the Fund are nonmembers of GATT, while 20 of these member countries of the Fund apply GATT regulations in practice. Of those Fund members that have accepted the obligations of Article VIII, 23 do not belong to GATT but 12 of them apply GATT regulations.

deficits. Second, capital movements play a critical role in economic development. The impact in augmenting domestic savings is most obvious when the capital is transferred in the form of foreign direct investment, although by seeking the highest rates of (risk adjusted) return, portfolio investment also has potentially significant benefits for economic growth. The impact of capital movements on monetary and exchange policies is also well recognized.

1. Global trends toward decontrol of capital movements

Exchange controls on international capital movements have been ended by virtually all industrial countries, although restrictions remain on the underlying transactions with regard to foreign investments in some sectors and for some types of instruments. The liberalization of foreign exchange markets has gone hand-in-hand with domestic financial market liberalization, including increasingly indirect instruments of monetary control. By end-1994 all industrial country currencies are expected to be convertible for capital transfers, as Iceland removes remaining restrictions. 1/ It had often been thought that liberalizing capital required strength in external positions, and a number of developing countries with structurally strong balance of payments positions had for some decades eliminated exchange controls on capital movements. In recent years, a number of countries with hitherto weak balance of payments have also eliminated fully the controls in the context of comprehensive stabilization and liberalization programs.

1/ Capital convertibility in this paper focuses on freedom from restrictions or taxes imposed directly on foreign exchange transactions in a way analogous to Article VIII, but on both inward and outward capital transfers. Under this approach, the following could be considered as exchange restrictions that apply to capital movements and which would give rise to exchange controls on capital account or discriminatory currency practices as related to capital transfers:

- Specific restrictions or requirements for approval to purchase foreign exchange for the purpose of acquiring assets abroad;
- Limits on the amount of foreign exchange that can be transferred for the purposes of investment abroad;
- Requirements, authorizations or restrictions on the repatriation of capital or foreign exchange holdings; and
- Multiple currency practices that apply to the purchase or surrender of foreign exchange related to capital transfers.

As normally defined, the concept of capital convertibility does not comprehend prudential requirements or market standards.

Nevertheless, outflows of capital remain restricted by the majority of developing countries, usually with the aim of preserving scarce domestic savings by reducing capital flight.

a. Industrial countries--convertibility nearly completed

The end of the 1970s marked a turning point in the use of exchange controls by industrial countries on capital movements, with the suspension of all exchange controls in 1979 by the United Kingdom, and the dismantling of restrictions on capital movements in Japan, beginning in 1980. 1/ Subsequently, Australia and New Zealand dismantled most controls in 1983 and 1985, respectively. In 1986, the Netherlands removed its remaining restrictions, and France, by removing the devise titre market for residents' acquisition of securities abroad, along with Denmark achieved virtually full liberalization by 1989. Italy eliminated its compulsory deposit requirement, which discouraged various forms of investment abroad by residents, Austria and Ireland removed a substantial number of restrictions, and Sweden and Norway liberalized exchange controls in 1989 and 1990. In March 1990, Belgium and Luxembourg abolished the two-tier exchange rate system that had been operated jointly by these countries since 1951. Since 1985, there have been only a few measures tightening controls on capital by industrial countries (Chart 2).

During 1991-94, those industrial countries that continued to maintain exchange controls on capital movements moved to eliminate them. Extensive liberalizations were undertaken by Austria in 1991, by Finland in 1991-92, and by Greece, Iceland, Ireland, Norway, Portugal, Spain, and Sweden in 1992 and 1993. Portugal and Ireland had eliminated all restrictions of an exchange control nature by the beginning of 1993. In March 1993, Greece eliminated controls on various capital transactions leaving only restrictions on loans and deposit accounts of less than one year's maturity; these were in turn abolished in May 1994. Iceland abolished all exchange controls on long-term capital movements at the beginning of 1994 and undertook to abolish all such controls on short term movements by year-end.

Apart from exchange controls, industrial countries have applied extensive controls to underlying capital transactions. The most restricted operation has been the admission of foreign securities on the domestic capital market, often reflecting concerns about the absorptive capacity of the domestic financial markets. Foreign bank credits and loans (both inflows and outflows) unrelated to international trade have also been more heavily restricted than other types of capital movements, possibly because of concern that such flows were short-term in nature. However, commercial

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1/ During the 1980s only France, Spain, Norway and Finland felt it necessary to suspend temporarily the freedom of capital movements under the OECD codes of liberalization of capital movements. For a detailed discussion see Liberalization of Capital Movements and Financial Services, OECD, Paris 1990.

credits related to international trade have generally enjoyed a high degree of freedom. While foreign direct investment inflows were generally treated liberally, many countries screened such flows from the point of view of ownership and industrial structure, and in some cases limited the areas of economic activity or the flows in the context of bilateral investment treaties. Foreign investments in real estate and the buying and selling of securities tended to be treated in a more restrictive manner than foreign direct investment inflows, for reasons that sometimes included concerns for investor protection.

A few industrial countries temporarily intensified restrictions on cross-border capital movements in 1992. In an effort to avert devaluations of their currencies within the ERM, Ireland and Portugal temporarily imposed or intensified direct controls over short-term (speculative) capital flows. However, these controls were not generally considered to have been effective in reducing short-term speculative pressures and had been rescinded by the end of 1992.

A broader concern is that capital controls are not only ineffective in controlling short-term speculative flows--the main rationale for Article VI in the original drafting of the Fund's Articles of Agreement--but that they may discourage longer-term portfolio and direct investment flows. The impact of capital account liberalization on the capital accounts of a sample of nine industrial countries has been reviewed (France, the Netherlands, Italy, United Kingdom, Australia, New Zealand, Denmark, Sweden, and Norway). All of these countries recorded larger net foreign direct investment outflows either in the year of the liberalization of capital controls or in subsequent years. In three countries--France, the Netherlands, and Italy--the larger foreign direct investment outflows were more than offset by larger portfolio and other capital inflows. 1/

b. Whither developing countries?

As a result of the liberalizations by industrial countries, the issue of capital account convertibility now affects almost exclusively developing countries. Countries such as the Middle East oil exporting countries and the offshore financial centers of Singapore and Hong Kong have maintained for many years liberal capital accounts. Indonesia eliminated its capital controls in 1970, and a number of small island economies and those, such as Panama and Liberia, that use the U.S. dollar have also maintained liberal exchange controls on capital movements. However, in most developing countries outward capital movements have remained tightly controlled until relatively recently. The generally slower progress toward currency convertibility in developing countries may have reflected the more acute shortages of domestic savings and the greater perceived risk of capital flight, particularly in countries with below-market interest rates and generally unsound macro policies. The more recent progress reflected the

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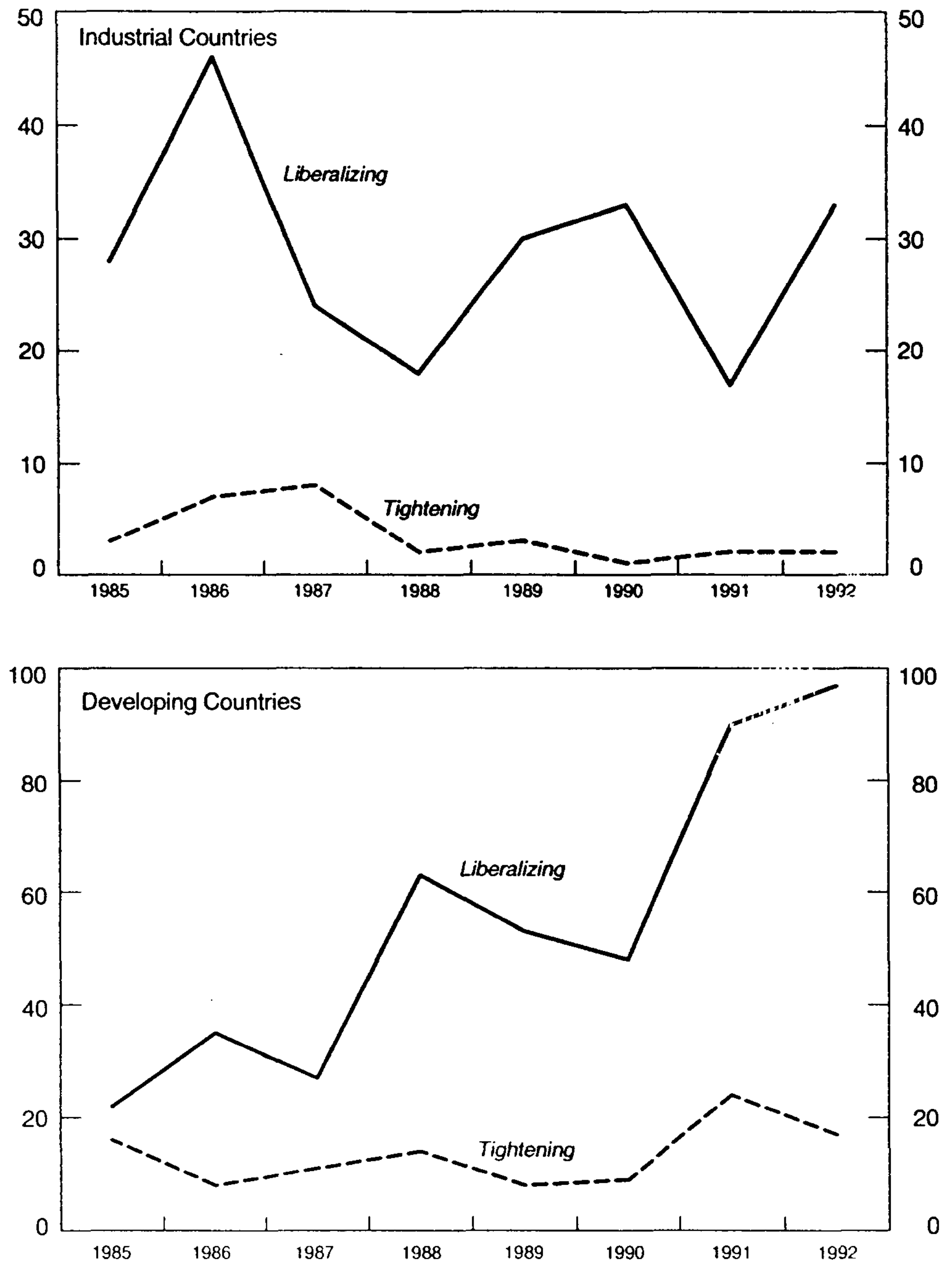
1/ For further discussion, see the supplement to this paper.

Chart 2
Capital Controls in Industrial and Developing Countries, 1985–92[1]
(Number of Measures)



Sources: IMF, AREAER 1986–93 and staff reports.
[1]These trends do not purport to indicate the economic significance of the measures taken over the period; however, they provide an overall sense of whether member countries are taking more or less restrictive measures.

adoption of more realistic exchange rates by this group of countries, since the early 1980s, and the development of more market-based instruments of monetary policy. The relationship to the exchange rate is a close one, because exchange controls have typically been used in attempts to maintain an exchange rate that was viewed as overvalued by the market.

In countries not considering a general liberalization of capital controls, greater emphasis was given in the aftermath of the debt crisis to liberalizing foreign direct investment inflows. 1/ In order to foster the investment flows, the World Bank's Multilateral Investment Guarantee Scheme (MIGA) was formally constituted in April 1988. 2/ On a bilateral level, the U.S. Government had announced in late 1981 that it would negotiate bilateral investment treaties (BITs) focused solely on investment. Unlike the previous bilateral treaties, which had established rights and obligations of nationals and companies, the BIT establishes rights and obligations with respect to specific investment. 3/

A common manifestation of exchange controls is the requirement to repatriate foreign exchange earnings. Such requirements were in force at the end of 1992 in 136 Fund member countries, of which 48 were members that have assumed the obligations of Article VIII. In 115 of the 136 countries, the repatriated proceeds were subject to a full or partial requirements, to be surrendered to the central bank or sold to domestic commercial banks

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1/ The Fund and the World Bank, mainly through the work of the Development Committee, have emphasized this aspect in recent documents. See Determinants and Systemic Consequences of International Capital Flows, Occasional Paper No. 77, Research Department, IMF, March 1991; "The Role of Foreign Direct Investment in Development", EB/CW/DC/91/2 (3/7/91); "Developing Country Access to Private Capital Flows" EB/CW/DC/93/2 (3/15/93); Development Committee, Development Issues: Presentations to the 46th Meeting of the Development Committee, Pamphlet No. 31, Washington, D.C., May 1993; IMF Survey, May 17, 1993, "Development Committee Communiqué" (page 150f.) and "Group of 24 Communiqué" (page 153f.); and "Trends in Private Investment in Developing Countries, 1993: Statistics for 1970-91," by G. P. Pfeffermann and A. Madarassy, IFC Discussion Paper No. 20, December 1992.

2/ By the end of its first full financial year of operations, 69 preliminary applications for guarantee covering potential direct investments in 24 member developing countries, and a broad range of sectors were registered with MIGA. In 1992/93, MIGA facilitated almost US$2 billion in direct investment flows. Given the long-term nature of most direct investment, MIGA typically provides guarantees for 15 years.

3/ The prototype treaty reflects six principles of a liberal investment regime, including free transfers of foreign exchange for all capital and all returns on an investment, full convertibility is to apply to any investments covered by a BIT. As at July 7, 1993, 24 countries had signed BITs with the United States, including 10 countries from Eastern Europe or the former Soviet Union, and 13 of these treaties have come into force.

within a specified period. However, there has been a trend toward significant liberalization of surrender requirements during 1990-92. Surrender requirements were either abolished, or their ratios reduced significantly, in some 30 countries, and only 7 countries introduced surrender requirements or tightened existing requirements.

Among the reforming centrally planned economies and some other developing countries there has been a practice of allowing residents to hold foreign exchange locally and exchange it freely for domestic currency--so-called "internal convertibility". Such policies were followed, for example, in Bulgaria, the former Czechoslovakia (non-enterprise holdings), Hungary, Poland, and Romania, as well as most countries of the FSU. By providing residents with the opportunity to hold and invest in foreign currencies through the local banking systems, these policies may have helped to limit capital flight, although complicating monetary management. In addition, experiences in other countries with foreign currency-denominated deposit accounts have emphasized the exposure risks of the implicit exchange rate guarantees both for depositors and banks, and in some cases, central banks. 1/

More recently, in the aftermath of the debt crisis and substantial capital flight that had evaded capital controls, there appears to have been an important shift in the policies of developing countries toward liberalization of their capital accounts. Many countries have liberalized exchange controls on capital movements and controls that affected directly the underlying capital transactions, and there have been relatively few tightening measures. The major developments during 1991-93 are as follows:

-- Eleven developing countries, Argentina, Costa Rica, El Salvador, the Gambia, Grenada, Honduras, Jamaica, Peru, the Philippines, Trinidad and Tobago, and Turkey, undertook extensive liberalizations of their exchange controls on capital movements, most in the context of measures aimed at strengthening a weak external position. As a result of these and earlier changes made in similar circumstances, Argentina, Costa Rica, El Salvador, Indonesia, Grenada, Guyana, Jamaica, Paraguay, Peru, Trinidad and Tobago, and Venezuela now have full currency convertibility. 2/

-- Twenty-three developing countries liberalized controls on foreign direct investment inflows, and two developing countries (Jamaica and Korea) also liberalized their controls on foreign direct investment outflows.

1/ See Section V.4.b below.

2/ A number of other countries have free or liberal capital systems, mainly those with structurally strong balance of payments positions. Venezuela has very recently reintroduced limitations on convertibility and Mauritius reportedly has introduced capital convertibility.

-- Twelve developing countries relaxed controls on long-term, and three on short-term, portfolio inflows. In most cases the liberalization granted foreigners freedom to invest in local securities or increased residents' freedom to borrow abroad under exchange control regulations. In addition to the eleven developing countries that significantly liberalized exchange controls, another five developing countries--Brazil, Colombia, Israel, Mali, and Mauritius--eased or eliminated exchange controls on portfolio outflows, either long- or short-term.

-- None of the developing countries reported an intensification of restrictions on portfolio or direct investment outflows and only four developing countries intensified controls on inflows--Brazil on foreign investments in real estate, Malaysia on residents' foreign borrowing, and Chile on short-term capital inflows. 1/

-- Ten developing countries 2/ liberalized commercial banks' operations in foreign exchange. Measures included liberalization of banks' operations in foreign currencies (Algeria, Dominican Republic, Jordan, Tunisia and Turkey), forward exchange transactions (India and Korea) and relaxation of surrender requirements (Chile and Jamaica). Six countries tightened controls on banks' foreign exchange operations. 3/ In all cases, the tightening applied to banks' open foreign currency positions and therefore appears to have been implemented primarily as a prudential measure rather than an exchange control.

-- Twenty-five developing countries liberalized exchange controls on resident domestic operations in foreign currency. One country, Honduras, simplified exchange arrangements that applied to capital transfers.

A preliminary review of developing country experiences with extensive liberalization of their capital accounts suggests a number of common features.

-- First, in all the above cases, the extensive liberalization measures affecting the capital account were undertaken as part of a program of macroeconomic stabilization or structural adjustment,

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1/ While there is some evidence in the case of Chile that the capital inflows slackened temporarily following the introduction of the controls, evasion of the controls also began quickly; see "Recent Expereinces with Surges in Capital Inflows", SM/93/113 (5/24/93).

2/ Algeria, Chile, Dominican Republic, India, Jamaica, Jordan, Korea, Sierra Leone, Sri Lanka, and Turkey.

3/ Brazil, the Gambia, Indonesia, Paraguay, the Philippines, and the Solomon Islands.

and in five of the countries these programs were supported by a Fund arrangement. In the case of Fund arrangements, the programs included debt reschedulings and, in some cases, the capital account liberalizations were part of a broader normalization of external financial relations.

-- Second, in all but one of the countries, the extensive liberalization of the capital account was in the context of a floating or managed floating exchange rate. The one country which pegged its exchange rate, Argentina, depreciated its exchange rate at the time that it liberalized its capital.

-- Third, extensive liberalization of the capital account either occurred simultaneously with liberalization of interest rates and movement to indirect instruments of monetary control--in the case of Guyana, and Paraguay--or followed a broader liberalization of the domestic financial system, including freeing interest rates, eliminating credit controls and introducing indirect instruments. 1/ However, in no case was currency convertibility introduced without concurrent or earlier moves toward market interest rates.

-- Fourth, extensive liberalization of current account transactions occurred either in advance of, or simultaneously with, the liberalization of the capital account. In the cases of Argentina, Jamaica, the Philippines, and Peru, the capital account liberalizations followed a number of years of reforms to eliminate multiple exchange rates and restrictions on current transactions. In the case of Costa Rica, El Salvador, Paraguay, and Trinidad and Tobago current and capital account transactions were liberalized virtually simultaneously.

-- Fifth, in all cases the liberalizations were accompanied by strengthening of the overall balance of payments. In many, the balance of payments had begun to improve prior to the liberalizations, owing to the impact of stabilization measures and exchange rate adjustment that had preceded capital liberalization. Rather than weakening the macroeconomic adjustment, the elimination of capital controls appears to have helped sustain it. The impact of the liberalization on private capital flows varied between countries. Total private inflows increased in Argentina, Costa Rica, Guyana, Indonesia, Jamaica, Peru, and Venezuela, and in Paraguay in part due to increased domestic interest rates. In those countries where data are available, both foreign direct investment and portfolio inflows recorded improvement. In about half of the

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1/ Interest rates in Indonesia and Venezuela were subject to regulation, at the time of the full exchange system liberalization although interest rates had already been adjusted to market-determined levels.

cases, the exchange rate appreciated at the same time as there was an improvement in the net private capital account, raising issues for competitiveness of domestic industry and the current account of the balance of payments.

2. Evolution of the Fund's policies on capital account convertibility: a brief history

The main arguments for controlling capital movements have included: (1) that capital controls could be welfare-improving by increasing the volume of domestic investment and local tax revenue; (2) that the liberalization of the capital account should be sequenced relatively late in the reform process to allow for the elimination of distortions in the goods markets and the development of the necessary supporting institutional arrangements including indirect monetary controls; (3) that additional freedom would be provided to domestic interest rate and exchange rate policy through capital controls; and (4) that controls on capital movements can help protect a country's reserves and improve its balance of payments. There have been a number of counterarguments, most important of which have been questions of whether the flows tend to be stabilizing rather than destabilizing. The empirical outcome suggests that industrial countries have judged the macroeconomic efficiency costs of the controls to exceed the benefits, while in developing countries the main experience has been the problem of enforcing the controls, although recent liberalizations by these countries have also questioned the optimality of the controls. 1/ Under the Bretton Woods system controls were seen to make it more difficult for market participants to test the authorities' resolve to defend an exchange rate parity. However, the advent of floating exchange rates and the rapid integration of capital markets has shifted the balance of costs and benefits away from the controls.

1/ Peter J. Quirk, "Capital Account Convertibility: A New Model for Developing Countries", paper presented to Central Banking Seminar on Frameworks for Monetary Stability, International Monetary Fund, Washington, D.C., March 1994. Mathieson, D.J. and L. Rojas-Suarez, Liberalization of the Capital Account: Experiences and Issues, Occasional Paper No. 103, IMF, March 1993; Haque, N.V. and P. Montiel, "Capital Mobility in Developing Countries--Some Empirical Tests", WP/90/117; Faruqee, H., "Dynamic Capital Mobility in Pacific Basin Developing Countries: Estimates and Policy Implications", Staff Paper, Vol. 39, No. 3, International Monetary Fund, Washington, D.C. (September 1992); Greene, J.E. and P. Isard, Currency Convertibility and the Transformation of Centrally Planned Economies, Occasional Paper No. 81, IMF, June 1991; Dooley, M. "Country Specific Risk Premiums, Capital Flight and Net Investment Income Payments in Selective Developing Countries", (Mimeo), IMF, March 1986; Deppler, M. and M. Williamson, "Capital Flight: Concepts, Measurement and Issues", Staff Studies for the World Economic Outlook, pp. 39-58, August 1987.

The Fund's Articles of Agreement do not extend the jurisdiction of the Fund to exchange transactions and transfers related to the large body of international capital movements, and as a result under the Articles members have been free to restrict capital transfers. 1/ Rules and procedures governing capital movements have been established in other fora, including by the Organization for Economic Cooperation and Development (OECD), 2/ and regional economic and monetary arrangements (such as the EU). 3/ However, the obligations established in these fora apply to only part of the membership of the Fund, mainly industrial countries.

Article VI, Section 3 of the Fund's Articles of Agreement provides that "Members may exercise such controls as necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions...", while Article VI,

Section 1 provides that the Fund may request a country using its general resources to impose controls to prevent these resources being used to meet large or sustained outflows of capital.

1/ See Manuel Guitián, "Capital Account Liberalization: Bringing Policy in Line with Reality" in Sebastian Edwards (ed.) Exchange Rates and Monetary Capital Controls, Policy in the World Economy, (Cambridge University Press, forthcoming, 1994).

2/ The OECD codes generally apply to all underlying capital transactions following a 1989 amendment. Prior to that amendment, most short-term capital movements, except for commercial credits and loans were excluded from the codes. The codes were broadened to cover practically all types of capital movements, but they do not extend the obligations of members to all types of exchange transactions related to capital movements. For example, taxes on transfers, multiple currency practices applicable to capital transactions, and advance deposit requirements are not covered by the codes. The OECD membership includes all countries classified by the Fund as industrial countries, and Turkey.

3/ Proposals to liberalize capital movements within the EU were first expressed in a 1983 initiative on financial integration. This was followed by a 1987 Directive liberalizing certain long-term capital transactions and security market transactions between members. The list covered long-term credits relating to commercial transactions, the acquisition in the capital market of one member state of securities issued by a company in another member state. Shortly thereafter, the EU considered the elimination of all remaining capital controls as part of a plan to establish a European financial common market, in the context of establishing a single market by 1992 in which goods, services, capital and individuals move freely. The conditions for such a market included not only elimination of capital controls, but also harmonization of bank supervision rules and taxes on capital yields.

The approach to convertibility in the Articles--that capital movements could legitimately be restricted, whereas current international payments should be free--can be traced to the Keynes and White plans for the creation of the Fund. In Keynes' view, in the context of the system of fixed but adjustable exchange rates that was envisaged, countries had to be able to protect themselves against short-term, speculative capital flight and transitory foreign inflows, in part reflecting concerns about monetary independence. 1/ However, the intention was not to interfere with legitimate international investment that would be long term in nature. Although there is no distinction in the Articles of Agreement between short-term speculative capital flows and productive investment flows, the language in Article I, by seeking to eliminate foreign exchange restrictions which hamper the growth of world trade, may have been intended to suggest that the restrictions to be eliminated were not only those that applied directly to payments in respect of current international transactions, but also those that inhibited the flow of productive capital. 2/

White's plan 3/ viewed exchange controls as an undesirable interference with trade and capital flows, but noted that at times it may be in the best interests of a country to impose restrictions on movements of capital, and on movements of goods. "The task ... is not to prohibit instruments of control but to develop those measures of control ... as will be most effective in obtaining the objectives of world-wide sustained prosperity." The background to these views was elaborated in the U.S. Treasury's commentary. 4/

Gold notes that, although Article VI, Section 3 permitting members to exercise control over capital movements was not modified at the time of the second amendment of the Articles of Agreement, it has to be read in conjunction with the amendment to Article IV, Section 1, particularly Section (iii) calling for members to avoid manipulating exchange rates. The Fund's policies with regard to surveillance over exchange rates were amended consistent with the revisions to the Articles of Agreement on members' exchange

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1/ Keynes, J.M., "Proposal for an International Clearing Union", British Government White Paper CMND 6437, April 1943. For discussion of this paper see <u>The International Monetary Fund, 1945-65</u>, Vol. III, edited by J.K. Horsefield, IMF, 1969.

2/ Gold, Joseph, "International Capital Movements Under the Law of the International Monetary Fund", IMF Pamphlet Series No. 21, 1977.

3/ White, H.D., "Preliminary Draft Proposals for a United Nations' Stabilization Fund and a Bank for Reconstruction and Development of the United and Associated Nations" (Mimeo, April 1942. For discussion of this paper, see Horsefield, J.K., (ad) op. cit.

4/ Department of the Treasury, <u>The Bretton Woods Proposals: Questions and Answers on the Fund and the Bank</u>", U.S. Treasury, 1944.

rate policies. The policies established included the principle of looking into capital movements in the exercise of surveillance over exchange rates. 1/

Currency convertibility has been examined in two recent Board papers dealing with the transformation of previously centrally planned economies, and a third dealing with surges in capital inflows that have often been associated with capital liberalization. 2/ In discussing SM/90/214, Directors supported the staff's position that current account convertibility should be achieved as soon as possible, but some Directors also emphasized that the appropriate speed of implementation had to be approached on a case-by-case basis, and needed to reflect the adequacy of supporting policies. During these discussions, a number of Directors expressed some disappointment with the treatment of capital controls and requested that the staff look more closely at these issues in the future. Most recently, in discussing the related topic of members' experiences with surges in capital inflows, Directors considered that the use of administrative restrictions on capital inflows and other measures, such as nonuniform reserve requirements, in response to these surges was limited in effectiveness. The restrictions were accepted as a possible reaction in the very short term--whose effectiveness diminishes and whose risks increase over time--and were therefore seen as second best and temporary responses.

1/ "The Fund shall consider the following developments as among those which might include the need for discussion with a member:

(iii) (b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements."

Selected Decisions of the International Monetary Fund, Eighteenth Issue, June 30, 1993.

2/ "Exchange Arrangements of Previously Centrally Planned Economics", SM/92/30 (2/11/92), "Currency Convertibility and the Transformation of Centrally Planned Economics", SM/90/214 (11/7/90), and Recent Experiences with Surges in Capital Inflows", SM/93/113 (5/24/93).

V. Evolving Roles of Exchange Rate Regimes

In the discussions preceding the formation of the Fund, issues of convertibility and choice of exchange rate regime were closely interwoven, as noted in Section IV. A basic objective was to set up a system in which current account convertibility would be consistent with the aims of the fixed exchange rate regimes--convertibility at fixed though adjustable rates--and thus to create a favorable environment for international trade.

With the advent of generalized floating and the Second Amendment of the Fund's Articles, obligations of members regarding their exchange rate policies changed fundamentally from those embodied in the original Bretton Woods Articles and, as amended, Article IV now gives members wide latitude in their choice of exchange arrangements. (The only practices precluded are a peg in terms of gold and, under Article VIII, multiple exchange rates.) In return, members agree to comply with certain broad obligations relating to the underlying stability of exchange rates and other more narrowly focused obligations, and the Fund in turn has the responsibility to oversee each member's compliance with these obligations. The broadest obligation is that each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. To this end, Article IV enumerates four particular obligations of the member countries. Two refer to the member's economic and financial policies: (1) to endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability; and (2) to seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic conditions. The other two obligations refer more specifically to exchange rates; (3) to avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and (4) to follow exchange policies compatible with members' undertakings under Article IV.

There are obligations for provision of sufficient information for the Fund to fulfill its mandate. Notifications by members of their foreign exchange arrangements constitute an important part of the members' obligations under the Articles, implemented under surveillance procedures. Each member is obliged to notify the Fund of its exchange arrangements within 30 days after becoming a member, and promptly thereafter of any subsequent changes. The aim of the notifications is that they be sufficiently comprehensive and meaningful, to enable the Fund to exercise firm surveillance.

Exchange rate policies, and the regimes that express them, are a central focus of the Fund's work, and the various aspects of the policies have therefore been reviewed in a number of studies and Executive Board papers prepared by the staff. 1/ The purpose of the discussion here is to bring to bear some empirical observations that derive from the Fund's annual and quarterly reports on main developments in regimes. 2/

1. Trends in the use of exchange rate regimes

a. Exchange rate classifications

From the time the Fund was established until generalized floating in 1973, the international monetary system was based on the original Bretton Woods system of par values, with a few exceptions of long-standing floating regimes that included an industrial country (Canada) and a developing country (Lebanon). Since 1973, exchange rate regimes adopted by members have covered a broad spectrum, ranging by degree of flexibility from single currency pegs to free floats. Most countries have adopted regimes that fall fairly readily into one or another of the major categories of the classification system adopted by the Fund in 1982, 3/ as summarized in Table 2. Countries with dual or multiple exchange markets normally have one market that is clearly the most important, and the Fund's classification refers to that market.

Within the group of fixed rate arrangements, there are several that deserve separate discussion. In the most pure form of a single currency peg, the currency of another country is used in circulation as legal tender. Several currencies are used in this way--the Australian dollar in Kiribati, the Italian lira in San Marino, the Russian ruble in Tajikistan, and the U.S. dollar in Liberia, the Marshall Islands, Micronesia, and Panama. In these countries, the financial stability provided by unifying the currency with the currency of the larger country, and reduced administrative costs, were judged to be more important than the loss of seignorage and absence of

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1/ See, for example, Borenztein, Eduardo and Paul R. Masson, "Exchange Arrangements of Previously Centrally Planned Economies", Occasional Paper No. 102, IMF, 1993; MacDonald, Ronald and Mark P. Taylor, "Exchange Rate Economics: A Survey", IMF Staff papers, Vol. 39, 1992, pp. 1-57; Frenkel, Jacob A.; Morris Goldstein, and Paul R. Masson, "Characteristics of a Successful Exchange Rate System", IMF, Occasional Paper No. 81, IMF, 1991; Aghevli, Bijan B.; Mohsin S. Khan, and Peter J. Montiel, "Exchange Rate Policy in Developing Countries: Some Analytical Issues", IMF, Occasional Paper No. 78, IMF, 1991; Quirk, Peter J.; Benedict Vibe Christenson, Kyung-Mo Huh, and Toshihiko Sazaki, "Floating Exchange Rates in Developing Countries: Experience with Auction and Interbank Markets", Occasional Paper No. 53, IMF, 1987.

2/ Annual Report on Exchange Arrangements and Exchange Restrictions, IMF, 1993 (1994 forthcoming); and "Quarterly Report on Changes in Exchange Rate Arrangements and in Real Effective Exchange Rates", SM/94/86 (3/30/94).

3/ For further discussion of the classification system, see "Exchange Arrangements of Fund Members", SM/82/44 (6/24/82).

Table 2. Exchange Rate Classifications

Peg: Single Currency

The country pegs to a major currency--usually the U.S. dollar or the French franc--with infrequent adjustment of the parity.

Peg: Currency Composite

A weighted composite is formed from the currencies of major trading or financial partners. Currency weights are generally country specific and reflect the geographical distribution of trade, services, or capital flows. They can also be standardized, such as those of the SDR or the ECU.

Flexibility Limited vis-à-vis Single Currency

The value of the currency is maintained within certain margins of fluctuation about the de facto peg, corresponding empirically to volatility within the pre-Second Amendment wider margins regime.

Flexibility Limited: Cooperative Arrangements

This regime refers to countries in the exchange rate mechanism (ERM) of the European Monetary System (EMS) and is a conceptual cross between a peg of each EMS currency to others in the system (presently within wide margins), and a float of all EMS currencies jointly vis-à-vis non-EMS currencies.

More Flexible: Adjusted According to a Set of Indicators

The currency is adjusted more or less automatically in response to changes in selected quantitative indicators. A common indicator is the real effective exchange rate that reflects inflation-adjusted changes in the currency vis-à-vis major trading partners; another is a fixed preannounced change.

More Flexible: Managed Float

The central bank quotes and supports the rate but varies it frequently. Indicators for adjusting the rate are broadly judgmental, including, for example, the balance of payments position, international reserves, or parallel market developments, and adjustments are thus not automatic.

More Flexible: Independent Float

Rates are market-determined, with any intervention aimed at the moderating rate of change, rather than establishing a level for the rate.

an independent monetary policy. A closely related type of peg is a currency board arrangement by which the country in question pegs its currency to the currency of a larger country and the issue of domestic currency is fully backed by the foreign currency. Argentina, Estonia, Hong Kong, Lithuania, and Singapore use modified versions of currency boards. 1/

A currency union is by definition a pegged arrangement at par among its members, which use their own common currency. The seven countries that make up the West African Monetary Union maintain a common currency, the CFA franc, which is issued by the Banque Centrale des Etats de l'Afrique de l'Ouest and is fixed in terms of the French franc. The CFA franc is also issued at the same fixed exchange rate by the Banque des Etats de l'Afrique Centrale to the six member countries of the Central African Monetary Area, 2/ in which the CFA franc is also the common currency. 3/ Similarly, eight Caribbean countries 4/ maintain fixed exchange arrangements and use a common currency, the Eastern Caribbean dollar, which is issued by the Eastern Caribbean Central Bank and is pegged to the U.S. dollar. These arrangements differ from those of the cooperative arrangements in EMS countries, which do not use a common currency and must therefore coordinate actively their economic policies.

At the other end of the spectrum, the distribution between managed and independently floating arrangements is important because it often reflects the policy stance for full, or limited, market determination of the exchange rate. In countries with managed regimes, as with pegged and other less flexible regimes, the foreign exchange market does not necessarily clear--even in the limited sense of equalizing supply and demand in the presence of restrictions on foreign exchange flows--and the result has often been the emergence of a parallel or black market exchange rate. In contrast, under independently floating regimes supply and demand is in continuous equality, albeit in the very short run partly as a result of intervention or exchange controls. Moreover, intervention has been limited in the independently floating group by definition--by the classification requirement that the intervention be only for smoothing purposes, and not aimed at establishing a particular level for the exchange rate.

1/ For discussion of existing currency board arrangements, see "Independent Currency Authorities: an Analytical Primer", Osband, K., and D. Villanueva, IMF Working Paper WP/92/50, 1992.

2/ Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, and Gabon.

3/ In addition, while the Comoros is not formally a member of the CFA franc zone, its exchange arrangements with France are very similar to those of the CFA franc countries.

4/ Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

The number of member countries that peg their currencies to a single currency or a basket of currencies, as well as the share of these countries in world trade, has decreased in recent years. The decline is even more marked if individual country peggers adhering to some form of regional arrangement, and thus with less true discretion regarding their choice of regime, are excluded. At the other extreme, the number of countries with more flexible exchange rates (particularly independently floating) regimes increased (Charts 3 and 4).

b. Changes in arrangements

During the period 1991-93, individual changes in exchange rate regimes continued to be almost universally one-way shifts toward more flexible arrangements. Thirty-four members reclassified their exchange regimes from pegs to more flexible arrangements, while only two members moved from more flexible arrangements to pegs. The 34 reclassifications to more flexibility occurred in a variety of ways, with the industrial country reclassifications (United Kingdom, Italy, Norway, and Sweden) being largely the result of the ERM crisis in 1992, 1/ and the developing country reclassifications generally implemented as a part of overall policy packages: eleven countries 2/ adopted floating arrangements upon unification of multiple or dual exchange arrangements; eight countries 3/ introduced interbank foreign exchange markets, auctions of foreign exchange or shifted most transactions to the free foreign exchange market; four new members 4/ introduced independently floating national currencies; and five countries adopted floating rates by other measures. 5/

Concerning the two sole members whose regime were reclassified from more flexible arrangements to pegs, Nepal pegged to a basket of currencies and Argentina's administration introduced a fixed rate regime in the context of a comprehensive economic program. Nicaragua also moved to a peg during the period but subsequently moved back to a managed float.

1/ For those countries remaining in the ERM, arrangements become more flexible in the sense that, with the exception of the cross rate between the Deutsche mark and the Dutch guilder, intervention margins were increased from ±2.25 percent to ±15 percent since August 1993.

2/ Belarus, Bulgaria, Guyana, Haiti, India, Islamic Republic of Iran, Kenya, Mongolia, Nepal, Sudan, and Tanzania.

3/ Albania, Dominican Republic, Ethiopia, Georgia, Latvia, Romania, Trinidad and Tobago, and Uganda.

4/ Armenia, Kazakhstan, the Kyrgyz Republic, and Moldova.

5/ Croatia (a new foreign exchange law), Costa Rica (elimination of crawling peg), Honduras (increased participation in the foreign exchange market), and Mozambique and Zambia (elimination of indicators based arrangements).

A number of countries adopted more managed exchange rate arrangements that offered discretion to the authorities in setting the exchange rate, without necessarily adopting a peg: the Malaysia ringgit and Turkmenistan's newly introduced manat were classified as managed floats; Nicaragua, Israel, Poland, and Sao Tome adopted preannounced crawling peg systems; Argentina and, for an interim period Nicaragua, pegged to the U.S. dollar, and Portugal joined the ERM. Four countries, including one of the above, switched from one form of currency peg to another. 1/

Between 1991 and 1993, a significant change in the membership of the Fund resulted from the new membership of the FSU and the Baltic States. A number of these countries were using the Russian ruble at the time of accession to membership in the Fund but, as of end-1993, 11 of the 13 countries in this group that had notified their exchange arrangements to the Fund were classified as having more flexible exchange rate regimes. Azerbaijan remained pegged to the Russian ruble, while Estonia has adopted a peg to the deutsche mark, and Lithuania a peg to the U.S. dollar on April 1, 1994.

2. Forward exchange rate regimes

Forward foreign exchange markets play an increasingly important role in market-based exchange systems of both industrial and developing countries. Development of forward exchange markets has been very rapid since the early 1980s, and was last reviewed by the Fund in 1988. 2/ Forward regimes include restrictions on forward cover transactions, and in some developing countries, arrangements for central bank determination of the forward premia or discounts, or provision of exchange rate guarantees by the central bank. Major forms of such restrictions on access are underlying ("real") transaction requirements, limits on maturities, and approval requirements for specific types of transactions. Access restrictions affect the extent of available coverage of transactions. Among the three major categories of transactions in forward exchange markets, namely, commercial transactions and scheduled debt service payments, interest arbitrage transactions, and transactions without underlying transactions, a number of developing countries permit forward cover only for the first category. Forward cover for the second category of transactions is allowed in countries that have capital convertibility so that international fund transfers to maximize yields on financial investments are permitted, although often only banks are permitted to undertake such interest arbitrage transactions. The third category refers to transactions of a purely speculative nature, which

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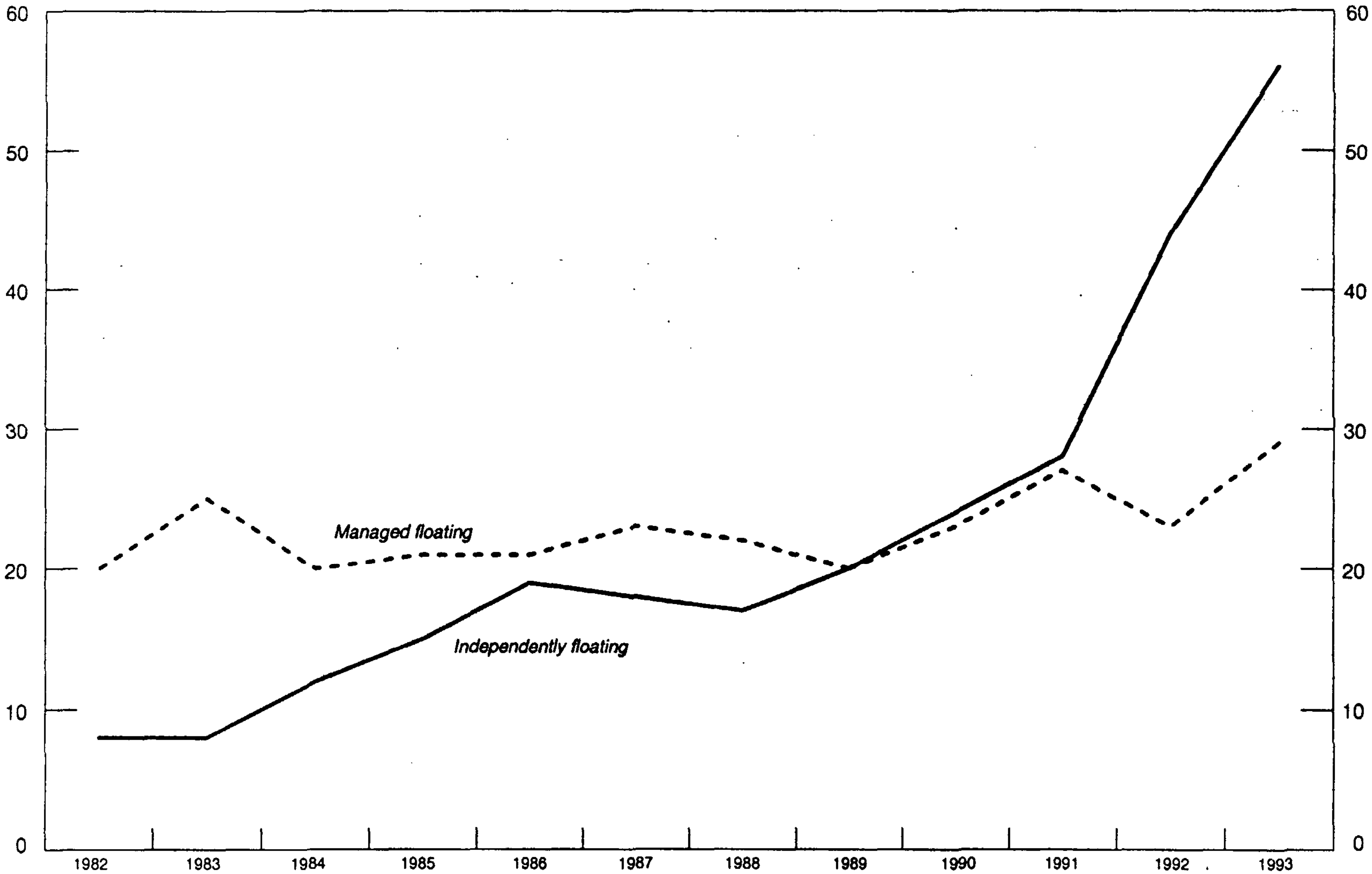
1/ Burundi and Tonga (from the SDR and Australian dollars, respectively, to undisclosed baskets), the Former Socialist Federal Republic of Yugoslavia in mid-1992 (from the deutsche mark to the U.S. dollar) and Poland from a basket to the U.S. dollar and back to a basket.

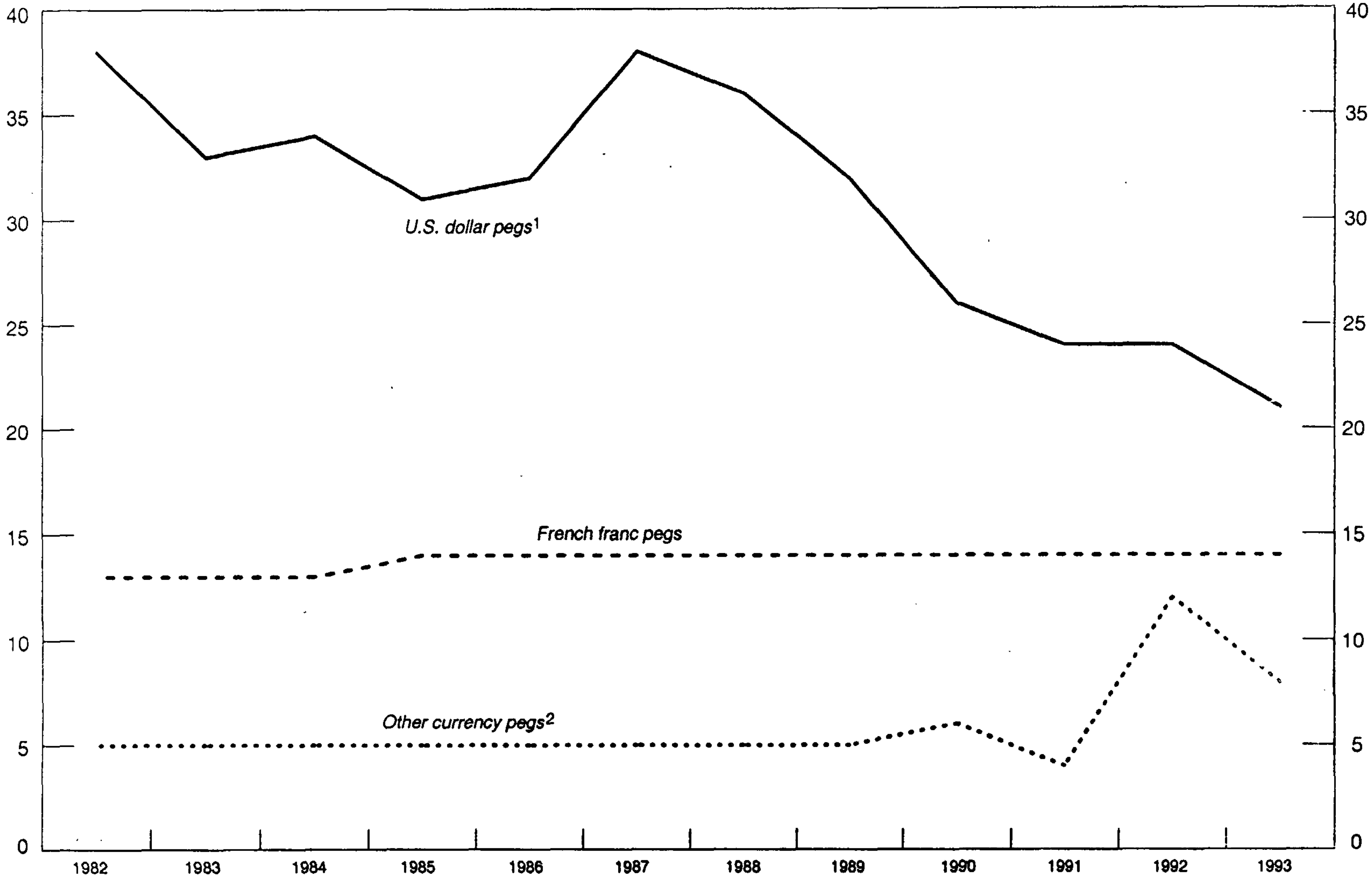
2/ See Policies for Developing Forward Foreign Exchange Markets, Occasional Paper No. 60, IMF, 1988.

Chart 3
Exchange Regimes Classified as More Flexible Arrangements, 1982-93
(Number of Measures)



Sources: IMF, AREAER (various issues).

Chart 4
Exchange Regimes Classified as Single Currency Pegs, 1982–93
(Number of countries)



Sources: IMF, AREAER (various issues).
[1]Including countries classified as having limited flexibility against the U.S. dollar.
[2]For 1992, this category includes six countries whose currencies were pegged to the Russian ruble and six to other currencies.

accompany open foreign exchange positions. In an attempt to limit speculative transactions, many developing countries prohibit these underlying transactions.

Compared with the situation when last surveyed in 1986, industrial countries have ended many restrictions on access to the forward markets and underlying transaction requirements, and removed limits on maturities available in forward markets (Table 3). Prior approval requirements by type of transaction were also abolished by a number of countries. As a result, all industrial countries other than Iceland now have market-determined forward exchange rate systems. In addition, a number of countries have removed restrictions on forward cover activities, such as access restrictions, underlying transaction requirements, limits on maturity, and approval requirements for specific types of transactions (Austria, Denmark, Finland, France, Ireland, Italy, Norway, Spain, and Sweden are countries that recently eliminated restrictions.) As a result, no industrial country with a forward exchange market now has limits on access to its forward cover markets, underlying transaction requirements, nor limits on maturity.

a. Developing countries

Since forward market practices in developing countries were last surveyed by the Fund in 1988, there has been continued liberalization and development of these markets (Table 4). Five larger developing countries have been added to those in which cover can be obtained from commercial banks (Brazil, Hungary, Israel, Mexico--up to six months, and Turkey). Only in Argentina were previous commercial cover arrangements no longer available, following adoption of a fixed exchange rate.

As a counterpart to the increased role for forward markets in the private sector, a number of countries either ceased regulating forward exchange rates for cover provided by the private sector (Hungary, Israel, and Turkey), or ceased providing cover directly through official agencies (Argentina, Costa Rica, Israel, the Philippines, and Venezuela). In two countries (Kenya and Zimbabwe) official cover was introduced as an adjunct to private cover arrangements--but is now being phased-out in Kenya.

The 1988 review of forward exchange markets underlined the dangers in officially-run exchange rate guarantee schemes, which had resulted in very large fiscal and quasi-fiscal losses in a number of countries. It noted disadvantages also with the provision by commercial banks of foreign exchange deposit accounts as hedging facilities, because they tie up liquidity compared with the use of forward exchange contracts, and they may also raise questions of the exposure of the banks to exchange rate risk, beyond their ability to be involved prudently, or at unrealistic nonmarket rates.

Table 3. Industrial Countries: Main Features of Regulations Affecting Forward Exchange Markets, December 31, 1992

	Transactions Covered	Access Restrictions		Underlying Transaction Required		Official Maturity Limit		Approval Requirements by Type of Transaction		Restriction by Currency		Policy of Official Intervention		Direct Regulation of Forward Rate	
		1986	1992	1986	1992	1986	1992	1986	1992	1986	1992	1986	1992	1986	1992
Australia	Commercial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
Austria	Commercial	Yes	No	Yes	No	18 ms.	No	No	No	No	No	No	No	No	No
	Financial	Yes	No	Yes	No	18 ms.	No	Yes	No	No	No	No	No	No	No
Belgium/ Luxembourg	Commercial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
	Financial	No	No	No	No	No	No	Yes	No	No	No	No	No	No	No
Canada	Commercial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
Denmark	Commercial	Yes	No	Yes	No	36 ms.	No	No	No	No	No	No	No	No	No
	Financial	Yes	No	Yes	No	36 ms.	No	Yes	No	No	No	No	No	No	No
Finland	Commercial	Yes	No	Yes	No	No	No	No	No	No	No	No	No	No	No
	Financial	Yes	No	Yes	No	No	No	Yes	No	No	No	No	No	No	No
France	Commercial	Yes	No	Yes	No	No	No	No	No	No	No	No	No	No	No
	Financial	Yes	No	Yes	No	No	No	Yes	No	No	No	No	No	No	No
Germany, Fed. Rep. of	Commercial	No	No	No	No	No	No	No	No	No	No	...	...	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	...	...	No	No
Iceland	No forward market	--	--	--	--	--	--	--	--	--	--	--	--	--	--
Ireland	Commercial	Yes	No	Yes	No	12 ms.	No	No	No	No	No	No	No	No	No
	Financial	Yes	No	Yes	No	12 ms.	No	Yes	No	No	No	No	No	No	No
Italy	Commercial	Yes	No	Yes	No	18 ms.	No	No	No	No	No	No	No	No	No
	Financial	Yes	No	Yes	No	18 ms.	No	Yes	No	No	No	No	No	No	No
Japan	Commercial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
Netherlands	Commercial	No	No	No	No	No	No	No	No	No	No	...	...	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	...	...	No	No
New Zealand	Commercial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	No	No	No	No
Norway	Commercial	Yes	No	Yes	No	No	No	No	No	No	No	No	No	No	No
	Financial	Yes	No	Yes	No	No	No	Yes	No	No	No	No	No	No	No
Spain	Commercial	Yes	No	Yes	No	12 ms.	No	No	No	Yes	No	...	...	No	No
	Financial	Yes	No	Yes	No	12 ms.	No	Yes	No	Yes	No	...	...	No	No
Sweden	Commercial	Yes	No	Yes	No	No	No	No	No	No	No	...	...	No	No
	Financial	Yes	No	Yes	No	No	No	Yes	No	No	No	...	...	No	No
Switzerland	Commercial	No	No	No	No	No	No	No	No	No	No	...	...	No	No
	Financial	No	No	No	No	No	No	Yes	No	No	No	...	...	No	No
United Kingdom	Commercial	No	No	No	No	No	No	No	No	No	No	...	...	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	...	...	No	No
United States	Commercial	No	No	No	No	No	No	No	No	No	No	No	...	No	No
	Financial	No	No	No	No	No	No	No	No	No	No	No	...	No	No

Sources: International Monetary Fund, Annual Report on Exchange Arrangements and Exchange Restrictions; and national authorities.

Note: "Yes" indicates it is a practice under the exchange system; "No" indicates it is not; ... indicates that information is not available; and -- indicates that the information is not applicable.

Table 4. Summary Features of Forward Exchange Systems in Selected Developing Countries, December 31, 1992

	Cover by Private Sector				Cover Provided by Official Agencies to						Forward Cover Provided by or Through Banks	
	Unregulated Rates		Regulated Rates		Banks		Traders		Debtors			
	1986	1992	1986	1992	1986	1992	1986	1992	1986	1992	1986	1992
Argentina	Yes 1/	Yes	No	No	Yes	No	Yes	No	Yes	No	Yes	No
Bangladesh	No	No	Yes	Yes	Yes	Yes	No	No	Yes	Yes	Yes	Yes
Brazil	Yes	Yes	No	No	No	No	No	No	No	No	No	Yes
Chile	Yes	Yes	No	No	No	No	No	No	No	No	No	No
China	No	No	Yes	Yes	No	No	No	No	No	No	Yes	Yes
Costa Rica	No	No	No	No	No	No	Yes	No	Yes	No	No	No
Egypt	No	No	No	No	No	No	Yes 2/	Yes	No	No	No	No
Hungary	No	Yes	No	No	No	No	Yes	Yes	No	No	No	Yes
India	No	No	Yes	Yes	Yes	No	Yes	Yes	No	No	Yes	Yes
Indonesia	Yes	Yes	No	No	Yes	Yes	No	No	No	No	Yes	Yes
Israel	No	Yes	No	No	No	Yes	Yes	No	No	No	No	Yes
Jamaica 3/	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Jordan	Yes	Yes	No	No	No	No	Yes 4/	Yes	No	No	Yes	Yes
Kenya	No	No	Yes	Yes	Yes	No	No	Yes	No	Yes	Yes	Yes
Korea	Yes	Yes	No	No	Yes	No	No	No	No	No	Yes	Yes
Malaysia	Yes	Yes	No	No	Yes	Yes	No	No	No	No	Yes	Yes
Malta	No	No	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes	Yes
Mauritius	No	No	No	No	No	Yes	Yes	Yes	Yes	Yes	No	No
Mexico	No	No	No	No	No	No	No	No	Yes	Yes	No	Yes 5/
Morocco	No	No	No	No	Yes	Yes	No	No	No	No	No	No
Nigeria	Yes	Yes	No	No	No	No	No	No	No	No	Yes	Yes
Pakistan	No	No	Yes	Yes	Yes	Yes	No	No	Yes	Yes	Yes	Yes
Philippines	Yes	Yes	No	No	Yes	No	No	No	Yes	No	No	No
Singapore	Yes	Yes	No	No	No	No	No	No	No	No	Yes	Yes
South Africa	Yes	Yes	No	No	Yes	Yes	No	No	No	No	Yes	Yes
Sri Lanka	Yes	Yes	No	No	Yes	Yes	No	No	No	No	Yes	Yes
Thailand	Yes	Yes	No	No	No	No	No	No	No	No	No	No
Turkey	No	Yes	No	No	No	No	No	No	Yes	Yes	No	Yes
United Arab Emirates	Yes	Yes	No	No	Yes	Yes	No	No	No	No	No	No
Uruguay	Yes	Yes	No	No	No	No	No	No	Yes	Yes	Yes	Yes
Venezuela	No	No	No	No	No	No	No	No	Yes	No	No	No
Zaïre	Yes	Yes	No	No	No	No	No	No	Yes	Yes	Yes	Yes
Zimbabwe	No	No	No	No	No	Yes	Yes	Yes	No	Yes	Yes	Yes

Sources: International Monetary Fund, Annual Report on Exchange Arrangements and Exchange Restrictions; and national authorities.

1/ Parallel (not officially recognized) market.
2/ Provided only to public sector agencies engaged in trade in special circumstances (not being utilized in Egypt).
3/ Market was inoperative in early 1998.
4/ Central Bank provides forward cover to banks only for corporations or projects of vital national interest.
5/ Authorized financial institutions provide short-term (up to six months) forward cover for foreign exchange operations.

On balance, the experience suggests that waiting for a market to develop in the private sector to provide the cover--eschewing nonmarket approaches in the meantime--seems the optimal course. The fact that such forward markets appear to be very sensitive to the overall level of financial sector liberalization and development constitutes another important reason to accelerate the reforms.

3. Multiple exchange rates

Multiple exchange rates, defined as different effective exchange rates for a currency applied to different types of transactions, transactors, and currencies, result from market segmentation caused by official action and are subject to Fund jurisdiction. Multiple exchange rates have been used for various purposes, including balance of payments objectives, and attempts to discourage or promote specific transactions, increase revenue, control prices or subsidize specific parties. 1/ Whatever the purpose, multiple exchange rates influence and distort relative prices, the distribution of income, and the allocation of resources. Multiple exchange rates are distorting not only from the standpoint of economic efficiency but also from the standpoint of fairness, as is often the case when authorities use them to provide special treatment for specific groups. Even when multiple exchange rates are implemented to correct a domestic market imperfection, such official action tends to create new, and possibly more serious, distortions elsewhere in the economy.

a. Developments in the use of multiple exchange rates

The number of countries using multiple exchange rates either to liberalize or to tighten foreign exchange restrictions can provide an overall sense of the extent to which countries are using the exchange system as a tool to manage their external accounts. These numbers may, however, be misleading if they result from transitional measures in countries planning to liberalize transactions in sequence. 2/ Thus, the introduction of multiple currency practices does not necessarily mean that the degree of complexity or restrictiveness of an exchange rate system has increased. Moreover, there are various types of multiple currency practices, and their scope and incidence can vary widely and be difficult to measure.

1/ Their use to influence imports is discussed above, in Section III.1.a.

2/ The existence of a secondary (parallel) market, where certain current transactions take place at a floating exchange rate that is more depreciated than the rate in the official market, is evidence of the inappropriateness of the official exchange rate. A parallel market exists in about 70 member countries where access to the official exchange market is restricted. A distinction may be made between legal and tolerated or illegal parallel markets from the standpoint of the jurisdiction of the Fund. If current transactions are channeled through more than one market, multiple currency practices result, which are subject to prior approval of the Fund.

The number of countries with multiple exchange rates in 1991-92 averaged 36, compared with 42 in 1989-90, and the share in trade of member countries with multiple exchange rates has fallen. In 1990, countries with multiple exchange rate systems represented only about 5 percent of total trade, compared with 13 percent in 1986 and 1988. Brazil, China, and Mexico alone represented one half of that figure (4 percent of total trade), and they have since unified their exchange rates.

The trend away from use of multiple exchange rates has been evident since the 1950s, although progress has not been continuous. In the early 1950s, the world dollar shortage, and the problems of bilateralism and inconvertibility stemming from it, accompanied an increased use of multiple currency practices by industrial and developing member countries. Some two thirds of the membership engaged in such practices in 1955, and weighted by trade, the incidence was about one third of the membership. In June 1957, the Fund adopted an important decision urging members to simplify their exchange rate structures; it also undertook to assist members in their efforts to do so, providing technical assistance where appropriate. 1/ In the late 1950s and early 1960s, these efforts, together with the establishment of convertibility among industrial countries and an improvement in the international trade situation, helped to simplify the exchange rate systems in both industrial and developing member countries. Progress in simplifying developing countries' systems was mixed thereafter, and the use of multiple exchange rates increased in the late 1960s (particularly in the form of advance import deposit requirements accompanied by import surcharges due to the increasing misalignment of exchange rates) and again in the early 1980s (in response to widespread balance of payments difficulties).

Since 1986, when 46 countries operated some form of multiple exchange rate regime, there have been renewed reductions in the incidence of multiple exchange rates. The number fell to 44 in 1988, and to 41 in 1993 or about one fourth of the Fund's membership. Multiple currency practices are applied to capital transactions in 13 countries. However, only in some of the South African Common Monetary Area countries and in Colombia were multiple exchange rates applied broadly to capital transactions rather than to certain specific capital operations.

Recent developments in countries with multiple currency practices may be characterized as a continuous trend of liberalization and movements toward unified exchange rate regimes. In the last two years, eight member countries eliminated multiple markets, while seven members introduced them. A question arises here as to whether the introductions indicate a retrogression to restrictive regimes in these countries. The answer to this question appears to be no--in most of the seven member countries that introduced a multiple market regime, it was a transitional measure forming

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1/ Executive Board Decision No.649-(57/33), adopted June 26, 1957, reprinted in Selected Decisions of the International Monetary Fund, IMF, 1992.

part of a plan to liberalize the exchange and trade regimes. Because of the nature of these newly-introduced multiple rates, the majority were approved by the Fund.

b. Fund policy

Article VIII, Section 3 stipulates as one of Fund member countries' obligations the avoidance of multiple currency practices. Multiple currency practices take many different forms, but can be divided into five main categories: a dual or multiple exchange market system applied to broad categories of transactions; a separate fixed exchange rate for specified transactions; taxes (or subsidies) that accrue to (or are paid by) the monetary or fiscal authorities on the value of specified exchange transactions or on exchange transfers; an excessive spread between buying and selling rates for foreign exchange; and broken cross exchange rates.

The Executive Board reviewed the Fund's experience with, and policies for, multiple exchange practices in April 1984 and February 1985. The main conclusion of these reviews was that multiple currency practices are costly in terms of efficiency and resource allocation and have not proven conducive to medium-term balance of payments adjustment. 1/ Most countries that introduced multiple currency practices did so at a time of external payments difficulties. In some cases, they did so to avoid a uniform change in the exchange rate--normally a devaluation--because they thought that it would entail high political and social costs. Some were concerned that a uniform devaluation would undermine growth prospects and cause inflation; others, that it would subvert social priorities by raising the costs of essential imports; and yet others believed that development prospects would be endangered by the higher costs of imported inputs for priority sectors.

In some instances, a dual exchange rate as a temporary device to approximate a realistic level for a proposed unified exchange rate was used as a transitional policy tool. Several countries established dual markets when their authorities were willing to unify the fixed official exchange rate with various other rates, but were uncertain about the appropriate level for the new exchange rate. The movement of the exchange rate in the free secondary market provided information for the new official exchange rate, though in some countries a greater depreciation in the secondary market occurred than warranted by economic fundamentals. In other countries, the authorities intended to move from a fixed exchange rate system to a more flexible exchange rate system and to unify the official exchange rate with various other rates, official and unofficial, but were concerned about the lack of maturity of the interbank market or possible volatility of the exchange rate in the free market. For these reasons, dual markets were maintained until these concerns were resolved.

1/ For further discussion of the 1984-85 review, see Annual Report on Exchange Arrangements and Exchange Restrictions, (Part One), IMF, 1985.

Introduction of a multiple currency practice is subject to approval under Article VIII, and the Fund's approval policies regarding multiple currency practices have remained flexible and responsive to each country's particular circumstances. An important consideration in the determination of whether to approve multiple currency practices relates to their temporary character, at least when introduced. 1/ Approval of the practices is based on the existence of a clear plan designed to bring about the unification over a specific and appropriately brief period of time. The development of such a plan, and firm intentions to unify the exchange market, are normally expected from a member undertaking an adjustment program supported by the use of Fund resources. The plan consists of either successive reductions in the dispersion of exchange rates through devaluation of the more appreciated rate(s), or shifts of the transactions undertaken in the various exchange markets toward the free market.

VI. Bilateralism and Regionalism in Cross-Border Payments

Bilateral or regional payments arrangements maintained between Fund members often give rise to exchange restrictions and multiple currency practices under Article VIII of the Fund's Articles of Agreement. Generally speaking, a basic feature of bilateral payments arrangements is that balances in the bilateral account, which is typically established to settle bilateral trade transactions, can be used only to make settlements between the two partner countries and cannot be transferred into another currency or be used to make payments to a third country. Where the transferability of balances in the bilateral account is subject to undue delays, an exchange restriction within the meaning of Article VIII, Section 2(a) may be involved. 2/ Bilateral payments agreements may also involve discriminatory currency features.

In September 1982 the Executive Board reviewed the Fund's policy with respect to bilateral payments arrangements and the use of countertrade arrangements. The broad conclusions of this review were the following: (1) the Fund's policy of not approving the maintenance of bilateral payments agreements with restrictive features and of encouraging their termination in the context of Article IV consultations had contributed to a decline in the use of bilateral payments arrangements; (2) the Fund's policy on payments arrangements maintained between Fund members in the context of the use of its resources will be continued. Intentions with respect to the elimination of bilateral payments arrangements that are inconsistent with Article VIII would continue to be a performance criterion under upper credit tranche stand-by and extended arrangements of the Fund; (3) the Fund would continue

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1/ In addition, for approval to be granted, the measure must be introduced or maintained for balance of payments reasons, and it must not discriminate between Fund members.

2/ Under the established Fund policy, a period exceeding 90 days is considered unduly long.

to encourage members to terminate payments agreements that are inconsistent with Article VIII, including those that are maintained under the transitional provisions of Article XIV; and (4) the use of countertrade arrangements and their impact on the development of a multilateral system of trade and payments need to be kept under review. 1/

1. Trends in bilateral payments agreements

Bilateralism in payments, as indicated by the number of agreements, had declined substantially among Fund members in recent years. 2/ However, with the accession into Fund membership of formally centrally planned economies and the breakup of the U.S.S.R. into separate states there has been an increase in the use of bilateral payment arrangements. Within the states of the FSU, these arrangements have primarily taken the form of correspondent account relationships between the central banks.

At end-1992, 52 Fund members out of a total membership of 175 maintained bilateral payments agreements compared with 38 out of a total membership of 159 at end-1991, as all new members joining the Fund, and countries succeeding members in 1992, maintained bilateral payments arrangements. Taking a longer trend and in spite of the number of new members maintaining bilateral payments arrangements, the percentage of Fund members with bilateral payment agreements was about the same--30 percent--in 1992 as in 1981.

Including the central bank correspondent accounts of FSU countries, members maintained 264 bilateral payments arrangements of which 209 were operative at end-1992. This represented an increase of 131 in total agreements and of 104 in operative agreements over 1991; 91 of the increases are accounted for by the correspondent accounts between central banks of the states of the FSU countries. Comparing 1992 and 1981, the total number of

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1/ A review of legal issues involved in identifying bilateral payments arrangements subject to Fund jurisdiction is now underway.

2/ The bilateral (regional) payment arrangement is used here to refer to the methods of international settlement involving a bilateral (regional) clearing mechanism.

The Executive Board's last review of bilateral payment arrangements took place in 1982 on the basis of the staff paper "Review of Bilateral Payments Arrangements", SM/82/169 (8/17/82). This paper concluded that there had been further progress by Fund members in reducing their reliance on bilateral payment arrangements. Earlier reviews were conducted in 1975, "Developments in Bilateral Payments Arrangements 1966-75", SM/75/271 (11/11/75); in 1966, "Policy on Bilateral Payments Arrangements", SM/66/72 (5/31/66); and throughout the 1950s, especially in 1955, The International Monetary Fund 1945-65, Horsefield, J.K. (ad.), IMF, 1969, Vol. II, pp. 302-305.

bilateral payments arrangements, including the central bank correspondent accounts of FSU countries, increased by 133 and the number of operational arrangements by 64.

The increase in bilateral payments arrangements in 1992 is fully accounted for by the 14 new members and the four countries which succeeded to old memberships of Czechoslovakia and Yugoslavia: Croatia, Slovenia, the Czech Republic, and the Slovak Republic. Excluding new members that joined the Fund between 1981 and 1992, the number of bilateral payments arrangements of members fell from 168 to 75, and the number of operational arrangements strikingly, from 145 to 35. Thus, of the total 264 bilateral payment arrangements in 1992, 189 are attributable to new members joining the Fund after 1981. Existing members of the Fund in 1981 therefore made considerable progress in eliminating bilateral payment agreements.

Five countries which maintained bilateral payments in 1981 had eliminated all of their agreements by 1992. 1/ At the end of 1981, five members maintained at least ten bilateral payment agreements. 2/ At end-1992, only three countries, excluding the FSU, maintained ten or more bilateral agreements--Iran, Islamic Republic of (13), Bulgaria (23), and Hungary (11)--and the majority of these arrangements were inoperative (See Appendix Table VI).

2. Trends in regional payments arrangements

A total of 60 countries participated in regional arrangements at end-1992. There had been a marked increase in the number of countries participating in regional payments agreements during the 1970s, with the number of such countries increasing from 20 in 1970 to 54 in 1980, but the number has been stable since the mid-1980s.

The main institutional difference between a multilateral payments system and a regional payments arrangement results from the increased involvement of central banks and the role of a clearing house in the latter. Under a regional payments arrangement, the central banks and the clearing house take the place of commercial banks and foreign exchange markets in effecting the settlements of international transactions. Commercial banks pay to, and are reimbursed by, their respective central banks in local currencies, and the central banks settle payment imbalances directly between themselves. 3/ In the case of multilateral payments, each transaction

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1/ The countries are Indonesia, Lebanon, Nepal, Sri Lanka, and the Republic of Yemen.

2/ Bangladesh (12 agreements), People's Republic of China (25), Islamic Republic of Iran (10), Romania (12), and Viet Nam (15).

3/ In some cases, balances are netted bilaterally between participants and net bilateral balances are passed to the regional clearing house for settlement.

is settled directly between commercial banks through their correspondent accounts, with conversions between domestic and foreign currency occurring through the foreign exchange market.

The present operative arrangements include the Asian Clearing Union (ACU), the Economic Community of the Great Lake Countries (CEPGL), the Latin American Integration Association (LAIA), the Central African Clearing Arrangement, the Preferential Trade Area (PTA) for Eastern and Southern African States Clearing House, and the West African Clearing House (WACH). In a number of cases, the membership and coverage of the regional arrangements have been expanded, and in some cases, such as the ACU, use of the facility made compulsory. 1/ As a result, the majority of intraregional trade of the countries covered by the regional arrangements is channeled through these arrangements. Regional clearing arrangements that have been terminated or suspended include: the European Payments Union (EPU) (1950-58), the Caribbean Community Multilateral Clearing Facility (1977-83), the clearing arrangement operated under the RCD/ECO (1967-90), the Central American Clearing House (CACH) (1961-92), and the regional payments arrangement operated by the members of the (former) Council of Mutual Economic Assistance (CMEA) from 1964 to 1991.

On January 22, 1993, the Heads of State of the Commonwealth of Independent States signed an agreement establishing the Interstate Bank (ISB). 2/ The operating modalities for the ISB are still being worked out, and in the meantime cross-border correspondent banking has increased rapidly. It is envisaged that the ISB would perform several roles in a regional clearing and settlement arrangement. First, the ISB would assist the participating central banks elaborating operating rules and technical standards for cross-border transactions and organizing the systematic and standardized clearing of interstate payments. Second, the ISB would act as the agent of the participating central banks to calculate their regionally netted positions for an agreed-upon settlement cycle and to effect settlement in Russian rubles. Third, the ISB would provide settlement credit to participating central banks in the settlement currency, within binding, predetermined limits. For these purposes, the ISB would hold and manage ruble accounts for participating central banks.

1/ Concerning participants, the CACH increased its member countries from 3 in 1961 to 5, adding Nicaragua and Costa Rica in 1963; the PTA expanded its membership from 15 to 17 in 1989 with the addition of Angola and Mozambique, and to 18 in 1990; and the WACH increased the number of participants from 12 to 14 in 1976 and 1978, and to 15 in 1980.

2/ All states of the FSU and the Baltic States, except Azerbaijan, Estonia, Georgia, Latvia, and Lithuania. Although, Azerbaijan and Georgia did not join the agreement, they subsequently did.

3. Trends in the use of countertrade and barter trade

Businesses in over 100 countries were reported in 1991-93 to have been engaged in countertrade of some sort, but most countries do not have established reporting procedures for these transactions and in only a few countries are there regulations requiring countertrade (Ecuador, Indonesia, Islamic Republic of Iran, Ukraine, issue countertrade regulations). 1/ Estimates of the scae of barter and countertrade vary from 10 percent to 25 percent of world trade. 2/

In the states of the FSU, barter was prohibited during the first half of 1991. However, this policy was changed due to strong pressure from former republics that viewed countertrade as a means of sustaining trade volumes, and because of shortages of convertible currencies. 3/ As a result, various new barter trade agreements have been concluded and the importance of barter trade increased substantially for Eastern Europe and the states of the FSU, substituting for the previous formal payments agreements. 4/ Barter trade is reported to have accounted for 40 percent of Russian exports during the first half of 1992, but to have declined to 11 percent of total exports in 1993, and for 60 percent of Russia's total trade with China in 1992, where the private companies were allowed to countertrade. In Ukraine the proportion of barter transactions in total trade is estimated to have risen from 13 percent in January 1992 to 62 percent in September 1992. Belarus' countertrade is reported to have accounted for 30 percent of all exports in 1992 and for about 26 percent during 1993. Romania has significant countertrade transactions in its trade with China.

A number of other countries reduced their reliance on countertrade and barter. In 1991, Albania terminated barter and clearing arrangements with Eastern European countries in favor of conventional trade and payments

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1/ Countertrade transactions refer to bilateral and multilateral trading arrangements under which the seller purchases specified goods or services as a partial or total settlement for his exports. Depending on the type of goods or services traded, financial arrangements involved, and the length of time required to complete transaction, countertrade arrangements are described as barter, buy-back, counterpurchase, compensation, offset, switch trading, and other. A countertrade agreement may contain more than one type of arrangement and involve more than two parties.

2/ Countertrade Outlook, No. 30, 1992, p. 4.

3/ For example, Latvia introduced tax exemptions for barter exports when imports of crucial raw materials and spare parts are involved, although this was only to facilitate the fulfillment of existing orders.

4/ New agreements include those between Bulgaria and Russia, and Ukraine, between Czechoslovakia and Russia and Ukraine, and an oil barter arrangement between Poland and Kazakhstan; Romania has reportedly signed bilateral commodity exchange agreements with Russia, Moldova, Turkmenistan, and other countries of the former Soviet Union.

arrangements, (but continued to trade with China on the basis of a barter-type clearing arrangement) and the Islamic Republic of Iran terminated oil-barter agreements with Bulgaria, Czechoslovakia, and Brazil, replacing them with payments in foreign exchange. The Indian authorities have stated clearly that the Government's policy is to discourage private countertrade. In mid-1991, the Government of Peru also withdrew from countertrade and stopped debt-for-export swaps which had been elaborated in late 1990.

About 20 countries continued to implement official offset programs and schemes. 1/ In most of these cases, the programs were applied to military contracts where the government imposed obligatory requirements of counterpurchase in the amount of 30-50 percent of the original transaction. However, these arrangements were executed in accordance with conventional trade and settlement practices.

4. Issues of bilateralism and regionalism

The conclusions of the 1982 Executive Board discussion of bilateral and countertrade arrangements continue to provide a sound basis for the Fund's policies in this area, and could be reiterated in light of the number of new Fund members with bilateral arrangements and the moves to accelerate progress in acceptances of Article VIII.

a. Issues raised by regional payments arrangements

The main argument advanced in support of establishing a regional payments arrangement is that the working balances in convertible currencies could be reduced, since convertible currencies would be used only for settlement of net balances at the end of each transaction period. However, the possible savings may be quite limited and would depend on (1) whether the deficits with one country or group of countries are offset by surpluses with other members of the clearing arrangement; and (2) the share of intra-regional trade in total trade. Also, the netting would lead only to a one-time reduction in the stock of working balances held for trade settlement purposes, and such balances are normally only a fraction of a country's total foreign exchange reserves. 2/ In examining the Latin American

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1/ Australia, Austria, Belgium, Canada, China, Denmark, Ecuador, Finland, Greece, Indonesia, Korea, Kuwait, Malaysia, the Netherlands, Singapore, Spain, Sweden, Syria, Tunisia, Turkey, United Arab Emirates, and United Kingdom.

2/ Polak, J.J., "Currency Convertibility in Eastern Europe: An Indispensable Element in the Transition Process", Columbia Journal of World Business, Vol. 26, Fall 1991, p. 41, concludes that "arrangements of this nature are of minimal economic effect ... The saving on reserves achieved by clearing payments on all intratrade rather than making and receiving payments on a transaction-by-transaction basis can at most be a trivial economy on float."

Free Trade Association (LAFTA) and the Preferential Trade Area for Eastern and Southern African States (PTA), the staff concluded that the foreign exchange savings would be relatively minor. 1/

If multilateral payments instruments are poorly developed--particularly the various trade credit and payment instruments operated through correspondent banking accounts--the regional clearing mechanism could have a role as a transitional arrangement while the multilateral payments system is being developed. However, the clearing arrangement should not substitute for or interfere with the development of conventional payments instruments and foreign exchange markets which would provide the next flexible payments arrangements. It is notable that the Concept Paper for the cross-border initiative for Southern and Eastern Africa focuses on the development of exchange markets, commercial bank correspondent banking, conventional payments instruments and current account convertibility of the currencies of participating countries as a preferred approach to enhancing payments within the region, rather than in developing regional payments arrangements through the PTA. 2/

Sometimes it is argued that regional payments arrangements are a step toward economic integration via trade liberalization and monetary policy coordination; 3/ or that regional clearing unions could result in a reduction in transaction costs associated with converting between currencies. However, a regional payments arrangement would only be part of a broader package to foster intraregional trade flows and regional integration. Conversion costs are also not avoided if trade is invoiced in a third currency, and reductions in cost have to be contrasted to the operating

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1/ See "The Possible Role of a Clearing House in the Latin American Regional Market", SM/63/67 (7/1/63); "The LAFTA Multilateral Compensation and Reciprocal Credit Mechanism", SM/66/43 (7/29/66); Payment Arrangements and the Expansion of Trade in Eastern and Southern Africa, Occasional Paper No. 11, IMF, July 1982. An examination of the LAIA (Latin American Integration Association), the successor of LAFTA, shows that while it has economized on the use of convertible currency, the majority of the saving results from the operation of the bilateral clearing arrangements between the members and was gained as a result of higher costs (including lower quality of imports).

2/ Concept Paper for the Initiative to Facilitate Cross-Border Private Investments, Trade and Payments, prepared by the staff of the Commission of the European Communities, World Bank, IMF and African Development Bank, June 1993.

3/ This objective has been stated by the EPU, the Caribbean Community Multilateral Clearing Facility (CARICOM), and CACH. Keesing and Brand (1963) state that a clearing house in the context of LAFTA has been considered by some as a prerequisite for the success of the trade liberalization policies pursued.

costs of the clearing facility. 1/ Regional payments arrangements may be viewed as an improvement over bilateral payments arrangements and they may decrease the general level of restrictions within the region. However, if any members of the regional group are already free of restrictions, then harmonization could result in increased restrictiveness for them, unless specifically guarded against. Moreover, the arrangements are potentially discriminatory and various aspects of regional payments arrangements could also give rise to restrictions on payments and transfers contrary to Article VIII.

b. Issues of countertrade and barter

Recourse to barter and countertrade is generally motivated by insufficient foreign exchange reserves or external financing, such as in the debt crisis, or the use of nonprice incentives associated with the quality or pricing of the goods traded. Arguments advanced in favor of barter and countertrade include increasing the volume of exports and essential imports, gaining access to markets, and attracting foreign investment. The disadvantages include the potential distortion of conventional trade dealing, pricing, and payment practices due to the nontransparency of the arrangements and the dumping of products on third markets, and high search and information costs. Official offset policy has evolved out of the objectives of balancing foreign exchange expenditures through counterpurchases. Offset policy has been used to increase nontraditional exports and to support industrial or regional development.

Barter and countertrade arrangements must be viewed as transitional arrangements while a multilateral system of payments is being developed. However, the lack of transparency of these arrangements creates a number of risks, and where the arrangements involve official action they may entail restrictive and discriminatory features contrary to the Fund's policy on bilateralism. The Fund's policy has therefore been to keep under review the use of countertrade arrangements and their impact on the development of a multilateral system of payments to ensure that restrictive and discriminatory exchange measures subject to Article VIII are not involved, as such discrimination could arise in countries that officially mandate use of the practices. 2/

1/ Experience has shown that the operating costs of clearing facilities can be quite high. In the WACH, for example, the average cost of a transaction in the last two years has been SDR 885. While the WACH may not be representative, the example shows the importance of considering the operating costs involved.

2/ "Review of Bilateral Payments Arrangements, 1976-81", SM/82/169 (7/17/82).

VII. Implications for the Fund's Technical Assistance

The Fund has played an important advisory and technical role in the selection of appropriate exchange rate regimes, including the development of foreign exchange markets. In the 1980s this role centered on assistance to develop the role of floating exchange rates, responding to widespread reserves shortages and large disequilibria associated with the debt crisis. Fund missions, including a number that were fielded specifically for this purpose from the former Exchange and Trade Relations Department, 1/ advised on operational aspects of setting up interbank and auction foreign exchange markets and associated macroeconomic policy steps, including unification of multiple exchange rates, liberalization of exchange and trade restrictions, foreign exchange intervention policies, and implications for the conduct of monetary policy. At a later stage of development of spot exchange markets, advice was also given on measures to develop forward foreign exchange markets.

In order to assist members to simplify and eliminate complex exchange systems, the Fund stands ready to meet members' requests for technical assistance in the preparation of economic programs and measures directed toward simplification and development of foreign exchange markets. Technical assistance in the area of exchange regimes covers a broad range of topics, from general considerations in the choice of exchange rate regime, to procedures for introducing new national currencies, management of foreign exchange auctions, development of decentralized foreign exchange markets, organization of central banks' foreign exchange dealing operations, drafting of foreign exchange laws and regulations, and management of official foreign exchange reserves. This activity has expanded rapidly since the early 1980s, as Fund members have moved increasingly to the market-based regimes, most with Fund advisory assistance, and in 1992 it was made part of the functions of the new Monetary and Exchange Affairs Department.

As a result of the accession to Fund membership in the late 1980s and early 1990s of a number of previously centrally-planned economies, the range of advisory work in foreign exchange systems has again shifted and broadened. About one half of the Fund's advisory missions dealing with foreign exchange matters in 1992-94 were to previously centrally-planned economies. 2/ The emphasis in the technical assistance to formerly

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1/ For example, Burundi, 1984-91; Dominican Republic, 1986; ECCB, 1982; Egypt, 1982-91; El Salvador, 1989; Guatemala, 1989; Guyana, 1990; Honduras, 1990; Hungary, 1991; Jamaica, 1984-90; Korea, 1989; Mauritania, 1991; Nepal, 1985-86; Nigeria, 1986-88; Romania, 1991; Sierra Leone, 1985; Somalia, 1986; and Venezuela, 1988-89.

2/ This period corresponds to the shift of technical assistance advisory functions in foreign exchange to the newly-formed Monetary and Exchange Affairs Department. Staffing of exchange system missions is now by MAE staff, by experts, and in the case of the Baltic States, Russia, and other countries of the former Soviet Union by staff of cooperating central banks.

centrally-planned economies was at a more basic and comprehensive level of market development, including establishment of central bank operations. Typically, such assistance began with the formulation of a new foreign exchange law and regulations. This was to form a basis for convertibility (limited in some countries) of foreign exchange in the newly-emerging private sector, and the establishment of central bank functions in administering the market, including exchange rate policymaking, centralization of official international reserves, market dealing operations (front and back offices), prudential regulation of foreign exchange exposures, reserves portfolio management, and statistical monitoring.

In the countries requesting assistance, a significant part of the advisory missions' work has focused on nonmarket foreign exchange systems, and arrangements to convert them to a more liberalized basis. This has involved in a number of instances difficult conceptual work to integrate market and nonmarket aspects into functioning mechanisms, as the movements to market-based systems were phased in some countries. Such work was facilitated by the jurisdictional focus of the Fund on issues of nonmarket exchange systems, which seeks to understand and to inform its membership on the benefits of convertibility and unified foreign exchange markets.

Recent advisory assistance to other countries in the forex area has continued to cover a wide range of topics, in many cases culminating in fully decentralized markets, with a significant degree of currency convertibility. In a number of instances, advice was directed to improving detailed operational aspects of forex markets. 1/ In others, the advice was for a fundamental change in policy and related institutional and structural aspects. In some countries this was directed to a change of exchange rate regime, 2/ degree of market centralization through adoption or replacement of an auction arrangement, 3/ adoption of current account convertibility, 4/ or capital account convertibility. 5/ With the increasing adoption of both current and capital convertibility in developing countries, it is expected that this aspect of the technical assistance work will grow significantly. Adaptation of regional systems toward a fully multilateral basis is another likely focus of technical assistance. Assistance in developing and refining foreign exchange markets and integrating them with monetary operations will remain prominent. Increasingly, the advice on exchange issues has been linked to other areas of technical assistance, including monetary operations, banking supervision and payments systems. In some instances, particularly in FSU and the Baltic States, this has taken place in comprehensive programs of technical

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1/ Albania, Bangladesh, Bulgaria, China, Croatia, Islamic Republic of Iran, and Romania.

2/ Algeria, Burundi, Madagascar, Mauritania, Mongolia, Sudan, Tanzania, and Zimbabwe.

3/ Ethiopia, Malawi, and Mozambique.

4/ Bangladesh, Tunisia, and Uganda.

5/ Fiji, Jamaica, and Trinidad and Tobago.

assistance on monetary and exchange issues. This reflects the strong technical and behavioral linkages connecting the different structural components. In particular, the progress toward capital account liberalization is facilitated by reforms of monetary control systems and the linkages between exchange and monetary developments become more pronounced with further freeing of capital controls.

VIII. Issues that Arise in the Context of Exchange System Developments

Some possible implications for the Fund's role in the area of current and capital account convertibility, exchange rate regimes, and cross-border payments arrangements emerge from the above review.

1. Current account convertibility

-- The Fund has developed over the years a well-defined policy that "before members give notice that they are accepting the obligations of Article VIII Sections 2, 3, and 4, it would be desirable that, as far as possible, they eliminate measures which would require the approval of the Fund, and that they are not likely to need recourse to such measures in the foreseeable future" (Executive Board Decision No. 1034-(60/27)). The experience suggests that this policy should be maintained by encouraging members to avoid assuming Article VIII obligations while they maintain transitional restrictions and their balance of payments outlook is uncertain, to prevent countries that have adopted Article VIII status from reverting to exchange restrictions to a significant degree.

-- While the present procedures adopted in 1993 have been effective, the issue of how to accelerate further the progress toward the achievement of the Fund's objectives under Articles I and VIII can be considered. A reinforcing procedure would be direct communication by the management of the Fund to the authorities of countries availing themselves of the transitional arrangements of Article XIV that would emphasize the benefits of rapid transition to accepting Article VIII obligations.

-- The formal representation under Article XIV, Section 3 to a member that conditions are favorable for withdrawal of a particular restriction could be considered in the case of members that clearly and immediately meet the requirements for accepting Article VIII obligations. A similar but informal effect could also be obtained through representation by the Managing Director, or by a decision of the Executive Board, noting that circumstances favor the acceptance of Article VIII obligations by certain members or by a group of members.

- -- The question also arises as to whether the time outstanding under Article XIV status is relevant to the issue of representation to the member. Clearly, the very long time periods involved at present for some members raise issues as to the meaning in the Articles of the term "transition". A more general declaration of conditions being favorable for general transition by the membership may be warranted. Such a general declaration might well need to exempt certain recent members, for example, members of less than five years' standing.

- -- There are separate issues relating to exchange restrictions maintained by countries that have already accepted Article VIII status. Present procedures call for explicit identification and discussion of members' restrictive exchange practices in the consultation report for the member. In this context, it would be useful to focus on the issues underlying approval or nonapproval of the members' restrictions during Executive Board discussions.

- -- External payments arrears evidence a form of ad hoc restriction with particularly serious implications for the international payments system, and the Fund's approach has been not to encourage notification of Article VIII status by the member when the remaining restrictions are not subject to a short and definite timetable for elimination. In some instances, the elimination of exchange restrictions evidenced by payments arrears may be dependent upon action by other Fund members. Examples are the rescheduling of external payments arrears by creditors and the renegotiation of bilateral payments agreements between the bilateral or regional partners. In those instances, the Fund would normally make representations to the partner countries (e.g., in the Paris Club) in order to accelerate the elimination of the arrears, or the bilateral agreements.

- -- Nonapproval of restrictive exchange practices has not been seen as a necessary impediment to use of Fund resources. Only when the practice is such that it would affect macroeconomic performance under the program has the issue dominated consideration of use of resources. An alternative approach might be for Fund-supported programs to include understandings regarding a timetable for elimination of the restrictions and accepting Article VIII obligations, with exceptions such as for transitional dual exchange markets or phased reductions of external payments arrears. In cases of members having approved or nonapproved restrictive exchange measures, there is the possibility that greater publicity could be given to the Fund's position on these restrictions, for example, in the form of a press release.

2. Capital account convertibility

Controls on capital movements raise questions for the role of the Fund in three broad areas: (1) the impact of controls on capital movements for overall macroeconomic management, including for exchange rates, interest rates, and balance of payments; (2) the role of capital account liberalization as part of programs of structural reform, and (3) the role of Fund jurisdiction. These issues are not readily separable. On the question of the role of the Fund in the area of capital account convertibility, the following issues arise:

-- As a practical and operational matter, the Fund's detailed examination of exchange systems has focused primarily on its jurisdictional responsibilities under the Articles, i.e., on the freedom to make payments and transfers for current international transactions. One implication of this approach is that by focusing on current international payments and transfers, the application of the Fund's jurisdiction has led to its covering a diminishing share of total exchange transactions. As an increasing number of members have eliminated exchange restrictions on most current transactions, the Fund's main jurisdictional effort has become focused on a smaller range of exchange transactions and payments arrangements that have become increasingly less important for the majority of members. On the other hand, difficulties in separating these nontrade current account transactions from capital transactions in administering controls may have impeded acceptance of Article VIII obligations. It may, therefore, now be an appropriate time to review the practical implications of the Fund's remaining jurisdictional responsibilities for the implementation of its broader responsibilities and objectives.

-- Potential links between the Fund's jurisdictional responsibilities and its examination of countries' exchange systems leads naturally to the question of whether the Fund's jurisdictional responsibilities should be extended to include payments and transfers and multiple currency practices related to international capital movements, which would be more in the nature of recognizing the practical reality. In addition to the above concern, no other international agency exercises jurisdiction over such transactions. The OECD codes apply to a limited membership of the Fund, do not cover all exchange restrictions and multiple currency practices, and are subject to countries' reservations on items in Annex B of the codes. Under the General Agreement on Trade in Services, recently signed as part of the Uruguay Round under the auspices of the GATT, countries may commit to liberalize capital transfers related to specified services, and such commitments would be overseen by the World Trade Organization.

-- The 1985 Board discussion on Fund jurisdiction over multiple currency practices related to capital transfers left the matter open for further consideration, and it may be timely to return to this subject. However, multiple currency practices related to capital transfers are not presently applied widely by members, and the effect of such recognition of jurisdictional responsibilities would be limited, and should not obviously preclude a broader review of the Fund' jurisdiction over payments and transfers related to international capital movements. Such a review could focus on whether the Fund's jurisdictional responsibilities remain consistent with its broader objectives to facilitate the exchange of goods, services, and capital among countries, and how best these jurisdictional responsibilities could be modified to serve better these responsibilities. The terms of reference for such a review, if it were judged to be desirable and timely for the Fund's work program, could include proposals for amendments to the Articles of Agreement and intensified surveillance.

3. Exchange rate regimes

-- Issues of exchange rate regimes have been discussed by the Executive Board on several occasions. The upshot of this discussion, and the implications of developments described above, have been that the case-by-case approach implied by a member's freedom to adopt the regime of its choice has been broadly endorsed. Nevertheless, it is important that the Fund continue to offer guidance on the main factors worthy of consideration in the choice of regime, and the technical assistance in putting in place efficient and stable foreign exchange markets.

-- Most recent multiple exchange rate systems have been transitional in character, a halfway house toward a liberalized exchange system. However, one quarter of the Fund membership still maintains such systems and there is an issue of whether the conclusions of the Fund's 1984-85 review of multiple exchange rates should be revisited, and members encouraged to remove the practices as soon as possible.

-- Forward exchange markets are developing rapidly, being virtually freed of restrictions in industrial countries. Elsewhere, forward markets have been slower to emerge, because they have proven sensitive to the state of overall liberalization and development of a country's financial markets. On the other hand, official provision of forward cover has proven very risky, and a significant source of fiscal and quasi-fiscal losses in a number of countries.

4. Regionalism and bilateralism in cross-border payments

-- The accession to Fund membership of the formerly centrally planned economies has once again highlighted the importance of payment arrangements. The disruption of trade and payments among the formerly centrally planned countries has been accompanied by an increase in the importance of bilateral payments, and countertrade and barter arrangements. Among other members, while there has been a sizable decline in the number of bilateral payments arrangements, the number of countries participating in regional payments arrangements has remained significant, while a regional arrangement among some FSU countries is being contemplated. The consistency of these developments with the multilateral objectives of the Fund is an issue which should perhaps be reviewed.

-- Although certain aspects of regional payment arrangements could be viewed as an improvement over bilateralism, regional arrangements may also involve discriminatory features between groups of members and the membership as a whole. Following the almost completed implementation of the Fund's policy toward bilateral payment agreements, in view of the very small fraction of world trade affected, policy toward regional payment arrangements would probably involve: (1) an in-depth review of regional payment arrangements to identify restrictions that are inconsistent with Article VIII, including those that may be maintained under the transitional provisions of Article XIV; and (2) encouragement of the members of the regional arrangements to eliminate these restrictive features. Similarly, restrictive features of payment agreements subject to Article VIII would not normally be approved by the Fund. The Fund's technical assistance services would, of course, be available to advise members on the necessary reforms to regional arrangements to eliminate the exchange restrictions.

5. <u>Technical assistance</u>

The growing liberalization of exchange restrictions has generally been part of a broader ranging program of stabilization and financial market reforms to foster market-based instruments of exchange and monetary policies. The efficient implementation of such structural reforms, and the associated technical assistance, require a continuing comprehensive approach that links reforms of exchange markets with the development of monetary operations, banking supervision, payment systems, and other central banking and financial market functions.