FOR
AGENDA

SM/97/86

March 25, 1997

To: Members of the Executive Board

From: The Secretary

Subject: **Capital Account Convertibility and a Possible Amendment of the Articles—Further Considerations**

Attached for consideration by the Executive Directors is a paper on further considerations relating to capital account convertibility and a possible amendment of the Articles of Agreement, which will be brought to the agenda for discussion on a date to be announced.

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

Att: (1)

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INTERNATIONAL MONETARY FUND

Capital Account Convertibility and a Possible Amendment of the Articles—Further Considerations

Prepared by the Legal, Monetary and Exchange Affairs, and Policy Development and Review Departments

(In consultation with other departments)

Approved by François Gianviti, Manuel Guitián, and Jack Boorman

March 25, 1997

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I. INTRODUCTION

1. In his concluding remarks at the recent Board seminar on capital convertibility (the "seminar"),[1] the Chairman noted that most, if not all, Directors supported an amendment of the Articles to include the liberalization of capital movements in the mandate of the Fund. The Chairman stated that the staff would prepare a brief paper that addresses the key issues that were raised during the seminar and that such a paper would serve as a basis for a meeting of the Executive Board that would aim, inter alia, at identifying and, if possible, agreeing upon recommendations to the Interim Committee and preparing a report to the Interim Committee on the progress that has been made and remains to be made on this subject.

2. In line with the Chairman's concluding remarks, this paper addresses the key questions that were raised during the seminar. In particular, it provides further analysis of a number of issues relating to a possible extension of Fund jurisdiction over capital movements, including the scope of such jurisdiction (Section II), the design of approval policies and transitional arrangements (Sections III and IV), and the relationship between an extension of jurisdiction and use of Fund resources (Section V). It is expected that the Chairman's summing up at the conclusion of the next Executive Board meeting on this subject will serve as the basis for a report to the April meeting of the Interim Committee. Accordingly, the analysis in this paper is not exhaustive since a further and more complete study of all relevant issues will need to be made in light of the Interim Committee's recommendations.

II. SCOPE OF JURISDICTION

3. In SM/97/32, the staff assessed the relative merits of an extension of jurisdiction over capital movements in a manner symmetrical with the Fund's existing jurisdiction over restrictions on current international payments and transfers. Under this "narrow approach", members' obligations would apply to the making of payments and transfers associated with capital transactions, but would not apply to the underlying transactions themselves. During the seminar, most Directors were of the view that the narrow approach would not provide a useful basis for extending Fund jurisdiction over capital movements because of the limitations that had been pointed out in SM/97/32. In that paper, it was noted that, by restricting its coverage to payments and transfers, Fund jurisdiction would have only limited relevance, since most capital controls are imposed on the underlying transactions rather than on the related payments and transfers. It was also noted that the narrow approach would fail to apply to inflows, in light of the fact that existing Fund jurisdiction covers the "making" but not the "receipt" of payments and transfers.

4. A few Directors were of the view that, notwithstanding the limitations of the narrow approach, it merited further consideration, particularly in light of the need to take into consideration the possible evolution of the institutional architecture for the liberalization of

[1]BUFF/97/21 (March 3, 1997).

capital movements.[2] For this reason, they suggested that the narrow approach may provide an appropriate basis for allocating responsibilities among the Fund and other international organizations and agreements. In responding to these views, the staff noted that other international organizations and agreements had not found the distinction between underlying transactions and payments and transfers meaningful for purposes of determining the scope of their own jurisdiction and coverage. To the extent that they deal with capital movements, all of the existing agreements recently surveyed by the staff in SM/97/32, Supplement 2, cover both the underlying transactions and the related payments and transfers.[3] Therefore, if an allocation of jurisdictions among international organizations were to be envisaged, it should be based on substantive criteria rather than on a distinction between payments and transactions. In particular, an extension of jurisdiction would need to cover those underlying transactions particularly relevant to the Fund's mandate.

5. As noted above, most Directors agreed that Fund jurisdiction should cover both inflows and outflows and should not be limited to payments and transfers. These Directors viewed the coverage of transactions under the "broad approach" outlined in SM/97/32 as overly comprehensive and in need of revision in a manner that paid greater regard to the role of the Fund in relation to other international agreements. They noted that this revision should also take into consideration the specific mandate of the Fund in overseeing the international monetary system. In that regard, a number of Directors expressed the view that direct investment made by nonresidents with residents ("inward direct investment") should be excluded from the scope of the underlying transactions to be covered under the amendment. With respect to a possible exclusion of inward direct investment, a number of observations can be made.

6. First, it is recognized that the issue of whether to include or exclude inward direct investment raises competing considerations. The liberalization of inward direct investment would be a particularly effective means of promoting sustainable economic growth (since such transactions give rise to important benefits, including the transfer of technology and managerial skills, and also facilitate the development of export markets), as well as of securing a viable external position. However, it is also recognized that when a country imposes restrictions on inward direct investment, it normally does so for reasons that are unrelated to balance of payments or macroeconomic management. Accordingly, if inward direct investment were excluded, the scope of the Fund's jurisdiction would be more focused

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[2]As noted in SM/97/32, the present coverage of other international organizations and agreements is somewhat limited (either in terms of the scope of transactions or in membership).

[3]It is understood that the proposed MAI will also not be limited to underlying transactions. With respect to current transactions, the GATS covers both service transactions and the related payments and transfers. Even in the area of trade, the coverage of GATT is not viewed by the WTO as excluding restrictions on payments and transfers.

on those transactions that are directly related to the Fund's mandate. In this regard, it is recognized that the stability of the international monetary system will require the *orderly* liberalization of capital movements and that, in contrast to restrictions imposed on inward direct investment, the Fund is well placed to determine how the removal of restrictions on other transactions should be sequenced with the necessary structural and macroeconomic reforms. Similarly, it is recognized that the Fund should also play a central role in determining when the temporary imposition of controls provides an appropriate means of addressing surges in capital inflows and outflows.

7. Second, the liberalization of inward direct investment is the central purpose of many foreign investment agreements and is expected to be covered comprehensively in the proposed MAI. Excluding inward direct investment on the grounds that these transactions are not directly related to the Fund's mandate would not, therefore, leave a void in this area as regards members subscribing to other agreements. As noted in SM/97/32, Supplement 2, however, foreign investment agreements generally do not establish obligations with respect to the ability of residents to make direct investments abroad ("outward direct investment"). Moreover, restrictions on outward direct investment are often imposed for balance of payments reasons. Accordingly, it would not appear appropriate to exclude outward direct investment from the coverage of the amendment.

8. Third, if a country permits a nonresident to make an investment but then limits its ability to repatriate the original capital or capital appreciation associated with this investment, such a restriction is normally imposed for balance of payments reasons. Accordingly, even if inward direct investment is excluded from the scope of underlying transactions to be covered, it would seem appropriate that the payments and transfers associated with inward direct investment be covered under the Fund's jurisdiction.

9. Finally, if inward direct investment is to be excluded from the scope of the Fund's jurisdiction, it is recognized that further consideration will have to be given to the definition of these transactions. For example, with respect to equity participation in an enterprise, consideration will have to be given to the applicable threshold of ownership. Many countries impose equity restrictions for social, sectorial, and strategic reasons that limit more than just the ability of a particular nonresident to exercise effective control over an enterprise. Moreover, in view of the fact that the ownership of real estate and certain physical assets (e.g., maritime vessels) is also regulated for reasons that are generally not related to balance of payments and macroeconomic management, it would appear appropriate to include such assets within the definition of inward direct investment.

III. APPROVAL POLICIES

10. It is generally recognized that an amendment should give the Fund the authority to approve restrictions on capital payments and transactions and that the criteria for approval should be specified in policies of the Executive Board (as adopted from time to time) rather than in the Articles themselves. In that context, the following further observations may be made.

11. With respect to the *temporary approval* of restrictions, it is recognized that approval policies will need to be developed so as to enable members to impose temporary restrictions on both capital inflows and outflows. Because of the potential volatility and size of capital movements and, accordingly, the need in some circumstances for members to impose such restrictions on an emergency basis, it is for consideration whether the Fund should adopt approval policies that provide for greater flexibility than the policy presently applied to restrictions on current payments and transfers. Specifically, under such an "emergency" approval policy, the Fund would agree to approve, on a lapse-of-time basis, the imposition of controls that members had notified to the Fund, such notification to be sent either before the restrictions are imposed or within a short period (perhaps 10 days) after imposition. This approval would be for a limited period (perhaps three months from the date of notification), but could be extended by the Executive Board on the basis of staff recommendations regarding, inter alia, progress on corrective policies. The modalities of such an approach would clearly require further elaboration.

12. Regarding *nontemporary approval,* the exclusion of inward direct investment from the scope of the Fund's jurisdiction would obviate the need for the Fund to adopt open-ended approval policies for restrictions on these transactions. Accordingly, such nontemporary approval policies would be primarily limited to restrictions imposed for national security and prudential reasons and, as discussed below, would build upon existing procedures.

13. With respect to national security restrictions, the Fund could simply extend the policy that it presently applies to restrictions imposed on current international payments and transfers. Under the existing policy, members are to notify the Fund with respect to restrictions that are imposed for reasons of national or international security. Unless the Fund informs the member within 30 days after receiving notice from the member that it is not satisfied that such restrictions are imposed solely for such security, the member may assume that the restrictions are approved.

14. A similar "no objection" approval policy could also be adopted for restrictions adopted for prudential reasons, i.e., approval would be withheld only if the Fund determined that the restrictions were not, in fact, imposed for prudential reasons. The approval policy for prudential restrictions would be revised from time to time to ensure that it remained consistent with generally accepted conventions and practices. As was noted in SM/97/32, it is

anticipated that most prudential measures will not constitute "restrictions" subject to the Fund's jurisdiction.[4]

IV. TRANSITIONAL ARRANGEMENTS

15. There is general agreement regarding the importance of transitional arrangements in the area of capital. During the seminar, Directors emphasized the importance of sequencing liberalization with structural measures, especially in the monetary and financial sector, and of pacing liberalization to the particular circumstances of each individual member. It was noted, however, that the transitional arrangements should not be used by members as a means of unnecessarily delaying the acceptance of liberalization obligations under the amendment.

16. In view of these considerations, the amendment should permit members to avail themselves of transitional arrangements. Specifically, restrictions in place at the later of the date of the amendment or the date of membership would be "grandfathered". Such restrictions, once removed, could not be reimposed without approval, thus preventing "backsliding".

17. Over the last several years, the Fund has become increasingly active in assisting members to accept the obligations of Article VIII. It has been able to promote the removal of restrictions through annual consultations, surveillance, and the provision of technical assistance. It is envisaged that these mechanisms would also serve as the primary means by which the Fund would assist members to ensure that capital liberalization was neither premature nor overdue. Indeed, it is because the Fund has the capability to engage in such a dialogue with members that it is appropriate for it to play a central role among international organizations in the determination of when capital liberalization is timely for a particular member.[5]

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[4]For example, pursuant to guidelines established by the Bank of International Settlements (described in SM/97/32, Sup.1), a number of members impose limits on the open foreign exchange positions of financial institutions. Such limits would not, on their face, give rise to restrictions because they do not specifically restrict credit transactions between residents and nonresidents. Rather, by imposing a limit on the "net" open position, they serve to minimize the foreign exchange risk of individual banks. As discussed in SM/97/32, prudential measures that may give rise to restrictions (and therefore would benefit from the approval policy discussed above) include the prohibition on the admission of nonresident securities for investor protection reasons.

[5]Under the transitional provisions of the present Articles (Article XIV), the Fund has the authority, in exceptional circumstances, to make representations to a member that conditions are favorable for the general or partial abandonment of restrictions on current international payments and transfers. If the member persists in maintaining these restrictions following such

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V. USE OF FUND RESOURCES

18. In SM/97/32, it was recognized that, for many members, demands for Fund financing may be reduced as capital liberalization deepens their access to capital markets. It was also noted, however, that the potential size and volatility of liberalized capital flows may, at times, lead to a greater need for Fund support. Such financing may be needed in the context of an adjustment program to allow time for corrective policies to take hold and for the restoration of market confidence and access to international capital markets.

19. Regarding the possibility that capital liberalization may increase the demand for Fund financing in crisis situations, during the seminar "[d]irectors underscored the moral hazard to be avoided in financing capital outflows and thus the need to retain a distinct constraint on the financing on such flows."[6] The various mechanisms that could be used to maintain the appropriate constraints on Fund financing were outlined in SM/97/32 and would be revisited at a later stage of the discussion.

20. In light of the above concerns regarding moral hazard, it is understood that there may be circumstances where the extent of adjustment required and the magnitude of the financial support needed outstrips both the member's capacity to undertake such adjustment and the ability of the Fund and others to provide the level of financing that would be required to maintain unrestricted payments. In such circumstances, arrears may arise because of a sovereign default or the imposition of capital controls. Whether or not the Fund will be prepared and able to provide financing in the presence of such arrears, including defaults on sovereign bonds, would affect the level of the Fund's financial assistance. These and other issues will be discussed in a forthcoming staff paper that will review the Fund's policy on external payments arrears to private creditors.

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[5](...continued)
a representation, the Fund may declare the member ineligible to use the Fund resources. The Fund has never declared a member ineligible on the basis of this provision.

[6]The Chairman's concluding remarks.